Liability of Directors and Officers in Canada

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INTRODUCTION

In the wake of recent corporate litigation beginning with the energy giant Enron, and expanding to include the bankruptcies of WorldCom, Adelphia, Parmalat, YBM, Tyco and others, sitting on a board of directors has become a more serious and complicated responsibility than ever before. The proliferation of class actions based on alleged failures in corporate governance, and even on more routine restatements of financial statements, has increased the risk that directors and officers will be sued. Often the amounts claimed in such lawsuits vastly exceed the limits of available insurance policies. As a result, the issue of director and officer liability, while not new, has become a source of heightened concern in boardrooms across Canada.

There has been a strong legislative response and increased pressures to hold directors and others involved in the management of corporations accountable for their actions. Moving away from traditional common law approaches to director liability, a wide range of Canadian statutes in many areas of the law now provide specific guidance as to the standards of conduct expected from directors, and attach personal liability for failing to meet those standards of conduct. At the same time, the common law in Canada has now evolved to recognize circumstances in which it is appropriate to hold directors personally accountable for tortious actions of the corporation.

This chapter provides an overview of the statutory and common law duties owed by company directors and the liability for their breach, as well as a brief discussion about director indemnification and insurance. The following main topics will be considered:

- Directors' responsibilities
- Directors' duty of loyalty

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- Directors' duty to act with care and skill
- Specific duties under securities, taxation, environmental, and employment statutes
- Lifting the corporate veil
- Indemnification and insurance

SOURCES OF LIABILITY

Canada is a federal state in which both federal and provincial statutes impose liability on directors and officers. There is a certain amount of duplication, but after a series of reforms the provisions at the two levels of government are generally similar. The number of statutes in Canada that impose such liabilities has been estimated at over 200, many of which are listed in Appendix A.

The Canada Business Corporations Act ("CBCA") and the Business Corporations Acts of each of the provinces set up the general framework for liability, and deal with such issues as the definition of a director and enumerate the various duties and responsibilities that a director must discharge in the management of a corporation. These Acts are then complemented by more specific statutes that deal with liability in such areas of the law as securities, tax, the environment and the workplace. Reference will be made primarily to the CBCA, as it is the applicable statute for companies incorporated federally and has provisions similar, if not identical, to most of the provincial corporate statutes. However, reference will also be made to the Ontario Business Corporation Act ("OBCA") where the two statutes differ. Ontario is the most populous province in Canada and supports the largest capital markets.

CANADA BUSINESS CORPORATIONS ACT

Definition of director

The CBCA provides that the term "director" in the Act refers to anyone who occupies the position of a director, by whatever name.[1] Anyone who guides or controls any function of the corporation can be subject to directors' liability within the meaning of the CBCA. Even employees may be held liable for actions of the corporation if they exercise some sort of managerial authority. It is the content of an individual's job that results in exposure to liability, not the title that the person has assumed, or been given. Many statutory provisions which define the obligations of "directors" are drafted to apply equally to "officers" of a corporation. In the absence of an express statutory provision stating that it applies to directors alone, any reference to directors' liability will be assumed to include officers' liability if the officer is in a position to guide or control the corporation.

Who may be a director

Most corporate statutes, including the CBCA, disqualify certain persons from acting as directors (minors, corporate entities). An individual may not serve if he or she is bankrupt.[2] There is no statutory requirement that a director hold shares in the corporation. Many corporate statutes require a fixed percentage of members of the board of directors to be resident Canadians.

Inside and outside directors

Under the CBCA, public companies must have at least three directors, two of whom must be outside directors.[3] Inside directors are those who hold a position of employment within the company in addition to their position as director. Outside directors are defined by the CBCA to be those who are not officers or employees of the corporation or its affiliates.

The reason that the CBCA requires outside directors is multi-fold. For one, inside directors, as employees or management of the corporation, may find themselves in conflict of interest situations. Thus, outsiders are needed to give advice in these situations and to vote for

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1 CBCA, section 2(1).
2 CBCA, sections 102 and 105(1)(d).
3 CBCA, section 102(2).

transactions involving these conflicts so that the decisions in question are not seen to be influenced unduly by any conflicts of interest and attacked on that basis.

Moreover, if inside directors are themselves controlling shareholders or appointed by such, outside directors are needed to ensure that the minority shareholders are treated fairly. Outside directors are also expected to bring to the corporation a breadth of business experience to complement the depth of experience that the insider directors have by virtue of managing the corporation on a day to day basis. Most importantly, however, outside directors should demonstrate the quality of objectivity in order that they may fulfil the role of watchdog over inside management.

In order to discharge the functions required of an outside director, the director should be free of influence by the corporation. However, the state of current regulations may not always ensure this to be the case. The CBCA, in permitting anyone who is not an employee of the company or its affiliates to fill the position of outside director, opens the door to many categories of people who are not truly independent.

In fact, the position of outside director is often filled by either bankers, lawyers, consultants or significant shareholders of the corporation, all of whom could, on certain issues, be said to have their independence compromised by their relationship to the corporation. Clearly, many valuable interests of the corporation and its shareholders will be served by having individuals with a real stake in the company's affairs serve on its board of directors. The concern is that individuals with such relationships to the company may not, in all circumstances, provide the necessary checks and balances for inside management.

The courts will consider a range of factors to determine whether a director is free of influence by the corporation and has been at all times free to deal with an impugned transaction on its merits.[4] Factors relating to independence that courts have considered include holdings in the company, business or personal relationships to major shareholders, professional associations, former working relationships, affiliations with other companies and past or present financial

[4] *Re Brant Investments Ltd. et al. and Keeprite Inc. et al.* (1987), 60 O.R. (2d) 737 (H.C.), at p. 756 ["Brant Investments"].

transactions. These considerations are particularly important in the Canadian business scene as the business community at the corporate level is rather small and there is a noteworthy concentration of share ownership.

Responsibilities of directors

The CBCA grants to the directors of a corporation the general power to manage the business and affairs of a corporation.[5] The directors' power to manage the business and affairs of the corporation can be restricted, in whole or in part, only by a unanimous shareholder agreement. When a unanimous shareholder agreement is adopted, the shareholders assume those rights, powers, duties and liabilities of the directors that have been removed from the directors by the unanimous shareholder agreement. In the absence of a unanimous shareholder agreement, the management of a corporation's business and affairs is the prerogative of the directors, not of the shareholders. How a director – and the directors as a group – fulfils this function depends upon the size of the corporation, the nature of the corporation's business, whether it is a public company, the applicable securities markets and regulatory bodies, the location of its operations and the corporation's own business history.

Directors must fulfil a number of legal functions according to the provisions of the CBCA, as supplemented by the corporation's by-laws and, for public companies, other regulatory instruments. The functions identified in the CBCA include the approval of financial statements[6], registration statements[7], proxy statements[8], periodic reports[9], dividend

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[5] CBCA, Section 102(1).

[6] CBCA, Section 158.

[7] See Section 58(1) of the *Ontario Securities Act,* which requires two directors to sign a prospectus on behalf of the board.

[8] See the provisions in CBCA, Sections 147-154, outlining the proxy solicitation process.

[9] National Instrument 51-102 – *Continuous Disclosure Obligations* (2004) 27 O.S.C.B. 3439, 28 O.S.C.B. 4975, 28 O.S.C.B. 10384, 28 O.S.C.B. 10463, Part 4, section 4.5 requires that all interim financial statements be approved by the board of directors before the statements are filed. Part 5, section 5.5 requires that all interim Management Discussion and Analyses be approved by the board of directors, though this task can be delegated to the audit committee of the board of directors.

declarations[10], major financings[11], remuneration of top management[12], recommendations for the appointment of auditors[13] and new board members[14], and the approval of directors' expenses.

Outside of those specific duties that they must perform themselves, directors are entitled to delegate some of their functions to the officers.[15] However, there are limitations on directors' ability to delegate. Unfettered delegation is typically not appropriate, as directors must maintain a general residual discretion. The only permissible means of fully delegating the discretion of directors is through a unanimous shareholders agreement.

Liability for mistakes is not absolute. Directors will not usually be held liable for an action or decision if they made it honestly and carefully, even if hindsight proves it to be unwise or imprudent. Section 123(4) of the CBCA outlines the due diligence defence available to directors. A director will not be held liable in certain circumstances if he or she exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on:

> (a) financial statements of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation to fairly reflect the financial condition of the corporation; or
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> (b) the report of a person whose profession lends credibility to a statement made by him or her.

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[10] See the decision in *McClurg v. Minister of National Revenue,* [1990] 3 S.C.R. 1020 which held that dividend declaration is restricted to the sphere of authority conferred upon directors. Shareholders cannot declare a dividend. The directors' power of the payment of dividends is subject to the same fiduciary obligation as the exercise of any other aspect of their managerial control over the corporation.

[11] CBCA, Section 25.

[12] CBCA, Section 125.

[13] CBCA, Section 104(1)(e) provides that the Directors will appoint an auditor for the initial audit at the organizational meeting. Section 171(1) of the CBCA requires the formation of an audit committee comprised of at least three directors, which among other things, recommends and supervise auditors.

[14] CBCA, Sections 106(7), 106(8).

[15] CBCA, Section 115.

The due diligence defence recognizes that a director's actions and the expected precautions will vary with the circumstances. The due diligence defence permits a director to show in a general way that he or she acted reasonably in the circumstances. For example, directors will not be held liable for a questionable purchase, redemption, acquisition or issuance of shares, payment of commissions, dividends or indemnities, giving of financial assistance, non-payment of wages or the breach of their fiduciary duty or duty of care if they reasonably rely in good faith on statements made by their advisors in reaching their decisions.

Whether a director's reliance has been reasonable is a context-specific inquiry. Reasonable delegation and reliance must be supported by evidence that the director has not abdicated his or her oversight role. To protect the availability of the due diligence defence, directors must:

- carefully select the officers and other advisors;
- monitor the performance of advisors and replace them when necessary;
- read all information given to them, make sure that they understand it and ask the "right" questions;
- review general business activities with the officers;
- if a significant transaction is at issue, go behind any reports to obtain independent verification of their accuracy, obtain outside expert advice and verify experts' qualifications and independence;
- ensure that duties delegated to officers are properly delegated, given the restrictions in the CBCA and the articles and by-laws of the corporation;
- investigate immediately and not rely on an officer's information if there are any grounds for suspicion that he or she is being less than entirely honest in his duties; and
- establish appropriate mechanisms to detect and deter fraud.

DIRECTORS' DUTIES UNDER CBCA

From a director's perspective, the most important provision of the CBCA is section 122(1), which sets out the general duties owed by a director to the corporation. It states that, in exercising his powers and discharging his duties, a director shall:

- act honestly and in good faith with a view to the best interests of the corporation; and
- exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

These duties are absolute. No provision of a contract, corporate resolution or corporate by-law can exempt a director or officer from these duties. Section 122(3) of the CBCA prevents corporations from relieving their directors from these duties. Thus, while a corporation may offer an indemnity or insurance to directors to protect them from liability arising from the discharge of their duties in good faith, the underlying liability remains.

It is immaterial for the purpose of assessing liability whether the director in question is an inside or outside director. Even though outside directors know less about the day to day workings of the business, they are still exposed to the same risks as inside directors.[16] In particular, they are not normally subject to lower standards when it comes to the fiduciary duty and the duty of care.[17]

Duty of Loyalty

The duty imposed by the CBCA in section 122(1)(a) on directors to act honestly and in good faith with a view to the best interests of the corporation has been described by the Supreme Court of Canada as the duty of loyalty.[18] A director's duty of loyalty, or fiduciary obligation,

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16 Wainberg and Wainberg, *Duties and Responsibilities of Directors in Canada*, Don Mills, Ont., CCH Canadian Ltd., 1987, at p. 8; Millard, *The Responsible Director*, Toronto, Ont., Carswell Co. Ltd., 1989, at p. 7.

17 *Canadian Corporate Secretary's Guide*, CCH Canadian Ltd., (Looseleaf, March 2006 Release), at para. 7080.

18 *People's Department Stores Ltd. (Bankrupt) v. Wise*, [2004] 3 S.C.R. 461 ["Peoples"]

puts him in a position relative to the corporation similar to a trustee to a beneficiary. As such, a director must always act for the benefit of the corporation and never for his own personal gain. He must be entirely truthful with the board, the management and the shareholders. He must never take personal advantage of a situation that has come to his attention through serving as a director. All his actions must be taken for business purposes and he must strive to minimize any situations where there may be even a potential conflict of interest.

The director's duty of loyalty is owed exclusively to the corporation. After some years of uncertainty, the Supreme Court of Canada in *Peoples* recently confirmed that directors owe their fiduciary obligations solely to the corporation, and not to a single stakeholder group:

> At all times, directors and officers owe their fiduciary obligations to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholder. [19]

Over time, the relationship between the corporation and its directors has been interpreted to encompass three primary fiduciary obligations:

- directors must act in the best interests of the company;
- directors must not "seize the corporate opportunity"; and
- directors must not engage in self-interested contracts.

Directors Must Act in the Best Interests of the Company

Historically, shareholder wealth maximization was the primary goal in the governance of corporations and all activities had to be justified against this objective. For a long time, therefore, acting in the best interests of the corporation was interpreted by aligning it with acting in the best interests of its shareholders.[20] More recently, courts have abandoned the shareholder-centred approach and have recognized that the corporation is a complex set of intricate relationships, and recognition of the interests of many stakeholders is necessary to the successful functioning of the

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[19] *Ibid.* at para. 43.

[20] *Hutton v. West Cork Railway Company* (1883), L.R. 23 Ch. D. 654; *Ibid.* at 673; *Iron Clay Brick Manufacturing Co. (Re)* (1889), 19 O.R. 113; *Martin v. Gibson* (1907), 15 O.L.R. 623.

company.[21] As such, it is legitimate for a board, in determining whether it is acting with a view to the best interests of the corporation, to consider the interests of these many stakeholders, including shareholders, employees, suppliers, creditors, consumers, governments and the environment.[22]

Given the myriad of factors potentially involved in the assessment of a director's duty of loyalty to the corporation, there is no single test that the court applies in determining whether a director has breached his duty of loyalty to the corporation. Traditionally, the standard for breach of fiduciary duty required proving lack of good faith by establishing evidence of actual and intended bad faith or malice. However, recent American jurisprudence suggests that the threshold to establish a lack of good faith in corporate decision-making has lowered in the post-Enron era, which may find its way into Canadian jurisprudence.

In *In Re The Walt Disney Company Derivative Litigation*,[23] the Delaware Court refused a motion to dismiss the allegation that some of the company's directors should be held personally liable for their failure to properly oversee the hiring and firing of an executive of the company. Among other things, the court was troubled that the final version of executive Michael Ovitz's employment agreement differed materially from the draft previously submitted to the compensation committee, and that Disney CEO Michael Eisner, without any evidence of consulting with the board or the compensation committee, negotiated a generous no-fault termination agreement with Ovitz. While noting its hesitancy to second guess the judgments of disinterested and independent directors, the court found that the facts alleged "belie any assertion that the board exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders." Liability was established. Consequently, following the *Disney* decision, directors now may be liable for not acting in good faith where they knowingly act without full information or knowingly make material decisions without adequate information or adequate deliberation.

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21 *Peoples, supra* note 18, at para. 42.
22 *Peoples*, *supra* note 18, at para. 42.
23 (2003) Del. Ch. Lexis 52 ["Disney"].

Directors Must Not Seize Corporate Opportunity

It is a breach of a director's duty to seize upon opportunities properly belonging to the corporation and use such opportunities for the director's own personal advantage. The purpose of the doctrine is to remove the temptation to favour one's own interests at the expense of those of the corporation. While the objective behind the doctrine is relatively straightforward, it is difficult to state precisely when the doctrine will be applied and courts have differed on the issue.[24]

Until 1974, the test was very strict. If the opportunity came to the director by virtue of his position and he profited from the opportunity, he would be considered to have breached his fiduciary duty, no matter what extenuating circumstances there may have been. It did not matter whether the director was acting in good faith or the company could not have taken advantage of the opportunity due to financial inability or some other factor, or whether the company actually suffered no harm as a result of the director's action. Even after resignation or dismissal, the director could not act on information that came to him while he was in the employ of the corporation.

The case of *Can Aero Services Limited* v. *O'Malley*[25] alleviated this rigidity and established that the application of the rule should be responsive to the circumstances of the case. Today, a director's duties in relation to a corporate opportunity will be reviewed against all relevant factors, including:

- the position or office held by the director or officer;
- the nature of the corporate opportunity;
- the ripeness of the opportunity;
- the specificity of the opportunity;
- the director's or managerial officer's relation to the opportunity;

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[24] For example, see: *Cook v. Deeks*, [1916] 1 A.C. 554 (Ont. P.C.); *Regal (Hastings) Ltd. v. Gulliver*, [1942] 1 All E.R. 378 (H.L.); *Peso Silver Mines Ltd. (NPL) v. Cropper*, [1966] S.C.R. 673; *Industrial Development Consultations Ltd. v. Cooley*, [1972] 1 W.L.R. 443 (H.C.); *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592.

[25] [1974] S.C.R. 592, at para. 48.

- the amount of knowledge possessed;
- the circumstances in which the information or knowledge was obtained and whether it was special or private;
- the factor of time in the continuation of fiduciary duties where the alleged breach occurs after termination of the relationship with the company; and
- the circumstances under which the relationship terminated, that is whether by retirement or resignation or discharge.

Directors Must Avoid Self-Interested Contracts

The classic formulation of the rule against engaging in self-interested contracts provides that fiduciaries are not permitted to enter into engagements in which they have, or can have, a conflict of personal interest and duty.[26] The rationale for this strict rule was that the fiduciary obligations of directors were such that no personal interest could be allowed to conflict with the carrying out of these obligations. Directors could not put themselves in a position in which their personal interests and their duties to the corporation could come into conflict.

Today, conflict rules with respect to directors, and exceptions to these rules, are fully addressed in s.120 of the CBCA.[27] In summary:

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[26] See *Aberdeen Railway Co. v. Blaikie Bros.* (1854), [1843-60] All E.R. 249 at 252 (Scot. H.L.), per Lord Cranworth L.C.: "[I]t is a rule of universal application that no one having [fiduciary] duties to discharge shall be allowed to enter into arrangements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness of a contract so entered into."

[27] Some instruments of securities regulation in Ontario give further guidance with respect to a director's duty to refrain from entering into self-interested contracts. For example, the "related party" transaction provisions of the Ontario Securities Commission Rule 61-501 (2000), 23 O.S.C.B. 971, Part 5, impose reporting and procedural requirements on directors for transactions between a corporation and one or more of its directors or senior officers. Similarly, Part 7 of Companion Policy 61-501CP, (2000) 23 O.S.C.B. 2719 sets out the role of directors in reviewing related-party transactions. Among other requirements, directors must disclose their reasonable beliefs as to the desirability or fairness of the proposed transaction, and the material factors on which their beliefs are based.

- Directors who have an interest in a material contract or material transaction with the corporation must disclose the nature and extent of their interest in writing or request to have the conflict entered in the minutes of the board.
- Disclosure must be made at the meeting when a proposed contract or transaction is first considered or, if board approval is not required for the contract, as soon as the director becomes aware of the conflict.
- A conflicted director must not vote on any resolution to approve the contract or transaction.
- Directors may make a general notice declaring an ongoing conflict.
- If a director fails to disclose his interest in a material contract or transaction, a court may set aside the contract or transaction on application of the corporation or a shareholder of the corporation.
- The CBCA also requires (although the OBCA does not) that the contract or transaction be approved by the directors or shareholders to avoid the director being accountable or the contract or transaction being void or voidable.

The OBCA contains several additional provisions not present in the CBCA:

- A conflicted director is not accountable to the corporation for any profit or gain realized from a contract or transaction if the conflict was properly declared and the contract was reasonable and fair to the corporation.
- A material contract or transaction in which a director has a material interest is not void or voidable for the sole reason of the conflict or that the director voted for the contract as long as the conflict was properly declared and the contract was reasonable and fair to the corporation.
- Shareholders may approve of conflicted contracts by special resolution which will, under certain conditions, protect the contract or transaction from challenge and the

director from accounting for the profits from the interested contract. Any shareholder approval requires that the director act honestly and in good faith and that the contract or transaction be reasonable and fair to the corporation.

It is important to note that the mere possibility that a director be placed in a conflicted position is insufficient to disqualify him. In *Stelco Inc. (Re)*[28], the employees of Stelco brought a motion to remove two new directors during its restructuring under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, because they believed that these directors were more likely to favour bids that maximized shareholder value at the expense of bids that might be more favourable to the interests of current and retired Stelco employees. The motions judge removed the two directors on the basis that there was a risk that they might not live up to their obligations to act solely in the best interests of Stelco in the future. The Court of Appeal overturned the motion court's decision and affirmed the reluctance of courts to become involved in the internal affairs of a corporation unless there is actual evidence of misconduct.

The Special Case of the Unsolicited Take-Over Bid

No situation can be more troublesome to a director from a conflicts perspective than trying to respond to an unsolicited takeover bid. An unsolicited bid may present three separate conflicts to a director of the target corporation:

- reconciling a personal financial interest as a shareholder in the corporation with the best interests of the corporation;
- resolving conflicting obligations to the bidding shareholder against obligations to offeree shareholders; or
- fulfilling the duty to act in the best interest of the corporation in the long term while protecting the economic interests of the offeree shareholders.[29]

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[28] [2005] O.J. No. 730 (S.C.J.), rev'd [2005] O.J. No. 1171 (C.A.).
[29] John W. Greenslade and Claudia L. Losie, "Takeovers - Fiduciary Duties" in *Directors' Duty in Unsolicited Takeover Bids* (Mississauga: Insight Press, 1989) at p. 22.

Regardless of the reaction of the corporation or its shareholders to the unsolicited bid, directors of a target corporation have an ongoing duty to minimize the conflicts inherent in the takeover bid by evaluating the bid in the most independent manner possible. To that end, directors should obtain independent legal and financial advice and establish an independent directors' committee consisting solely of outside directors who are free from conflicts in relation to the bid to objectively evaluate the bid; these measures will assist directors to fulfil their obligations to avoid conflicts to the greatest extent possible.[30]

If a corporation is "in play" the duty of the directors of the target company will shift from the best interests of the corporation to the best interests of the shareholders.[31] A corporation is "in play" if there is *bona fide* takeover bid offer that may result in a sale of equity and/or voting control.[32] If there is some insurmountable obstacle to the success of the takeover, then the corporation is not truly "in play" and the directors' obligations remain strictly to the corporation. The requirement that the corporation be "in play" before directors' duties shift to the shareholders and away from the corporation can be critical to a successful defence of an undesirable bid.[33]

Once the corporation is "in play" the directors owe a fiduciary duty to the shareholders as a whole to maximize shareholder value by seeking the best value reasonably available to the shareholders in the circumstances. Often, this duty is fulfilled by conducting a share auction,

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[30] *CW Shareholdings Inc. v. WIC Western International Communications Ltd*. (1998), 39 O.R. (3d) 755 at 768-769 (Gen. Div.) ["CW Shareholdings"], citing with approval *Brant Investments Ltd. v. Keeprite Inc.* (1987), 60 O.R. (2d) 737 (H.C.), aff'd. (1991), 3 O.R. (3d) 289 (C.A.).

[31] *CW Shareholdings Inc., ibid.*. See also: *Maple Leaf Foods Inc. v. Schneider Corp*. (1998), 42 O.R. (3d) 177 at 190-194 (C.A.) ["Maple Leaf Foods"]; *Revlon Inc. v. MacAndrews & Forbes Holdings* (1985), 506 A. 2d 173 at 182 (Delaware S.C.) ["Revlon"].

[32] *CW Shareholdings, ibid.* See also *Benson v. Third General Investment Trust Ltd.* (1993), 14 O.R. (3d) 493 (Gen. Div.).

[33] In the hostile takeover bid for Air Canada in *Re Airline Revitalization Co. Inc. and Air Canada* (1999), 45 O.R. (3d) 370 (Gen. Div.), Air Canada argued that because the *Air Canada Act* precluded any person from holding more than 10% of the votes to elect directors, the company was never truly "in play" and Air Canada was not obliged to seek out competing bids to that of Onex. This argument, however, was not addressed in the decision. See also: *Maple Leaf Foods, supra* note 31.

particularly if there are several bidders or potential bidders.[34] This duty to maximize shareholder value is otherwise known as the Revlon Duty (taken from a 1986 decision of the Delaware Supreme Court).[35] The Revlon Duty requires directors or a target company to search actively for competing bidders[36] and determine, on reasonable grounds, whether it is appropriate and desirable to attract such bidders with break fees or asset options.[37]

The Revlon Duty does not usurp the directors' duties to the corporation if the directors believe that the bid presented to the company is not in the best interests of the corporation or its shareholders. Directors retain the burden of evaluating the bid, as regulators have declined to set down a code of conduct for directors confronted with an unsolicited bid.[38] Rather, the directors must evaluate a hostile bid and each of the alternatives in light of all the circumstances. For example, a hostile bid was properly rejected where the offered price did not adequately reflect

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[34] *CW Shareholdings, supra* note 30. The overriding duty of the board is to seek the best value reasonably available to the shareholders in the circumstances. If an auction is the most appropriate mechanism to fulfill such duty, such as when a company is for sale and it becomes clear that there are several bidders, then it will likely be considered necessary. However, it constitutes only one of the possible options that a target board may take in order to maintain its neutrality and attain maximum shareholder value in the circumstances. See, *Maple Leaf Foods, supra* note 31, at paras. 61-63; and *Ventas Inc. v Sunrise Senior Living Real Estate Investment Trust,* 2007 CarswellOnt 1705.

[35] The Revlon Duty was first articulated in the decision of the Delaware Supreme Court in *Revlon, supra* note 31 at p. 182. The Revlon Duty has been adopted by the Ontario courts. While a full discussion of directors' duties under securities laws is beyond the scope of this paper, it is noteworthy that the Revlon Duty has been codified to some extent in National Policy 62-202: "Take-Over Bids – Defensive Tactics" (1997), 20 O.S.C.B. 3525.

[36] A takeover bid must remain open for 35 days in Ontario. While in some cases, a white knight will present itself to the corporation within this time frame, in other situations, shareholder rights plans (otherwise known as poison pills) may permit a defending board to extend the time for the bid.

[37] A break fee is "a payment employed by the target corporation for the purpose of enticing another competition bidder to enter the fray." In *CW Shareholdings*, *supra* note 30, Blair J. held that the break fees offered by the target company were judged to be appropriate on the grounds that: (i) they were necessary to attract a better bid; (ii) did in fact attract a better bid and (iii) the fees stuck a reasonable balance between inhibiting an auction and drawing competing bidders to the corporation. Blair J. applied similar reasoning to determining the propriety of offering asset options as a strategy to attract competing bidders.

[38] See National Policy 62-202, *supra* note 35. Securities regulators acknowledge that setting down rigid codes of conduct would be "inappropriate" as doing so would risk "containing provisions that might be insufficient in some cases and excessive in others."

the value of the company.[39] Similarly, a bid may be properly rejected where the bidder intends to sell the assets of the target company rather than continuing its operations, otherwise known as a "bust-up" takeover.[40]

As with all other business decisions made by the board, the courts will not lightly intervene to set aside *bona fide* business decisions of the board made during a hostile takeover bid situation, whether they involve the nature of the share auction, a review of defensive strategies adopted by the board, or otherwise.[41]

Recently, the duties of directors have come under increased scrutiny in the context of the implementation of a Shareholders' Rights Plan ("SRP") or a "Poison Pill", particularly when put into place by directors in response to an unsolicited take-over bid. A typical SRP is a document that sets forth instances in which a takeover bid will be permitted by the company. If the bid falls outside the terms of the SRP, then the SRP is activated. Once activated, the SRP provides shareholders of the target company with the right to purchase additional shares of the class that is subject to the bid at a very low price. Such shares are issued to all shareholders with the exception of the bidder. Accordingly, the effect of the SRP is to dilute the bidder's holdings, thereby making it much more difficult to complete the take-over bid.[42]

The Securities Commissions have indicated that the implementation of an SRP is a defensive tactic that may give rise to increased regulatory scrutiny.[43] As with defensive tactics in general, the directors bear the onus of showing that they acted in the best interests of the company as a whole, and that their actions were reasonable in relation to the threat posed.[44] For

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[39] *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254 (Div. Ct.).

[40] *John A. Moran v. Household International Inc.*, 490 A.2d 1059 (1985). See also *Revlon, supra* note 31.

[41] *Brant Investments, supra* note 4, at 759-60; *Maple Leaf Foods*, *supra* note 31 at 91.

[42] Mary G. Condon et. al., *Securities Law in Canada: Cases and Commentary* (Toronto: Emond Montgomery Publications Limited, 2005) at p. 510.

[43] National Policy 62-202, *supra* note 35.

[44] See for example, *Falconbridge Ltd, Re.* (2006) 29 O.S.C.B. 6783; *Cara Operations Ltd., Re* (2002) 25 O.S.C.B. 7997; *Chapters Inc., Re.* (2001) 24 O.S.C.B. 1657; see also *347883 Alberta Ltd. v. Producers Pipelines Inc.,* [1991] 4 W.W.R. 557 (Sask. C.A.) at para. 40 ["Alberta Pipe"].

example, a legitimate purpose of an SRP is to give directors time to assess the take-over bid and consider alternatives, or to protect shareholders from an unfair, abusive, or coercive take-over bid. Ultimately, the key issue is whether the SRP unduly interferes with the shareholders' right to determine the disposition of their shares. If the SRP has the effect of denying the shareholders the ability to make a fully informed decision and of frustrating an open take-over bid process, then securities regulators or courts will likely deem the SRP unreasonable.[45]

In addition, directors cannot hold an SRP in place indefinitely if doing so prohibits shareholders from responding to the bid.[46] The reasonableness of holding a "Poison Pill" in place is evaluated according to two principles[47]:

- If the SRP is permitted to remain in effect for a reasonable further period, is there a reasonable possibility that a better offer will come along during the period so that, whether or not this results in the offeror increasing its bid, the shareholders will be advantaged?

- If the SRP is not terminated prior to the end of the current period for the acceptance of the bid, is it likely that the offeror will not extend the period for acceptance for such reasonable further period and thus deprive the shareholders of the opportunity to decide whether they wish to accept the offeror's bid?

Finally, various factors are taken into account in determining the appropriate balance between permitting the directors to fulfill their duty to maximize shareholder value in the manner they see fit and protecting the right of shareholders to decide whether to tender their shares to the bid. Shareholder approval of the impugned shareholder rights plan is seen as one of the most important factors, though not conclusive.[48] Other factors include[49]:

- When the plan was adopted;

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[45] National Policy 62-202, *supra* note 35.

[46] *Re Royal Host Real Estate Investment Trust* (1999) 22 OSCB 7819 ["Royal Host"].

[47] *Ibid.* at para. 50.

[48] *Re Cara Operations* (2002), 25 OSCB 7997 at 8003; *Alberta Pipe, supra* note 47; *Royal Host, supra* note 46.

[49] *Royal Host, supra* note 46 at 74.

- Whether there is broad shareholder support for the continued operation of the plan;
- The size and complexity of the target company;
- The other defensive tactics, if any, implemented by the target company;
- The number of potential, viable offerors;
- The steps taken by the target company to find an alternative bid or transaction that would be better for the shareholders;
- The likelihood that, if given further time, the target company will be able to find a better bid or transaction;
- The nature of the bid, including whether it is coercive or unfair to the shareholders of the target company;
- The length of time since the bid was announced and made;
- The likelihood that the bid will not be extended if the rights plan is not terminated.

Thus, while directors may employ an SRP as a legitimate defensive tactic, it must be for the purposes of maximizing shareholder value. Directors will not been seen to have acted in the best interests of the corporation if they implement an SRP that is seen to frustrate the shareholders' ability to decide how they will dispose of their shares.

Duty of care

The minimum standard of care to be exercised by directors has been codified in section 122(1)(b) of the CBCA. Directors must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Unlike the fiduciary duty, directors' general duties of care can be owed to any third-party stakeholder. In *Peoples*,[50] the Supreme Court of Canada held that, while directors are not

[50] *Peoples, supra* note 18.

ordinarily liable to creditors for the debts of the corporation, directors do have general duties to creditors. The importance of creditors' interests increases in relevancy as the corporation's financial position deteriorates. If the corporation is insolvent or close to insolvent, directors should carefully consider the impact of proposed corporate actions on creditors of the corporation.

The assessment of the requisite standard of care is contextual.[51] Each director is assessed on an individual basis. While a director will be held to an objective standard of care, the content of the standard will be determined in the context of the skill and training of the director, as well as the circumstances surrounding his or her actions. As it is the shareholders who elect the director, they cannot then demand that he be someone who he is not. However, in general, a higher degree of skill will normally be expected from an experienced business person than a lay person. The circumstances surrounding the actions of the director or officer, as opposed to his or her subjective motivations, are the key to assessing whether the director has satisfied the applicable standard of care.[52] It is not enough for a director to simply say that he or she "did his or her best."[53] Rather, objective factors such as whether or not the particular director is a member of management or a specific committee on the board, whether or not a particular director was provided with information that should have objectively raised a particular concern, whether or not a particular director was selected to serve on the board because of professional qualifications or skills, and so on, will be determinative.

Business Judgment Rule

The duty of care under the CBCA is subject to the business judgment rule, which presumes that business decisions are made by disinterested and independent directors on an informed basis and with a good faith belief that the decisions will serve the best interests of the

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[51] *Ibid*. at paras. 62 and 63.
[52] *Ibid*. at para 63, referring to the court's articulation of an "objective-subjective" standard in *Soper v. Canada,* [1998] 1 F.C. 124 at para. 41 ["Soper"].
[53] *Soper, ibid,* at para. 41.

corporation.[54] The rationale for the protection offered to directors by this rule is that shareholders choose the directors to make the company's decisions and it is unfair and improper for the courts, with the benefit of hindsight, to set aside and second-guess the business expertise of directors. As the Supreme Court of Canada has noted:

> Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions that make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision-making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.[55]

Directors raising the business judgment rule in defence to a claim for negligence must provide evidence that their decisions were objectively reasonable. In contrast to the very broad deference to the business judgment rule seen in the past, courts now are willing to scrutinize closely the diligence with which directors have made their decision. In *UPM-Kymmene Corp. v. UPM-Kymmene Miramachi Inc.*[56] the Ontario Court of Appeal upheld the lower court, which set aside of a generous executive employee contract that had been approved without proper consideration or discussion by the compensation committee or the board of directors of Repap Enterprises Inc. The court restricted the application of the business judgment rule to situations in which directors provided actual evidence of the exercise of their business judgment and diligence in arriving at decisions. The court held that it is settled law that directors must make decisions on an informed and reasoned basis. Where, as here, the board relied on the advice of a

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[54] D. Block, N. Barton, S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors*, 5th ed. (Aspen Law & Business, 1998, vol.1).
[55] *Peoples*, *supra* note 18, at para. 67.
[56] [2004] O.J. No. 636 (C.A.) ["Repap"].

committee that had made an uninformed decision and did not engage in any kind of analysis, the protection of the rule would not be available.

Commentators have questioned whether, under similar facts, a court would have arrived at the same result before the Enron scandal and the resulting scrutiny of corporate governance issues.[57] Historically, courts have set aside decisions of directors where they found that the board had not acted honestly, prudently, in good faith and on reasonable grounds. In practice, these situations most often arose when a board was presented with a clear conflict, such as when the jobs of the board were at stake, as during a takeover. This was not the situation in *Repap*. Although the chairman had not acted properly, there were no claims of bad faith made against the board and no evidence that the board had acted in self-interest. In the past, reliance on an independent consultant and a compensation committee has been considered a complete defence against liability. The decision in *Repap* makes clear that a director who fails to exercise reasonable care and skill can no longer shelter behind the business judgment rule.

The decision of the Ontario Court of Appeal in *Kerr v. Danier Leather Inc.* suggests that the business judgment rule can protect a corporation from liability when management makes decisions prudently, carefully and considerately in the circumstances.[58] In this case, the Court of Appeal found that the trial judge erred in failing to give appropriate effect to the business judgment of management in its determination of whether a financial forecast was achievable.[59] The court held that deference to management's honest, subjective belief is warranted when the decision is within a range of reasonable alternative opinions open to business people in their position, knowing what they knew and facing the circumstances they faced.[60] A clear determination on this issue is forthcoming, as an appeal of this decision is currently pending at the Supreme Court of Canada.

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[57] See Gary Luftspring, Elizabeth Ellis & Marc Kestenberg, "Recent Developments in Directors & Officers Liability" available at http://www.lexpert.ca/directory/rd.php?area=D4 (accessed on May 20, 2005).

[58] *Kerr v. Danier Leather Inc.* (2005), 77 O.R. (3d) 321 (Ont. C.A.).

[59] *Ibid.* at paras. 154-172.

[60] *Ibid.* at para. 154-155.

Directors can therefore have confidence that the business judgment rule will protect their reasoned, diligent and informed decisions. Directors do not have to be experts and do not have to second guess all management decisions. As long as directors are disinterested and independent, review and consider all pertinent information that is reasonably available and do not act with an ill or improper motive, it remains unlikely that a Canadian court will disrupt or reverse a decision of the board or hold the directors personally liable for the results of those decisions.

A director who follows the following principles should likely meet the requisite standard of care:

- Directors should keep themselves informed as to the policies, business and affairs of the corporation; have a general understanding of how business is conducted, revenue is earned, and resources are employed; and be aware of the functions and acts of its officers. Directors are expected to use their common sense, to act carefully and deliberately, and to try to foresee the consequences of their acts.
- Directors must make reasonable and informed decisions regarding the business, affairs and policies of the corporation; however, directors need not participate in the day to day business activities of the corporation.
- Generally, the standard of care that directors must meet is to act as carefully as they would have acted under the same circumstances if they were acting on their own behalf. If directors meet this test, they will not usually be held personally liable for the outcome.
- Directors should, in practice, ensure they fully understand the issues brought before them. To do so, directors need accurate, timely and comprehensive information that identifies the major features of the issues to be decided and that canvasses available options. They should ensure that they have been furnished with all the necessary information on which to make their decisions.

REMEDIES AVAILABLE AGAINST DIRECTORS UNDER CBCA

Aggrieved corporations and in some circumstances, third party stakeholders, have a variety of remedies against directors under the CBCA available to them.

Unfair treatment

Under Part XX of the CBCA, shareholders or other affected parties can bring actions against the corporation, its affiliates or the directors, for conduct that is not necessarily illegal but that is unfair. For the most part, these actions are commenced because of malfeasant or inactive directors who are causing damage to the corporation.

The additional statutory remedies available under this part constitute a distinct departure from judicial non-intervention in corporate affairs. Originally, the only remedy shareholders had against directors was the power to remove them at elections. The common law bestowed upon shareholders some slight control, but it is really only since the advent of the new statutory provisions that shareholders and creditors are able to restrain and punish unfair behaviour.

Oppression remedy

In the event of a breach of one of the duties above or otherwise, the CBCA provides a remedy to persons aggrieved by oppressive conduct by directors of a corporation.[61] Section 241, also known as the oppression remedy, gives a complainant the right to apply to a court for relief if any act or omission of a corporation or its directors is oppressive or unfairly prejudicial to or unfairly disregards the interests of any security holder, creditor, director or officer, or if the business or affairs of the corporation or any affiliate are conducted in a manner that has this effect. Provincial corporate law statutes have similar provisions. The wording of the oppression provisions encompasses a broad range of corporate conduct, and claims brought under these provisions are increasing in number and scope. Indeed, oppression claims are increasingly being brought within shareholder class action litigation and in conjunction with derivative actions.

[61] CBCA, Section 241.

The oppression remedy gives wide discretion to a court to determine whether an applicant is a proper complainant under the section. “Any person who, in the discretion of the court, is a proper person to make an application” has standing to bring an oppression claim. Shareholders and directors of a corporation are granted automatic standing to bring an oppression claim. Additionally, creditors have been granted standing to bring oppression claims before the courts.

The potential range of oppression claims is staggering, as the provision is aimed at determining whether the action of the board is one that is “oppressive, unfairly prejudicial or that unfairly disregards” the interests of the complainant. Falling squarely within the purview of the oppression claim is a shareholder complaint of a corporate transaction that is against the best interests of the corporation.[62] However, “no case has laid down a comprehensive definition of oppression”.[63] The many cases that have addressed oppressive conduct have articulated tests that remain, of necessity, vague. As recently stated in *OMERS*:

> “[C]ourts rather than attempting to find an exhaustive all-purpose definition of oppression have tended to look for badges or indicia of oppressive conduct”.[64]

The case of *Arthur v. Signum Communications Ltd.*[65] sets out the substantive elements of an oppression claim under the OBCA. Austin J. focused on the fundamental fairness of the impugned transactions in question, a complicated share reallocation, holding that the oppression remedy of the OBCA required the court to “test qualifying transactions for substantive fairness.”[66] While noting that no single indicator of oppressive conduct would be conclusive,

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[62] *Loveridge Holdings Ltd. v. King-Pin Ltd.*, [1992] O.J. No. 47 (Gen. Div.) and *Arthur v. Signum Communications Ltd.*, [1991] O.J. No. 86 (Gen. Div.).
[63] *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board* (2006), 79 O.R. (3d) 81 (C.A.) at para. 174, leave to appeal refused [2006] S.C.C.A. No. 77 [“OMERS”].
[64] *Ibid*. at para. 92.
[65] *Supra* note 62.
[66] *Ibid*. at para. 131.

Austin J. provided the following list of badges, or indicia, that a given transaction may indeed be oppressive[67]:

- lack of a valid corporate purpose for the transaction;
- failure on the part of the corporation and its controlling shareholders to take reasonable steps to simulate an arm's length transaction;
- lack of good faith on the part of the directors of the corporation;
- discrimination between shareholders with the effect of benefiting the majority shareholder to the exclusion or to the detriment of the minority shareholders;
- lack of adequate and appropriate disclosure of material information to the minority shareholders; and
- a plan or design to eliminate the minority shareholder.

At its essence, the oppression remedy is equitable in nature and requires the court to make a fact-intensive, context-specific inquiry. Oppression remedy jurisprudence is therefore of limited precedential value due to the fact that conduct found to be oppressive in one context may not be so in another.[68] If a finding of oppression is made, the court is free to make any interim or final order it thinks fit to remedy the oppressive or unfair situation, including setting aside an oppressive transaction or ordering compensation for the complainants.[69] The remedial aspect of the oppression provisions is so broad, that the Ontario Court of Appeal has recent upheld a trial judge's decision to award an oppression complainant an equitable remedy of a constructive trust and punitive damages.[70]

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[67] *Ibid.* at para. 132.
[68] *Ferguson v. Imax Systems Corp.*, [1980] O.J. No. 168 (H.C.J.).
[69] CBCA, section 241(3); OBCA section 248(2).
[70] *Waxman v. Waxman* (2004), 44 B.L.R. (3d) 165, leave to appeal refused [2004] S.C.C.A. No. 291.

Despite the broad remedies available under the oppression provisions of corporate statutes, the court's discretion to fashion remedial orders is not unlimited. Courts have recognized that they should not interfere with the affairs of a corporation lightly and that "where relief is justified to correct an oppressive type of situation, the surgery should be done with a scalpel, and not a battle axe."[71] Similarly, the Ontario Court of Appeal recently rejected a wide-ranging power to grant oppression relief, noting that that statutory discretion must be exercised judiciously and "judicial interference with the affairs of the affected corporate should be undertaken only to the extent necessary to rectify the oppression in question".[72]

Courts have confirmed that directors and officers can be the subject of a personal order under the oppression provisions, providing certain preconditions are met.[73] In *Budd*, the Ontario Court of Appeal ruled that where a complainant can demonstrate oppressive conduct by a director or officer acting as such, the director or officer may be personally liable for a monetary order to compensate the aggrieved parties.[74] Such an order will only be appropriate in circumstances where:

> it is alleged that the directors or officers personally benefited from the oppressive conduct, or furthered their control over the company through the oppressive conduct. Oppression applications involving closely held corporations where a director or officer has virtually total control over the corporate provide another example of a situation in which a director or officer may be held personally liable to rectify corporate oppression.[75]

In light of these requirements, it is unlikely that directors will be found personally liable in an oppression action in which the allegations are that the corporation was mismanaged or that the corporation was acting in a manner that was oppressive.

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71 *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 123 at para 140, affirmed (1991), 3 B.L.R. (2d) 113 (Div. Ct.) ["Ballard"].

72 *Catalyst Fund General Partner I Inc. v. Hollinger Inc.* (2006), 79 O.R. (3d) 288 at paras. 54-55.

73 *Budd v. Gentra* (1998), 43 B.L.R. (2d) 27 (Ont.C.A.).

74 *Ibid*. at paras. 43 and 46.

75 *Ibid*. at para. 52.

However, the absence of a requirement that the complainant show a director has acted tortiously enlarges the scope for personal liability of directors in an oppression context. Directors should be aware that because the duties of directors in an oppression context include obligations that parallel their corporate duties at large, directors may be found to have acted oppressively where they breach statutory or contractual duties, or duties arising in tort. Directors may also be found to have acted in an oppressive manner even where they have not breached any of these duties.[76] Consequently, the obligations of directors in the oppression context include "a discrete yet amorphous obligation to refrain from engaging in conduct that results in oppression to a shareholder, creditor, director or officer".[77] As noted above, determination of these criteria remains, necessarily, fact-specific.

Derivative action

Under this remedy, shareholders, both present and past, as well as any other person "who, in the discretion of a court, is a proper person to make an application," may apply to the court for leave to bring an action in the name of and on behalf of the corporation. An application to bring a derivative active can be made when the directors of the corporation are unwilling to take steps to have the action commenced on behalf of the corporation, usually because at least some of them would be defendants. The complainant must give reasonable notice to the directors of the action and must be acting in good faith. A court will not grant leave to bring a derivative action unless it is in the interest of the corporation that the action be brought. The court will generally give leave if the applicant meets these conditions and the action seems to have a reasonable probability of success.[78]

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[76] *Ballard*, supra note 71, at 119.

[77] Mendy Chernos, Michael D. Briggs and Brandon Kain, "Recent Watershed Developments in Oppression Remedies and Shareholder Activism", in *Annual Review of Civil Litigation*, *2006*, (Thompson Carswell, 2006) p. 33 at p. 51.

[78] *Foss v. Harbottle* (1843) 2 Hare 461, 67 E.R. 189 provides for a derivative action at common law. See *Re Northwest Forest Products Ltd*, [1975] 4 W.W.R. 724 (B.C.S.C.); *Marc-Jay Investments Inc. v. Levy* (1974) 5 O.R. (2d) 235 (Ont. H.C.J.); *Re Bellman and Western Approaches Ltd.* (1981), 130 D.L.R. (3d) 193 (B.C.C.A.); *Discovery Enterprises Inc. v. Ebco Industries Ltd.* (1998) B.C.L.R. (3d) 195 (B.C.C.A); *A E Realisations (1985) Ltd. v. Time Air*

Restraining or compliance order

If a director is not complying with the CBCA, the by-laws and articles of the company or a unanimous shareholders' agreement, the court can make an order either restraining him from breaching these provisions, or ordering him to comply with them.

Winding-up remedy

The courts usually do not use the remedy of winding up an entity except as a last resort. Situations such as a deadlock in a partnership or fraud may give rise to its use.

SECURITIES LEGISLATION

As part of an effort to achieve fair and efficient capital markets, the legislature has imposed extensive liability on directors for their actions in securities matters. The CBCA contains some provisions in this regard, but most of the relevant legislation is at the provincial level. There are Securities Acts in each of the provinces, most of which are quite similar. As Ontario's Securities Act is generally the trend-setter for the others, the following references to the "Securities Act" will be to the Ontario Securities Act ("OSA"). The OSA contains several offences for which a director may be held liable.

Insider trading

Directors are deemed to be in a special relationship with the reporting issuer that employs them and are therefore insiders. Insiders are subject to reporting obligations and must file an initial report with securities regulators disclosing the extent of their interest in the corporation and file subsequent reports if there are changes to that interest. In addition, insiders are subject to certain restrictions on the trading of shares of that issuer as well as restrictions on disclosure of information in regard to the reporting issuer. Non-compliance with these restrictions can result in liability for insider trading.

Inc., [1995] 3 W.W.R. 527 (Sask. Q.B.) for examples of judicial consideration of the elements required to obtain leave to bring a derivative action.

Trading in Response to an Undisclosed Change

It is an offence for insiders to trade in shares of the reporting issuer when they are aware of undisclosed material changes. Section 76(1) of the OSA provides:

> No person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or a material change with respect to the reporting issuer that has not been generally disclosed.

The phrases “material fact” and “material change” are defined in section 1 of the OSA. They are essentially facts and changes that “would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer.” General disclosure is not defined in the OSA, but section 75(2) states that a material change must be disclosed forthwith by a press release. Whether a press release will be sufficient to constitute general disclosure will depend on the circumstances of each case. One thing is certain however: general disclosure does not occur the moment the press release is issued. A director must wait a reasonable length of time before trading to ensure that the information has reached the general public before trading in securities based on that information. The Securities Commissions suggest that a reasonable time will have been found to elapse when the information is disseminated in a manner calculated to effectively reach the marketplace, and public investors have been given a reasonable amount of time to analyze the information.[79] Case law suggests that one full trading day following the release of the information should pass before insiders trade, though this time will vary depending on the nature and complexity of the information.[80]

Tipping

Section 76(2) of the OSA provides it is an offence for an insider to “tip” others of material facts before they are generally disclosed by the company:

> No reporting issuer and no person or company in a special relationship with a reporting issuer shall inform, other than in the necessary course of business, any person or company of a material

[79] National Policy 51-201 – *Disclosure Standards*, (2002) 25 O.S.C.B. 4492, section 3.5.
[80] *Re Harold P. Connor,* [1976] O.S.C.B. 149.

> fact or a material change with respect to the reporting issuer before
> the material fact or material change has been generally disclosed.

The same definitions for "material fact" and "material change" apply to this second offence.

Penalties

The penalties for being found guilty of insider trading or tipping can be severe. Under OSA section 122, the general offence section, a breach of the prohibitions against insider trading and tipping can result in a court imposing a penalty of up to five years' imprisonment or a fine of up to Cdn. $5,000,000, or both.

Additionally, the director or officer is accountable to the corporation for any direct benefit received or receivable by the director or officer, and must also compensate the person with whom he or she transacted for any loss suffered by that person. Section 134(6) of the OSA outlines the factors that must be taken into account by the court when assessing damages. The price paid for the securities is compared to the average market price in the 20 days following general disclosure of the material fact or material change. If the plaintiff paid more or received less compensation for the securities than this average, the discrepancy should be payable in damages. The Court may alter this award by taking into account any other relevant factors.

The Ontario Securities Commission, the provincial regulator, can bring an action on behalf of the investor and, without going to court, can impose an administrative penalty of up to $1 million, in addition to imposing other sanctions including cease trading orders and orders preventing an individual from being registered or from acting as an officer or director.

The *Criminal Code* also recognizes offences of prohibited insider trading and tipping in sections 382.1.[81] A conviction for prohibited insider trading could result in imprisonment for up

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[81] Section 382.1 of the *Criminal Code*, as amended by S.C. 2004, c.3, s.5. "Insider information" is defined in the *Criminal Code* as "information relating to or affecting the issuer of a security or a security that they have issued, or are about to issue, that (a) has not been generally disclosed; and (b) could reasonably be expected to significantly affect the market price or value of a security of the issuer."

to ten years, while an individual convicted of tipping could be liable to imprisonment for up to five years.

Defences

There are two defences common to each of the insider trading offences provided for by the OSA. First, the director can prove that he believed the material fact or material change to be already generally disclosed. Second, he can prove that that information was known or reasonably ought to have been known to the other party to the trade. Under the offence of tipping, it is also open to the director to prove that the information was released in the necessary course of business.

Corporations can take many steps to regulate the type of behaviour that can lead to insider trading liability. They can put restrictions on trading in sensitive periods such as those prior to and after the release of important financial information or advice. They can also take steps to ensure confidentiality when information is revealed during the necessary course of business. In order to protect themselves personally, directors should only purchase securities of their own corporation as a long-term investment or at least obtain independent legal advice before proceeding with any transaction involving these securities.

Misrepresentation

Directors may also face personal civil and criminal liability under the OSA for misrepresentations in securities documents. While liability may arise from a misrepresentation in any document furnished under the OSA, it is the prospectus which is of central concern. Section 130(1) of the OSA states that:

> Where a prospectus together with any amendment to the prospectus contains a misrepresentation, a purchaser who purchases a security offered thereby during the period of distribution or distribution to the public shall be deemed to have relied on such misrepresentation if it was a misrepresentation at the time of purchase and has a right of action for damages . . . or . . . the purchaser may elect to exercise a right of rescission . . . .

A "misrepresentation" includes any untrue statement of material fact, an omission to state a material fact that is required to be stated, or an omission to state a material fact that is necessary to make a statement not misleading in the light of the circumstances in which it was made.[82] This latter category captures under the rubric of misrepresentation "so-called 'half-truths.'"[83] A director must be pro-active in ensuring that all facts are included in the prospectus so that it constitutes full, true and plain disclosure. A potential investor must be able to make a fully informed investment decision based on the information provided.

Subsection 130(1)(c) imposes liability on every director of the issuer at the time the prospectus or the amendment was filed. If a purchaser elects to exercise the available right of rescission, he is entitled to receive the purchase price of the securities. If he elects to receive damages, they will be assessed as the depreciation in value of the securities as a result of the misrepresentation relied upon, with a maximum of the price at which the securities were offered to the public.

Section 130.1 of the OSA provides for civil liability in the event of a misrepresentation in an offering memorandum. Section 131 of the OSA provides for civil liability in the event of a misrepresentation in a circular, which includes take-over bid circulars, issuer bid circulars, directors' circulars and director and officers' circulars. The same penalties and defences apply as to misrepresentations in prospectuses.

Penalties

Penalties for misrepresentation can be imposed under the general offence section of the OSA. Section 122 specifically imposes quasi-criminal liability for misrepresentations in any document required to be filed or furnished under the OSA. Therefore, in addition to prospectuses and circulars, directors can be held liable for false statements or omissions in applications, releases, reports, returns, financial statements, statements of material fact and a variety of other documents. Liability may be imposed on directors if they "authorised, permitted or acquiesced"

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82 *Kerr v. Danier Leather Inc.*, *supra* note 58 at para. 61.
83 *Ibid*. at para. 112.

in the making of the statement. The same maximum fine of Cdn. $5,000,000 and maximum jail term of five years apply as they do to insider trading.

Criminal liability for the issuance of a false prospectus can also be imposed under section 400 of the *Criminal Code*, which provides that:

> Every one who makes, circulates or publishes a prospectus, statement or account, whether written or he knows is false in a material particular, with intent (a) to induce persons ... to become shareholders or partners in a company . . . is guilty of an indictable offence and liable to imprisonment for a term not exceeding ten years.

It is by virtue of section 21 of the *Criminal Code* that a director can be charged for a crime committed by the corporation. The director must have actively participated in, assisted in or encouraged the offence. Mere acquiescence is not enough to engage liability under section 21, but directors should be careful if they are in a position to stop the commission of the offence. Some case law suggests that this position will be sufficient to make the director a party to the crime.

The language of section 21 provides that intention is a necessary ingredient of the offence, but case law has suggested that intention can be established by inference. As such, a director must defend himself from such inference once a misrepresentation is located in the prospectus. He is allowed to prove honest but mistaken belief in the false statement. While this test is subjective and does not require an element of reasonableness, any investigation into the background of the impugned statement will be taken into account when assessing the director's defence.

Defences

Section 130 of the OSA sets out the defences available to directors facing liability for misrepresentation. First, a director may prove that the purchaser knew of the misrepresentation at the time of purchase. Second, he may prove that the prospectus was filed without his knowledge or consent and he gave reasonable general notice of this fact on becoming aware of the filing.

Third, he may prove that he withdrew his consent on becoming aware of a misrepresentation, giving reasons therefore, and that he did this before the plaintiff purchased the securities.

A separate defence is available if the misrepresentation was contained in any expertised portion of the prospectus. This could be a geologist's or engineer's report, a legal opinion or a financial statement, among others. A director will not be held liable if he:

> . . . had no reasonable grounds to believe and did not believe that there had been a misrepresentation or that such part of the prospectus . . . did not fairly represent the report, opinion or statement of the expert or was not a fair copy of or extract from the report, opinion or statement of the expert.[84]

There is an onus on the director to check the qualifications of the expert and review the prospectus and report in order to ensure that they match. This will give him "reasonable grounds" for believing that a misrepresentation does not exist. If the report is described accurately in the prospectus but is internally incorrect, it is unlikely that the director will be held liable unless he had some special expertise in those areas that would make him aware of the inaccuracy. If the report is internally correct but is described inaccurately in the prospectus, the director may be found not to have been diligent enough in verifying the information.

A similar defence is available if the false statement was either made by an official person or was contained in a public official document. As long as the statement is correctly and fairly represented in the prospectus and the director had reasonable grounds to believe and did believe the statement to be true, he will not be held liable.

If the director cannot avail himself of any of the aforementioned defences, his only remaining option is to prove due diligence in his investigation of the facts presented in the prospectus. The prosecution is not required to prove wrongful intention. Proof of the misrepresentation is enough to shift the onus to the director to prove that he conducted a reasonable investigation so as to provide reasonable grounds for a belief that the prospectus contained full, true and plain disclosure. If the director can prove due diligence in this sense, as well as an honest belief that there was no misrepresentation, the director will not be held liable.

[84] OSA, section 130(3)(c).

The level of investigation necessary to establish this defence will vary according to the issuer and the individual director. Senior issuers with complicated histories will normally require more investigation than junior issuers offering a first security. As well, a director who is very involved with the company or has special expertise in an area covered by the prospectus could be held to a higher standard of diligence than an outside director with no special knowledge. At the very minimum each director must conduct his own independent investigation and avoid merely relying on management's reports.

The defence to general OSA offences is provided by OSA section 122(2). The director will not be liable if he "did not know and in the exercise of reasonable diligence could not have known that the statement was misleading or untrue or that it omitted to state a fact that was required to be stated or that was necessary to make the statement not misleading in light of the circumstances in which it was made."

There are many steps that a director can take to ensure that he will be found to have exercised due diligence in his investigation of prospectuses and other documents. Among others, it is suggested that directors:

- read all the documents carefully;
- be sure of the completeness of documents;
- check experts' qualifications;
- ensure that the business is described properly;
- make sure there is appropriate evidence that the company has the assets it says it has;
- make sure that legal opinions have been obtained to confirm that the company has the power and capacity to carry on the business;
- make sure the use of the proceeds are adequately described;

- make sure legal opinions confirm that the shares are validly issued;
- ensure that all of the transactions between the issuer and the management have been disclosed;
- ensure that all risks are disclosed;
- check all dollar amounts with the auditors;
- get written analyses from directors or officers involved in certain areas of the business of the descriptions of those areas in the document; and
- keep a record of all investigative efforts.

Most importantly, each director should remember to do his own investigation or ensure that an independent investigation has been carried out into all material facts stated in public materials, and rely as little as possible on management and other directors.

Secondary Market Disclosure Liability

The Ontario legislature has recently passed legislation creating secondary market civil liability regimes.[85] "Secondary market liability" refers to liability to investors in the secondary markets of public companies, and the directors, officers and others connected with them. Directors of reporting issuers may be liable to investors who acquire or dispose of shares of the company during a period of time in which there is an uncorrected misrepresentation in a

[85] See OSA, Part XXIII.1, S.O. 2002, c. 22; S.O. 2004, c. 31, Schd. 34. British Columbia has enacted similar legislation. See *Securities Act*, [RSBC 1996] c. 418, s. 131, in force as of May 18, 2006. See also Bill 25, which amends the *Securities Act*, R.S.A. 2000, c. S-4 to create civil liability for secondary market misrepresentations, and which received Royal Assent on May 24, 2006 (proclaimed into force December 31, 2006). In Manitoba, Bill 17 amends the *Securities Act*, C.C.S.M. c. S50, received Royal Assent on June 13, 2006 (proclaimed into force January 1, 2007). In Saskatchewan, Bill 19 amends the *Securities Act*, 1988, S.S. 1988-89, c. S-42.2, received Royal Assent on May 17, 2007 (expected to be proclaimed into force July 1, 2007). In Nova Scotia, Bill 75, which amends the *Securities Act*, R.S.N.S. 1989, c. 418, received Royal Assent on November 23, 2006 (not yet proclaimed into force). In Newfoundland, Bill 51, amending the *Securities Act*, R.S.N.L., 1990, c. S-13, received Royal Assent on December 12, 2006 (not yet proclaimed into force).

document or public oral statement or where there has been a failure to make timely disclosure of a material change. Directors may be liable for the release of a "document" containing a misrepresentation whether or not that director played a part in the release. "Document" is defined broadly to include any communication that must be filed, that is filed or that is made and, once made, may reasonably be expected to affect the market price or value of the security of issuer.

Where public oral statements contain a misrepresentation or where there is a failure to make timely disclosure of a material change, directors will be liable if they authorize, permit or acquiesce in the making of the public oral statement or the failure to disclose.

In certain circumstances, a lesser standard of care is applied. Where there is a misrepresentation of a "non-core" document or in a public oral statement, directors will only be liable if the plaintiff can prove that, at the time the document was released or the statement was made, the director knew there was a misrepresentation, deliberately avoided acquiring knowledge of the misrepresentation or was guilty of gross misconduct in connection with the misrepresentation. Similarly, where there is a failure to make timely disclosure of a material change, a director will only be liable if the plaintiff proves that at the time of the failure, the director knew the change was material, deliberately avoided acquiring knowledge of the change or was guilty of gross misconduct in connection with the failure to disclose.

There are several defences to secondary market liability. Directors will not be liable if they can prove that they made a reasonable investigation and they had no reasonable grounds to believe that there was a misrepresentation or that failure to make timely disclosure would occur. A director will also have a defence if the plaintiff acquired or disposed of the securities with knowledge that there was a misrepresentation or with knowledge of the material change.

A director's total liability under these provisions is normally limited to the greater of $25,000 and 50% of his or her total twelve-month compensation from the issuer and its affiliates. However, if a director is guilty of knowingly misrepresenting or knowingly failing to disclose certain information, he may be liable for the whole amount of the damages. Further, the statutory right of action under the secondary market liability regime is expressly granted in addition to and

without derogation from any other rights. Therefore, plaintiffs may still be free to avoid the statutory cap on damages.

Certification of Financial Statements and Sarbanes–Oxley Compliance

Multilateral Instrument 52-109 – *Certification of Disclosure in Issuers' Annual and Interim Filings* ("MI 52-109") came into force on March 30, 2004 in all jurisdictions except British Columbia and Quebec as Canada's response to the certification requirements in the U.S. *Sarbanes-Oxley Act*.[86] MI 52-109 came into force in Quebec on June 30, 2005 and in British Columbia on September 19, 2005. MI 52-109 requires each chief executive officer and each chief financial officer (or, in either case, the person who performs those functions) of reporting issuer, other than a non-investment fund, to sign an annual certificate relating to its annual filings, being its annual information form, annual financial statements and annual management discussion and analysis, and an interim certificate relating to its interim filings, being its interim financial statements.

The certifications required are in prescribed form and cannot be altered. The certifications provide that, based on the knowledge of the person signing: (i) the annual or interim filings do not contain any untrue statement of a material fact or omit to state a material fact necessary to make a statements not misleading in light of the circumstances under which it was made; and (ii) the annual or interim financial statements together with the other financial information included in the annual or interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of the dates and for the periods covered. The certificates also contain statements regarding the issuer's disclosure controls and procedures and its internal controls.

A false certification could expose a certifying officer to criminal, administrative or civil proceedings under the OSA. A false certification could also potentially be the subject of a private action for damages either at common law or under the OSA in relation to statutory civil liability for misrepresentation in continuous disclosure documents. The liability standard applicable to a document required to be filed with the OSC, including an annual certificate or

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[86] *Sarbanes-Oxley Act*, 12 U.S.C. § 7201 (2003).

interim certificate, depends on whether the document is a "core document" as defined in the secondary market liability requirements of the OSA. Annual certificates and interim certificates are not included in the definition of "core document" but would be caught by the definition of "documents."

In an action commenced under the secondary market liability regime, a court has the discretion to treat multiple misrepresentations having common subject matter or content as a single misrepresentation. In appropriate cases, this provision could permit a court to treat a misrepresentation in an issuer's financial statement and a misrepresentation made by an officer in an annual certificate or interim certificate that relate to the underlying financial statements as a single misrepresentation.

TAXATION

A director is subject to both civil and criminal liability if the corporation fails to comply with federal and provincial laws regulating tax matters and other source deductions. Of all the potential liability faced by directors, the one that historically has been the most likely to materialize is the liability of a director for unfulfilled withholding obligations of a corporation under the *Income Tax Act* (Canada) (the "ITA"). In the last few years, the Canada Revenue Agency (the "CRA") has been vigorously pursuing directors in this area.

Civil liability under the Income Tax Act (Canada)

A corporation is required by the ITA to deduct, withhold, remit or pay amounts relating to:

- the payment to employees and others of salaries, wages, certain benefits and payments out of various plans; and
- the payment or crediting of certain amounts such as dividends, interest or royalties, to non-residents.

Also covered, but only of limited interest to most corporations, are patronage dividends and payments under now-cancelled programs for scientific research tax credits and share purchase tax credits.

If a corporation fails to withhold or remit the above-noted amounts, it is liable for the payment of the tax, plus interest and penalties. Section 227.1(1) of the ITA provides that the directors of a corporation that has failed to withhold or remit the taxes are jointly and severally liable, or liable together with the corporation, to pay those amounts and any interest or penalties relating to them.

Additionally, sections 159(2) and (3) of the ITA provide that any person who acts as an "assignee, liquidator, receiver, receiver-manager, administrator, executor or any *other like person*" (emphasis added) in administering, winding up, controlling or otherwise dealing with the property of a corporation without obtaining a clearance certificate, indicating that all taxes have been paid or secured, will be personally liable for any tax liability of the corporation up to the value of the property distributed. Although these provisions are not specifically designed to impose liability on directors of corporations, the CRA and the courts have taken the view that a director of a corporation can, in certain circumstances, be an "other like person" on the winding up of a corporation.[87]

Criminal liability under the Income Tax Act (Canada)

Section 242 of the ITA imposes criminal liability on directors who authorise, direct, assent to, acquiesce in or participate in an offence under the ITA by the corporation. Where a corporation is guilty of an offence under the ITA, an officer, director or agent of the corporation who directed, authorised, assented to, acquiesced in, or participated in the commission of the offence is a party to and guilty of the offence and is liable on conviction to the punishment whether or not the corporation has been prosecuted or convicted. For example, directors could be prosecuted under section 242 for:

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[87] See Interpretation Bulletin IT-368, "Corporate distributions – Clearance Certificates" (Ottawa: Revenue Canada, March 28, 1977); and *Malka v. R.* (1978), 78 D.T.C. 6144 (F.C.T.D.).

- failing to file tax returns on time or at all;
- failing to report dispositions of property (where the corporation is a non-resident corporation);
- issuing false receipts for political contributions;
- failing to withhold and remit taxes;
- failing to keep proper records and documentation;
- failing to carry out compliance orders; and
- making false or deceptive statements on a tax return.

Punishment varies depending on the offence, with fines as high as Cdn. $25,000, or 200 per cent of the tax which should have been remitted if tax evasion is at issue, and imprisonment for up to five years.

In order for directors to be found liable under section 242, the Crown must prove beyond a reasonable doubt the guilt of the corporation and that the director at least assented to the offence. At a minimum, the *mens rea* under this section must include knowledge of the circumstances surrounding the offence, an ability to influence the corporation and failure to take the steps to either have the tax paid or CRA apprised of the situation.

Other tax statutes

There are many other statutes, both at the federal and provincial level, which impose liability on directors for general failure to comply and failure to withhold and remit certain amounts. Other federal statutes include the *Employment Insurance Act*, the *Canada Pension Plan Act*, and the *Excise Tax Act*. Some Ontario statutes are the *Corporations Tax Act*, the *Retail Sales Tax Act*, the *Employer Health Tax Act*, and the *Pension Benefits Act*.

The Goods and Services Tax ("GST") is regulated by the *Excise Tax Act* and imposes joint and several liability on directors, together with their corporation, for the corporation's

failure to remit GST. Liability will include the net GST owing as well as any interest accrued and penalties. Directors are liable for remitted net tax whether or not the GST was collected.

A director must also ensure that he withholds and remits the proper amount of pension benefits, health benefits, employment insurance and provincial retail sales tax in order to comply with these other statutes. As most of these statutes are modelled after the ITA, provisions regarding directors' liability and defences are substantially similar.

Defences to tax liability

There are several defences that are available to directors under Canadian tax statutes. The main defence is, again, that of due diligence. A director may attempt to prove that he exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the corporation's failure to pay, deduct, withhold or remit the required amounts. Canadian courts have found this to be a standard that combines the objective standard of reasonable prudence with an individualized assessment of the particular director's situation and level of skill and experience.[88] At a minimum, directors should seriously consider the following preventative measures:

- become familiar with the sections of the taxation statutes that apply to the corporation so that they are aware of the withholding and remittance obligations;
- establish a system which will ensure timely remittances;
- insist on regular reporting from officers on the implementation of the system;
- obtain regular confirmations that the withholdings and remittances have been made;
- establish a separate account for these amounts;

[88] See Martha O'Brien, "The Director's Duty of Care in Tax and Corporate Law" (2003), 36 U.B.C.L. Rev. 673-691.

- do not rely on any officer's, director's or professional's assurance that everything is under control; and
- advise the Canada Revenue Agency immediately if there is a withholding problem.

Case law suggests that a lack of control over the corporation's failure to remit may be an adequate defence. If the director is in the minority or is a passive director but attempts to persuade the board that the proper amounts should be withheld and remitted and has these efforts recorded in the minutes, it is unlikely that he will be held liable. Similarly, if the director has no power to act due to the appointment of a trustee in bankruptcy or a receiver-manager, it is possible that he may not be found responsible.

Where a corporation is in financial trouble, courts may require directors to go beyond discussing the problem with the officers of the corporation and require "physical intervention and evidence of active corrective measures and follow up."[89] If the assessment of a director is a possibility, the CRA will give advance notice of this fact and allow the director to outline elements of a due diligence defence in writing before they decide whether to prosecute.

ENVIRONMENTAL LIABILITY

Responsibility for environmental regulation is divided between the federal and provincial governments, with some overlap between the regimes. The provincial sphere is generally of greater concern as provincial regulators have traditionally taken a more active role in prosecuting environmental offences. This chapter will examine the federal and the Ontario provincial environmental regimes.

Canadian Environmental Protection Act

The *Canadian Environmental Protection Act, 1999* ("CEPA") is the main federal statute which imposes environmental liability on directors and officers. It is complimented by other statutes addressing specific federal environmental issues, such as the interprovincial

[89] *Machula v. Canada* [2003] T.C.J. No 481 (Tax. Ct.)

transportation of dangerous goods and other activities.[90] Section 280.1 of the CEPA imposes on directors the duty to take all reasonable care to comply with CEPA and its regulations. If a corporation commits an offence under CEPA or its regulations, any officer or director who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is a party to and guilty of the offence, and is liable to the punishment provided for the offence, whether or not the corporation has been prosecuted or convicted.[91]

There is a wide range of indictable and summary conviction offences under the CEPA for which a corporation and hence a director may be held liable. They include: providing information or notices as required under CEPA; the failure to do proper testing; the failure to comply with transportation of dangerous goods requirements; the manufacture and import of unapproved substances; improper use of sewer systems; the failure to comply with occupational health and safety requirements; or any orders issued under CEPA and any form of pollution involving air, land or water. Punishments differ for the various offences with a ceiling of Cdn. $1,000,000 for fines and three years' imprisonment, or five years in respect of fraudulent activities.

CEPA offences are strict liability offences subject to the due diligence defence. A director who is charged with an environmental offence must generally show that he was duly diligent or took all reasonable care to prevent the occurrence of the offence. Liability can be imposed if a director fails to prevent what he should have foreseen. The standard used is that which a reasonable man would have foreseen in comparable circumstances. As such, this section establishes a positive duty for directors to comply with CEPA and prevent any environmental damage.

To complement the offence provisions, CEPA contains provisions by which directors can be made subject to administrative orders by virtue of the fact that they have "charge" of a property or substance. These orders can be either preventive or remedial. The cost of compliance is usually quite high. If a director ignores such an order, the Ministry of the

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[90] For example: the *Transportation of Dangerous Goods Act*, the *Fisheries Act* and the *Hazardous Materials Information Review Act*.

[91] CEPA, section 280(1).

Environment may take the measures itself, and claim the costs back from the director personally as a debt due to the Crown.[92]

Provincial regimes - Ontario

The Ontario *Environmental Protection Act* ("EPA") is the main environmental statute in Ontario. Like CEPA, it is complemented by other statutes addressing specific environmental issues, many of which have provisions regarding director liability comparable to those of the EPA.[93]

The EPA imposes on all directors a duty to take all reasonable care to prevent the corporation from contravening the EPA. The content of a director's duty under the EPA is to provide oversight and management of the environmental affairs of the company. To discharge this duty, directors should confirm that officers are addressing promptly the environmental concerns that are brought to their attention. They have an obligation to be aware of the industry environmental standards and, in fact, have a duty to react immediately and personally when they become aware that any system has failed. This duty includes the obligation to review environmental compliance reports provided by the officers of the corporation, subject to their "... placing reasonable reliance on reports provided to them by corporate officers, consultants, counsel or other informed parties."[94] Failure to do so exposes the director or officer of a corporation to conviction, whether or not the corporation itself has been prosecuted or convicted.

For a successful prosecution, the Crown must prove beyond a reasonable doubt that: (i) the director directs a company that engages in an activity that may result in a discharge of a contaminant into the natural environment and therefore has the duty set out in the EPA, (ii) there

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[92] CEPA, section 291(3).

[93] See, for example: the *Ontario Water Resources Act*, the *Pesticides Act*, the *Health Protection and Promotion Act*, the *Business Practices Act*, the *Occupational Health and Safety Act*, and the *Nutrient Management Act*, *2002*.

[94] *R. v. Bata Industries Ltd.* (1992), 70 C.C.C. (3d) 394 at para. 147 (Ont. Ct. (Prov. Div.)) (WL).

was an action or failure to prevent an unlawful discharge and (iii) it was objectively foreseeable to the director that the action or failure to take action would cause the unlawful discharge.[95]

Recent revisions to the EPA have strengthened the enforcement sections. Persons convicted of an offence are now liable for a fine of up to Cdn. $50,000 for the first conviction and up to Cdn. $100,000 for a subsequent conviction, to imprisonment for up to a year, or to both. Directors can also be subject to the financial consequences of administrative orders made under the EPA by virtue of the directors' charge, management or control of the substance or the property.

Due diligence defence

The due diligence defence is available under all Canadian environmental statutes. Directors are not expected to always be entirely successful in preventing offences from occurring, but they are expected to take reasonable care to do so. Some factors which the courts have taken into account when assessing the due diligence defence include:

- the magnitude of the injury caused to the environment, business or individuals;
- the existence of an adequate pollution prevention system;
- supervision of this system;
- the timely reporting of any infractions;
- the directors' responses to the situation;
- the existence of emergency plans;
- the accepted practices in the industry;
- the existence of alternatives to the steps that were taken;

[95] *R. v. Commander Business Furniture* (1993), 9 C.E.L.R. (N.S.) 185 (Ont. Ct. Prov. Div.), aff'd [1994] O.J. No. 313 (Ont. Ct. Gen. Div.).

- the economic feasibility of these alternatives;
- the foreseeability of a potential source of danger (the reasonable man in this case being an environmentally conscious person with the specialised knowledge one would obtain from that particular industry);
- the ability to control the damage (thus, no one would be held liable for "acts of God"), and
- the newness of the technology involved.

To protect against liability, directors should consider taking the following steps with respect to discharging their environmental duties:

- ensure that inspection and clean-up systems are implemented and have adequate budgets;
- receive regular reports on the functioning of inspection and control systems;
- assign responsibility to individuals for both the implementation and reporting;
- ensure that all staff are properly trained;
- set up an internal discipline system to ensure compliance;
- get independent advice from environmental experts;
- use equipment designed to cause the least amount of harm to the environment;
- update and replace the equipment regularly and keep pace with or exceed industry standards;

- insert mechanisms into the agreements with contractors to ensure that they work in an environmentally sound manner;
- consider increasing security to prevent occurrences of vandalism which could result in environmental damage; and
- keep an extensive record of the corporation's environmental measures at all times.

WORKPLACE LIABILITY

Unpaid wages

Corporate statutes and employment standards legislation in many provinces make directors liable to employees for unpaid wages. For example, the corporate statutes and the *Employment Standards Act, 2000* (Ontario) (the "ESA") render directors jointly and severally liable to employees for all debts not exceeding six months' wages payable to each employee for services performed for the corporation while they are directors. Under section 119(1) of the CBCA, a director is liable for up to six months of "debt for . . . services performed for the corporation" while the director is in office.

Canadian courts have held that section 119 of the CBCA applies to bonuses, sales commissions, and expenses incurred on behalf of the corporation. It does not include wages for wrongful dismissal which the Ontario Labour Relations Board requires the employer to pay, damages, moving expenses, bonuses promised but not earned, termination pay or severance pay. The ESA specifically makes directors responsible for vacation pay, holiday pay and overtime pay.

It is an offence under the both the CBCA and section 136 of the ESA for a corporation to fail to pay unpaid wages. Any director who authorizes, permits or acquiesces in a contravention of the ESA becomes a party to the offence, regardless of whether the corporation is prosecuted or convicted. Upon conviction, a director is liable to a fine of up to Cdn. $50,000 or imprisonment

for up to twelve months, or both, and may be ordered to pay the amount unpaid by the corporation.

A director can avoid or reduce liability in several ways. Under the CBCA, a director can raise a due diligence defence and prove that he took reasonable steps to ensure payment of unpaid wages; however, the ESA places the onus on the director to prove that he or she did not authorize, permit or acquiesce in the contravention. By resigning, a director can cap liability at the amount accrued to employees at the time of resignation. Some director insurance policies will cover liability for unpaid wages. Directors can also cause the corporation to establish a trust with a capital fund in an amount equal to potential liabilities for unpaid wages, to be paid out to employees in the event the corporation is unable to satisfy these debts. The ESA permits the corporation to indemnify a director in respect of liability, and permits a director to seek contribution from other directors.

Occupational health and safety

Directors can also be held liable under the *Occupational Health and Safety Act* (Ontario) ("OHSA") (or other applicable occupational health and safety legislation, as the case may be). Section 32 of the OHSA imposes a positive duty on directors and officers:

> Every director and every officer of a corporation shall take all reasonable care to ensure that the corporation complies with,
>
> (a) the Act and the regulations;
>
> (b) orders and requirements of inspectors and Directors; and
>
> (c) orders of the Minister.

It is not only directors and officers who have express duties under the OHSA. Workers, owners, constructors, licensees, supervisors and suppliers each have duties to ensure that there is a working health and safety policy in effect, that it is updated annually, that there are joint health and safety committees, regular work inspections, that employers and workers comply with the OHSA, that equipment is well maintained, that people are trained properly, that all dangerous substances are stored and handled properly, that any dangers or contraventions of the OHSA are

reported and responded to immediately, that there is a system to deal with work accidents, and generally, that the health and safety of workers is protected.

Penalties apply to any of the persons who contravene the OHSA or fail to comply with government orders. Fines can be as high as Cdn. $25,000 and imprisonment as long as twelve months. Due diligence is again available as a defence.

Recent amendments to the *Criminal Code*[96] have also increased corporate accountability for workplace accidents. Everyone who directs, or has the authority to direct, how another person does work or performs a task, has a duty to take reasonable steps to prevent bodily harm to that person, or to any other person, arising from that work or task. In cases of serious workplace accidents, companies could face substantial fines, while directors and senior officers could be liable to a maximum prison terms of life, where death results, and ten years where the accident results in bodily harm.

Labour relations

Collective bargaining relationships between employers and unionized employees in Ontario are governed by the provisions of the *Labour Relations Act, 1995* (Ontario), which provides the framework of rules and regulations to be followed in collective bargaining situations. A breach of these rules can give rise to an unfair labour practice, which may be adjudicated by the Ontario Labour Relations Board. There is no explicit provision in the Act imposing liability on directors and officers, but the Labour Relations Board has defined these individuals as "persons acting on behalf of the employer," and thus responsible for compliance with the rules under the *Labour Relations Act, 1995*.[97]

LIFTING THE CORPORATE VEIL

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[96] See *Criminal Code,* section 217.1, introduced by S.C. 2003, c. 21, s. 3.

[97] *L.I.U.N.A., Local 1059 v. 715241 Ontario Ltd.,* [1998] O.L.R.B. Rep. 974 at paras. 11-12. Sections 70, 72, 73 and 78 of the *Labour Relations Act, 1995* impose liability upon persons "acting on behalf of the employer".

It is a basic concept of corporate law that the corporation is a separate legal entity from its shareholders and employees. As far back as 1897, in the famous case of *Salomon v. Salomon & Company Ltd.*,[98] and more recently in the various business corporations acts, it has been recognised that the corporation is akin to a natural person, with its own set of rights and liabilities. This separation between a corporation and its owners is commonly referred to as the "corporate veil." The historic benefits of this division in terms of the financing of entrepreneurial activities and the creation of capital markets are undeniable.

The common law has evolved with the increasing pressure to hold those responsible for corporate action accountable for any tortious conduct by them or the corporation. Canadian courts have confirmed that there is no principled basis for protecting directors, officers and employees from liability for their own tortious conduct on the basis that such conduct was in pursuance of the interests of the corporation.[99] However, the doctrine of the corporate veil has not been abolished. Directors, officers and employees of limited companies remain protected from personal liability unless it can be shown that their actions are themselves tortious or exhibit a separate identity from that of the company so as to make the act or conduct complained of their own.[100] It is not yet clear whether a director or officer could be held liable for an unintentional tort.[101]

The legal standard appears to change where the conduct complained of goes beyond mere tort and becomes criminal or near criminal. In this case, the courts do not generally require the actions to exhibit a separate identity of interest of the corporation.

There are four circumstances in which liability will be imposed on directors for criminal or near criminal acts of the corporation:

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98 [1897] A.C. 22.

99 *ADGA Systems International Ltd.* v. *Valcom Ltd.* (1999), 43 O.R. (3d) 101 (C.A.)

100 *Scotia McLeod Inc.* v. *Peoples Jewellers Ltd.* (1995), 26 O.R. 481 (C.A.), leave to appeal to S.C.C. refused 183 D.C.R. (4th) vi; *Meditrust Healthcare Inc.* v. *Shoppers Drug Mart* (1999), 124 O.A.C. 137 (C.A.) leave to appeal to S.C.C. refused 134 OAC 399; *Immocreek Corp.* v. *Pretiosa Enterprises Ltd.* (2000), 186 D.L.R. (4th) 36. See also J. Sarra, "The Corporate Veil Lifted: Directors and Officer Liability to Third Parties" (2001), 35 C.B.L.J. 55-72.

101 *Sugitan* v. *McLeod,* [2002] O.J. No. 878 (S.C.J.), in which the issue was raised but not determined.

- where the corporation was formed for the express purpose of doing a wrongful or unlawful act;
- when the director expressly or impliedly directed that a wrongful thing be done;
- where the corporation is being used as a cloak to cover fraud or improper conduct; and
- where it would be "flagrantly opposed to justice" not to lift the corporate veil. [102]

Similarly, the corporate veil cannot be used to protect directors against liability for crimes committed by the corporation. As Stuart C.J. commented in *R* v. *United Keno Hill Mines*:[103]

> Sentencing, to be effective, must reach the guiding mind - the corporate managers: be they directors or supervisors. They are the instigators of illegality either through wilfulness, wilful blindness, or incompetent supervisory practices. ... A corporate veil should never afford the slightest measure of protection to anyone for criminal conduct. . .

CRIMINAL AND NEAR-CRIMINAL ACTS

General Criminal Liability

Just as there is no corporate veil protecting directors and officers from personal liability for negligent acts committed in office, directors and officers have personal criminal liability for criminal acts done in the course of their duties.[104] Liability can be imposed either individually,

[102] Bill McNally and Barb Cotton, "A Thesis Regarding the Civil Liability of Directors for Criminally or Near Criminally Culpable Acts", The Advocates' Quarterly, Vol. 30 at p. 194 (2005).
[103] (1980), 10 C.E.L.R. 43 (Y. Terr. Ct.), at p. 52.
[104] *Criminal Code*, s. 21(1).

or where it is proven that there was a common intention among two or more directors and/or officers of a corporation to commit an unlawful act.[105]

It is not a bar to personal conviction that the acts were committed on behalf of a corporation, and that the corporation itself is liable. The director and/or officer can still be held liable, either as the principal, or as an aider or abettor, as the facts may prove.[106]

Threats and Retaliation Against Employees for Disclosing Unlawful Conduct

A new offence designed to prohibit threats or retaliation against employees for disclosing unlawful conduct was introduced into the *Criminal Code* in 2004.[107] The provision reads as follows:

> **425.1** (1) No employer or person acting on behalf of an employer or in a position of authority in respect of an employee of the employer shall take a disciplinary measure against, demote, terminate or otherwise adversely affect the employment of such an employee, or threaten to do so,
>
> (a) with the intent to compel the employee to abstain from providing information to a person whose duties include the enforcement of federal or provincial law, respecting an offence that the employee believes has been or is being committed contrary to this or any other federal or provincial Act or regulation by the employer or an officer or employee of the employer or, if the employer is a corporation, by one or more of its directors; or
>
> (b) with the intent to retaliate against the employee because the employee has provided information referred to in paragraph (a) to a person whose duties include the enforcement of federal or provincial law.

The new provision has been criticized as a measure likely to have little effect, given that whistleblowers will take little comfort in the protections afforded by the provision.[108]

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[105] *Criminal Code*, s. 21(2)
[106] *R.* v. *Fell*, (1981) 64 C.C.C. (2d) 456 (Ont. C.A.)
[107] *Criminal Code*, section 425.1.
[108] Scott C. Hutchison & Marie Henein, "Life After Martha, It's Not a Good Thing: Corporate Crime and Criminal Corporations," republished in "Crime & Corporations", Osgoode Hall Professional Development (Toronto: 2006) at p.9

Nonetheless, the inclusion of the provision in the *Criminal Code* sends a strong signal to the business community that it cannot enforce a corporate code of silence to protect wrongdoing.

Anti-Terrorism Legislation

The *Criminal Code* was amended in 2001 to create new and serious liability risks for corporations and their directors in relation to terrorist financing and activity. These new provisions potentially expose directors and officers of corporations to criminal charges for fundraising or other financial activities that are proven to directly or indirectly support or facilitate broadly defined 'terrorist activities' or 'terrorist groups.'

As a result of the breadth of application of the anti-terrorism provisions of the Criminal Code and the serious consequences which flow from them, directors of corporations must now be extremely diligent in ensuring that they do not contravene the many criminal and civil law offences under the Act and related federal legislation.

In addition to the potential criminal liability for assisting terrorist activities and terrorist groups, certain types of organizations must perform ongoing audits to ensure that they are not in possession of property owned or controlled by such groups.[109] Such entities must make a report to the agency or body that supervises it under federal or provincial law either that it is not in possession or control of property owned or controlled by or on behalf of a listed terrorist entity, or that it is in possession or control of such property, in which case it must also report the number of persons, contracts or accounts involved and the total value of the property.[110] The directors of such organizations are responsible for fulfilling the corporate audit and reporting obligations.

No criminal or civil proceedings lie against a person for making a report in good faith, but any person who fails to make the reports required are guilty of an offence and liable on summary conviction, to a fine of not more than $100,000 or to imprisonment for a term of not

[109] *Criminal Code*, s. 83.11(1). The entities include certain foreign banks, cooperative credit societies, most insurance companies, fraternal benefit societies, trust and loan companies, and securities and investment dealers.
[110] *Criminal Code*, s. 83.11(2)

more than one year, or to both; or on conviction on indictment, to imprisonment for a term of not more than 10 years.[111]

REDUCTION OF LIABILITY: INDEMNIFICATION AND INSURANCE

There are many methods that can be used to reduce a director's personal exposure to liability. Indemnification by the corporation and the purchase of insurance are two of the most common methods.

Indemnification

Permissive indemnification

Section 124(1) of the CBCA permits a corporation to indemnify a director or officer, or a former director or officer, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity. However, the corporation may not indemnify an individual unless that individual:

(1) acted honestly and in good faith with a view to the best interest of the corporation; and

(2) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, the individual had reasonable grounds for believing that the individual's conduct was lawful.[112]

If the director meets these two tests, the corporation is permitted to indemnify him. The corporation is under no obligation to do so, however, unless a specific indemnification agreement was executed before the action was commenced.

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[111] *Criminal Code*, ss. 83.11(3), 83.12(1)
[112] CBCA, section 124.

Several situations can arise where a director has met these tests but the board does not wish to indemnify him. They may be concerned about the director's honesty or a hostile merger or take-over may have taken place. For protection, directors should always ensure that they enter into an indemnification agreement with the corporation when they are first employed.

Mandatory indemnification

Section 124(5) of the CBCA states that, if a director has met the two tests outlined in section 124(3) and "was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done," the director is entitled to the indemnity as of right, and the corporation must indemnify him.

Prohibitions against indemnification

The CBCA provides many exceptions where indemnification will not be permitted. It is evident from section 124(3) that honesty and good faith are prerequisites to coverage. As such, reimbursement is eliminated for certain conduct, particularly breach of fiduciary duties, in respect of which a director can be sued successfully. While corporate charters and indemnification agreements can modify the indemnification rules outlined in the statute, they cannot override the requirements of honesty and good faith. As well, section 124(4) states that a corporation may not indemnify a director in the event of a derivative action without the approval of the court.

The main drawback of indemnification is its ineffectiveness in the event of an insolvency. In those circumstances, a director will usually find himself saddled with defence costs and, possibly, a judgement as well. There are ways to stop this situation from occurring. The corporation could secure its indemnification obligation by establishing a special trust fund as a reserve. However, this would have to be done sufficiently in advance of the corporation experiencing any financial difficulties to avoid the challenge by creditors that the agreement was a preference or fraudulent conveyance. As well, if a closely held corporation is involved, a director may ask to be indemnified by the principal shareholder.

As a practical matter, indemnification always covers costs, charges and expenses reasonably incurred in mounting a defence, but often does not cover amounts paid to settle an action or a judgement in the case of derivative actions. In some cases, the court will order the company to deposit security for the director's costs. If the director is not successful, he may have to pay for his own costs as well as those of the corporation.

Insurance

The principal type of insurance available to protect against liability is directors' and officers' liability insurance ("D&O insurance"). Such insurance will normally protect directors and officers from claims alleging wrongful acts against them personally. Wrongful acts are generally defined as errors, misstatements, misleading statements, acts, omissions, neglects or breaches of duty or claims made against an individual solely as a result of his/her position as director or officer of a certain corporation.

A director should be aware of standard exclusions from the D&O policies as well as any written into particular contracts of insurance since policies vary widely between insurance companies.

The first standard exclusion is based on section 124(6) of the CBCA, which states that a corporation may purchase insurance for any director or officer referred to in subsection 124(1) against any liability incurred by the individual "in his capacity as a director or officer." As such, and because of the operation of section 124(3), as with indemnification, insurance cannot be used to bail out a director who has acted dishonestly or fraudulently. Other standard exclusions include pollution and nuclear liability. Most policies also do not cover prior or pending litigation or any claims or incidents which occurred before the commencement of the insurance period.

In reading any given insurance policy wording, directors should be careful of ambiguous wording and undefined terms. For example, does "director" include past, present and future directors? Does it cover outside directors? Does "company" include subsidiaries? Are defence costs included? If so, will they be paid as they are incurred or will they be reimbursed after the action is over? If the former, will the director be able to have a lawyer of his own choosing? If

the latter, will the director be able to withstand the cost of litigation until the lawsuit is concluded?

Insurance policies also vary greatly in regard to coverage, premiums and deductibles. Some insurers may cover derivative actions; some may not. In addition, if the company has taken out a policy to cover its indemnity to directors, the relationship between that policy and the policy insuring the directors themselves should be examined carefully to ensure that there are no unacceptable gaps.

Generally, indemnification and insurance will be available in the same situations, with the exception of insolvency. In an insolvency, it is possible that insurance will provide protection when an indemnity will not. Additionally, if a director or officer breaches the standard of care of a reasonably prudent person but complies with his fiduciary duty to act honestly and in good faith in the best interests of the corporation, a situation which may be characterised as "honest negligence," insurance may well provide protection whereas an indemnity may not.

Other reduction measures

Insurance policies and indemnification should not be used alone in an attempt to reduce liability exposures. A thorough risk management program can go a long way in reducing a director's exposure in the first instance. A prudent director's checklist should include the following:

- attend all board meetings;
- speak your mind (silence is consent);
- insist on receiving in advance all relevant information relating to matters requiring board approval;
- insist that the materials circulated be meaningful, comprehensible and succinct;
- read circulated materials carefully, and in advance;

- ensure that the board is regularly exposed to members of the corporation's senior management, not just its chief executive officer;
- review all minutes when received;
- keep personal notes of meetings;
- keep a file in which to collect minutes and other important documents;
- consider obtaining independent legal advice on any major corporate steps to be taken and on written professional opinions from specialists such as accountants, valuers and investment advisers on whose advice the board is expected to act;
- insist that the minutes record any disclosure, abstention or dissent made by a director;
- insist on good audits and an effective audit committee; and
- be alert and responsive to changing circumstances.

CONCLUSION

Increased public scrutiny of corporate governance issues in the post-Enron era, coupled with the proliferation of cross-border suits, higher standards of care and an increased willingness by the courts to intervene, signal a new era of director and officer liability. Directors who accept the position of trust and confidence entrusted to them are increasingly asked to answer for their conduct. How directors will respond to these new challenges remains to be seen.

CANADA

APPENDIX A

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The Antarctic Environmental Protection Act, S.C. 2003, c. 20;

The Aeronautics Act, R.S.C. 1985, c. A-2;

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The Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3

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The Canada Cooperatives Act, S.C. 1998, c. 1;

The Canada Business Corporations Act, R.S.C. 1985, c. C-44;

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The Trust and Loan Companies Act, S.C. 1991, c. 45.

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The Pay Equity Act, R.S.O. 1990, c. P-7;

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