

Litigation Bulletin

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Reasonable but not perfect: The Standard for Directors

Directors and senior officers may be held personally liable for bad decisions, even when honestly made, now that the Business Judgment Rule has been found an insufficient defence in two cases. While the Court of Appeal reversed the lower court decision both times, directors are well advised to ensure they analyze and understand issues before them, retain independent advisors, test and challenge their advisors, and ensure the amount of time spent on the issue is proportionate to its importance and complexity.

The Business Judgment Rule

Directors and senior officers have traditionally been protected against hindsight and second guessing by shareholders and other stakeholders, thanks to the Business Judgment Rule. The Business Judgment Rule provides that the courts will defer to the business expertise of the directors and will not interfere with reasonable business decisions.

That was the state of the law in Canada, at least until the trial decisions in the Quebec case *Peoples Department Stores Inc. (Trustee of) v. Wise*, and the Ontario case *Kerr v. Danier Leather*. At trial, both cases appeared to dispense with the traditional deference shown by courts to directors' business decisions, and imposed significant damage awards against directors and senior officers when decisions honestly made had bad outcomes.

The Peoples Case: A Change in Policy That Caused a Bankruptcy is Later Challenged

In the *Peoples* case, three brothers who were the majority directors of both Peoples Department Stores Inc. and Wise Stores Inc., related entities, were sued by the Trustee in Bankruptcy of Peoples. The suit arose from a decision made by the three directors to change the inventory procurement policy for both companies. The trial judge found the change policy had caused the bankruptcy. He rejected the defences raised by the directors that their decision was protected under the Business Judgment Rule and found them personally liable for \$4.4 million in damages.

This finding was reversed by the Quebec Court of Appeal and this reversal was upheld by the Supreme Court of Canada. Although the Supreme Court of Canada applied the Business Judgment Rule, the Court made it clear that courts will closely examine the business decision and the circumstances or context of the decision, to determine if the business decision was reasonable.

The "Process Approach"

This is referred to as the "process approach" which recognizes that it is impossible to assess whether a decision is reasonable based solely on the outcome. It is necessary to analyze the process used to make the decision to determine whether the decision was reasonably made.

The Kerr v. Danier Leather Case: Statutory Misrepresentation Charged After Sales Do Not Meet Forecast

The December, 2005 Ontario Court of Appeal decision in *Kerr v. Danier Leather Inc.* was a good example of the shift toward a process approach, signaling a more aggressive review of the process used to make business decisions, yet recognizing the limits on a court's ability to second guess the business judgment of directors and officers.

This case involved alleged breaches of the Ontario Securities Act. The case involved an IPO made by Danier in 1998. The prospectus given to potential investors contained a forecast of Danier's projected revenue and earnings for the last quarter of its fiscal year. An internal analysis, prepared a few days before the offering closed, showed that Danier's fourth quarter revenue and earnings were lagging behind projections. However, on the date of the closing, Danier's senior management still believed Danier could achieve the forecasted results because of a planned Victoria Day sale which was scheduled to begin after the initial offering closed.

Unfortunately, Danier did not meet its forecast and Danier's CEO concluded that the low sales would continue due to unseasonably hot weather. Danier filed a revised forecast with the OSC which caused a significant but temporary decline in its share price. The weather cooled and leather sales heated up. Danier substantially achieved its original forecast. Nonetheless, a class action by unhappy shareholders was commenced for prospectus misrepresentation under the *Ontario Securities Act*. Danier and two of its inside directors and senior officers were found liable and the unhappy shareholders were awarded damages based on the temporary drop in the share price, although the shares had shortly thereafter regained their value.

The Ontario Court of Appeal reversed the trial decision, reviewed the process that led to the decision to go public with the revised numbers and chastised the trial judge for among other things, not applying the Business Judgment Rule.

Considerations for Judges

Thus, while judges can now be expected to be reluctant to second guess business decisions, they will examine whether the directors

exercised the appropriate degree of prudence and diligence in the process they applied in reaching the business decision.

Some Questions Directors Should Be Prepared to Answer

At a time when directors and officers of Canadian companies are increasingly concerned about personal liability, the strong appellant Court endorsement of the basic elements of the Business Judgment Rule in *Peoples Department Stores Inc. (Trustee of) v. Wise and Kerr v. Danier Leather Inc.* does provide some level of comfort. However, directors should be prepared to answer questions such as:

1. Did the directors analyze and understand the issue before them?
2. Did the directors retain independent advisors or advisors recommended by management? Did the advisors have the requisite

expertise and experience?

3. Did the directors test and challenge their advisors, or merely follow recommendations without question?
4. Was the amount of time the directors spent on the issue proportionate to its importance and complexity?
5. Did the directors debate the issue amongst themselves and engage in a candid exchange of views?
6. Were the directors actually present?
7. Were the discussions and decision properly minuted?

Keeping these points in mind will help lay the groundwork to 'evidence' a proper exercise of business judgment, in the event you are called on to justify a decision, and it may help you avoid the dreaded lawsuit.

Pallett Valo LLP Commercial Litigation Law Group

Our firm has the largest Litigation Department in Peel Region. We have the depth and expertise to provide legal advice and representation in complex litigation matters. Collectively, we apply a business approach to commercial disputes recognizing the benefits of litigation avoidance and early extraction strategies.

Our advice is designed to minimize and avoid risks through the use of negotiation and alternative dispute resolution mechanisms to resolve commercial disputes with a minimum of business interruption to our clients. However, there are times when our clients' interests are best served by knowledgeable and strategic advice coupled with decisive and aggressive action in the Courts. Our litigators have extensive trial and appellate experience and have fought numerous motions over injunctive remedies such as Mareva and Anton Piller Orders. We work closely with clients to develop and implement sound strategies geared toward achieving identifiable objectives while providing timely advice as to issues and options.

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