

Directors' Briefing

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DIRECTORS' DUTIES IN THE SPOTLIGHT ONCE AGAIN

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Introduction

The collapse of Bernard Madoff's multi-billion dollar Ponzi scheme left ripples across the international investment world and resulted in a multitude of lawsuits around the globe. One of these cases is *Madoff Securities International Limited v. Stephen Raven et al.*,² a recent decision released by the High Court of Justice in the United Kingdom. In this case, the Court clarified the scope of a director's duty to act in what he or she believes in good faith to be in the interests of the company. The Court also provided important guidance on how directors are expected to comply with this duty in light of the practical commercial realities of their role; in particular, the need to work together with other directors.

Background

The case concerned the actions of the former directors of Madoff Securities International Limited ("Madoff Securities"), a UK company, with regard to certain payments that were made by Madoff Securities prior to the discovery of the Ponzi scheme and the subsequent conviction of Mr. Madoff in the United States.

There were three sets of payments made by Madoff Securities that were the subject of this litigation. The first series of payments (the "MSIL Kohn payments") involved payments made to Mrs. Kohn for services rendered by her, such as the introduction of important individuals, advice on financial matters, and research. These payments to Mrs. Kohn totalled \$27 million over a 15-year period. The second series of payments (the "interest payments") were in the form of interest payments made on personal loans by Mr. Madoff to Madoff Securities. The third series of payments (the "lifestyle payments") made out of the company's director's loan account, concerned goods and services purchased by Madoff Securities on behalf of Mr. Madoff and his family.

Duties of Directors

The liquidators of Madoff Securities claimed that the directors, by permitting these payments, acted in breach of their duties as directors of Madoff Securities. With regard to the MSIL Kohn payments, amongst other allegations, the liquidators claimed that the directors knew Mrs. Kohn's written research was useless and of no value. Therefore, the payments made for the worthless research constituted a breach of the directors' duties. In addition, it was alleged that the interest payments were unnecessary and that the lifestyle payments were an improper use of company funds. With these serious allegations, the Court took the opportunity to revisit the law on the duties of directors

and what may constitute a breach of those duties. Throughout the analysis, the Court identified the three main duties of directors as follows:

- (1) to act in good faith in the interests of the company;
- (2) to exercise power for the purposes for which they are conferred; and
- (3) to exercise reasonable care, skill and diligence.

Within English law, these three duties have been legislatively codified in much more detail than in Canadian law. However, although these duties may be provided for through legislation, the case law is very important in identifying what may constitute a breach of these duties.

As with English law, the general duty owed to a company is set out in section 122(1) of the *Canada Business Corporations Act*³ ("CBCA"), which reads as follows:

- 122.** (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall
- (a) act honestly and in good faith with a view to the best interests of the corporation; and
 - (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.⁴

In the case of *Madoff Securities*, the Court identified the importance of this duty on directors. The judge stated:

... it is trite law that a director owes a duty to the company to act in what he honestly considers to be the interest of the company. This may be regarded as the core duty of a director. It is a fiduciary duty because it is a duty of loyalty.⁵

Although these duties are imposed on directors through legislation, they have been interpreted through jurisprudence on several occasions. These court interpretations have clarified the duties for directors and have also, on some occasions, increased the standard of care for directors.

The Court in this case has summarized some of these important considerations as follows:

1. ... the duty is to act in what the director believes, not what the Court believes, to be the interest of the company. The test is a **subjective** one.⁶ (our emphasis)

Note that in Canada the test for the duty of care of directors is an **objective** test. The Supreme Court of Canada concluded in *People's Department Stores Inc., Re*⁷ that the standard of care pursuant to section 122 of the CBCA is an objective standard and indicated that "the factual aspects of the circumstances surrounding the actions of the directors or officers are important in the case of the ... duty of care".⁸

2. A director "owes a duty to the company to inform himself of the company's affairs and join his fellow directors in supervising them. It is therefore a breach of duty for a director to allow himself to be dominated, bamboozled or manipulated by a dominant fellow director where such involved a total abrogation of this responsibility.⁹

3. A director who has knowledge of his fellow director's misapplication of company property and stands idly by, taking no steps to prevent it, will thus not only breach the duty of reasonable care and skill ... but will himself be treated as party to the breach of fiduciary duty by his fellow director in respect of that misapplication by having authorised or permitted it.¹⁰

4. In fulfilling this personal fiduciary responsibility, a director is entitled to rely upon the judgement, information and advice of a fellow director which integrity skill and competence he has no reason to suspect.¹¹

5. Directors may reach a decision ... by a majority. A minority director is not thereby in breach of his duty, or obliged to resign and to refuse to be party to the implementation of the decision.¹²

6. Where a director fails to address his mind to the question whether a transaction is in the interest of the company, he is not thereby, and without more, liable for the consequences of the transaction.¹³

7. A director owes a fiduciary duty to exercise the powers conferred on him by the constitution for the purposes for which they were conferred.¹⁴

The Court analyzed each series of payments, and in each case, found none of the directors to be in breach of their duties to act in good faith in the interest of the company. The Court held that the MSIL Kohn payments did not constitute a breach since the directors were found to have honestly believed that the payments to Mrs. Kohn were in the best interest of the company. As for the interest payments, the Court concluded that the payments were made honestly and reasonably on loans that the directors had believed in good faith to be in the interest of Madoff Securities. Finally, the Court found no breach in the lifestyle payments being made, since the payments were applied to discharge loans made by Mr. Madoff to Madoff Securities. The Court held that it was irrelevant whether the loans were repaid directly to Mr. Madoff or to a third party at his request, so long as the loan amount was reduced. In conclusion, the judge stated that "Bernard Madoff's fraud itself blighted (the directors') lives and tainted their good nature simply by association".¹⁵

Conclusion

The Court has summarized what constitutes the responsibilities that directors of organizations face in the fulfilment of their duties. Directors must supervise the actions taken on behalf of the company and exercise independent judgment as to whether an act or omission is in the interest of the company. Directors should be aware, however, that on certain occasions, they may defer to the views of their fellow directors while still complying with their legal duties.

The role of director is one that should not be taken lightly. Although many may think that directors are shielded by the corporate veil, the multitude of cases on director liability have shown that the decisions of directors can and will be looked at under a microscope when things go wrong. It is therefore of vital importance that directors understand what their duties are and how to avoid making decisions that may land them in hot water.

Notes:

¹ The writers wish to express their appreciation to Ryan Chua, student-at-law at Minden Gross LLP, for his assistance in the preparation of this article.

² [2013] EWHC 3147 (Comm).

³ RSC 1985, c C-44.

⁴ *Ibid.* at s. 122(1).

⁵ *Supra* note 1 at para. 187.

⁶ *Ibid.* at para. 189.

⁷ 2004 SCC 68.

⁸ *Ibid.* at para. 63. While the duty of care owed to the corporation (and possibly to its stakeholders) is an objective standard, a duty to act in the best interests of the corporation (the fiduciary duty) may still be a subjective one.

⁹ *Supra* note 1 at para. 190.

¹⁰ *Ibid.* at para 191.

¹¹ *Ibid.* at para 192.

¹² *Ibid.*

¹³ *Ibid.* at para 193.

¹⁴ *Ibid.* at para 194.

¹⁵ *Ibid.* at para. 469.

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