KORNFELD LLP

1100 ONE BENTALL CENTRE
505 BURRARD STREET, BOX 11
VANCOUVER, B.C., CANADA V7X 1M5
T: 604.331.8300 F: 604.683.0570
WWW.KORNFELDLLP.COM

Daniel S. Parlow
dparlow@kornfeldllp.com
d: 604.331.8322

THE CASE FOR EMPOWERING CANADIAN CORPORATIONS TO LIMIT DIRECTORS' PERSONAL LIABILITY: REVISITING THE "CHARTER OPTION"[1]

"[D]irectors may tend to be risk averse if they must assume a substantial degree of exposure to personal risk relating to … a business decision gone bad. They need not worry under Delaware law about mistakes of judgment—even "stupid" ones."[2]

Introduction

It is in the interests of society to foster a business environment in which corporations can achieve their primary objectives of raising capital, expanding earnings and improving profitability. To that end, it is necessary to attract directors who are highly competent and motivated to take risks in the best interests of the corporation.

Directors are subject to a number of duties which may give rise to personal liability. These include:

- The fiduciary duty to act honestly, in good faith and without self-interest
- The duty to refrain from making misrepresentations in documents which may be distributed to investors in the primary or secondary markets
- The duty to refrain from insider trading or tipping
- The duty to ensure that the corporation receive proper consideration for shares issued and that employees and government entities receive statutorily prescribed payments
- The duty to refrain from conduct that is oppressive or unfairly prejudicial to others
- The duty to exercise care, diligence and skill in directing the affairs of the corporation (the "Duty of Care")

Persons agreeing to assume the important role of a director are aware that they must act honestly and loyally, that they must refrain from misconduct, and that there are potential statutory liabilities with prescribed limits.

However, the potential breadth of the Duty of Care is so great that it is very difficult for a director or prospective director to predict or anticipate under what circumstances he or she may be in breach of that duty and thereby subject to personal liability in favour of an aggrieved party. That person may thereby be less inclined to act as a director, and less inclined to take bold, calculated risks if they do accept that role.

In 1986 Delaware[3], followed by some 37 other U.S. states over the ensuing seven-year period[4], legislated the option for a corporation (the "Charter Option"), through its charter, to exonerate or restrict directors' personal liability in the event they were to breach the Duty of Care. This was done in the wake of a crisis in the availability of directors' and officers' (D&O) insurance following a Supreme Court of Delaware decision holding directors personally liable in connection with a proposed cash-out merger which, it was held, "was not the product of an informed business judgment"[5].

The Charter Option and other options to limit directors' liability were considered but rejected by the authors of a federal discussion paper released November 1995[6] ("*Federal Discussion Paper*"); and legislators then revising the *Canada Business Corporations Act* ("CBCA") declined to implement any such measure. Neither the Government of Canada nor that of any Canadian province has followed the Delaware lead in subsequent revisions to their business corporation laws.[7]

To foster economic activity and encourage job growth, it is urged that Canadian jurisdictions adopt a statutory amendment permitting corporations to regulate, through their charters, the potential liability of their directors for breaches of the Duty of Care. As in the United States, the Charter Option would *not* be available in cases of bad faith, misconduct or other liabilities prescribed by statute.

Duty Of Care: *Canada vs United States*

Beyond the Charter Option, there are two main differences in the Canadian and American versions of the Duty of Care. The first difference is the characterization of the duty, and the second is the test applied to determine whether the duty has been fulfilled.

The Duty of Care, as set out in the CBCA as well as provincial business corporations acts across Canada, operates independently of directors' fiduciary duties.[8] In *Peoples Department Stores Inc. (Trustee of) v. Wise*[9], the Supreme Court clarified that directors' duty to act "honestly and in good faith" under CBCA s. 122(1)(a) and their duty of care under s. 122(1)(b) are *independent of one another*:

> The first duty has been referred to in this case as the "fiduciary duty". It is better described as the "duty of loyalty". We will use the expression "statutory fiduciary duty" for purposes of clarity when referring to the duty under the CBCA. This duty requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation. The second duty is commonly referred to as the "duty of care". Generally speaking, it imposes a legal obligation upon directors and officers to be diligent in supervising and managing the corporation's affairs.

This distinction was confirmed by the Supreme Court in *BCE Inc. v. 1976 Debentureholders*[10] at para. 36.

The Canadian characterization is to be contrasted with the American model in which the director's duty of care, often called the "duty of due care and attention", *arises from and is inextricably linked to the fiduciary duty*, as set out in *Smith v. Van Gorkom*[11]:

> Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. *But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye* in assessing information of the type and under the circumstances present here.

The U.S. Second Circuit put it this way in *Hanson Trust PLC v. ML SCM Acquisition, Inc*[12]*:*

> "… the exercise of fiduciary duties by a corporate board member *includes* more than avoiding fraud, bad faith and self-dealing. Directors must exercise their "honest judgment in the lawful and legitimate furtherance of corporate purposes…"[13]

(emphasis added)

The inextricable link between the American Duty of Care with their fiduciary duty is seen by the characterization of the Charter Option codified in s. 102(b)(7) of Delaware's General Corporation Act ("DGCL"), reproduced in Schedule A hereto. S. 102(b)(7) permits the certificate of incorporation to include a provision:

> …eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages *for breach of fiduciary duty as a* director, *provided that such provision shall not eliminate or limit* the liability of a director: (i) For any breach of the director's *duty of loyalty* to the corporation or its stockholders; (ii) for acts or omissions *not in good faith* or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an *improper personal benefit*.
>
> (emphasis added)

Although the Duty of Care is not specifically mentioned therein, it is clear from the jurisprudence reviewed *infra* that this provision is aimed at breaches of the Duty of Care; in other words, the Duty of Care is, in the United States, part of the director's fiduciary duty.

The second distinction is the test applied by the courts to determine whether a director is in compliance with the Duty of Care.

In *Peoples,* The Supreme Court of Canada put the test this way:

> 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*. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether *an appropriate degree of prudence and diligence* was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.[14]
>
> (emphasis added)

The American test appears to require more before a director can be held in breach of this duty. The Supreme Court of Delaware in oft-cited *Aronson v. Lewis*[15] held that the standard amounts to "gross negligence":

> [Additionally], to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, *our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence*.[16]

However, in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*[17], the U.S. Second Circuit granted an injunction prohibiting a board decision for breach of the Duty of Care without finding it necessary to make a determination

whether the conduct amounted to gross negligence.[18] It may be that the decision was influenced by the stage of the proceedings, i.e. the plaintiffs were seeking injunctive relief to prevent a lock-up provision in a takeover battle rather than a *post facto* claim of damages against the directors personally. The case was decided under New York law.

In subsequent decades, the "gross negligence" standard has been applied repeatedly in Delaware and in the preponderance of U.S. states following Delaware corporate law. The development of this standard was discussed by the Delaware Chancery Court in *In re Walt Disney Co. Derivative Litigation.*[19]

Although the gross negligence test has not been applied in Canada, it may be asked whether the difference between the Canadian and U.S. standards is more one of semantics than of substance. Certainly, the development of the business judgment rule, upon which the directors' decisions are often measured, has followed a similar path in Canada as in Delaware. The similarity was put thus by the Ontario Court of Appeal in *Maple Leaf Foods Inc. v. Schneider Corp.*[20]:

> The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. *As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision.* This formulation of deference to the decision of the Board is known as the "business judgment rule".[21]
>
> (emphasis added)

This passage was cited with approval by the Supreme Court of Canada in *Peoples, supra,* at para. 65, although the court did not directly address whether the U.S. gross negligence standard makesit easier in practice for the actions of American directors to withstand the court's scrutiny.

Rationale For Current Canadian Regime

There is little doubt that the mood prevailing upon enactment of the CBCA was to make directors more, rather than less, accountable in the exercise of the Duty of Care.

The CBCA was based in large part upon the recommendations of a 1971 report[22] by Dickerson, Howard and Getz (the "*Dickerson Report*"). The report proposed, *inter alia*, implementation of a statutory duty of care which was stricter than that then prevailing under common law[23]:

> The formulation of the duty of care, diligence and skill owed by directors represents an attempt to upgrade the standard presently required of them. The principal change here is that whereas at present the law seems to be that a director is only required to demonstrate the degree of care, skill and diligence that could reasonably be expected from him, having regard to his knowledge and experience … *Recent experience has demonstrated how low the prevailing legal standard of care for directors is, and we have sought to raise it significantly.*

As noted recently by the Supreme Court of Canada in *Peoples*, this proposal was ultimately enshrined in CBCA

s. 124(1)(b) though under somewhat different wording:

> The statutory duty of care in s. 122(1)(*b*) of the CBCA emulates but does not replicate the language proposed by the Dickerson Report. The main difference is that the enacted version includes the words "in comparable circumstances", which modifies the statutory standard by requiring the context in which a given decision was made to be taken into account. This is not the introduction of a subjective element relating to the competence of the director, but rather the introduction of a contextual element into the statutory standard of care. *It is clear that s. 122(1)(b) requires more of directors and officers than the traditional common law duty of care* outlined in, for example, *Re City Equitable Fire Insurance, supra*.[24]
>
> (emphasis added)

Twenty years after enactment of the CBCA and 9 years after Delaware's implementation of the Charter Option, the authors of the *Federal Discussion Paper, supra*, considered the possible implementation of three legislative options to restrict directors' liability. These were, firstly, the "Charter Option"; secondly the "cap on money damages"[25]; and thirdly the "self-executing" approach[26].

It was noted in the *Federal Discussion Paper* that "(s)everal objections can be made to a liability cap". For reasons which follow, in the author's respectful view the arguments advanced therein did not hold water in 1995 and, given subsequent jurisprudence and legislative change, are even less persuasive today. The first-mentioned "Charter Option" is by far the most prevalent adopted measure in North America and, for the reasons outlined herein, is the primary focus of this article.

The first objection was that that in "limiting the liability faced by directors essentially transfers that liability, and the risk, from them, their corporations, and their insurers back to the injured party. That party could be the corporation's employees, creditors, the government, or other third parties."

The Charter Option would restrict or exempt liability *only* for a director's breach of the Duty of Care. The intent is only to limit indeterminate liability for errors. It would *not* apply to self-dealing, to bad faith or to liability for specific debts and obligations imposed by statute such as the liability for employee deductions and overdue GST. It would not bar action for insider trading. It would also not apply to the vast majority of claims which might be brought under the oppression remedy provisions of s. 241 of the CBCA and similar provincial statutes[27].

The Charter Option also would not restrict legislated secondary market liability for prescribed wrongs for which directors, officers and others face the prospect of class action lawsuits brought by investors.[28] These provisions include specific prohibitions regarding misrepresentation, non-disclosure and market manipulation.

The second objection discussed in the *Federal Discussion Paper* was that:

> "…a cap imposed on both large and small corporations could never be optimal; it would reflect a considerable trade-off and might be neither efficient nor effective. In the case of large corporations, even a very large liability cap might not even come close to approaching the potential liabilities faced by directors and, as such, it might negate the effectiveness of directors' liability as a deterrence mechanism. In the case of small corporations, a large cap probably would always be larger than any liability that directors of these small corporations face."

This objection is really an argument addressed at a global cap applicable to all corporations, while the essence of

the Charter Option is to allow the shareholders of each corporation to assess whether to bar or cap liability and to what extent. If circumstances were to change over time the shareholders would be free to amend their charter should they determine that the existing rules require modification.

The third objection was that an earlier report by the Toronto Stock Exchange on corporate governance had recommended against capping directors' liability:

> "We do not think a cap could be effectively implemented simply through amendments to a corporation's governing statute. A cap would require coordination amongst the jurisdictions imposing personal liability on directors of a particular corporation – a practical impossibility."

While this argument is understandable in the case of secondary market liability or other forms of prescribed legislative liability, it is difficult to see how this rationale renders the Charter Option objectionable. As noted above, the Charter Option is not intended, nor would it purport, to exempt directors from liability generally.

In the author's view, none of the objections listed in the *Federal Discussion Paper* is a persuasive bar to the implementation of a Delaware-style Charter Option.

Reasons For Change

1. Encouraging Risk-Taking and the Business Judgment rule

The main purpose of the Charter Option would be to make it easier for corporations to attract directors who would otherwise be deterred by the prospect of personal liability for losses arising from their negligence.

However, Delaware section 102(b)(7) does not permit exoneration:

> "…(i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law … or (iv) for any transaction from which the director derived an improper personal benefit."

As noted by E. Norman Veasey who served from 1992 to 2004 as Chief Justice of the Delaware Supreme Court, while the jurisprudence on s. 102(b)(7) is somewhat tortured "the bottom line is that derivative due care claims seeking personal liability of directors can normally be dismissed on motion."[29] He notes that "the purpose of s. 102(b) is "designed to operate like the business judgment rule to protect directors and to encourage qualified persons to act as directors."

As discussed *supra*, the business judgment rule is at the heart of Canadian corporate law as it is in Delaware. As noted by Veasey:

> The business judgment rule is the foundation of our corporation law. That rule teaches that courts will not second-guess directors' business decisions and will not interfere *with investors' expectation that directors will take honest and prudent business risks to advance the economic well-being of the enterprise*. To carry out this entrepreneurial theme that lies at the heart of Delaware jurisprudence, the concept of good faith is an immutable ingredient of the business judgment rule.[30]
>
> (emphasis added)

In an oft-cited takeover case[31], the Delaware Court of Chancery noted that "there is great social utility in

encouraging the allocation of assets and the evaluation and assumption of economic risk by those with . . . skill and information." Accordingly, "courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith."[32]

Veasey notes that it is "very much in the stockholders' interest that the law not encourage directors to be risk averse. Some opportunities offer the prospect of great profit at the risk of very substantial loss, while the alternatives offer less risk of loss but also less potential profit."[33]

The encouragement of corporate risk-taking has long been a tenet of English law and had been applied in Canada before enactment of the CBCA, as noted by Greenberg J. of the Québec Superior Court in his trial judgment in *Peoples*[34]:

> The [English] Court of Appeal, pursuant to the opinion of Mr. Justice Romer, exonerated the defendants and, in so doing, laid to rest the notion that in elaborating their duties and liabilities, directors were to be equated with trustees under the Common Law. It is in the nature of business to take risks and hence directors, although they clearly have a fiduciary duty to their company and its shareholders, could not be expected to conform to the same high objective standard of Common Law trustees.
>
> Romer, J. elaborated three basic reasons to have exculpated the defendants:
>
> (i) a director need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience;
>
> (ii) a director is not liable for errors in business judgment, as his primary function is to use his own particular talents in advocating corporate risk taking; and
>
> (iii) a director is not bound to give continuous attention to the affairs of the corporation. In the absence of grounds for suspicion he is fully justified in trusting corporate officials to be honest.
>
> That third branch of his holding clearly applies more to what we would call "outside directors", such as for example Messrs. Stevenson and Cossette were here. However, the three Individual Respondents were not only directors and officers of Peoples and Wise Stores, but were also employed fulltime in the business enterprise of those companies. [35]

This is a very different perspective on risk than that considered by the authors of the *Dickerson Report* who might well have been opposed to a Charter Option had it then been considered:

> We are aware of the argument that raising the standard of conduct for directors may deter people from accepting directorships. The truth of that argument has not been demonstrated and we think it is specious. The duty of care imposed by s. 9.19(1)(b) is exactly the same as that which the common law imposes on every professional person, for example, and there is no evidence that this has dried up the supply of lawyers, accountants, architects, surgeons or anyone else. *It is in any event cold comfort to a shareholder to know that there is a steady supply of marginally competent people available under present law to manage his investment.*[36]
>
> (emphasis added)

In fact, this concern over the prospect of attracting less competent directors was not supported by any data. It is discussed further below, *Fostering Economic Activity by Attracting Directors.*

In *BCE*, the Supreme Court of Canada emphasized that directors must often make difficult decisions in an environment in which the interests of disparate groups are being considered. Although the case involved allegations of oppression inherent in an impugned corporate arrangement rather than *ex post facto* allegations of directors' liability, the court considered the difficult job faced by directors where their decisions could not possibly satisfy all actors:

> "Faced with renewed speculation and BCE having been put "in play" by the filing by Teachers of the Schedule 13D report [with the U.S. Securities and Exchange Commission], the Board met with its legal and financial advisors to assess strategic alternatives. It decided that it would be in the best interests of BCE and its shareholders to have competing bidding groups and to guard against the risk of a single bidding group assembling such a significant portion of available debt and equity that the group could preclude potential competing bidding groups from participating effectively in an auction process.[37]"

2. Fostering Economic Activity by Attracting Directors

It is in the interests of Canada's continued prosperity to attract the best people possible to oversee and direct management of our corporations. However, it is *not* in our interests to attract directors who may act out of self-interest or who are otherwise disloyal to the corporation they owe a duty to serve.

Veasey underscores the difference between the directors' decision-making process and the decision itself in the context of their potential liability:

> In the area of the directors' oversight responsibility (as distinct from the context of business judgment in a board's decision-making role), in my view, former Chancellor Allen's *Caremark* decision is particularly significant:
>
> Indeed, one wonders on what moral basis might shareholders attack a *good faith* business decision of a director as "unreasonable" or "irrational." Where a director *in fact exercises a good faith effort to be informed and to exercise appropriate judgment*, he or she should be deemed to satisfy fully the duty of attention.[38]
>
> (footnote omitted; emphasis is Mr. Veasey's)

In her book *Corporate Governance*[39], Professor Christine A. Mallin analysed data from a number of studies underscoring the importance of non-executive directors in small companies and the difficulty in attracting them:

> In terms of the impact on corporate governance structures, it can be expected that in general, small and medium-sized firms will have simpler corporate governance structures than large firms…; a smaller number of non-executive directors (NEDs); a combined chair/CEO; longer contractual terms for directors due to the *more difficult labour market for director appointments into small and medium-sized companies.*
>
> The role and importance of NEDs was emphasised in the Cadbury Report (1992) and in the Code of Best Practice that NEDs 'should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct' (para. 2.1). Similarly, the Hampel Report (1998) stated: 'Some smaller companies have claimed that they *cannot find a sufficient number of independent non-executive directors of suitable calibre. This is a real difficulty, but the need for a robust independent voice on the board is as strong* in smaller companies as in large ones'(para. 3.10). …

> From Table 5.1, it can be seen that the areas where potential difficulties are most likely to arise tend to be those relating to the appointment of directors, particularly non-executive directors, which has implications for board structure. *These differences arise partly because of the difficulties of attracting and retaining suitable non-executive directors in small companies.*
>
> Mallin and Ow-Yong (1998b) found that the most important attribute for small business when recruiting non-executive directors was their *business skills and experience. Overall, the inference could be made that the ability to 'add value' to the business is the most important factor influencing NED appointments,* which is in line with a study by Collier (1997). Similarly, the Hampel Committee (1998) stated 'particularly in smaller companies, non-executive directors may *contribute valuable expertise not otherwise available to management'*(para 3.8).

It is human nature for a prospective director to be averse to serving if he or she will face personal liability for honest decisions made while serving on a board. On the other hand, directors will understand that they owe a duty to act loyally and without self-interest; they will understand that the law cannot, and will not, protect them should they act otherwise.

From this perspective, it matters not that the business judgment rule protects directors from liability so long as they elect "from one of several reasonable alternatives"[40]. This test denotes to directors that they may have to justify any decision in court as being a "reasonable alternative", even if made with complete loyalty and in good faith. This test will inevitably be less comforting than one in which they will be exculpated from liability so long as their decisions are made selflessly and in good faith.

In particular, small business, which accounted, as of 2004, for half of all private sector employment in Canada[41], may consider the Charter Option to be especially helpful both in attracting quality directorial candidates and in reducing or eliminating the need for D&O insurance which is often disproportionately expensive and difficult to obtain, if available to them at all.

In this author's respectful view, the documented importance of attracting quality directors far outweighs any perceived concern over any possibility of attracting "a steady supply of marginally competent people available under present law to manage his investment" as posited in 1971 in the *Dickerson Report*[42]. To the author's knowledge, there is no evidence suggesting that the imposition of a liability cap will lead to diminishment in the quality of directors, nor that directors in corporations having a legally effective exculpatory clause are any less competent than those directing corporations without such a clause. In fact, one could just as easily argue that concern over potential indeterminate liability is an indicator of a wise, forward-thinking director than an indicator of a marginally competent one.

Furthermore, assuming the Charter Option in Canada bears out the American experience whereby "derivative due care claims seeking personal liability of directors can normally be dismissed on motion[43]", legal costs of defending such claims will be much less for defendant corporations and directors alike than if they were obliged to justify their decisions at trial as a "reasonable alternative".

Finally, it is reasonable to anticipate that legal costs of some prospective proceedings would be avoided altogether by investors' disinclination to mount a challenge absent evidence of bad faith.

Liability And Indemnification

There is currently a disconnect between Canadian statutory provisions allowing corporations to indemnify directors for negligent decisions while disallowing them to exculpate them from personal liability.

This issue was addressed by the Delaware Supreme Court in *In Re The Walt Disney Company Derivative Litigation*[44]. In that case the plaintiffs attempted to argue that the alleged breach of Duty of Care amounted to a breach of the duty of good faith and hence was not exculpated by the relevant Charter Option. The court rejected this argument on the basis that to do so:

> …would eviscerate the protections accorded to directors by the General Assembly's adoption of Section 102(b)(7)" of the DGCL, as well as by parallel provisions[45] under which a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.[46]

Business corporations legislation in Canada contains similar indemnity provisions to those in Delaware. For example, Ontario's *Business Corporations Act*[47] allows at section 136(1) for indemnification of directors and others for:

> "all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any … proceeding in which the individual is involved because of that association with the corporation … Subsection (3) then provides that a "corporation shall not indemnify an individual under subsection (1) unless the individual acted honestly and in good faith with a view to the best interests of the corporation … for which the individual acted as a director…".

The CBCA, British Columbia and Alberta all have provisions to similar effect.[48] In none of these is there any prohibition on indemnification in cases of negligence or even gross negligence.

In the author's view, it is anomalous to allow corporations to indemnify their directors for losses occasioned by conduct while not allowing them to exculpate them from liability in respect of the same conduct.

Bad Faith And Self-Dealing

As noted above, it is urged that Charter Option provisions in Canada, as with Charter Option jurisdictions in the United States, disallow corporations from exonerating directors in the event of bad faith, self-dealing or other instances of non-loyalty. A number of U.S. cases demonstrate how courts can deal with claims involving an exculpatory clause and allegations of disloyalty.

It will be incumbent upon the court to determine whether the impugned decision was *in fact* taken disloyally. This may be evident from extrinsic evidence or, in exceptional circumstances, from the board decision itself. In other words:

> A court may… review the substance of a business decision made by an apparently well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.[49]

The Supreme Court of Delaware in *Gantler v. Stephens*[50] illustrates how an impugned transaction can be subject

to a higher standard of review if directors are motivated by self-interest. In *Gantler*, the plaintiff was a minority shareholder and former director of a bank's parent when it was presented with several offers to purchase the bank. The Court found that the board's process in reviewing the subject offers and, in instead pursuing an internal privatization restructuring, was tainted by a conflict of interest under which several board members would have been personally better off by the opportunity to preserve the bank as a key business client (in the case of two directors) or by the opportunity for the CEO to remain in that position.

These facts, supplemented by evidence of actual sabotaging of the bid process by certain directors' and officers' refusal to respond to reasonable due diligence requests, led the court to conclude that the business judgment rule was not applicable and that, were the allegations proven at trial, the defendants would be guilty of breach of fiduciary duty *notwithstanding that the privatization transaction had been subsequently approved by the shareholders after the conflicts of interest were disclosed*.

In its focus on procedural fairness, the Court concluded that the subsequent shareholder ratification was tainted:

> First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.[51]

Gantler is a good example of a situation in which directors would *not* be exonerated even if a corporation were to invoke the Charter Option. Had they invoked an alternative process such as the appointment of an independent M&A committee to evaluate the options, the directors could likely have avoided any finding that they were in breach of their fiduciary duty.

As noted *supra*, the delineation between negligence and bad faith is discussed in the litigation involving Michael Ovitz's appointment and later dismissal as President of Walt Disney Company resulting in a severance payment of some US$130,000,000. In a 2003 decision[52] later upheld by the Delaware Supreme Court, the Court of Chancery declined to strike plaintiffs' claim due to allegations that "the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision".

However, those claims were not proven at trial wherein it was held that, despite an imperfect process of review, the decisions had been made in good faith, having taken independent advice and having given due consideration to the options. The Chancellor determined that "the director defendants did not breach their fiduciary duties or commit waste."[53]

In approving the trial judgment, the Supreme Court[54] drew a clear line between the failure to exercise due care as measured by a gross negligence standard, and the failure to act in good faith. However, the court noted that there is still room for a finding of bad faith in rare cases involving intentionally destructive acts or omissions:

> A failure to act in good faith may be shown, for instance, where the fiduciary *intentionally acts with a purpose other than that of advancing the best interests of the corporation*, where the fiduciary acts with *the intent to violate applicable positive law*, or where the fiduciary *intentionally fails to act in the face of a known duty* to act, demonstrating a conscious disregard for his duties. There may be other examples of bad

> faith yet to be proven or alleged, but these three are the most salient. [55]

In approving this analysis, the Supreme Court held at p. 72 that [t]hose articulated examples of bad faith are not new to our jurisprudence. Indeed, they echo pronouncements our courts have made throughout the decades."

A number of recent Delaware cases illustrate the operation of the Charter Option in business sale cases not involving self-interest. In *McPadden v. Sidhu*[56] the court ruled that even an allegedly reckless sale process, resulting in a grossly undervalued sale, is subject to summary dismissal in the face of an exculpatory clause. The court summarized at p. 1:

> Though what must be shown for bad faith conduct has not yet been completely defined, it is quite clearly established that gross negligence, alone, cannot constitute bad faith. Thus, a board of directors may act "badly" without acting in bad faith. This sometimes fine distinction between a breach of care (through gross negligence) and a breach of loyalty (through bad faith) is one illustrated by the actions of the board in this case.

Thus the plaintiffs' claim was dismissed summarily even though the Court concluded "that the complaint does plead particularized facts demonstrating that material and reasonably available information was not considered by the board and that such lack of consideration constituted gross negligence, irrespective of any reliance on the [independent] fairness opinion"[57]. The case might be considered extreme because the board, knowing their subsidiary's president was conflicted, allowed him to oversee the sale process. Nevertheless in the absence of self-interest the exculpatory provision was operative.

Lear Corporation Shareholder Litigation[58] was another case in which a proposed sale was attacked by plaintiffs. In *Lear* a deal was struck with the board under which the suitor would increase his offer by some $90,000,000 on the condition that the company pay him a $25,000,000 termination fee if the shareholders voted "no". After the termination fee was paid, the plaintiffs alleged that the transaction was entered into in bad faith in that it had been a virtual certainty that the offer would be rejected by shareholders. The Court once again struck the lawsuit:

> Here, it is critically important that another substantial dividing line be respected. After *Van Gorkom* met an unenthusiastic reception, the General Assembly adopted §102(b)(7), authorizing corporations to exculpate their directors from liability for violations of the duty of care. Lear's charter contains such an exculpatory charter provision.
>
> To respect this authorized policy choice made by Lear and its stockholders, this court must be vigilant in reviewing the complaint here to make sure that it pleads particularized facts pleading a non-exculpated breach of fiduciary duty. That requires the plaintiffs to plead particularized facts supporting an inference that the directors committed a breach of the fiduciary duty of loyalty. More specifically here, because the plaintiffs concede that eight of the eleven Lear directors were independent, the plaintiffs must plead facts supporting an inference that the Lear board, despite having no financial motive to injure Lear or its stockholders, acted in bad faith to approve the Revised Merger Agreement. *Such a claim cannot rest on facts that simply support the notion that the directors made an unreasonable or even grossly unreasonable judgment*. Rather, it must rest on facts that support a fair inference that the directors *consciously acted* in a manner contrary to the interests of Lear and its stockholders.

(emphasis added; original footnotes omitted)

Finally, in *Ryan v Lyndell*[59] the Supreme Court reversed a ruling that, despite a "blowout market premium", the board process of approving a merger was sufficiently troubling that the action might survive. The lower court[60] had pointed to a number of factors, including the lack of an independent valuation; the speed with which the transaction was approved; the lack of board involvement in the negotiations; and the adoption of deal protection measures tending to dissuade potential competitive bids; which all contributed to the possibility that the "Board's failure to engage in a more proactive sale process may constitute a breach of the good faith component of the duty of loyalty … and thus potentially falls outside the exculpation permitted by DGCL Section 102(b)(7)."

However the Supreme Court disagreed:

> …the record establishes that the directors were disinterested and independent; that they were generally aware of the company's value and its prospects; and that they considered the offer, under the time constraints imposed by the buyer, with the assistance of financial and legal advisors. At most, this record creates a triable issue of fact on the question of whether the directors exercised due care. There is no evidence, however, from which to infer that the directors knowingly ignored their responsibilities, thereby breaching their duty of loyalty. Accordingly, the directors are entitled to the entry of summary judgment.[61]

The Delaware decisions demonstrate how well the business judgment rule can live side-by-side with the Charter Option. Whether the duty of due care and attention emerges from fiduciary obligations (as in the U.S.) or from independent codified common law principles (as in Canada); and whether the test for breach of that duty is "gross negligence" (as in the U.S.) or a failure to exercise an "appropriate degree of prudence and diligence" (as in Canada) there is nevertheless in both countries a space in which the Charter Option, if invoked, can operate to exculpate or limit personal liability of directors acting imprudently but in good faith.

Conclusion

Corporations in Canada should have the right, through their charter, to eliminate or restrict the personal liability of directors for monetary damages arising from a failure in the exercise of the duty to exercise "care, diligence and skill". Implementation of the Charter Option in appropriate cases will serve both to attract competent directors and to discourage them from being risk averse when making decisions in the best interests of the corporation.

The language of our amendment should reflect the Canadian separation between the director's fiduciary duty and the duty of care, diligence and skill.

This measure would not, and should not, restrict shareholder rights and remedies in cases of bad faith, self-dealing or other statutory breaches.

Schedule "A"

Section 102(b)(7) of the Delaware General Corporation Law, Title 8, ch. 1

102…

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this

section, the certificate of incorporation may also contain any or all of the following matters…

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

End Notes

1 I gratefully acknowledge the assistance of my associate Gareth Carline in the organization and flow of this article.
2 E. Norman Veasey with Christine T. DiGuglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A retrospective on some key developments* (2005) 153 Univ. of Pennsylvania Law Review 1399 at 1425, online at http://www.weil.com/files/Publication/9389a586-7d86-41df-afe2-fae3dc511661/Presentation/PublicationAttachment/ce013f5b-a292-4ebc-9432-c045b49512e2/VeaseyArticle1.pdf
3 Section 102(b)(7) of the Delaware General Corporation Law ("DGCL") is reproduced in Schedule "A" to this paper.
4 D. Block, N. Barton and S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, 4th ed. (Englewood Cliffs, New Jersey: Prentice Hall, 1993) at 1099
5 *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985) (holding directors to be personally liable after the transaction in question was completed, and establishing gross negligence as the test at 873, following *dicta* in *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). The 2nd circuit however opted for a broader test in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264,273-76 (2d Cir. 1986), discussed *infra* under "Risk-Taking and the Business Judgment Rule"
6 Corporate Law Policy Directorate, Industry Canada, *Discussion Paper on Directors Liability, Canada Business Corporations Act* (Ottawa:, Industry Canada, Nov. 1995), online: http://dsp-psd.pwgsc.gc.ca/Collection/C2-280-7-1995E.pdf
7 Each Canadian jurisdiction has prescribed defences applicable to specific statutory causes of action. In British Columbia's *Business Corporations Act*, S.B.C. 2002, c. 57 ("BCBCA") a statutory defence pursuant to s. 140(1), to a director's "exercise [of] care, diligence and skill that a reasonably prudent individual would exercise in comparable circumstances"., Though a step in the right direction, the defence, contained in s. 157(1) of the B.C. Act, requires the director to establish specific reliance on specified documents or representations and it is therefore questionable whether it would operate to exculpate a director beyond cases where the business judgment rule, discussed *infra*, is otherwise applicable. Saskatchewan and New Brunswick have similar though narrower defences against breach of that duty: Business Corporations Act, R.S.S. 1978, c. B-10, s. 117(4); Business Corporations Act, S.N.B. 1981, c. B-9.1, s. 80(3) . In other Canadian jursidictions, the defence is not available at all in respect of the duty of care, see eg s. 135(4) of the Ontario *Act*, R.S.O. 1990, ch. B.16 (OBCA) which applies only to the duties listed in s. 134(2), and the specific no-exculpation provision contained in CBCA s. 122(3)
9 2004 SCC 68, [2004] 3 S.C.R. 461
10 2008 SCC 69, [2008] 3 S.C.R. 560
11 488 A.2d 858, 872 (Del. 1985)
12 781 F.2d 264 (2d Cir. 1986)
13 *Ibid*, at para. 33
14 *Peoples, supra*, note 9, at para. 67
15 473 A.2d 805 (Del. 1984)
16 *Ibid*¸ at 812
17 781 F.2d 264 (2d Cir. 1986)
18 *Ibid*, at 273-76
19 825 A.2d 275 (Del. Ch. 2003) at 289-290.

20 (1998), 42 O.R. (3d) 177
21 *Ibid*, per Weiler J.A. at 192
22 R. Dickerson, J. Howard and L. Getz, *Proposals for a New Business Corporations Law for Canada* (Ottawa: Information Canada, 1971)
23 *Ibid*., vol. 1, at 83, para. 242.
24 *Peoples, supra*, note 9, at para. 61. English law developed in *Re City Equitable Fire Insurance* [1925] 1 Ch. 407 (C.A.) and other cases, eschewed the concept of 'gross negligence' in favour of three propositions, at 428:
(1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.
(2) A director is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed.
(3) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.
25 This approach would limit the damages that may be assessed against a director in a suit by or in the right of the corporation or by the shareholders directly to the greater of a specified sum or the amount of cash compensation received by the directors from the corporation during the preceding year.
26 Under this approach, a director would not be personally liable for monetary damages to the corporation or any other person except in defined circumstances. The corporation would not be able to prescribe the applicable circumstances nor what monetary limits, if any, might apply.
27 The most prevalent instances of oppression and unfair prejudice were considered by the Supreme Court of Canada in *BCE, supra*, note 10, at paras 91-94.
28 See, for example, Part XXIII.1 of the *Securities Act*, R.S.O. 1990, c. S.5*; An Act To Amend The Securities Act (Quebec) And Other Legislative Provisions* (S.Q. 2007, C. 15); Part 16.1 of the *Securities Act*, RSBC 1996, c. 418; Part 17.01 of the *Securities Act* (Alberta) R.S.A. 2000, c. S-4
29 Veasey, *supra*, note 2, at 1433
30 *Ibid*, at 1399
31 *In re J.P. Stevens & Co. Stockholders Litigation*, 542 A.2d 770 (Del. Ch. 1988)
32 *Ibid*, at 780
33 Veasey, *supra*, note 2, at 1422
34 (1998), 23 C.B.R. (4th) 200, 1998 CarswellQue 3442 at paras 144-6. The reference therein was to *Re City Equitable Fire Insurance, supra, note 24*. Note that the judgment of Greenberg J. was later reversed by the Quebec Court of Appeal and the Supreme Court of Canada, without any disagreement with this characterization.
35 *Ibid*, at paras 144-6 . The reference was to *Re City Equitable Fire Insurance, supra,* note 24.
36 *Dickerson Report, supra*, note 22, vol. 1, para. 242.
37 *Re BCE, supra*, note 10, at para. 13
38 Veasey, *supra*, note 2, at 1443
39 2d Ed. (New York: Oxford University Press, 2007)
40 *Maple Leaf Foods, supra*, note 20, at 192, as applied in *Peoples, supra*, note 9, at para. 65
41 Western Economic Diversification Canada, *Small Business Employment Profile* (Ottawa: Western Economic Development Canada, 2005), online: http://www.wd.gc.ca/eng/8216.asp
42 *Supra*, note 22, vol. 1, at 83
43 Veasey, *supra*, note 2, at 1399.
44 S.C. of Del, No. 411 (Del. 2005)
45 DGCL s. 145(a) and (b)
46 *Ibid*, at 68.
47 R.S.O. 1990, ch. B.16
48 CBCA s. 124; BCBCA ss. 162-3; *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 124.
49 *In re J.P. Stevens & Co. Stockholders Litigation*., 542 A.2d 770, 780 (Del. Ch. 1988)
50 C.A. No. 2392 (Del. 2009)
51 *Ibid*, at 32
52 *In re The Walt Disney Co. Deriv. Litig*., 825 A.2d 275, 289 (Del. Ch. 2003)
53 *In re The Walt Disney Company Derivative Litig.*, 2005 WL 20566651, at 1 (Del. Ch. Aug. 2005)
54 *In re The Walt Disney Co. Deriv. Litig*., C.A. No. 15452 (Del. S.C. June 8, 2006)
55 *Ibid*, extract from Chancery judgment cited with approval by Supreme Court at 71
56 No. 3310 (Del. Chancery, Aug. 29, 2008)
57 *Ibid*, at 18
58 No. 2728-VCS (Del. Chancery, Sep. 2, 2008)
59 No. 3176 (Del. S.C., Mar. 25, 2009 supplemented Apr. 16, 2009)
60 No. 3176-VCN (Del. Chancery, July 29, 2008)