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Directors' Duties and Governance Best Practices in Response to COVID-19

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The COVID-19 pandemic is presenting many unique challenges to directors in their efforts to strike the right balance between fulfilling their oversight responsibilities and allowing management to run the day-to-day operations. Finding this balance can be difficult for directors as the impact of the current crisis on each company and the risks to its business, financial condition and stakeholders continue to evolve and remain highly uncertain. This situation may be exacerbated by the fact that, for the past year, many market participants have emphasized the need for directors to shift their focus away from a traditional shareholder-primacy model toward the corporation's long-term best interests, having regard to a wide range of stakeholders, including customers, employees, suppliers, retirees and pensioners, creditors, shareholders and communities.

In this article, we discuss some key principles and considerations that directors and management should consider as they continue to tackle the implications of the COVID-19 pandemic on their businesses and stakeholders.

COVID-19 Doesn't Change Directors' Fiduciary Duties

The fiduciary duties of the board do not change as a result of COVID-19: Directors must act honestly and in good faith with a view to the best interests of the corporation, taking into account the interests of the various stakeholders of the corporation.[1]

Decisions made by directors who devote sufficient time to making fully informed decisions (including with the benefit of advice from appropriate advisers), on a reasonable basis and without conflict, should continue to receive deference under the business judgment rule.

The board of directors is required to supervise the management of the business and affairs of the corporation. It is management, not the board, that is responsible for day-to-day operations. While the board may want more frequent updates in connection with the COVID-19 crisis, its role remains one of oversight – requiring the board to monitor the way in which the corporation's business and affairs are being managed – and not to usurp management's conduct of the business. Rather, the board should reserve to itself the ability to intervene in management's decisions and to exercise final judgment on any matter which is material to the corporation.

Specific COVID-19 Board Oversight Responsibilities and Considerations

Board risk management oversight. Consistent with the above principles, the board has responsibility for overseeing the management and mitigation of the corporation's material risks. COVID-19 presents risks of varying significance to each business – risks that will be different depending on whether their impact is primarily near term, medium term or long term. Specific risk management issues that may take on heightened significance in light of COVID-19, and on which directors may wish to receive more regular reports from management, include the following:

- **cybersecurity risks**, including the heightened risks of data breaches resulting from increased reliance on remote working arrangements and IT infrastructure, and the explosion of hackers seeking to exploit vulnerabilities;
- **capital allocation and liquidity risks** (discussed below), including risks of non-compliance with debt covenants and solvency requirements;

- the effectiveness of the corporation's **internal controls and disclosure controls** and procedures, which may be reduced by changes in practices as a result of COVID-19;
- general and entity-specific risks of COVID-19, and the effectiveness of **management's risk management or mitigation strategies** in response.

Board committees and delegations of authority. A board may delegate its authority to a board committee (or other delegates such as officers), subject to the exception that most corporate statutes require the board itself to take certain prescribed actions, including issuances of securities; declarations of dividends; purchases or redemptions of securities; and approvals of proxy circulars, financial statements and takeover bid and directors' circulars. Given the multitude of issues that boards and management are juggling, many boards are relying more heavily than usual on their committees to provide focused attention and recommendations on specific issues. **Some boards may also be considering whether to strike a special committee of independent directors in order to have a more nimble, focused subset of directors working to oversee and support management through these difficult times.** The practices and protections that may need to be put in place will depend on the circumstances; but in all cases, boards should ensure that delegated issues fall within the mandates of the applicable committees. **There will also be issues that rise to a level of materiality that they should therefore be considered by the entire board, rather than a committee, in order to facilitate the directors' fulfilment of their duties.**

Adequacy of liquidity and capital resources. Many companies are seeking ways to increase or preserve their cash positions, out of either necessity or prudence, to prepare for the uncertain impact that COVID-19 may have on businesses, their financial condition and the markets. **Increasingly, companies are drawing on their credit facilities in preparation for future cash needs, while lenders are focusing on assessing their funding obligations and their clients' creditworthiness. In addition, some companies are announcing suspensions of their dividend programs and/or halting share buy-back programs.** Companies seeking to take advantage of government programs, such as support under the *CARES Act* in the United States, should consider whether the terms of such government support preclude the payment of dividends or share buy-backs. In addition, such decisions can have repercussions for companies, including how they are perceived by the market, investors and other stakeholders – and so should not be taken lightly. There will also be corporate and securities law considerations that boards should factor into their decision-making. For example, under corporate law, if a board has already declared a dividend, that declaration has created a debt obligation by the corporation to its shareholders, which the board cannot simply reverse. In that case, absent insolvency issues, the board likely cannot decide not to pay the dividend. If a company has a regular dividend policy or program in place, even if future dividends have not yet been declared, a variety of factors will be relevant to that board's decision whether to suspend, delay or reduce future dividend payments. And these factors will go beyond simply ensuring the basic solvency test will still be satisfied if the company declares or pays the dividend. Dividend and share buy-back decisions will form part of the company's broader capital allocation and liquidity strategy, which the board will typically want to re-evaluate holistically. Any policy changes with respect to dividends, share buy-backs or other capital allocation or liquidity decisions should also take into account the issuer's disclosure record, both past and future. For example, a decision to suspend dividends and/or halt share buy-backs will often constitute a material change. Accordingly, a board that is even in the preliminary stages of considering such a course of action should discuss it with legal counsel, given the need to timely disclose all material changes and the potential secondary market liability for failing to do so.

Human capital and compensation decisions. Many companies are being forced to lay off some of their workforce, even if only temporarily, to manage the immediate stress and financial implications of COVID-19. At the same time, companies also need to ensure that they can retain the requisite talent needed for their companies' success in the future. Compensation committees of boards should be considering the implications of COVID-19 on their executives and workforce more generally, to ensure the appropriate compensation arrangements are in place to address employee cash needs and retain essential personnel while maintaining sufficient working capital. **In seeking to strike the right balance, some companies have announced voluntary pay cuts by their executive officers and/or more broadly across their organizations, either in combination with or as an alternative to layoffs.**

CEO and C-suite succession planning. One of the most important responsibilities of a board is CEO succession planning and, in turn, ensuring the CEO has an appropriate succession plan in place for the company's C-suite officers. Each year, we witness varying degrees of preparedness by issuers for the departure, often unexpected, of a CEO or other key member of the executive team. **In the context of**

the COVID-19 pandemic, the risk of a permanent or temporary loss of members of management is elevated. Consider for example the recently announced death of the Jeffries Group CFO due to complications linked to the coronavirus. Oversight of the CEO and executive succession plans should feature on each board's agenda. Each board should know the answer to the question: "If the CEO (or any other executive) were suddenly unable to perform his or her duties, who would step up in the next 24 hours to fill that person's shoes?" And the board should ensure it has the current CEO's candid insights on the topic. With respect to the C-suite, the board should understand why each successor has been identified and should have a high level of familiarity with the internal candidates should also be maintained. Evergreen lists of potential external candidates. Doing so will help the board avoid reactive (and therefore often ineffective) decisions and properly fulfill one of its most important responsibilities, while facilitating an orderly transition of executive responsibilities should the need arise.

Personal Liability. Directors should also remain attuned to their responsibilities to employees and under environmental and other laws, some of which impose specific duties and personal liability on directors. Directors may wish to seek more regular reporting from management to ensure these statutory obligations are being met. In addition, **if a corporation is facing potential liquidity issues, the board of directors should ensure that the corporation makes the necessary statutory withholdings for which directors may be personally liable, including potentially establishing a trust for such withholdings if the corporation is facing acute liquidity issues**. These withholdings include source deductions, GST and retail sales tax remittances.

Potential activism and short selling. As a result of COVID-19, some issuers are facing activism by investors seeking to implement change in the company's governance and/or strategy. In other cases, an issuer that had been facing activism by an investor may see the investor's demands change and/or the parties' relative leverage shift, which will alter the issuer's and investor's manner of approaching and dealing with each other. In yet other cases, companies that are expected to be more acutely affected by the COVID-19 pandemic are facing short-selling activity, adding increased volatility and potentially significant reputational damage to their business. For activists, the usual legal restrictions and rules of the game apply, which we discuss in our publication Shareholder Activism and Proxy Contests. For issuers, shareholder activism may present additional potential crisis management issues for boards and their management, which cannot be ignored even in these challenging times. With respect to short selling in particular, as we discussed in our article Short Selling in Canada, the legal and practical responses available to companies facing a short-selling campaign can be quite limited, especially since many companies are still trying to evaluate and quantify the impact of COVID-19 on their businesses and financial condition, making it more difficult than usual to provide definitive answers. **To date, neither Canadian securities commissions nor the SEC have imposed any restrictions on short selling as a result of the COVID-19 pandemic, though certain countries in Asia and Europe have.**

Corporate opportunities or takeovers. COVID-19 may present opportunities for accretive acquisitions or dispositions for some companies. In most cases, the board will have oversight responsibility for approving any significant transaction involving its company. Given how rapidly situations are changing, companies considering transactions may need to move swiftly. That said, process is paramount for boards to establish compliance with their corporate and securities law responsibilities and protection under the business judgment rule. **Even in these turbulent times, boards and management must ensure the right protocols are implemented at the right times to properly consider, evaluate, negotiate and, if determined to be in the best interests of the corporation, approve a significant transaction.** External legal advice and/or financial advice will often be required, as may separate independent advice and/or fairness opinions. You should consult with legal counsel at the earliest possible stages if a significant transaction is being considered.

Insider trading and selective disclosure. COVID-19 will likely have implications on issuers' previously disclosed strategies and plans. Boards should ensure management is considering, and regularly reporting on, whether and how the COVID-19 crisis is affecting their previously issued guidance and other expressed outlooks and forward-looking information, and when and how new information is being conveyed to the market, to ensure timely disclosure of material information. **In this context, companies should ensure appropriate protocols are in place to maintain compliance with insider trading and tipping restrictions.** With respect to the latter, there may be situations in which the issuer may share material non-public information on a selective basis, if it is done in reliance on the "the necessary course of business" exception. While that exception may permit certain selective disclosures, it will not afford protection for improper insider trading. **As the situation continues to change rapidly, what might not have been material information one day may very**

well become material the next. Issuers must have in place appropriate blackouts or trading restrictions to ensure insiders and others in a special relationship are not trading during periods when material information has not been generally disclosed.

[1] For a more in-depth discussion of directors' fiduciary duties, please see our Governance Insights publication online at https://www.dwpv.com/en/Insights/Publications/2019/Davies-Governance-Insights-2019.

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