# DIRECTORS OF OWNER MANAGED COMPANIES: MANAGING THEIR ROLE, DUTIES AND LIABILITIES

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**The subject of directors' roles, duties and liabilities has been thoroughly canvassed in a number of books and journals.[1] Much of that material is aimed at directors of public companies or not-for-profit organizations. The purpose of this article is to briefly overview some issues of concern to directors of owner managed companies, and to give some practical suggestions on how they can manage their role, duties and liabilities.[2]**

## Introduction

The potential liabilities in being a director of a company are well recognized now, and regarded with a great deal of concern. In addition, most owner managers are reluctant to have a true board of directors, for a variety of reasons. As a result, most owner managed companies do not have a formal board of directors. Advisory boards are far more common, if any kind of board is involved at all.[3]

On the other hand, some owner managed companies do have a formal board of directors, especially if there are third party investors or succession planning issues to be dealt with. When that happens, there are a number of things which board members should consider, whether they are company insiders, professional advisors or true independent directors.

## The Role of the Board in an Owner Managed Company: Some Unique Concerns

In any organization, the role of the board comes down to a few major initiatives:

- Providing strategic guidance to the organization; making sure it has a strategic direction which is consistent with the opportunities and challenges facing the organization, and the needs of its stakeholders; doing its best to ensure that this strategic direction is well known in the organization, and that decision-making reflects that strategic direction.

- Making sure the organization has competent, trained, committed and appropriately compensated senior management, including hiring and firing the CEO; and supporting and overseeing the CEO's decisions in hiring, developing and sometimes firing senior management.

- Ensuring the company follows sound financial practises and policies, including selecting the organization's auditors and having a channel of communication where the auditor's assessment of senior management and their financial abilities and systems can be monitored without management's involvement; and ensuring that financial reporting is fair, accurate and complete, including approving the organization's annual financial statements.

- Ensuring the needs and interests of all stakeholders in the organization are kept in mind, and that no particular group's needs and interests holds too much sway – including shareholders, employees, customers, suppliers and the community at large.

- Ensuring the organization is complying with its legal obligations, including government reporting.

- Casting an ethical shadow over the organization, and being active in setting the organization's culture from an ethical, charitable and financial management perspective.

- Recommending additions to the board or replacements for departing directors.

- Holding senior management, and the whole organization, accountable for all of the above.

The very nature of owner managed companies provides some interesting challenges in fulfilling these roles:

- The owner manager may be a close friend, client or even your employer. In those circumstances, speaking your mind or holding him or her accountable can present risks that directors of public companies do not need to consider.

- Owner managers by nature are independent minded and do not like to feel controlled. Few successful business people enjoy being challenged, which is often an even bigger issue for owner managers.

- Many owner managers see no difference between their personal money and the company's money, and do not want to be or do not feel the need to be held accountable on company financial matters.

- Most owner managers are good at one or two things, but are less than excellent on at least one key component in their business – either sales, finance, administration, service or product fulfillment, or leadership generally. This can be compounded by a similar lack of excellence in their management team, especially for smaller owner managed companies who can not yet afford expensive talent in all areas, or by the owner manager's inability to recognize or admit his or her deficiencies.

- Many owner managed companies are using a formal board because of the involvement of third party investors. Issues of owner manager autonomy and accountability, and the real possibility of conflicting agendas between a small number of key shareholders, can make for an interesting mix of politics and business, especially as you may have been appointed to protect the interests and follow the lead of one particular stakeholder.

Therefore, in taking on the role of a board member for an owner managed business, there are some things you can do before accepting the post, and from time to time as necessary while serving on the board:

- Be very clear on why the company has a formal board of directors at all.
- Understand the goals and objectives of the owner manager and any key third party shareholders with seats on the board.
- Be very clear on why you in particular are on the board, who appointed you, and what role you are expected you to play.
- Review the generic roles outlined above with the person who appointed you, and understand their priorities or thoughts on each one.
- If you were not appointed by the owner manager, try to determine his or her thoughts on those priorities as well.
- Get a commitment from the owner manager and all other stakeholders on the board that you will not be penalized for speaking your mind, insisting on professional procedures, holding people accountable, or resigning from the board if you ever get to feel uncomfortable or that you are not contributing.
- Provide your assurance to the person who appointed you that you will remove yourself without any resistance or difficulty from the board at any time if it is determined that you are more of a liability than an asset, or if the opportunity to replace you with someone better comes along.

## Director Duties Generally

No matter what kind of organization you are involved in, your general duties as a director can be summarized as follows:

> *Every director and officer of a corporation in exercising his or her powers and discharging his or her 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]

There are numerous other statutory duties that can apply, including:

- Complying with the enabling legislation, the company articles and by-laws, and any unanimous shareholders' agreement;

- Avoiding conflicts of interest; and

- Declaring you personal interest in matters before the board.

You will also hear of "fiduciary duties" from time to time. These are similar to the duties described above, but are imposed by the courts as a matter of common law as opposed to a matter of statute.

A detailed discussion of these duties is beyond the scope of this article. However, you must keep in mind that all directors are bound by these duties, including the owner manager.

Professional advice should be obtained if there is any doubt about whether an individual director, group of directors or the board as a whole are fulfilling these duties.

## Director Liabilities Generally

The list of potential director liabilities is extensive, and is beyond the scope of this article.[5] However, the main liabilities you need to be concerned about in most owner manager company situations can be summarized this way:

- Employees – you can become personally liable for any monies owing to employees of the company; however, as long as the employees are being paid (including base salary, commissions, contractual bonuses, vacation pay, termination pay, severance pay, etc.), then you should be alright.

- Government – you can become liable for any monies owing to a government or government agency, including employee source deductions (employer and employee portions of employee taxes, CPP and EI), corporate taxes, GST, PST, WSIB premiums, etc.; however, as long as all government remittances are paid and up to date, the you should be alright.

While there are many more potential liabilities, in practise simple management of these two risks provides almost complete protection.[6]

It should be noted that the limitation periods on director liabilities tend to be very short, and that liabilities are only incurred during the period of time you are a director. Therefore, seek professional advice when you are concerned about potential liabilities, and resign earlier rather than later if the concerns are legitimate, substantial or intensifying.

## Managing Your Duties and Liabilities

Complying with your duties and avoiding personal liability need not be a complicated exercise.

The duty of good faith should not be hard to satisfy – it is just the basic honesty, integrity and fair dealing which all people of good character should share.

The duty of care and due diligence is also based upon an achievable standard, that of *a reasonably prudent person in comparable circumstances*. Nothing superhuman or extraordinary is required.

Also, many statutes contain a "due diligence" or similar defense, which provide that there is no liability to a director who can show that he or show met that "reasonably prudent" standard of care. The *Income Tax Act* provides, for example, that *A director is not liable ... where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.*[7]

Some practical suggestions for ensuring you are complying with your duties and avoiding personal liability, in no particular order, include:

- Due reasonable due diligence on the company before accepting the appointment, including seeing financial statements, reference checking the owner manager, reference checking with other current and past board members, and reference checking with professional advisors, bankers, lenders and investors.

- Review the role of the board, and your role on the board, with the owner manager and the stakeholder who appoints you (see notes above on the role of directors in owner manager companies).

- Insist that the board meet regularly, and often enough to give you confidence that you are current on the company's affairs and fulfilling your obligation to oversee the owner manager and senior management.

- Attend board meetings when they are scheduled, and participate. Absentee board members significantly increase their risk of exposure.

- Ask that agendas and background material be circulated prior to the board meeting, and take the time to read it before hand.

- Ask that current financial statements be part of every board meeting, compared to last year's actuals and this year's budget wherever possible, with variances explained in the notes or at the meeting.

- If necessary, ask the board to invite senior management or outside advisors (accountants, lawyers, consultants, etc.) to participate in all or part of a board meeting, as required.

- Satisfy yourself that government remittance funds are segregated and managed as appropriate.

- Ask for and obtain assurances from the owner manager and senior management on a regular basis that all government remittances are being made. If appropriate, ask that a Compliance Certificate be provided (see sample on my website – www.philthompson.com).

- If minutes are kept, have them circulated, amended and approved as appropriate. Consider keeping your own minutes of important matters

- Keep a file on all board materials during your tenure, and for at least three years after you cease to be a director.

- Be familiar with how the company works and operates. Ask about its major policies and procedures, and push for changes if they are not adequate.

- Make sure you know and are known to senior management and the other directors. Maintain lines of communication around the owner manager and the management team, as appropriate. Know how to reach them.

- Make sure the company has adequate professional advisors, and uses them. Make sure you have contact information for them as well.

- If the company has audited financial statements, ask that a proper audit committee be set up and that the auditors meet with audit committee members independently of the owner manager and management team following each year end. Ask that the management letter be circulated to all board members.

- If the company comes into hard times, make sure all reasonable efforts are being made to ensure the company is appropriately financed, and that appropriate professional advisors are being retained (e.g. turnaround specialists etc.) at the right time.

- Ask about director's liability insurance. Have the company purchase and maintain such a policy if appropriate, and make sure you have full particulars in your file.

- Ask about the usual indemnity for directors in the company's by-laws, and obtain a copy for your files.

- Be proactive. Be as focused on prevention of difficulties as you are in dealing with them after they occur.

As mentioned earlier, many of these initiatives could conflict with the owner manager's sense of autonomy and control. However, compliance with these initiatives can bring a whole new dimension of professionalism and accountability to an owner managed enterprise, which is the most essential reason for an owner managed business to have a formal board of directors at all.

## Director's Fees and Owner Managed Companies

In my experience director's fees in owner managed companies range anywhere from nothing to a few thousands of dollars per meeting, depending mostly on the size of the enterprise, the relationship between the owner manager and his or directors, and the value of the director in question to the company and its future.

In most cases, the owner manager, senior management and investor appointed representatives are not paid director fees by the company.

However, since we never seem to value what we do not pay for, and since we tend to take our commitments more seriously if we are being paid to do a job, I always recommend that an appropriate director's fee be paid to directors who are not already on the company payroll or the payroll of the third party investors.

On the other hand, I rarely find that stock options are appropriate compensation for directors of owner managed companies. For private company options, the lack of liquidity makes their value questionable, unless an IPO is in the near future. Other issues around shareholder agreements, non-competition and similar formalities can make private company options a headache to implement and maintain. Finally, directors looking for a "stock play" may not bring the kind of philosophy that is most useful to an owner managed business.

## Some Closing Thoughts

Sitting on the board of an owner managed enterprise can be fun and exciting, and a great learning experience. But it can also be a challenge, especially due to the unique characteristics of many owner managed businesses – small, limited financial and other resources – and the nature of many owner managers themselves – independent minded, control oriented, not used to being held accountable.

However, it is because of these unique characteristics that a formal board of directors can be an essential and very productive step in the development of a company, its management team, and its owner manager. While the transition from an entrepreneurial owner operator to a business leader of an enterprise with real substance can represent the greatest potential risk to an already successful owner manager, making that transition should provide equally great rewards.[8] It is in making this transition that a well founded, well structured and enthusiastic board of directors can be a highly effective, low cost asset to an ambitious owner manager.

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[1] Consider, for example: Priest, Margot et al, *Directors' Duties in Canada: Managing Risk – 2 nd Edition, 2002*, CCH Canadian Limited (2002).
[2] This article focuses on private Ontario companies, and the law current as of February, 2003.
[3] See the following article on my website – www.thompsonlaw.ca - *Holding Yourself Accountable: Effective Advisory Boards for Owner Managed Business (2001).*
[4] Ontario *Business Corporations Act*, s.134(1), RSO 1990, as amended, as at March, 2003.

[5] See Priest, Margot et al, *Directors' Duties in Canada: Managing Risk – 2 nd Edition, 2002*, CCH Canadian Limited (2002), pages 168 to 186 for a list of 76 different statutory liabilities listed as of the time of that edition.

[6] Environmental liabilities are a third significant category to be concerned about, at least on a theoretical level. While the likelihood of exposure is low, the losses can range from insignificant to catastrophic. You should immediately seek professional assistance from an environmental law expert if you have any concerns about environmental risks associated with any company you are associated with.

[7] s.227.1(1) *Income Tax Act*, RSC as amended.

[8] See the following articles on my website – www.thompsonlaw.ca - *Successful Entrepreneurs Beyond Startup: Achieving Growth and Longevity (2000), Entrepreneurial CEO's: The Top Three Skills You Need To Learn And Maintain (1997).*