A Director's Guide to
EXECUTIVE COMPENSATION

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Fiduciary Duties

What are They and Why do They Matter?

In our prior issue, we reviewed the non-competition terms frequently included in executive employment agreements and the concerns that can arise with their enforcement. Interestingly, even when executives are not subject to written non-competition agreements, they may still owe post-employment duties to their former employer that effectively prevent them from competing on the basis that they were fiduciaries while employed.

The concept of implying special duties on people in certain relationships is not new. Our legal system recognizes various relationships in which one party is required to act in the best interests of the other, such as: a parent and child, a doctor and patient, a lawyer and client, along with a fiduciary and beneficiary – the topic of this newsletter.

What are fiduciary duties?

In the employment context, an executive who is a fiduciary owes his or her employer the following duties:

- loyalty
- good faith
- to act in the best in of his or her employer
- to avoid self-interest and conflicts of duty

These duties effectively preclude fiduciaries from obtaining for themselves any business advantage belonging to their employer or for which the fiduciary has been negotiating on behalf of the employer. They may also preclude a fiduciary from soliciting the clients of their former employer.

Who is a fiduciary?

Courts often hold executives to be fiduciaries with the obligation to act in the best interest of their beneficiary, their employer. Whether an executive is a fiduciary depends on the facts in each situation. However, the following three criteria are frequently cited when assessing if an individual is a fiduciary:

1. The individual has authority to exercise discretion or power
2. The individual can unilaterally exercise that power or discretion to affect a beneficiary's legal or practical interests
3. The beneficiary is particularly vulnerable to or at the mercy of the person holding the discretionary power.[1]

In applying these criteria to key executives, it becomes evident why they are

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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From the Editor

Companies are at the mercy of those authorized to act on their behalves – be it superstar CEOs or rogue executives. Given this vulnerability, the law imposes fiduciary duties on those who act on behalf of companies. This newsletter reviews these duties and includes comments on the Quebec perspective from Stephan Scott Trudeau, formerly VP and General Counsel at ABB Inc. and now Counsel at Davis LLP, a leading full-service law firm with offices across Canada and in Japan. — *Nadine Côté LL.B.*

held so often to owe fiduciary duties to their employer. Key executives typically possess considerable discretionary power in performing their duties and make decisions that can significantly affect the companies for whom they work.

Moreover, various corporate statutes have essentially codified this duty as it applies to the directors and officers of the company. For example, the *Business Corporations Act* (Ontario) and the *Canada Business Corporations Act* require the directors and officers of the companies incorporated under those statutes when exercising their powers to act honestly and in good faith with a view to the best interests of the company.[2]

Taking corporate opportunities

The leading case on fiduciary duties in the employment and post-employment context is *Canadian Aero Service Ltd. v. O'Malley*.[3] In *CanAero*, the President and Chief Executive Officer, along with the Executive Vice President of Canadian Aero Service for several years explored the opportunity of doing topographical mapping and aerial photography in Guyana, while seeking government funding for the project. Shortly before the Canadian government awarded a contract to fund the project, the executives resigned from Canadian Aero Service, incorporated their own company and continued pursuing the contract for the benefit of their new company. Their proposal reflected their in-depth knowledge of the area, gained in the years exploring the project while working for Canadian Aero Services. They successfully obtained the $2.3 million contract for their own company, not for Canadian Aero Services.

Canadian Aero Service sued the former executives on the basis that they were fiduciaries and breached their post-employment fiduciary obligations. The Supreme Court of Canada agreed with Canadian Aero Service and held the departed executives to be fiduciaries in breach of their duties.

The Court determined the executives were members of senior management and exerted a degree of control over the affairs of their employer that demanded a higher standard of conduct than lower-level employees. The standard included a duty of loyalty, good faith and avoidance of a conflict of duty and self-interest. The Court noted several factors to be considered in assessing whether the fiduciaries breached their duties in usurping a corporate opportunity, including:

- The ripeness of the corporate opportunity
- If the fiduciary learned of the opportunity from his or her position or independent of it
- If the fiduciary devoted working time to develop the opportunity
- If the fiduciary resigned or was terminated from his or her employment
- The time that lapsed from when the fiduciary ceased working to when the opportunity came to fruition

In considering these factors, the Court noted that the executives learned

Fiduciary Duties in Quebec

By Stephan Scott Trudeau, Davis LLP

So how are fiduciary duties addressed under Quebec civil law? Pursuant to the Civil Code of Québec, the overarching principle is that parties to all contracts are required to act in good faith.[4] Furthermore, in employment contracts, employees are required to carry-out their duties with prudence and diligence, faithfully and honestly and cannot use confidential information obtained during the course of their work for their employer.[5] The Civil Code provides that these obligations continue for a reasonable time after cessation of the employment contract, and permanently when the information concerns the reputation and private life of another person. When read together, these provisions highlight the underlying element of trust that is inherent to employment contracts under Quebec law.

Generally, the degree of fiduciary duty owed by an employee varies depending on the position the employee occupies or the role he or she plays in the organization. As such, a senior executive may be in a position in which a higher fiduciary duty is owed to an employer than would, for example, a financial analyst. That said, the extent of any fiduciary duties is always fact specific and assumptions based only on titles should be avoided.

In addition to the above-noted Civil Code requirements, employers can include restrictive covenants in employment agreements, such as non-competition and non-solicitation clauses. However, the Civil Code again regulates the scope of many of these types of covenants. For example, the Civil Code requires that non-competition clauses be limited in time, geographic scope and type of employment, to whatever is necessary to protect the legitimate interests of the employer. Further, the burden of proof for demonstrating the reasonableness of the clause lies on the employer. Accordingly, it is important to draft non-competition clauses so they are not overly broad or excessive given the risk they would be unenforceable.[6]

Thanks for the contribution of Stephan Scott Trudeau, Counsel at Davis LLP, specializing in Corporate and Commercial Law, including matters related to the duties of directors and officers of corporations. Davis LLP is a leading full-service law firm providing comprehensive legal services to clients through offices across Canada and in Japan.

of and developed the corporate opportunity in Guyana over several years while working for Canadian Aero Services. The opportunity had nearly matured and they anticipated the Canadian government was going to fund the project when they resigned to pursue it on their own. Within a few months of resigning, the contract was awarded to the executives' newly formed company. The Court decided that the executives owed a duty to Canadian Aero Services not to usurp the corporate opportunity they had developed on that company's behalf over several years. The Court concluded that in resigning just before the opportunity came to fruition to pursue it on their own behaves, the executives breached the fiduciary duties they owed to Canadian Aero Service.

When fiduciary duties end

Fiduciary duties can exist during employment and continue for a reasonable period of time following its cessation. The period of time that will be reasonable depends on the facts in each case, taking into consideration whether the employment relationship was terminated by the employer, with or without cause, or whether the executive resigned.[7]

Why fiduciary duties matter

It is important that organizations and executives understand the fiduciary duties a departing executive may owe to his or her former employer. Organizations and executives sometimes wrongfully assume that if they have not entered into a non-competition or non-solicitation agreement: the executive can depart at any time, compete and usurp his or her former employer's corporate opportunities; the former employer is without recourse to halt the misconduct; and, the new employer has no liability exposure in hiring the executive and usurping the former employer's corporate opportunity. Of course, all of the assumptions may be wrong if the executive who departed is held to be a fiduciary.

An executive that owes fiduciary duties to his or her former employer may be restricted in his or her abilities to carry-out the duties for which he or she was hired. If the fiduciary fails to comply with his or her duties, the following claims may be brought by the former employer:

- A claim against the departed executive for breach of fiduciary duty
- A claim against the new employer for inducing the breach of the fiduciary duty
- A claim against the departed executive and the new employer for wrongfully interfering with the former employer's economic interests

A departed executive who is held to have breached his or her fiduciary duties may be liable for damages. Damages may be assessed as the profit made by the departing executive and his or her new employer in connection with the corporate opportunity usurped from the former employer. Additional damages may be claimed if the former employer can show it suffered damages greater than the fiduciary's gain.

Practical considerations

With the foregoing in mind, companies should be careful in recruiting executives to gain insight into a project they were working on for their former employer. Conversely, executives should be careful about pursuing opportunities that may be seen to conflict with the duties they owe their current or former employer. Executives seeking to pursue such opportunities should first inform their employer, obtain written consent and consider if a board resolution or shareholder approval are necessary.

Securities updates

CSA's 2009 Enforcement Report

The Canadian Securities Administrator (CSA) released its 2009 Enforcement Report. There were 141 cases completed, up from 123 in 2008, which involved 160 individuals and 103 companies, down from 193 individuals and 129 companies in 2008. The following statistics are noteworthy:

- Illegal insider trading resulted in approximately $1.8 million in fines and penalties, $1.7 million in restitution and disgorgement and $350,000 in costs
- Disclosure violations resulted in approximately $14.4 million in fines and penalties, $68.1 million in restitution and disgorgement, which arose from the Research In Motion Ltd. settlement, along with $3 million in costs;
- Court proceedings resulted in jail terms for four individuals ranging from 30 days to 30 months[8]

CSA's new insider reporting regime

This updates our February 2009 issue, which noted that in December 2008, the CSA released for comment the proposed National Instrument 55-104 *Insider Reporting Requirements and Exemptions* and its Companion Policy 55-104CP. Following the comment period, in January 2010, the CSA introduced a new insider reporting regime effective April 30, 2010.

National Instrument 55-104 *Insider Reporting Requirements* and its Companion Policy (collectively, the "New Regime") harmonize the insider reporting requirements and exemptions in one national instrument across Canadian jurisdictions, except Ontario where the *Securities Act* continues to apply, with some amendments.[9] Consequent with the introduction of the New Regime is the repealing of National Instrument 55-101 *Insider Reporting Exemptions* and its Companion Policy and Multilateral Instrument 55-103 *Insider Reporting for Certain Derivative Transactions (Equity Monetization)* and its Companion Policy and other related amendments. Key changes that are part of the New Regime include:

- Reducing the number of people required to file insider reports with the introduction of a subclass of insiders called "reporting insiders"
- Accelerating the filing deadline for insider reports from 10 days to 5 days effective October 31, 2010
- Simplifying the reporting requirements for security-based compensation arrangements
- Permitting issuers to file an "issuer grant report", which may allow reporting insiders to file their reports on a deferred basis.

1 *Frame v. Smith* (1987), 42 D.L.R. (4th) 81 (S.C.C.) at 99.

2 *Business Corporations Act* (Ontario), R.S.O. 1990, c. B.16, s. 134(1); *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 122(1).

3 *Canadian Aero Service Ltd. v. O'Malley* (1974), 40 D.L.R. (3d) 371 (S.C.C.) [*CanAero*].

4 Civil Code of Québec, S.Q. 1991, c. 64 [Civil Code] at articles 6 and 1375.

5 Civil Code, article 2088.

6 Civil Code, article 2089.

7 *Edac Inc. v. Tullo* (1999), 47 C.C.E.L. (2d) 264 (Ont. S.J.) at 278.

8 CSA, 2009 Enforcement Report, online: www.securities-administrators.ca/uploadedFiles/General/pdfs/CSAReportENG09[FA].pdf.

9 National Instrument 55-104 – *Insider Reporting Requirements* (2010) 33 O.S.C.B. 645 and Companion Policy 55-104CP *Insider Reporting Requirements and Exemptions* (2910) 33 O.S.C.B. 701; *Securities Act*, R.S.O. 1990 c. S5 as am.