OECD CONFERENCE

Thursday, December 7, 2000

Session 4: The Board of Directors

SPEAKING POINTS

Introduction

- Industry Canada's Corporations Directorate is responsible for administering *The Canada Business Corporations Act, The Canada Corporations Act* (Not-for-Profit), *The Canada Cooperatives Act*, and several other related statutes.

- We work hand-in-hand with the Corporate Law Policy Directorate of the Corporate Governance Branch of Industry Canada, who are responsible for issues related to the amendment of the legislation.

Our Mandate

- The mandate of the Corporations Directorate is *to balance the rights and interests of corporations with those of shareholders and other stakeholders in a manner that benefits the competitiveness of Canadian companies and, ultimately, the prosperity of the nation*.

- In keeping with this mandate, our administration of the acts is enabling rather than restrictive.

The Canadian Environment

- In Canada, the jurisdiction to incorporate is shared between 14 governments (one federal jurisdiction and thirteen provincial and territorial).

- It should be noted that at present, there are currently 150, 000 active federal incorporations. We represent about 10% of active Canadian corporations. However federal corporations represent 50% of the Financial Post's Top 500.

- As well, in Canada, jurisdiction for securities law is shared among the provinces and territories, with no federal regime.

- This creates an incorporation "market" in Canada where companies can choose the legislation, regulations and fees that best meet their needs.

- This situation has an impact on how we approach legislation and regulation.

- If, for example, we were to add an age restriction to membership on boards of directors for federal companies, it is possible that many of the companies affected would simply change jurisdiction.

Boards of Directors

- There are no provisions in the CBCA dealing with board structure. Our legislation is, therefore, fairly permissive in terms of requirements for boards of directors.

- The CBCA requires that:

- there has to be at least one Director (S. 105)
- directors have to be at least 18 years old
- they must be of sound mind (or at least that they have not been found unsound by a court)
- they must be an individual (can't be a corporation or other form of "natural person")
- they must not have the status of bankrupt, and finally
- the majority of directors must be resident Canadians (as defined in regulations)

· the latter point is one of the few restrictions that the legislation currently places on Board members. Impending reform of the CBCA will reduce the residency requirement for board members to 25% with certain exceptions.

· Other restrictions could be included in the companies' articles or bylaws, but these would be challengeable in court if they are considered to be prejudicial to some members.

DIRECTORS'& OFFICERS' DUTIES & LIABILITIES

The tendency on the part of legislators to hold directors and officers personally liable for corporate conduct, combined with other factors, seems to increase the potential for liability of directors and officers. That is why the Federal Government has introduced the due diligence defence in its proposed amendments to the CBCA.

LIABILITY AT COMMON LAW

In the past, directors might have been forgiven for failing to pay close attention to the question of personal liability. *Salmon v. Salmon & Co. Ltd (HL) 1897 A.C.22*

> A corporation is a legal entity, distinct from its shareholders and directors with the result that shareholders and directors were generally accorded the advantages of limited liability.

Over time, various exceptions were introduced. Courts were somewhat hesitant to "pierce the corporate veil" and to impose personal liability. They did so where the corporation could be termed to be constituted or operating as a mere cloak or sham, where it really carried out wrongful or illegal acts and where the company is a vehicle for fraud.

Where the corporation is a mere agent of a shareholder (Law of principal and agent). Here Canadian courts will only find such a relationship in the clearest of circumstances. There must not only be control, but also use of the control to commit fraud or wrongdoing. The issue of fairness is beginning to creep more and more into the law.

Directors can be held liable in contract at common law if it does not appear from the terms of the contract that the director was not contracting on behalf of the company.

Directors who cause a corporation to breach a trust or participate in a breach of trust obligations may be personally liable.

Where the corporation creates a tort, directors and officers will not be held personally liable merely by reason of their office, but if those in

control expressly direct the tort to occur, they may be exposed to liability. (They make the actions their own.)

STATUTORY LIABILITIES

Most of the exceptions to *Salmon* have been dealt with through legislation.

There are criminal or summary conviction offences included. There are three categories of offences established by the SCC in *R. v. Sault Ste Marie (City)* 1978 85 DLR (3d) 161:

1. Mens Rea Offences
   In CCC cases requires proof by the prosecution beyond a reasonable doubt of both the act complained of and the intention to commit the act.
2. Strict Liability Offences
   The prosecutor must show beyond reasonable doubt that the act occurred. Here the accused has the right to use the due diligence defence.
3. Absolute Liability Offences
   Requires proof that the act occurred and does not admit a due diligence defence.

PERSONAL CIVIL LIABILITY

In exercising and discharging their various powers and duties, the directors and officers of a corporation are required to adhere to a certain standard of behaviour. Under ss. 122(1) of the *CBCA*, directors and officers in the exercise of their duties must:

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

The *CBCA* imposes a positive duty to comply with ss.122(1) (as well as all other provisions of the Act, the regulations, articles, bylaws and any unanimous shareholder agreements). It further provides in ss. 122(3) that no provision of a contract, the articles, the bylaws or a resolution relieves a director or officer from his or her duty to act in accordance with ss. 122 (1), the regulations, or from liability from a breach thereof.

Fiduciary Duties

Fiduciaries are required to demonstrate loyalty and good faith in the performance of their duties and to avoid any conflict of their duty and self-interest.

Duty of Care, Diligence and Skill

Did away with *Re City Equitable Fire Insurance Co. Ltd.* (1925) Ch. 407 where Romer J stated that the director need exhibit only that degree of care and skill that might be expected of a person with the knowledge and experience of the director in question. The present standard is - that of a reasonable person in comparable circumstances. It is more objective and somewhat higher, although, it does not require the level of care that might be expected of a reasonably prudent director in comparable circumstances.

Courts have given little guidance concerning the precise nature of duty of care, diligence and skill required as a director. What is the level of skill? It appears that anyone with or without any skills can be appointed as a director. A legally trained director will see legal issues for example, should one without legal skill see the legal issues?

The level of diligence is also considered at the same standard; carry out the duties diligently as a reasonably prudent person in the position of a director could be expected to exercise, at a minimum, to attend diligently to the managerial and other duties imposed by statute.

So, directors who wish to meet the statutory standard of care will need to be attentive, active and informed.

Recent Changes

- Recently, the Canadian Federal government undertook a legislative reform initiative to update the CBCA (Bill S-19), including the introduction of a “due diligence” defence as previously referred to.

- The proposed amendments were developed to improve the legal framework for CBCA corporations, fostering enhanced shareholder input in decision making and providing corporations with greater flexibility in pursuing marketplace opportunities.

· Specifically, the amendments were designed to:
  - expand shareholder rights -- by giving shareholders improved means to communicate, make proposals and participate in decision making;
  - enhance global competitiveness -- by allowing stronger international representation on the boards of CBCA corporations and supporting risk taking;
  - clarify responsibility -- by addressing the liabilities of directors, officers, shareholders and other parties, notably in regard to the provision of financial information; and
  - eliminate duplication and reduce costs -- by modernizing the Act and harmonizing with provincial laws.

What are the main proposed changes to the CBCA? Without going into detail on each of the major changes, I will highlight the area of the proposed changes with a short explanation of the objectives sought.

<u>Directors' Residency</u>
- Drop the requirement for Canadian resident directors from 50% to 25%
- Avoid use of Unanimous Shareholder Agreements
- The 50% rule is deemed to be an impediment for foreign investors
- Export oriented corporations want to increase number of foreign board members

<u>Financial Assistance Provisions</u>
- At present, the Financial Assistance provisions restrict a corporation from giving financial assistance to insiders where there is reasonable grounds that the corporation can't meet a solvency and assets test. In fact the Canadian Institute of Chartered Accountants (CICA) forbids its members from certifying that a corporation does meet the criteria.

- The amendments propose to follow the “disclosure” only model as is the case in the province of Saskatchewan.

Shareholder Communication

There are two types of shareholder communications that are dealt with.

a) between Corporations and Shareholders

- At present, corporations cannot communicate with shareholders. In some cases, shareholders don’t want the corporation to know who they are. Corporations have to go through intermediaries. Corporations want to communicate directly.
- New law will allow direct communication where the shareholder does not object.

b) between shareholders

Communications between shareholders is presently inhibited unless an onerous and expensive proxy solicitation route is followed. Institutional and independent investors are becoming more active, they want to communicate amongst themselves. Need to relax the rules.
- The amendments will grant an exemption for oral and written as long as not seeking proxy authority.
- The amendments will allow proxy solicitations through public broadcast, speech, publication provided proxy circular is sent to the corporation and filed with the Director CBCA (Quebec and Ontario now allow proxy solicitation by newspaper ads).

Shareholder Proposals

- increase the maximum number of words allowed in a proposal
- set minimum size required for proposals and minimum of time
- drop the exclusion of beneficial

Directors, Officers, Others' Liability

- uncertainty can inhibit decision making in risky situations. Need to take risks in global scenario. Introduction of the "due diligence" defence.
- broader indemnification for directors to allow indemnification for investigative proceedings and those acting on boards at the company's request, remove restrictions on insurance, clarify duties of directors

Auditors

Auditors were complaining that because of the present liability provisions contained in the present CBCA, they were consistently held financially responsible in failing corporation scenarios (Deep Pocket Theory). At present, joint and several liability is the law.

- The amendments will render auditors liable only when they are negligent in the preparation of an audit and to the proportion of the damages caused by their wrongdoing "proportionate liability".

Takeover Bids

Presently, publicly traded CBCA corporations are also regulated by provincial securities law in the area. In 1996, the Standing Senate Committee recommended increasing the takeover threshold from 10% to 20%.

Insider Trading

- Status quo, harmonization with provinces

Going-Private Transactions

Does the CBCA allow for going-private transactions? The 1994

Corporations Directorate policy statement said it was permissible. Because of some lingering doubts, the amendments will clearly allow "Going-Private Transactions".

Stakeholder Interest debate

Some United States legislation and some European countries provide for the consideration of stakeholder interests in decision making in one form or the other. At present, Canada has decided not to introduce this element into the CBCA but will go through an extensive consultation on the issue during its consultations on the Not-For-Profit legislation consultations which have begun this December and will continue throughout 2001.

The proposals which brought forth the above amendments followed extensive public consultations, with several hundred stakeholders taking part. The Bill to amend the CBCA was at an advanced stage in the Parliamentary review and approval process when a federal election was called in October. We will have to go through the process again with the new Parliament. As a result, the new amendments should be in place sometimes in late 2001 or the Spring of 2002.

CBCA Response to Issues Raised in Davies Paper

- The CBCA has been developed to be largely self-enforcing by civil action initiated by an aggrieved party, not through severe penalty sanctions or sweeping investigative power.

- The Act allows two forms of redress via court action

Derivative Actions - Management vs shareholders as a class

- Derivative actions (s. 239) allow a complainant to seek to enforce a right of the corporation.

- Typical examples of cases where a derivative action may be undertaken are actions against directors for a breach of duty (such as self-dealing or negligence), an action for an injunction to preclude a threatened injury to the corporation, or an action to restrain an act outside the scope of the corporation, its directors or officers.

- This form of redress is not available to enforce the rights of individual shareholders or groups of shareholders.

Oppression Remedy

- The Act also gives shareholders, creditors, directors and officers the right to apply to the court for an oppression remedy (ss. 241(1). Subsection 241(2) states:

If, on an application to a court, the court is satisfied that in respect of a corporation or any of its affiliates,

(7) any act or omission of the corporation or any of its affiliates effects a result;
(8) the business or affairs of the corporation or any of its affiliates have been carried out in a manner, or
(9) the power of the directors of the corporation or any of its affiliates are or have been exercised in a manner

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any shareholder, creditor, director or officer, the court may make an order to rectify the matters complained of.

Involvement of the Director of Corporations

- In his paper, Davies generally discards this sort of application to court as a minimalist approach (expensive and courts lack the expertise), however the Canadian model also requires that the Director of Corporations be informed of any applications under section 241. Under the CBCA, the Director has the right to appear and be heard in court.

- Pushing the power to initiative litigation further down within the shareholder body to either minority group of shareholders or even individual shareholders creates the risk that litigation will not be brought in the interest of the shareholders as a class, but in order to promote the particulars and interests of a small group of shareholders.

- Director examines the documentation relating to the court application on the basis of fairness to all parties and makes a decision to intervene or not.

- The participation of the Director adds an extra level of review to ensure fairness and the costs associated with undertaking a court
  action reduce the possibility of frivolous actions being undertaken.

Corporation vs Stakeholders (non-shareholders)

- Section 122 requires the directors to act in the best interests of the corporation, defined by the courts as the best interests of the shareholders. Consultations were held on widening this responsibility to include other stakeholders but no consensus was reached.

CONCLUSION

Each of the presentations that you have heard today point to one direction: The key role of strong corporate governance system, whether they be in hard law or soft law. Let us keep striving in that direction.
A good corporate governance regime in a competitive environment is the key to successful corporate vitality.

As Peter Drucker once said, and I paraphrase as I don't remember where I read it: "In every instance of corporate failure, the last to find out that things were going wrong was the Board of Directors".