

Goodmans^{LLP} Update

The Legal Status of Board Observers in Canada

As part of an equity investment or financing transaction, investors often seek the right to appoint a board observer in addition to or in place of receiving an actual seat on a company's board. These arrangements provide an investor with advance notice relating to the company and allow the investor a better opportunity to monitor the investment and keep up-to-date with matters affecting the company's business.

A recent U.S. federal appellate court decision considering the potential liability of board observers under applicable U.S. securities legislation highlights some uncertainty south of the border regarding the potential liability for these observers. In Canada, similar uncertainty exists given the lack of consideration of the issue by Canadian courts. With that in mind, it is important that investors and their observer nominees understand the risks presented by this role, and take reasonable steps to protect against them.

Obasi Investment Ltd. v. Tibet Pharmaceuticals Inc.

In *Obasi Investment Ltd. v. Tibet Pharmaceuticals Inc.*,¹ the U.S. Third Circuit Court of Appeals (the "Court") concluded that board observers were not subject to liability under section 11 of the *U.S. Securities Act of 1933* for misrepresentations concerning a company's financial condition in its initial public offering registration statement (referred to as a prospectus in Canada). Section 11 imposes liability on those "named in [a] registration statement as being or about to become a director, [or] person performing similar functions".

The central question in the case was whether the board observers possessed at least some of the core powers and responsibilities that define corporate directorship such that they performed functions similar to an actual director. On the facts of this particular case, the Court concluded that the two observers were not persons "performing similar functions" to directors, for three main reasons:

1. The board observers did not have the right to vote for board action;
2. They did not owe a duty of loyalty to the company; and
3. Their tenures were set to end automatically on a specified date, so the shareholders would have no opportunity to vote them out.

While the decision in *Tibet Pharmaceuticals* provides an example of a court's reasoning in determining whether board observers are subject to liability under the U.S. *Securities Act*, it does not provide a complete answer to questions concerning their legal status in the U.S. The answer to this problem in Canada is even less clear given the absence of meaningful judicial consideration.

The State of the Law in Canada

There is no statutory authority in Canada that addresses the liability of board observers and to date there is no reported case that considers the issue in any context. However, decisions from the Ontario Securities Commission and the Tax Court of Canada suggest that a person may be subject to the same liabilities as those of a properly elected director where the person performs functions similar to those of a director. While these cases did not involve board observers, their reasoning is nonetheless instructive when considering observer arrangements.

¹ 931 F. 3d 179.

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Directors and “De Facto” Directors

Section 1(1) of the Ontario *Securities Act* (“OSA”) defines “director” as “a director of a company or an individual performing a similar function or occupying a similar position for any person”. Similarly, section 2(1) of the *Canada Business Corporations Act* (“CBCA”) defines “director” as “a person occupying the position of director by whatever named called”. Both of these definitions are expansive, and intended to catch all individuals who are acting as the “directing mind” of a company. These provisions aim to prevent persons who exercise the powers of a director from avoiding liability by arranging for others to be named under the formal position while maintaining effective control over the company’s affairs.²

In analyzing cases involving the application of these definitions, Canadian securities regulators and courts have developed the concept of *de facto* directors. A person is a *de facto* director if, under the particular circumstances, the person is an integral part of the mind and management of the company, taking into consideration the entirety of the alleged director’s involvement within the context of the business activities at issue.³ Where a person is found to be a *de facto* director, they could be subject to the same liabilities as an elected director.⁴

If a person takes part in some or all of the following activities, among other things, the person may be considered a *de facto* director (depending on all of the relevant circumstances):⁵

- Taking responsibility for the supervision, direction, control and operation of the company;
- Actively managing key aspects of the company’s business;
- Taking an active role in board meetings, including preparing agendas, moving motions, and providing direction to the board or management;
- Voting on or signing board resolutions;
- Instructing professional advisors (such as law firms, accounting firms or financial advisors) on the company’s behalf;
- Preparing and authorizing the content of corporate documents, including promotional materials such as brochures or press releases;
- Negotiating on the company’s behalf;
- Having financial and trading authorization over the company’s accounts; and
- Arranging a public offering.

If a board observer is found to be a *de facto* director, that observer may be subject to liability as a director, including under securities⁶ and tax legislation.⁷ Further, this reasoning could be extended to subject board observers to the fiduciary duty and duty of care owed under section 122 of the CBCA, as courts have emphasized that persons who exercise the powers of a director should not be allowed to avoid liability simply

² *Momentas Corp., Re*, 2006 ONSEC 15 at para 99; see also *Wheeliker v. R.*, [1999] 172 D.L.R. (4th) 708 (Fed. Ct. App.) at paras. 16-20, leave to appeal ref’d [1999] S.C.C.A. No. 260.

³ *Momentas Corp., Re*, 2006 ONSEC 15 at para. 101; see also *McDonald v. R.*, 2014 TCC 315 at paras. 23-26 and *Bremner v. R.*, 2007 TCC 509 at paras. 17-19.

⁴ *Momentas Corp., Re*, 2006 ONSEC 15 at paras. 114-199; see also *Winick, Re*, 2013 CarswellOnt 11071 at paras. 119-120 (Ont. Sec. Comm.), *Wheeliker v. R.*, [1999] 172 D.L.R. (4th) 708 (Fed. Ct. App.) at paras. 16-20, leave to appeal ref’d [1999] S.C.C.A. No. 260, and *Bremner v. R.*, 2007 TCC 509 at paras. 19-20.

⁵ *Momentas Corp., Re*, 2006 ONSEC 15 at para. 102; see also *World Stock Exchange, Re*, (2000) 9 A.S.C.S. 658 at 18 (Alta. Sec. Comm.) and *Winick, Re*, 2013 CarswellOnt 11071 at para. 120 (Ont. Sec. Comm.).

⁶ *Securities Act*, R.S.O. 1990, c. S. 5, ss. 122 and 129.2; see *Winick, Re*, 2013 CarswellOnt 11071 at paras. 162-165 (Ont. Sec. Comm.).

⁷ *Income Tax Act*, R.S.C. 1985, c. 1, s. 227.1(1); see also *Excise Tax Act*, R.S.C. 1985, c. E-15, s. 228(2), *Wheeliker v. R.*, [1999] 172 D.L.R. (4th) 708 (Fed. Ct. App.) at para. 63, leave to appeal ref’d [1999] S.C.C.A. No. 260, and *Bremner v. R.*, 2007 TCC 509 at para. 28.

because they have not been formally elected as a director.⁸

Practical Steps for Board Observers

Given the uncertainty concerning the legal status of board observers, parties who intend to engage in observer arrangements should take steps to protect themselves from potential future liability.

To minimize risk, the observer agreement should expressly define the board observer's role, function and tenure, and the observer should:

- Ensure that all actions, communications, corporate records (including board minutes) and filings reflect the person's attendance of status as a board observer, and not as a director;
- Avoid chairing or directing the conduct of board meetings, or other actions that indicate "hands-on" management of the company;
- Not vote on motions or sign resolutions; and
- Not represent to others, through oral representations or by conduct, that he or she is a director.

For further information concerning board observer arrangements, please contact any member of our [Corporate Finance and Securities Group](#) or our [Shareholder Rights and Activism Group](#).

All Updates are available at www.goodmans.ca. This Update is intended to provide general comment only and should not be relied upon as legal advice.

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⁸ *Momentas Corp., Re*, 2006 ONSEC 15 at para 99; see also *Wheeliker v. R.*, [1999] 172 D.L.R. (4th) 708 (Fed. Ct. App.) at paras. 16-20, leave to appeal ref'd [1999] S.C.C.A. No. 260.