The External Directors of a SME

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OVERVIEW:

Good governance can and should **create value** for SMEs
Good governance can constitute **protection** against a director's potential liability
The **general duties** of the director of a SME are the same as those of the director of a large corporation **(care and loyalty)**
The **terms for complying** with duties and implementing governance should be **simple** and practical **in the context of a SME**
An **adequate structure** and **openness by management** must be present before agreeing to act as an external director
Several **measures** can and should be taken **at the external director's initiative**

INTRODUCTION
Many SMEs have a true Board of Directors and have asked outsiders to sit on it.

The **contribution** individuals with relevant experience and skills can make to a business and the creation of value their advice can bring cannot be denied. **The positive effects of good governance** should also not be overlooked.

However, it is a fact that many **entrepreneurs** are **reticent** to create a Board they do not completely control. The creation of a Board is often required by a lender, an investor or the prospect of a public offering. Entrepreneurs often prefer to do without a true board for fear of losing control and wasting time in meetings. In some cases, they set up a **formal or informal advisory committee** made up of service providers, friends or acquaintances.

In **this bulletin**, we will **begin** by pointing out the **duties** of directors of SMEs and the goals or benefits of governance and then **suggest certain actions** directors may want to take in order to fulfil their duties in the context of a SME and protect themselves against potential liability.

REMINDER - DIRECTORS' DUTIES
The **general duties** of the directors of a legal person **are the same** for all directors, whether the legal person is a large or small corporation, a non-profit or for-profit corporation, a Crown corporation or any other type of legal person.

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These two general duties are known as the duty of care and the duty of loyalty.

THE DUTY OF CARE

As it is defined by law[1] and interpreted by the courts[2], the duty of care involves the following:

Nature: act with prudence and diligence
Jurisprudential interpretation:
- perfection not required
- the decision must constitute a reasonable business decision when it is made (comparison with accepted industry practice)

Involves, among other things: preparation, reflection, questioning, intervention, the providing of information and relevant knowledge
Presumption of diligence in some cases if the directors base themselves on certain reports provided by management or outside experts

In **assessing** whether **reasonable diligence** was exercised, the courts compare the actions of a corporation or individual who is sued with **accepted industry practice**

Several **factors** may be **taken into account by the courts**. The number of such factors will naturally vary depending on the circumstances. The courts will examine, among other things and **depending on the circumstances:**

the nature and **seriousness** of the harm
the **investigation** and detection systems that have been set up and more generally the **risk management** system (assessment and treatment)
the **quality of verifications** conducted on a regular and timely basis
the corporate **culture**
the relevant **policies** adopted by the corporation and their follow-up
the **training** and assistance provided to employees regarding **prevention** of the type of risk that has materialized
the **foreseeability** of the loss, problem or event
prior **knowledge** of the problem or **indicators** of a potential problem
how long it took **to react** and the steps taken to correct the problem once detected
the company's background or **history in such matters**
the **degree of tolerance** to risk or to breaches in the past
the **availability of measures** to prevent the harm or reduce its impact
the **skills** of the people in charge

THE DUTY OF LOYALTY

The duty of loyalty includes the obligation to act in **good faith** and with **integrity**, but in this bulletin we will **only look at its third component**, namely the obligation to act in the best interests of the legal person. This aspect as developed by the law 1 and the jurisprudence 2 can be described as follows:

Nature: act in the corporation's best interests
Jurisprudential interpretation:
- the corporation as a responsible corporate citizen
- "it may also be appropriate, although not mandatory, to consider the impact of corporate decisions on [...] stakeholders"
- if the interests of the stakeholders cannot be reconciled with the best interests of the corporation, the corporation's interests must prevail
- the Board must act such that the corporation's legal and contractual obligations are met

Involves, among other things:
- disclosure and avoidance of conflicts of interest
- confidentiality (including with respect to the person who nominated the director)
- solidarity with decisions made
- no use of property and information belonging to the corporation for purposes other than the corporation's best interests

The **main breaches** of this duty therefore usually involve the **pursuit of interests which differ from those of the corporation**. The following are a few examples:

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acting in the interests of the person who nominated the director
acting in the interests of the group the director is part of
acting in one's own interest
favouring one supplier or another person with whom the director has a privileged relationship or with whom he would like to develop a relationship
usurping the corporation's business opportunity for one's own benefit or that of a third party

Interests may perfectly **coincide**. Nonetheless, interests other than those of the corporation must be **disclosed** even in such cases.

Since directors **hold office personally**, they cannot give a proxy. They are mandataries of the corporation, not the person or group that nominated them or appointed them to the Board. They therefore cannot follow the orders or instructions of such a person or group. They must nonetheless give the Board that person or group's points of view and positions on an issue, if they are aware of them. In the end, they must conduct their own analysis in the best interests of the corporation and vote according to the outcome of analysis.

The notion of "good corporate citizen" or **"responsible corporate citizen"** adopted by the Supreme Court of Canada in BCE[3] will no doubt be clarified further by the courts over the coming years. We suggested possible interpretations in another bulletin available on our website[4]. This notion clearly implies that SMEs cannot ignore the stakeholders. Directors who ultimately become liable for the management of SMEs under corporate law must therefore incorporate this element into their decision-making process when it is appropriate to do so.

STATUTORY LIABILITY

Other than these general duties, some laws impose statutory obligations on directors or make them subject to liability or presumptions of liability or guilt in certain circumstances. The following are a **few examples** among many:

directors' liability for up to six (6) months of **unpaid wages**[5]
directors' liability for unpaid **GST** and **QST**[6]
liability for unremitted **deductions at source**[7]
the presumption of guilt of directors where the legal person of which they are the directors is found guilty of an offence under the *Environment Quality Act*[8]
the presumption created by the *Act respecting occupational health and safety*[9]

The **nature of** the legal person's **activities will determine** the potential cases of statutory liability or guilt to which the directors are exposed. The nature of the legal person's obligations can increase the directors' burden of statutory obligations and, accordingly, in many cases, their risk of liability or guilt.

Note that in most cases, a **defence of reasonable diligence** may be asserted if the directors were in fact diligent. However, the wording of the presumption provision in certain statutes, such as the *Environment Quality Act*[6], could make this defence difficult.

The director of a SME is therefore subject to these general duties and statutory obligations or liability.

GOVERNANCE WITHIN A SME

There are many definitions of corporate governance. **Governance is synonymous with the management and operational processes and systems a legal person adopts to comply with laws and contracts and fulfil its mission.** These processes and systems include: the definition of duties and their allocation among the legal person's various decision-makers (management, Board of Directors, etc.), the setting of expectations, a framework for activities and people through policies

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and mechanisms and supervisory, control and internal audit measures.

> As Professors Yvan Allaire and Mihaela Firsirotu[10] point out, governance or more specifically the duties of directors do not only translate into what the common law calls “fiduciary duties”. Governance and the exercise of a director’s duties must also **create value.**

Allaire and Firsirotu have also suggested that such governance must be based on **four pillars**:

1 - the legitimacy and credibility of board members
2 - the strategy process and dialogue
3 - the quality of financial and strategic information
4 - the compensation and incentive system

The Institute for Governance of Private and Public Organizations (IGOPP) follows this approach in its courses.

Directors should not however ignore the **precautions** that are available to them to protect themselves against liability. In the Peoples case, the Supreme Court of Canada held as follows:

“[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.”*[11] [emphasis added]

The measures we suggest in this bulletin emphasize precaution. However, use of precautionary measures should always be based upon and driven by the goal of creating value for the SME.

Governance is therefore **important** not only for the **SME** itself, but also for the **directors**.

SMEs normally do not have the means (human and material resources) to adopt and apply the same systems and processes as large reporting issuers and Crown corporations. Furthermore, an entrepreneur who runs a SME and who ends up with a Board of Directors has neither the time nor the inclination to become involved in a system that is likely to prevent him from devoting his time to the efficient running of the business.

As a result, **the principles and guidelines of good governance must be adapted to the specific reality of each SME.**

An external director should therefore encourage the establishment of good governance within the SME by suggesting the use of simple and practical measures and by taking several initiatives he can control himself.

SUGGESTED MEASURES

CONTEXTUAL MEASURES
1 - Ensure management’s cooperation

Setting up governance measures will no doubt be easier where the SME has several shareholders, some of which are not part of management. However, both in such a case and where the SME is controlled by a majority shareholder who is also the principal officer, it could be difficult if not impossible to implement such measures without management’s complete cooperation.

The **measures** suggested below will not have any **true impact unless such cooperation exists**. The power of persuasion and the personality of the **external director** will also play an important role, but they will hardly be effective if the external director **is not perceived by management as a useful and relevant player** in helping the SME achieve its goals and fulfil its mission.

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It goes without saying that the controlling shareholder and principal officer can quickly call a special meeting of the shareholders he controls and replace the external directors he is not pleased with, unless a unanimous shareholder agreement or an agreement with a lender or investor prevents him from doing so.

2- Encourage the presence of other external directors

An external director has every interest in not being the only external Board member. The presence of other external directors will give a better balance of power, lead to greater cooperation, increase the chances of certain measures being accepted and provide a sounding board for the discussion of concerns between meetings.

MINIMUM FORMAL MEASURES

Certain more formal measures, most of which are of minor importance, could create an environment more conducive to the fulfilment of the director's duties. The following is a **non-exhaustive** list of such **measures**:

election of a **Chairman** of the Board or a **lead director** chosen from among the external directors
adoption of a **description of the Board's duties and responsibilities** (mandate or **charter**)
adoption of a work plan and a **schedule** to be followed by the Board in performing its duties
adoption of a **standard agenda** including specific items for each meeting appropriate to the Board's work, such as "Business arising" and "Remittance and review of management certificates"
use of a **corporate secretary or meeting secretary to** help prepare for meetings, take notes and draft minutes (several independent notaries and lawyers offer this service on a contract basis)
obtaining management **certificates** on a regular basis (regarding financial aspects, controls and internal audits, compliance with laws and regulations, the payment of salaries, the payment of GST/QST, deductions at source, the environment, occupational health and safety, lawsuits, threatened lawsuits and other aspects which could lead to the statutory liability or guilt of the directors)
implementation of **internal control** and **information management systems**
preparation and adoption of minutes for each meeting
obtaining of **"Directors and Officers" liability insurance** and **contractual** undertakings to **indemnify** the directors from the SME and in certain cases shareholders or even lenders

Management should be prepared to agree to the setting up of most if not all of these measures.

MEASURES AT THE INITIATIVE OF THE EXTERNAL DIRECTOR

Several other measures could or should be taken by the external directors. They might include the following:

generally

become familiar with the SME's activities and the market in which it carries on business, its competitors and its legal and contractual environment
use one's knowledge and skills to bring **added value** to the SME (positive and proactive role)
devote the **time** necessary to provide a quality contribution (mere attendance at meetings not enough)
have the **courage** to express one's views based on the development and realization of the value of the business, even if they might not be welcome (avoid complacency)
use **skills** and **psychology** to communicate one's questions, requests and points of view
show high **ethical standards** and **integrity, comply** with the law and contracts and respect the people involved in one's reflections, decisions and actions as a director
use good **common sense** and the "smell test"
resign if the environment is unsatisfactory or if you can't make a good contribution

and more specifically

do not hesitate to **have items added** to the agenda
meet with management between meetings and discuss the corporation's major files and perspectives
talk to the other external directors between meetings and discuss each person's thoughts and concerns
during meetings, **repeat** one's **understanding** of the information provided by management at meetings or in

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conversations between meetings, ask the other directors to do the same and have management confirm (or correct) one's understanding and that of the other external directors, and **have this recorded in the minutes**

with respect to any proposed transaction or capital expenditures or with respect to any other major decision, ask for **explanations** from management, including:

- a description of the nature and elements of the proposal
- the main reasons for adopting it
- the other options that were considered and why they were set aside
- the scope and nature of the verifications conducted, the methodology followed for such purpose and the confirmations of internal or external experts obtained
- the expected benefits or return on investment

and have the answers noted in the minutes if doing so would be appropriate

encourage the establishment of adequate and reliable **financial controls** and ensure they are effective

identify the **main risks**, check how they are managed and regularly update and monitor these aspects

verify the SME's **succession planning** and identify the people who could take over as president and CEO and fill the other important executive positions temporarily or for the long term

in the same manner, **identify potential** acquisition or merger **targets** and other business opportunities to avoid being taken by surprise if management suddenly presents a proposal, so as to be able to offer other suggestions

give management any **information** you may have about the market, useful contacts (financing, underwriting, competitors' initiatives, business partnerships, etc.), including newspaper or magazine articles or other documents of interest

identify the **personal interests of the other Board members** and management and suggest measures to protect the search for and consideration by everyone of the corporation's best interests

encourage the **adoption of policies** to support compliance with the law and contracts, including the adoption of a code of conduct

ensure that contracts to which the SME is a party do not contain any **misrepresentations** by asking the management questions in this regard and obtaining a description of what management has done to confirm them

in the case of the **acquisition of another business**, ensure that the people who did the **due diligence** of the other business had adequate means to do it and find out from them whether the results raised any concerns

encourage the establishment of a **complaint reporting** and **whistleblowing** system

investigate or have an independent investigation conducted and obtain adequate explanations about any serious complaint or mention of an event which could constitute a breach of the law or contracts or which could cause material damage or bodily harm

when a **problem** arises, insist that it be **dealt with promptly** in order to identify possible solutions and ensure that the chosen solution is implemented quickly and efficiently

in the case of the proposed sale of the business or another material transaction to be submitted for shareholder approval, ensure that **all shareholders** have **access to the same information** as management and are treated fairly

in the case of the sale of the business, a change of control or other transaction resulting in a material change, ensure that the **interests of** all **stakeholders** are taken into account if they can be reconciled with those of the corporation

conduct a **post mortem** of Board decisions and a comparison of the actual results achieved compared to the projections submitted by management

obtain clear **confirmation** regarding the **financial criteria** prescribed by law in the case of the declaration of dividends or other transactions or operations modifying the assets of the legal person or involving significant disbursements by it

when necessary or advisable, ask for more time and information before making a decision and, in certain cases, do not hesitate to insist on having the advisability of a major decision validated by **outside experts**

increase the **intensity** of one's oversight and the amount of information which must be provided to the directors in the case of a major decision by or financial difficulty of the business

if the business is experiencing **financial difficulty**, also obtain more regular written confirmation from management that certain payments have been made (GST/ QST, wages, deductions at source, etc.) and consider the possibility of resigning or obtaining additional guarantees of indemnification, and obtain advice from the corporation's legal counsel with respect to other protection that could be provided, where applicable, pursuant to laws governing insolvency and bankruptcy (including an undertaking by shareholders or major lenders)

disclose your interests to the Board and, in the case of a **conflict of interest** in connection with a decision, refrain from participating in the decision

in the case of a fundamental disagreement with a major decision, immediately have your **dissent** entered in the minutes and/or send the Secretary and the Chairman of the Board written notice of your dissent

FURTHER THOUGHTS

Many Board **decisions** which turned out in hindsight to be unwise and some of which opened the door to lawsuits **stemmed from**

inaccurate, incomplete or mis-information given to the Board or the failure to adequately check and validate information provided

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not enough time spent analysing the situation or proposal
a **lack of resolve** by the Board and, more specifically, the external directors faced with a difficult decision
the **failure to follow common sense** and to notice apparent indicators of failings or problems
the **failure to take required action in a timely manner**

There's no **substitute for common sense**. Rational arguments do not always make up for an uncomfortable feeling about a situation. That uncomfortable feeling should be identified, investigated and acted on. In terms of integrity, the following question should be asked: **Will I be able to look at myself in the mirror tomorrow and am I sure that I'm not only "doing the right thing" but "doing things right"?**[12].

CONCLUSION

SMEs play a very important role in our economy and are essential to the development and well-being of society. They require the knowledge and skills of various individuals and a certain framework. Holding office as a corporate director is therefore an **important social contribution**.

Acting as the director of a SME and contributing to its development can also be a **very interesting and rewarding challenge.**

Directorship involves certain **duties and obligations** and the failure to comply with them can lead to **liability** and even conviction in some cases.

The presence of shareholders and executives on the Board of a SME, the more limited resources of a SME and certain conduct can **sometimes** make the performance of the duties of an external director difficult and **precarious**.

Measures adapted to the reality of SMEs can be taken but they can only be used effectively with management's cooperation. The presence on the Board of several external directors can help create a conducive environment. However, **other measures and precautions**, like those suggested in this bulletin, **are essential**.

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[1] *Civil Code of Québec*, R.S.Q., c. C-1991, art. 322, *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 122(1), *Business Corporations Act*, R.S.Q., c. S-31.1, s. 119.

[2] *Peoples Department Stores Inc.* v. *Wise*, [2004] 3 S.C.R. 461 at par. 32, *BCE Inc.* v. *1976 Debentureholders*, [2008] 3 S.C.R. 560 at par. 36.

[3] 2008 S.C.C. 269.

[4] "Directors' Duties in Light of the Peoples and BCE Decisions ", September 2009, by André Laurin and André Vautour (Lavery, de Billy website-publications-André Laurin).

[5] See for example: *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 119(1), *Business Corporations Act*, R.S.Q., c. S-31.1, s. 154.

[6] See for example: *Excise Tax Act*, R.S.C. (1985), c. E-15, s. 323(1).

[7] See for example: *Income Tax Act*, R.S.C. (1985), c. 1 (5th Suppl.), s. 227.1, *Tax Administration Act*, R.S.Q., c. A-6.002, s. 24.0.1.

[8] *Environment Quality Act*, R.S.Q., c. Q-2, s. 115.40.

[9] *Act respecting occupational health and safety*, R.S.Q., c. S-2.1, s. 241.

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[10] CD Howe Institute, Changing the Nature of Governance to Create Value (No. 189, November 2003), Allaire and Firsirotu, 2003.

[11] *Peoples Department Stores Inc*. v. *Wise* 2004 S.C.C. 68.

[12] Ethics and Corporate Social Responsibility: Why Giants Fall, Ronald R. Sims, Prayers, 2003, p. 8.

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