IN FACT AND IN LAW

Corporate Governance
Securities Law
Directors' and Officers' Liability

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When should a director resign?

By André Laurin

OVERVIEW

- **A director should seriously consider resigning in the following situations:**
  - in the case of a **material contravention of the law** or violation of the corporation's by-laws, its shareholders agreement or the corporation's undertakings, if the contravention is not rectified promptly;
  - in the case of **bankruptcy** or insolvency, if the director is unable to obtain adequate protection from the trustee, the corporation's creditors or other third parties;
  - if the corporation or the Board does **not allow him to perform** his duties, despite his repeated requests;
  - in certain cases, if he **disagrees with the corporation's major practices or orientations**, and if he has advised the Board of his disagreement and the importance that he attaches to such disagreement;
  - in the case of persisting and **irreconcilable conflicts of interest or conflicting loyalties;**
  - in the case of a **provision** that stipulates resignation (e.g., pursuant to a statute, corporate by-law, unanimous shareholders agreement);
  - if he is **unable to devote the time and efforts** required to perform his duties, or if he is not prepared to do so;
  - if he received a **negative performance evaluation** or was asked to resign.

- In many instances, the **expression of dissent** does not suffice.
- Each case is **unique** and must be assessed by the director with the assistance of his colleagues and external counsel, if required.
- A director **is entitled to resign** during his term of office, but he should **not do so without a serious reason and at an inopportune moment,** if he does not want to risk being held liable for the damages that may be caused by his resignation.
- The obligation of loyalty to the corporation applies, to a certain extent, to the **manner of resigning.**

LAVERY, DE BILLY

BARRISTERS AND SOLICITORS

Introduction

The title of this Newsletter was deliberately chosen to attract attention, because while very relevant, the question nevertheless receives little attention. Moreover, proper comprehension of the issue is often clouded by ignorance of the applicable rules, by conflicts of interest or by a certain complacency.

This Newsletter does **not** address the issue **solely from a legal perspective**. It also considers it from an **ethical** and **logical** point of view. However, the author does not regard any of the courses of action, criteria and factors as absolutes. The comments set forth in this Newsletter are not intended to instigate resignations. On the contrary, they seek to encourage **coherence**, integrity and prudence. Directors should view this Newsletter as food for thought.

1. Context

By agreeing to become a director of a corporation, a person automatically accepts the duties and responsibilities related to that position. Those duties and responsibilities fall under two major headings, namely the **obligation of diligence or care and the obligation of loyalty.**

Like anyone with obligations, a director is exposed to **potential liability**, either contractual, or extra-contractual, in the case of non-performance or inadequate performance of his obligations and, in some cases, to penal sanctions.

A career as a director is an attractive one with particularly stimulating challenges. **Directors play a crucial role** in our economy and, more generally, in civic life. However, that career or, more specifically, a director's responsibility, involves various risks that numerous judicial decisions have highlighted, especially in the past few years. A director must therefore weigh and assess those **risks**. The evaluation standards applied to a director's performance are clearly higher than what they were just 15 years ago.

A **director** must be very **aware of the business realities and legal framework** in which he operates and must ensure that he can at all times comply with his duties and with the law.

Moreover, the goals of the corporation of which he is a director cannot be pursued without applying standards of **integrity** and **ethics**. The context in which he performs his duties and, more specifically, the corporation's management, must allow him to act with integrity and ethically. He must avoid endorsing or tolerating questionable practices.

From all evidence, the lure of gain, the protection of certain interests, the possibility of losing certain privileges, career development concerns, business relationships or friendships, among other things, all, at one time or another, complicate the exercise of the independent judgement mentioned in Canadian Securities Administrators ("CSA") corporate governance guidelines. Such situations can be obstacles to compliance with the duty to act in the best interests of the corporation and in keeping with integrity and ethical values. All of us, without exception, are, on occasion, **confronted** with certain **conflicts of interest** and certain **contradictory objectives**.

Anyone who agrees to act as a director of a corporation does not usually accept that responsibility lightly. He or she knows, or should know, that it is not a short-term or fair-weather commitment. It would be illusory for a director to think that the objectives of the corporation of which he is a director can be easily and effortlessly achieved. Consequently, it would be natural that he **not abandon ship** and that he attempt to bring it safely into port, or at least ensure that the shareholders or members and other stakeholders do not sustain too much damage.

Under Quebec law, a director is the corporation's mandatary and, as such, he **cannot terminate his mandate "without a serious reason and at an inopportune moment"** without running the risk of being held liable for any damage caused to the corporation by his resignation.

In such a context, are there criteria or principles to guide a company director who wonders or should be wondering whether or not he should resign?

2. Some preliminary distinctions and clarifications

Specific case

Obviously, every case is a **specific case** and the director must evaluate the grounds that could require him to resign in the circumstances, after seeking the opinions of his colleagues on the Board and of outside counsel.

Certain differences depending on the type of corporation

The corporation's **object** or mission may create an **evaluation context** that varies from one corporation to another. Similarly, if a director "represents" a particular shareholder, or a group of members from a particular geographic region or activity sector in a non-profit organization ("NPO") with prescribed representation, that fact can also influence the relative importance given to a reason for resignation. This author's Newsletter entitled "Directors of Non-profit Organizations in Québec", published in September 2006, deals with that issue. Thus, in the case of an associative NPO that represents members' interests, it may be clearly preferable to continue to advance the minority point of view despite the orientations backed by the majority.

However such **differences do not play any real role if** the reasons for resigning represent serious obstacles to the director's ability to fulfil his duties of diligence and loyalty or, especially, if they are based on his commitment to not be involved in a contravention of the law by direct action or deliberate failure to act.

Dissent

Dissent and, specifically, the written expression thereof, gives the director some **protection**, but that protection **diminishes** greatly where the dissent is not sustained and where the director participates in the decisions on implementation and follow-up of the decision in respect of which he dissented.

The following is a brief review of the **rules pertaining to dissent.**

Section 123 of the *Canada Business Corporations Act* ("CBCA") deals with the concept of director's dissent. The Québec *Companies Act* refers to it in sections 123.85 and 123.86 of Part IA and implicitly in sections 94 and 95. For NPOs constituted under the Québec *Companies Act*, the only mention of the notion of dissent is made by reference to section 95 of Part I, which deals with loans to shareholders (hence to members).

As a general rule, it should be borne in mind that **dissent** on any major issue should be **expressed** at the meeting and **noted in writing** in the minutes. Where a director is **not present at the meeting**, he should **notify** the Corporate Secretary and the Chairman of the Board **of his dissent** as quickly as possible, in writing sent by registered mail, and ask them to record that dissent in the minutes of the meeting or to append his dissent thereto (within seven (7) days of becoming aware of the resolution that he disagrees with, in the case of a corporation constituted under the CBCA). In some cases, there are rules clearly stated in legislation (the CBCA, for example) whereas, in other cases, these are mere recommendations on our part.

Formal expression of **dissent is aimed at protecting** a director who disagrees with a decision or resolution and, where possible, at avoiding the **potential liability** arising from the making of the decision and, especially, from its implementation. It provides protection in many cases but does not always result in **exoneration**, as, for example, in cases of statutorily prescribed liability (e.g. for employees' wages for the last six (6) months). Clearly, dissent should not be resorted to lightly. Formal dissent should be expressed only where a decision constitutes or involves contravention of legislation, of the corporation's by-laws or of third party rights, and where there is no adequate corrective measure for the questionable practice or where a major decision is involved, as the case may be.

3. Cases, benchmarks and criteria

The various answers to the question asked in the title of this Newsletter are grouped under the following headings:

- contravention of the law, of the corporation's by-laws, of the shareholders agreement or of the corporation's undertakings;
- insolvency or bankruptcy;
- inadequate resources and context to ensure compliance with the obligation of diligence;
- disagreement with the corporation's values, orientations or certain major practices;
- conflicts of interest or conflicting loyalties;
- legislative, corporate by-law or contractual provisions;
- inability or unavailability to devote the necessary time;
- negative performance evaluation and suggested resignation.

Contravention of the law or the corporation's by-laws, shareholders' agreement or undertakings

Under the **Criminal Code**, a person, regardless of his role, may be an accessory to an offence under the law by knowingly taking part in an offence, by aiding a person to commit the offence or by helping the offender to conceal the offence or by hiding the offender or the fruits of the offence [1].

In the case of certain offences, several statutes have expressly **broadened** the **notions** of **complicity** or **party to an offence**, usually referred to as "aiding and abetting" in common law terms. The classic decision of the US Supreme Court in the *Central Bank* [2] case dealt with that issue at great length. The judgement of the *US District Court for the Southern District of Texas, Houston Division*, in the *Enron* case in which the CIBC was the defendant, is a recent example of the US application of the concept [3]. In Canada, especially in the area of securities, there are various **illustrations** of the legislative extension of complicity or being party to an offence, such as in the *Québec Securities Act* [4]:

> *"**205 [Complicity]** Every officer, director or employee of the principal offender, including a person remunerated on commission, who authorizes or permits an offence under this Act is liable to the same penalties as the principal offender."*
>
> *"**208 [Complicity]** Every person who, by act or omission, aids a person in the commission of an offence is guilty of the offence as if he had committed it himself. He is liable to the penalties provided in section 202 or 204 according to the nature of the offence.*
>
> ***[Inducement]** The same rule applies to a person who, by incitation, counsel or order induces a person to commit an offence."*

Clearly, the **contravention** of a legislative or regulatory provision or contractual undertaking may also constitute a **civil fault** ("tort" in common law) resulting in civil liability if that fault caused damage to anyone.

[1] See sections 21 and 23 for example.

[2] Central Bank, N.A. v. First Interstate Bank, N.A. 511 U.S. 164.

[3] 2002 U.S. Dist. Lexis 25211.

[4] R.S.Q., c. V-1.1.

Insolvency or bankruptcy

Several laws impose specific statutory liability on directors. In cases of insolvency or bankruptcy, the defence of reasonable diligence may be somewhat specious or simply not available. The means implemented to ensure compliance with various obligations may, in cases of bankruptcy or insolvency, be ineffective for all practical purposes, like, for example, in relation to the **liability to employees for** unpaid **wages** for up to six (6) months of wages (section 119(1) of the CBCA and section 90 of the Companies Act (Québec) which applies to Part 1A) and the liability for deductions at source and for payment of the federal **goods and services tax** and provincial **sales tax**.

In addition to the risk of statutory liability, is the increased risk of **lawsuits by creditors and the difficulty, in bankruptcy or insolvency situations, of determining what the best interests of the corporation are**. To the extent that there is little likelihood of financial recovery and that realization of the assets would not result in any distribution to shareholders or, in the case of a NPO, to another NPO of the same type, the directors are confronted by many divergent interests.

Where the risks of lawsuits may result in a director's personal financial liability, and if he is not prepared to assume a major personal financial risk, he should resign unless he obtains an **undertaking** from the trustee, from the solvent creditors or from third parties to fully **indemnify** him.

Resources provided and context are inadequate for compliance with the obligation of diligence

If a director finds that, despite his requests and suggestions, he is not given the information or assistance required to fulfil his responsibilities and obligations, or if the Board's operating context is inadequate, he should resign.

Recommended corporate governance practices have changed and are generally widely known or accessible. Consequently, today's directors can readily **compare the operating methods** of the corporation of which they are directors with those recommended to, or practiced by, corporations of the same type (i.e. industry standards). It is also suggested to prospective directors that they conduct a due diligence verification of the corporation's operating methods and corporate governance systems and procedures before agreeing to become a director.

While not exhaustive, the following list sets forth **examples** of **deficiencies**, which unless corrected, should cause a director to consider whether it is necessary or advisable to resign:

- inadequate information submitted to Board members or insufficient resources;
- refusal or resistance by management to give full and frank answers to questions;
- insufficient time given for questions and opinions of directors both inside and outside meetings;
- Board meetings are mere "rubber stamping" exercises;
- refusal of the Board (or of management) to conduct validations or seek external opinions on major matters;
- Board functions in an undisciplined and inconsistent manner;
- failure to conduct an evaluation of the management and of the Board's performance and functioning;
- failure to exercise competent and independent judgement or the lack of seriousness of a majority of Board members.

Disagreement with the corporation's values, orientations or some of its major practices

Except in the case of a corporation with prescribed representation regarding the composition of the Board where nuances are called for, **profound discomfort** with the corporation's practices or a **fundamental disagreement** with the corporation's **values**, **orientations or major decisions** should lead a director to resign if, despite his attempts to make changes in line with his vision of things, such practices, decisions, orientations or values do not change.

In reality, a director should not continuously and repeatedly dissent nor, however, should he by his very presence ratify in practice the adoption of various resolutions that complement main orientation decisions with which he does not agree. **If he does not resign, he, along with the other directors, must bear the consequences** of implementing the originating decisions that he did not approve, thus opening the door to the risks of potential liability. Moreover, the director should question whether if by staying and by adopting the path of systematic opposition, he is not in conflict with his obligation of loyalty to act in the best interests of the corporation.

Values form the very basis of an organization. Consequently, if they are not clearly defined and shared, and acted on by the organization and its directors, the framework of a director's duties is seriously weakened.

Obviously, the reasoning outlined in the foregoing paragraphs does **not** apply to **mere differences of preferences** or points of view. A director may prefer one orientation to another, without the other being unacceptable and without value.

Lastly, in the case of **corporations with prescribed representation** pursuant to a unanimous shareholders agreement, or imposed by the law or by the corporation's by-laws, the evaluation of the need or advisability to resign cannot be conducted in a vacuum by the director. Preferably, it should be conducted with the person or organization that he "represents", taking into consideration his risks and obligations as director.

Conflicts of interest or conflicting loyalties

In an earlier Newsletter we dealt with the **conflicting loyalties** confronting a director-representative or nominee (i.e. nominated by a shareholder or by a member or a particular group). See the **May 2006 Newsletter** published by this author, referred to on the last page of this Newsletter.

Case law provides abundant examples of **conflicts between a director's interests and those of the corporation** (e.g. appropriation of property, results of research or ideas, business opportunities, confusion between the interests of a particular shareholder and those of the corporation to the detriment of other shareholders, etc.).

While conflicts of interest can usually be resolved by disclosure of the conflicting interests, abstaining from voting and, ideally, refraining from participating in discussions, **permanent conflicts of interest and irreconcilable conflicting loyalties should lead to the resignation of the director** because he cannot, in such circumstances, comply with his obligation of loyalty to the corporation, thus leaving the door open to lawsuits against him by the corporation or its shareholders or members. The *Gemini* case, analyzed in the Newsletter cited above, is eloquent testimony to that proposition.[5]

The **mere presence** of a director on the Board may also **harm** the corporation and adversely affect achievement of its objectives (due to the director's prior actions, the positions he holds elsewhere, persistent media attention, his reputation, prejudicial attitudes or for other reasons) even though the director conscientiously fulfilled his obligations and did not in any manner intend to harm the corporation. A director should then evaluate if it would not be preferable for him to resign in the best interests of the corporation.

Provisions of a law, of the corporate by-laws or of an agreement

A director who is elected in accordance with the provisions pertaining to prescribed representation pursuant to a shareholders agreement, an incorporating statute or the corporation's by-laws, should not, in most cases, continue to sit as a director if he loses his eligibility or if the person or the group that proposed him so requires.

However, subject to any specific provision requiring resignation that is binding on him, a director is not legally obliged to resign given that, once elected, his obligation of loyalty is to the corporation and not to the person or the group that elected him or had him elected. It must be borne in mind that a Board of directors does not usually have the power to remove a director; this right belongs to the shareholders or members.

Independently of the absence of such a provision that would be binding on a director, such a **"director-representative" cannot easily perform his role if he loses his eligibility status or if his proposer repudiates him.** He should resign to avoid creating difficult and conflictual situations that would not serve the corporation's best interests. Some of the comments under the heading "Conflicts of interest or conflicting loyalties" are also pertinent in that respect.

There is a growing trend in the United States, in the case of reporting issuers, to prescribe in their corporate by-laws that if a director does not receive a certain percentage or sufficient number of votes in support of his nomination, he must resign or become ineligible to stand for office. Such a measure is explainable in the context where a director is deemed to remain in office until he is replaced.

Unavailability or inability to devote the necessary time

Inability to properly fulfil his responsibilities due to illness, lack of time or any other cause of chronic unavailability, should motivate a director to resign, unless the other members of the Board want him to stay and unless the director expects that his inability or unavailability will be only for a short period.

Boards are increasingly constituted by considering the skills and experience of individual members, and by taking into account the needs of the corporation. The **inability** or **unavailability** of a director to sit may therefore affect that balance and thus **may also conflict with the** director's **obligation of loyalty** requiring him to act in the best interests of the corporation of which he is a director.

Lastly, a director of a corporation constituted under the CBCA is subject to a **presumption of approval** of Board decisions, unless he expresses his dissent in writing within seven (7) days of becoming aware of the decisions. Other laws create general or specific presumptions of the same kind. See the comments under the previous heading "Dissent".

[5] PWA Corporation v. Gemini Group Automated Distribution Systems Inc., 10, B.L.R. (2d), p. 109.

In such cases of frequent absence or chronic unavailability, how can a director adequately assess decisions made? He **cannot claim to have displayed diligence** in making those decisions. He, therefore, risks being held liable without being able to eventually raise personal grounds of defence unless he registers his dissent regarding every major decision or decision which may result in directors' liability (see the comments above on that last point).

As we all know, the position of company director is **not** merely **an honorary role.**

Negative performance evaluation and suggested resignation

A director should not ignore negative conclusions reached by his colleagues in their evaluation of his performance as a director, nor a desire that he resign expressed by the Nominating Committee or Board of Directors.

In the first case (negative evaluation), it follows that a director's ability to work in a team with the other directors would necessarily and seriously be compromised if he decides to stay.

In the second case (suggested resignation), a director should clearly **evaluate** the request in light of the **best interests of the corporation**. The position of director is not a permanent position and sound governance practices presuppose a certain refreshment and partial and periodic renewal of the Board. However, our earlier comments concerning boards with prescribed representation and, more specifically, those regarding consultation with the director's proposers or principals, are pertinent.

4. Right to resign and how to resign

A director **is entitled to resign during his term of office**. Preferably, it should be done by **notice in writing** or by letter addressed to the Corporate Secretary and to the Chairman of the Board, stating the effective date of his resignation and explaining, if he so wishes, the reasons for his resignation. Nevertheless, he may do so **verbally at a Board meeting**. In such a case, he should ensure that his resignation and the effective date thereof are **noted in the minutes of the meeting, in the corporation's books and in the public records**. Once his resignation has taken effect, a director should abstain from taking part in Board deliberations so that he will not be regarded as a "de facto" director or find himself in a "holding over" situation. Resignation cannot be made retroactive.

Moreover, a director who has made a considered decision, for serious reasons, to resign should, to the fullest extent possible, do so **being careful not to cause serious harm to the corporation**. A **director** is a **mandatary**, under Quebec law and certain obligations are imposed on a mandatary who wishes to terminate his mandate. The relevant provision of the Civil Code of Québec reads as follows:

> *"Art. 2178. A mandatary may renounce the mandate he has accepted by so notifying the mandator. He is thereupon entitled, if the mandate was given by onerous title, to the remuneration he has earned until the day of his renunciation.*
>
> *The mandatary is liable for injury caused to the mandator by his renunciation, if he submits it without a serious reason and at an inopportune moment."*
> (our underlining).

Moreover, transmission of his notice of **resignation must**, as much as possible, **be made in compliance with his obligation of loyalty to the corporation** ("in the best interests of the corporation"). It is important to caution directors who wish to resign against making public statements that could harm the corporation, as ego-satisfying as such statements may be.

Where the corporation is a **reporting issuer**, the degree of prudence should be even higher, given the potential publicity surrounding disclosure of the reasons cited for resignation and the impact such disclosure could have on the trading price of the issuer's shares. Moreover, the CSA cite the resignation of a director in their list of examples of events that may be material changes that should be announced by the issuer by means of a **press release**.

It must be borne in mind that a resigning director remains liable for all actions taken and all decisions made during his term of office, namely between the date of his election and the effective date of his resignation, and that resignation cannot be made retroactive. On the subject of resignation, the discussion of **indemnification** and insurance coverage in our **November 2005 Newsletter** may be of interest.

Conclusion

Several situations could induce a director to resign or, at least, to seriously and reasonably consider the advisability and soundness of doing so.

In all cases, he should resign only for serious reasons, personal or external, and then, in so doing, he should be careful to cause as little damage as possible to the corporation.

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Other publications of interest for directors

The author has published several Newsletters on corporate governance and directors' liability and has given numerous conferences and training sessions.

Those Newsletters can be accessed on the Lavery, de Billy website (www.laverydebilly.com → lawyers → André Laurin → Publications), or a paper copy can be obtained from André Laurin's assistant (at 514-871-1522, ext. 3974). The titles of those Newsletters are as follows:

September 2006
Directors of Québec non-profit Organizations ("NPOs")

May 2006
A recent Québec Court of Appeal decision involving extra-contractual liability of directors

May 2006
The "Nominee" director and conflicting loyalties

November 2005
Corporate Directors: Suggested Precautions

November 2005
Directors' Liability, Indemnification and Insurance Coverage

July 2005
The new Corporate Governance Rule and Guidelines

March 2005
Recent Development respecting Corporate Governance and Directors' Liability

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