

DIRECTORS' DUE DILIGENCE: TIPS AND TRAPS

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DIRECTORS' DUE DILIGENCE
TIPS, TRAPS AND RECENT DEVELOPMENTS

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OUTLINE FOR REMARKS

I. The General Duty of Care

- There are two aspects
- (a) Fiduciary - to act honestly in good faith and with a view to the best interest of the corporation.
 - loyalty
 - good faith
 - honesty
 - avoidance of conflict
 - protection of corporate information, property and opportunities
- (b) Negligence- to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
 - the standard is reasonableness not perfection
 - no liability for errors in judgment
 - entitled to be wrong if acting reasonably
 - analysis of liability is fact driven
 - what would a prudent person do in the circumstances

- identify the issues/risk
- identify the costs/benefits
- determine if expert advice is needed, if so obtain it
- note that under corporate statutes if directors rely in good faith on the opinion of experts (legal, audit, accounting, engineering, etc.,) they have a defence of prudence/ due diligence
- must identify the issues assemble the information/advice needed and then DECIDE having regard to the best interest of the corporation.
- Canadian Courts defer to the business judgement of corporate decisions makers. So long as a reasonable process is followed that is directed to the best interest of the corporation there will be no liability.

(c) Practical Example

Re Soper and The Queen (1997), 49 D.L. R. (4th) 297 (F.C.A.)

- the "objective subjective" standard
- standard can differ between inside and outside directors
- what is prudent
- what is not necessary
- when is the positive duty to act triggered
- case attached as Appendix "A"

- (d) To whom is the duty owed
 - (i) to the corporation
 - (ii) to the shareholders?
 - something of a misnomer
 - interests of shareholders may conflict (majority vs. minority; between classes)
 - (iii) To creditors?
 - their interest must be considered in times of financial difficulties

- (e) The oppression remedy
 - designed to protect reasonable expectation of shareholders from "unfair conduct or results"
 - sweeping remedial power to make "such order the Court sees fit"
 - potential for personal liability for directors exists
 - no need to prove bad faith
 - courts have shown restraint in application of remedy against directors personally
 - Budd v. Gentra Inc. (1998), 43 B.L.R. (2d) 27 (O.C.A.)
 - Sidaplex Plastics Supplies Inc. v. The Elta Group (1998), 40 O.R. (3rd) 563 (O.C.A.)

II. Due Diligence in a Hostile Take Over

- there are numerous specific, technical requirements in the securities legislation which are beyond the scope of this discussion
- the fundamental duty remains the same. Directors must act in the best interest of the corporation. Means maximizing shareholder value in take over context.
- response to the hostile bid
 - analysis
 - seek expert advice as required (legal, accounting, investment banking)
 - in most cases investment banker advice will be need as to adequacy/fairness of the bid
 - no liability for good faith reliance in the advice of experts - so USE them
 - delay in order to consider/develop alternatives. Goal is to enhance value for the shareholders
 - No positive obligation to put forward an alternative. The bid may be the best option
 - advise shareholders and provide a recommendation
- Special Committees
 - no hard and fast rules
 - use for efficiency and where conflicts exists

- insider/management bids
 - related party bids
 - relates back to fiduciary duty. Avoidance of real and potential conflicts
- Rely on the business judgement principle
 - the court will not interfere if directors have acted reasonably with a view of the best interest of the corporation.
 - therefore,
 - (a) review and analyse bid
 - (b) identify issue/alternatives
 - (c) seek professional advice as needed
 - (d) understand the advice
 - (e) establish special committees as needed. Avoid conflicts
 - (f) made a recommendation
 - If the shareholders want to sell, (and they will if bid is at a premium to market) do not get in the way
 - keep in mind that while there is nothing to stop someone from commencing an action with allegations of negligence and misfeasance, it is very difficult to prove such a case.

III. Emerging Issues

1. Proposed Changes to C.B.C.A.

- Bill S-19 died on the order paper October, 2000 but will be revamped and reintroduced imminently.
- Significant changes expected

(a) Expanded shareholders rights to allow greater participation in major decisions

- enhance communication between shareholders
- permit proxy solicitation via public broadcast, a newspaper advertisement
- minimum length of time for owning shares to ensure that proposals founded on genuine stake in the company.

(b) Director liability

- replace good faith reliance defence with a defence of due diligence
- will be more onerous for directors
- expanded/clarified rules of indemnification for defence costs including legal proceedings and regulatory investigations

(c) Modified proportionate liability

- currently there is joint and several liability for negligence in preparations and disclosure of financial information

- proposed amendment to apportion damages according to degree of responsibility
- change would not apply to liability to the Crown, charities, unsecured trade creditors and individual plaintiffs whose investment is below a prescribed amount
- Maximum penalty for insider trading increased from \$5,000.00 to greater of \$1,000,000.00 or three times the profit made or loss avoided whichever is greater.

2. Expanded Liability for Misrepresentation

- (a) Proposed Statutory Civil Remedy for Investors in the Secondary Market
 - Allen Committee Report 1997
 - non-compliance with continuous disclosure regime was a problem
 - existing sanctions inadequate
 - deterrence through civil action for damages
 - Canada Securities Administrators (C.S.A.)
 - Draft legislation in line with Allen Report released November 3, 2000

- CSA plans to recommend changes to securities legislation but at present no government has decided to proceed with the amendments
- create a limited right of action for secondary market investors to sue public companies and key related persons (directors, responsible senior officers etc.) for damages for written or oral misrepresentations or failure to make timely disclosure of material information.
- important features include
 - no need to prove reliance on the misstatement. Fraud on the market concept
 - need leave of the court to commence the action.
Establish good faith and reasonable prospect of success
 - Court approval of any proposed settlement
 - defendants have due diligence defence and in some circumstances the plaintiff must show actual knowledge of misrepresentation or gross misconduct
 - limited liability
 - for issuers the greater of \$1,000,000.00 or 5% of market capitalization

- for directors and officers the greater of \$25,000.00 and 50% of compensation in last 12 months
- for experts the greater of \$1,000,000.00 and fees earned in last 12 months
- no cap if fraud
- full text proposed amendments attached as Appendix "B"
- Implications for directors
 - need a comprehensive compliance program in order to make due diligence defence available.
 - the case law establishes that if (1) a system exists to promote and monitor compliance (2) the director used the system, due diligence defence can be established
 - therefore recommend
 - (a) establish a disclosure compliance committee
 - (b) establish training/education programs
 - (c) establish policies, protocols to foster compliance
 - (d) monitor compliance

3. Common Law Liability for Misrepresentation

- NBD Bank. Canada v. Dofasco Inc., et al (1999), 46 O.R. (3rd) 514
(Court of Appeal)
- Corporate representatives do not enjoy any immunity from personal liability for acts done within scope of duties and *bona fide* directed to the best interest of the corporation
- Carom v. Bre-X Minerals Ltd., [2000] O. J. No. 4014 (Court of Appeal)
- negligent misrepresentation claim was allowed to proceed as a class action.
- case attached as Appendix "C"

IV CONCLUSION

- trend is to greater responsibility and hence liability
- Courts still show deference to good faith decisions made after a reasonable process
- establishment of rules, policies, protocols with effective follow up monitoring is essential for proof of due diligence
- class actions are on the rise. We have only seen the tip of the "strike suit" iceberg.