Lawyers on boards

assessing the risks and limiting the liability

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For business development reasons, sitting on the board of directors of a client has long been popular with lawyers. At first blush, adding a legal counsel to the board of directors appears to benefit both the corporation and the lawyer.

The corporation benefits from having the legal advice of its lawyer readily available at all board meetings, and the benefit of any extra knowledge and expertise the lawyer brings to the table.

From the lawyer's point of view, there is prestige and status in being appointed to a board, and sitting on a client's board may solidify or enhance the business relationship between the client and the lawyer's firm.

However, sitting on a client's board is not without its risks, and prudent lawyers should tread carefully. This article reviews the concerns and issues a lawyer should consider before accepting an invitation to sit on a client's board.

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Professional obligations and conflicts of interest

A good starting point is Rule 2.04(3) of the *Rules of Professional Conduct*. This Rule imposes a responsibility for all members of the profession to avoid placing themselves into positions of conflicting interest. A "conflict of interest" is broadly defined to encompass any situation where the lawyer had an interest that "would be likely to affect adversely a lawyer's judgment on behalf of, or loyalty to, a client or prospective client" or that "a lawyer might be prompted to prefer to the interests of a client or prospective client."

Clearly, providing services as both a director and a lawyer creates a potential conflict of interest. Indeed, the commentary to Rule 2.04 specifically cites an example of a lawyer taking on a directorship as performing a dual role that:

> "may raise a conflict of interest because it may affect the lawyer's independent judgment and fiduciary obligations in either or both roles, it may obscure legal advice from business and practical advice, it may invalidate the protection of lawyer and client privilege, and it has the potential of disqualifying the lawyer or the law firm from acting for the organization."

Rule 2.04(3) should be read in conjunction with Rule 6.04, which governs a lawyer's professional obligations when engaged in another occupation concurrently with the practice of law. Rule 6.04 provides that:

> "(1) A lawyer who engages in another profession, business, or occupation concurrently with the practice of law shall not allow such outside interest to jeopardize the lawyer's professional integrity, independence or competence.
>
> (2) A lawyer shall not allow involvement in an outside interest to impair the exercise of the lawyer's independent judgment on behalf of a client."

Once again, the commentary to this rule specifically cites the example of a lawyer as a director.

Directors of a corporation owe statutory and common law duties of care and fiduciary obligations to the corporation and its shareholders which require that directors must, at all times, act honestly and in good faith in the best interests of the corporation. Generally, though not always, this requires directors to act with a view to maximizing shareholder value in the corporation. These duties may also require the director to take account of broader interests, including those of the corporation's employees, creditors, suppliers, consumers, governments and the environment.

Legal counsel also have fiduciary obligations to the corporation as the client and to the legal profession generally. These professional duties include providing competent and professional legal services to the corporation, maintaining the confidentiality of information provided to the lawyer in confidence by the corporation, and maintaining a strict code of professional ethics. The lawyer's fiduciary duties are generally less broadly construed than those of the director, and involve taking into account the interests of fewer constituents.

Providing multiple services to the corporation may affect the lawyer's continuing ability to provide legal representation to the corporation. For example, where the lawyer-director participates in board meetings that give rise to future litigation, the lawyer-director may be prevented from acting as legal counsel on the future matter where he or she will be called on as a key witness. This can occur when other directors on the board seek to protect themselves by suggesting they relied on the advice of the lawyer-director in agreeing on the course of action that led to the litigation.

It is therefore critically important to recognize that professional obligations require an awareness of the conflict inherent in providing business as well as legal advice to a corporation, and that conflicts of interest can manifest themselves in many ways.

Although the accepted standards of professional ethics do not broadly prohibit lawyers from acting as both directors and legal advisors to the corporation, there is a strict ethical obligation to assess the risks of a conflict before accepting a position on a client's board.

At a bare minimum, it is incumbent on any lawyer contemplating a dual mandate, or who may be asked to sit on the board of an existing client, to consult the client and clarify the risks involved. The client needs to understand the ramifications of those conflicts, such as the possibility that the lawyer may, in future, be required to recuse himself from further acting on behalf of the client as a lawyer because his or her independent judgment has, or may be, compromised.

Statutory liabilities

Pursuant to a number of provincial and federal statutes, all directors face the potential for personal liability arising out of the failure of the corporation to meet specific obligations.

The most common (there are many more) statutory liabilities for directors include:

- up to six months' wages and 12 months accrued vacation pay which the corporation fails to pay;
- income tax withheld at source from employee wages which the corporation fails to remit;
- Ontario Health Premiums which the corporation fails to collect from employees and remit;
- employee and employer contributions to CPP that the corporation neglects to remit;
- employment insurance remittances that the corporation fails to make; and
- GST which the corporation fails to remit.

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In addition, there are statutes that create offences which impose potential criminal or quasi-criminal penalties on directors for acts of their corporation such as:

- failure to take all reasonable care to prevent the corporation from causing an unlawful discharge of pollutants; and
- failure to take all reasonable care to ensure a safe workplace.

Most of the statutes creating civil or criminal liability for directors also provide for a due diligence defence. But keep in mind, a lawyer-director may be held to a higher standard of care than a non-lawyer director.

Loss of solicitor-client privilege

One of the most serious corporate risks by virtue of the lawyer's participation on the board of directors is the possible waiver of solicitor-client privilege.

Part of the traditional rationale of having a lawyer serve as director is having a ready supply of legal advice to the board. However, the lawyer-director's advice and opinions to the board are not guaranteed blanket privilege merely because the director is also the corporation's counsel.

Solicitor-client privilege only attaches to communications where three criteria are met (*Solosky v. The Queen*, [1980] 1 S.C.R. 821):

(i) the communication is between solicitor and client;

(ii) which entails the seeking or giving of legal advice; and

(iii) which is intended to be maintained as confidential by the parties.

Meeting the burden of proof that privilege attached can be difficult where the communication arises as a part of a board meeting which dealt with multiple issues, only one of which gave rise to the lawyer-director rendering legal advice.

Added burdens of a public company lawyer-director

Directors of public companies today are expected to perform at higher levels, the result of recent spectacular financial disasters for which the boards have been justly criticized for lack of independence.

Best corporate governance practices suggested by regulators focus on the need to have effective and independent board members to provide a real check on management.

Ontario has adopted National Policy 58-201 entitled "*Corporate Governance Guidelines*" which defines as "independent" directors who have "no direct or indirect material relationship" with the corporation.

A "material relationship" means a relationship "which could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgment."

For greater certainty, the definition states that the payment to an entity that provides legal services in which the director is a partner would mean that the director was in a material relationship with the corporation and would, therefore, not be considered independent. Thus, the appointment of a lawyer whose firm has served management for years as external counsel and whose firm continues to act for the corporation would not qualify as an independent director.

One of the best practices recommended by National Instrument 58-201 is for the board to adopt a written code of business conduct and ethics that applies to all directors, officers and employees. Such policies are supposed to include "reporting of illegal or unethical behaviour." This laudable goal creates a further strain on the lawyer-director's obligation to maintain "in strict confidence all information concerning the business and affairs of the client acquired in the course of the professional relationship."

Rule 2.03 of the Rules of Professional Conduct allows for disclosure of confidential information where it is "expressly or impliedly authorized by the client or required by law to do so." Therefore, a code of conduct mandating disclosure of unethical behaviour by the lawyer-director may well require such disclosure, whereas the same lawyer likely would not have to report unethical behaviour that falls short of illegal behaviour if not also acting as a director.

Another challenge all directors of public companies face is the new secondary market liability regime introduced in Ontario at the end of 2005 arising from certain amendments to the *Securities Act* (Ontario). Under these amendments, directors can be held personally liable for misrepresentations made by the corporation in some circumstances. This is another circumstance where a lawyer-director may be held to a higher standard.

Dealing with challenges faced by the lawyer-director

Lawyers and their firms have a number of options to respond to the risks inherent in acting as both a lawyer and a director.

Law firm policies

Many larger law firms have instituted formal policies that, subject to exceptional circumstances, generally prohibit lawyers from acting as directors of either public or private companies. There are some exceptions, such serving as a director for non-profit charitable organizations because of the public service aspect and the significantly reduced risk associated with taking on such directorships.

Lawyers are also routinely allowed to act as directors with respect to personal holding companies. Most law firm policies also have increasingly rare exceptions for lawyers to serve as directors for corporations that are clients of the firm if there is a

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material benefit to the firm without significantly increasing the risk to the firm. Typically any lawyer granted permission to serve as a director would be expected to resign if continuing to serve puts the law firm in a conflict of interest or otherwise impairs its ability to serve as counsel to the corporation.

As a matter of caution and, in many cases policy, many law firms would not allow a lawyer sitting as a director to render legal advice during his or her tenure as director. Furthermore, prudent law firms will usually require written confirmation from the client that the lawyer serving as a director does so in his individual capacity and not as a representative of the firm, and that the client understands the risks associated with the lawyer sitting as director. With these limitations imposed by law firms, the potential benefits from the perspective of the corporate client of having a lawyer sit as a director are substantially reduced.

Lawyers who do assume directorships would do well to remember their own advice on solicitor-client privilege and ensure a clear record is created that clarifies when the lawyer-director is acting as a lawyer. It is particularly important in reviewing the minutes of board meetings to be alert to this issue, and to insist that the secretary accurately reflect these discussions as being privileged in the minutes. In any subsequent litigation it becomes much easier to defend a privilege claim if the board minutes record that the board's expectation was that the portion over which privilege is claimed would remain confidential and privileged.

Insurance considerations

Dual capacities also expose lawyers, and possibly their firms, to liability for conduct related to the lawyer's role as director. Lawyers serving as directors therefore should protect the interests and limit the exposure of both the lawyer-director and the law firm.

Because LawPRO's professional liability insurance policy does **not** provide coverage for liabilities arising as a result of a lawyer's actions as a director, any lawyer considering acting as director for a corporation should secure adequate liability insurance coverage to minimize risks of personal exposure to judgment.

Directors' and Officers' insurance policies (D&O policies) are the principal means of protecting directors from the risk of personal liability as a result of their corporate activities. The two types of D&O coverage available are:

(i) single policy coverage for all directors and officers of the corporation, often maintained by the corporation; and

(ii) outside director insurance policies ("ODL Policies") secured by lawyers and/or their firms.

The standard D&O policy is underwritten and issued on a group basis, and is intended to insure all of the corporation's directors and officers for the services provided to the corporation in those capacities. D&O policies generally are not written with any specific profession in mind, nor with particular regard to the particular group covered.

A corporation can indemnify a director for any liability arising out of his or her role as director, and may maintain D&O insurance for this purpose. Indemnification by the corporation is permitted provided that any civil or regulatory liability of the director arises out of actions taken honestly, in good faith and with a view to the best interests of the corporation.

Given the wide variation in D&O policy terms noted above, it is important to thoroughly investigate what kind of D&O insurance the corporation offers, if any, before taking on the role of director. In addition, it is sound practice to stipulate as a condition of directorship that the corporation provide indemnification and undertake to maintain adequate levels of D&O insurance to this end. If the corporation is unwilling or unable to provide this assurance, the lawyer may want to reconsider whether or not to join that company's board of directors.

Even if the corporation agrees to indemnification, this is not an absolute guarantee against the risks of personal exposure. If a corporation faces insolvency, the corporation may be unable to fulfill its obligations of indemnity and maintain adequate levels of insurance to protect directors, particularly if extended or "tail" coverage is not obtained. Moreover, if there is doubt about whether the lawyer was giving advice in his or her capacity as lawyer or director, the D&O policy and lawyer's professional liability policy may both deny coverage.

In addition to D&O coverage, lawyers who accept directorships may also want to consider ODL coverage, available for example from the Canadian Bar Insurance Association (CBIA). ODL policies are intended to operate as excess insurance coverage, providing defence and indemnity coverage for lawyers over and above any corporate indemnity agreements and D&O policies that exist.

The ODL policy offered by the CBIA is fairly flexible and provides three bases for coverage including: (i) individual coverage for a named lawyer; (ii) group coverage for selected lawyers who act as directors within a firm; or (iii) group coverage for all lawyers within the firm. In addition, policy limits can be adapted to the particular circumstances of a lawyer or firm and the extent of underlying insurance coverage.

Conclusion

The growing trend today is for lawyers to decline the invitation to become a director for a client corporation. The traditional view that a board seat would cement the relationship between the lawyer and the client must be re-examined in light of the potential for conflicts of interest, the ever-growing list of potential liabilities facing modern directors, and heightened expectations for good governance standards and independent directors. Acting as external counsel at a board meeting is one of the best ways to avoid potential liabilities and provide the legal advice and a direction that corporate clients expect and value.

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