OSLER

Institute of Corporate Directors
Institut des administrateurs de sociétés
Better Directors. Better Boards. Better Business.™

Directors' Responsibilities in Canada

October 2014

Osler, Hoskin & Harcourt LLP

Institute of Corporate Directors

In Memory of Purdy Crawford
1931 – 2014

We remember Purdy for his extraordinary leadership and the remarkable impact he had on those he mentored and worked with over his extensive career. We are honoured to have counted Purdy as a friend and colleague for so many years, and we will greatly miss his wisdom, generosity and pursuit of excellence in all things.

Directors' Responsibilities in Canada

October 2014
Sixth Edition

Foreword

A Retrospective and Prospective Look at the World of Corporate Governance: Insights from Three Institute of Corporate Directors Fellows.

"The more things change, the more they stay the same." This old adage applies to many areas of business, and corporate governance is no exception. The spate of regulations that followed the global financial crisis has put corporate directors squarely in the cross-hairs. Beyond heightening the levels of accountability expected of boards, these regulations introduced the potential for increased director liability. However, today's definition of "good corporate governance" continues to draw on meaningful lessons learned from the principles that have long guided Canadian boardrooms.

In recognition of our twenty-fifth year of publishing Osler's guide to *Directors' Responsibilities in Canada*, produced in collaboration with the Institute of Corporate Directors (ICD), we spoke with three legends that have shaped governance best practices and principles in this country – Purdy Crawford, Peter Dey and Brian Levitt – and captured the Osler alumni and ICD fellows' thoughts on the evolution of corporate directorship.

Purdy Crawford’s name is synonymous with Canadian business and law. The “dean emeritus of Canada’s corporate bar,” he was a mentor to several of Canada’s brightest economic thinkers and is recognized for his contribution to changing the way business is done in the boardroom, particularly in opening the door for women.

Peter Dey, the founding author of *Directors’ Responsibilities in Canada*, chaired the Toronto Stock Exchange Committee on Corporate Governance in Canada that released the seminal Dey Report, which established governance standards for Canadian companies. In addition to a successful career as an M&A advisor, securities regulator and investment banker, Peter remains an active corporate director and continues to drive the reform process, including the critical importance of diversity.

Brian Levitt is a Vice-Chair of Osler, having had successful careers as a lawyer advising on M&A and corporate governance matters and as a CEO of what was at the time one of Canada’s largest companies as measured by market capitalization. For more than 25 years, he has served as a director of various public companies, and currently serves as a board chair, having chaired another board prior to that.

The Evolution of Corporate Governance

According to all three professionals, much has changed in the world of corporate governance in recent years.

“Corporate directorship is much less of a ‘boys club’ than it was in the past,” Purdy says. “There is greater recognition of actual or potential conflicts of interest and the need for good, transparent processes to lead to proper outcomes. There is also a greater emphasis on professionalism, training, mentorship and meritocracy.”

Peter concurs. “I think the evolution that has taken place is the significant increase in the proposition of institutional investors in our capital markets, with a broad range of investment time horizons imposing an equally broad range of pressures on boards of directors.”

“The heightened focus on the role and responsibility of directors in delivering corporate performance began with the Enron scandal and the passage of the Sarbanes Oxley legislation in the United States, and has been intensified by the emergence of activist investors and the impact of the Great Recession on financial markets,” Brian adds. “As economies recover, directors can’t lose track of that business. The marker of good corporate governance is not having good processes; it’s having a healthy business. Directors cannot be expected to guarantee a perfect outcome. In business, you need to take risks because, without risk, there would be no reward. This may increase the risk of judgments being contested, but directors who make business judgments based on a sound factual foundation have nothing to fear.”

Paving the Way for Good Corporate Governance

As much as corporate governance in Canada has evolved in recent years, the fundamental principles remain the same.

“There has always been a recognition of the inherent value of ethical behaviour on behalf of all stakeholders,” Purdy asserts. “But many of these factors have become formalized in law and policy guidelines. However, their essential value has always been around. It has simply now become fashionable to recognize it.”

“There have always been good boards that provide value and effective management oversight,” Brian agrees. “While the process that guides this behaviour has risen in importance over the past few years, the substance remains as important as it ever was.”

According to Peter, these underlying behaviours underpin the ongoing relevance of our early corporate governance guidelines. “Governance is just good common sense,” he says. “When you put a group of people together, it’s about the steps they take to ensure they make sensible decisions.”

Adapting Guidelines for Today's Markets

While Purdy, Peter and Brian agree that many of the early corporate governance principles remain relevant, they would consider the addition of a few additional guidelines.

"I think boards should focus on the sustainability of the enterprise over the longer term, rather than being too responsive to a component of the investment community whose compensation depends on how their investments prosper quarter-to-quarter," Peter says.

"I would also emphasize leadership's role in establishing the ethical culture of an organization," he continues. "And I might put in a guideline to emphasize the importance of diversity – not just by gender, but by thought process, experience and knowledge."

Enhancing Shareholder Value Through Governance Best Practices

Strong corporate governance has long focused on the imperative of enhancing shareholder value. Achieving this objective, however, requires an understanding of how board decisions translate into business results.

"If you get the right people on the board and in management, with the right mix of skills and experience, and everyone understands their role, you maximize the likelihood that the critical decisions that a company has to make, such as those regarding capital allocation and leadership, will enhance its value for all stakeholders," Brian explains.

"Corporate directors must always focus on enhancing shareholder value, but determining what this means is not simple," adds Purdy. "Actions that highlight ethical behaviour, contributions to society and generally being a good corporate citizen can often be seen as appropriate to enhancing long-term shareholder value."

"Management is typically focused on today's issues and a board can often fall into the trap of just looking at what has happened, rather than at helping management focus on looking forward," he continues. "The board does this by making forward-looking strategy part of the discussion at the boardroom table and by putting management incentives in place to encourage this forward thinking."

What Constitutes Good Corporate Governance

Although Canada is often cited for its world-class corporate governance practices, directors and leading experts in this space continue to contemplate strategies for improving performance.

"The practice in Canada of separating the CEO position from the Chair of the Board position, rather than combining these roles in one person, has in many ways set the tone for a more principle-rich approach to governance," Purdy notes. "This approach is inherently more balanced and adaptable to evolving governance issues than a rules-based, ticking-the-box approach."

"For my part, I think it's important that directors are either owners or think like owners," Peter says. "Directors should take their compensation, if possible, in equity and hopefully develop a meaningful investment over time, which encourages them to think like owners and should produce better decisions and better results."

Brian sums up by asserting that good governance requires a combination of two things: a clear and mutual understanding of who is accountable for what, and a relationship of trust and confidence between management and the board. "The linchpin for both these elements is the CEO's attitude towards the board," he says. "If the CEO wants feedback and the benefit of the board's advice, and respects and trusts the board, then you get a positive mutual feedback loop that encourages board members to rise to the challenge."

Plotting a Course for the Future

There are, of course, considerably more challenges for today's directors than in the past, which is why Osler's guide to *Directors' Responsibilities in Canada*, produced in collaboration with the ICD, bears ongoing updating and review. Beyond covering the duties of directors, the role of shareholders and the shifting regulatory mandates to which boards must adhere, this guide is designed to help directors discharge their duties in a way that benefits all corporate stakeholders while simultaneously contributing to effective and transparent operation of the capital markets. We believe you will continue to find it a valuable tool in fulfilling your responsibilities amid today's constantly evolving business trends, market shifts and technological innovations.

Message from the President and CEO of the Institute of Corporate Directors

In recent times, rarely does a day go by without some story in the media about corporate governance. Not only is the media focused on corporate governance, but so too are society, stakeholders, regulators and politicians.

In an increasingly transparent, competitive and challenging global environment, demands and expectations for corporate and organizational performance, and director effectiveness and performance have been elevated. As stewards of their corporations and organizations, directors are expected, among other things, to engage in the oversight of strategy, talent management, executive compensation, risk management, and the appointment and continuing evaluation of the CEO. High performance boards add value in all of these areas.

But to whom do directors owe their duty? The seminal decision of the Supreme Court of Canada in BCE Inc. makes it clear that directors owe their duty to the corporation. In discharging this duty, directors are required to have fair regard to the interests of various stakeholders.

Furthermore, the BCE Inc. decision makes it clear that directors should focus on the creation of value over the longer term. In doing so, directors will be challenged to overcome pressures brought to bear by proponents of short-termism and short-term thinking.

How should directors balance short-term pressures with the need to conduct business in a socially responsible manner, and create high performing and sustainable organizations? Ultimately, the key will lie with the exercise of business judgement by directors. But in exercising this business judgement, directors must be familiar with the legal framework within which they operate.

As the "go-to" community for directors in Canada, the ICD is committed to the sharing of wisdom, information and tools to enable directors to build better boards and ultimately, better businesses. We are delighted to collaborate with Osler in the publication of this guide and hope it will continue to be a valuable reference for the director community in understanding and discharging its legal obligations.

Yours truly,

Stan Magidson

Table of Contents

Introduction

Directors of corporations have good reason to be concerned about their responsibilities and potential liabilities. Society is very interested in proper corporate governance and, in particular, the accountability of individuals who direct corporate behaviour. There is complex securities regulation in the corporate governance area in Canada and the United States. Courts, regulators, legislators and shareholders closely scrutinize the way in which directors discharge their responsibilities.

Directors respond by closely monitoring the activities of the corporation they serve, by critically evaluating their exposure to liability as a result of the corporation's activities and financial condition, and by recognizing that, in many cases, they can manage the risks if they fully understand the nature of their obligations so that they can properly discharge them.

This guide outlines the responsibilities and liabilities imposed on directors of Canadian corporations. While the guide focuses on public companies, private company directors have essentially the same responsibilities and liabilities as their public company counterparts except for those imposed by securities laws or stock exchange requirements. The guide deals with the issues confronting directors in the following way:

- Part I sets out corporate and common law duties of directors and describes the general principles applicable to the discharge of those duties. It also outlines the manner in which the corporation, shareholders and third parties may enforce those duties.
- Part II describes the role of shareholders.
- Part III addresses corporate governance as it relates to the process by which boards of directors discharge their responsibilities.
- Part IV discusses a number of decisions that directors typically face and highlights the issues which should be of particular concern to directors making such decisions.
- Part V describes some of the additional statutory duties imposed on directors, the penalties associated with a breach of those duties and the defences available to directors.
- Part VI reviews the ways that directors can reduce their risk of personal liability, in particular through indemnities and insurance.

Reference is made primarily to corporations governed by the *Canada Business Corporations Act* (the CBCA) and the duties and liabilities imposed on directors of those corporations. While provincial business corporations legislation is, in most cases, substantially similar to the CBCA, there are differences from one statute to the next in the provisions dealing with directors. Some significant differences are highlighted, but directors should consult counsel to ensure they are aware of all of the responsibilities imposed on them by their corporation's governing statute. Corporations that carry on business in regulated industries such as banking are not subject to these corporate statutes. However, the governing statutes of many of these corporations impose the same broad duties on directors as do the corporate statutes, in addition to certain other responsibilities relevant to the particular industry in question. These industry-specific responsibilities are referred to occasionally, but are not treated exhaustively. Again, boards of directors should consult their legal advisors for advice on liabilities pertinent to their industry.

Reference is made to the 1994 report (the "1994 TSX Report") of the Toronto Stock Exchange Committee on Corporate Governance in Canada (informally known as the Dey Committee after its chair, Peter Dey) and the 2001 report (the "2001 TSX Report") of the Joint Committee on Corporate Governance (informally known as the Saucier Committee after its chair, Guylaine Saucier). The guide also details recommended or required corporate governance practices under securities laws. In particular, the guide describes the corporate governance guidelines in *National Policy 58-201: Corporate Governance Guidelines* (NP 58-201), corporate governance disclosure requirements in *National Instrument 58-101: Corporate Governance Disclosure* (NI 58-101) and standards for audit committee composition and practices in *National Instrument 52-110: Audit Committees* (NI 52-110).

Finally, this guide identifies only a sampling of the more significant statutory duties imposed on directors. Directors must ensure they are fully informed of all their responsibilities and potential liabilities in order to meet the standards imposed on them by law.

I. Duties of Directors

I. Duties of Directors

Part I describes the duties of directors and the general principles applicable to the discharge of those duties. Directors are responsible for monitoring the business and affairs of the corporation consistently with their two principal duties: fiduciary duty and duty of care. The directors' fiduciary duty requires them to act honestly and in good faith, with a view to the best interests of the corporation. Their duty of care requires them to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances. In discharging these duties, directors have the benefit of the business judgment rule. In most jurisdictions they also have the benefit of an expert reliance defence. Part I also outlines the manner in which the corporation, shareholders and third parties can enforce these duties: oppression; derivative actions; and compliance orders.

In Canada, a director's duty is owed to the corporation. This duty is grounded in basic principles of good faith, stewardship and accountability. Requirements imposed both by common law and various statutes seek to establish the parameters of this duty without limiting the flexibility of these principles.

This part of the guide sets out the function and mandate of the board of directors. It describes the fundamental statutory and common law duties of directors and the general standards applicable to the discharge of those duties. Finally, it identifies the remedies available to shareholders, creditors and others to ensure that directors discharge their responsibilities in the manner prescribed by law.

1. Function of the Board of Directors

The role of director is one of stewardship. Directors are responsible for managing, or supervising the management of, the corporation. Shareholders make a financial investment in the corporation which entitles those with voting shares to elect the directors. If shareholders are not satisfied with the performance of the directors, they may remove the directors or refuse to re-elect them. Except for certain fundamental transactions or changes, shareholders normally do not participate directly in corporate decision-making, and while, as a practical matter, boards want to know the views of the shareholders, strictly speaking, directors are not normally required to solicit or comply with the wishes of shareholders.

Directors have complete discretion to exercise their powers as they deem appropriate, subject to the constraints imposed by law. Each director must act honestly and in good faith with a view to the best interests of the corporation and must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Delegation is permitted with certain exceptions and must be reasonable in the circumstances, but responsibility for major decisions and the exercise of general discretion will always be the responsibility of the directors.

(a) Manage versus Monitor

The complexities of modern business impose a number of challenges on the ability of directors to manage or supervise the management of a corporation. A board should supervise, direct or oversee the business and affairs of a corporation, but cannot manage them in a day-to-day sense. In most respects, directors monitor rather than actively manage the corporation's business and affairs. Directors are neither required nor expected to devote their full time and attention to the corporation's affairs. Rather, they perform their functions periodically, primarily in preparing for and attending meetings of the board of directors.

Responsibility for the day-to-day management of a corporation's affairs is delegated to the Chief Executive Officer, Chief Operating Officer, Chief Financial Officer and other senior executives who are responsible to, and report back to, the board. Appointing these senior executives and evaluating their performance are among the most important functions of the board. The relationship between the board and senior management — some of whom typically also sit on the board — is critical to good corporate governance and to minimizing the risk of liability to directors. The board must have confidence in the abilities, judgment and integrity of the corporation's senior executives. Communication and candor between the board and management are critical if the board is to be confident that it is being kept fully abreast of issues and developments facing the corporation.

Notwithstanding the delegation to senior executives of very broad powers over a corporation's affairs, the board of directors must reserve to itself the ability to intervene in management's decisions and to exercise final judgment on any matter that is material to the corporation. Although no bright line separates the duties of the board from the duties of senior management, the overriding principle governing delegation is that directors must retain ultimate control over the corporation. Directors must be sufficiently familiar with the business and affairs of the corporation to know that it is being managed in an appropriate fashion. They must exercise sufficient leadership to ensure that the corporation is following a course that they have approved. Whether business decisions actually originate with the directors is less central to the board's function than whether the directors are monitoring how these decisions are formulated and implemented.

The perception of the corporate director as a figurehead is as inaccurate as ever. The old perception of directors as passive observers of the corporate process no longer applies. Directors are now far better informed, more visible and more involved.

(b) Mandate of the Board

The mandate of the board will vary from corporation to corporation. Corporate statutes offer some flexibility in the way each corporation is governed to allow the parties involved to tailor the allocation of responsibility for running the corporation among shareholders, directors and management to suit particular needs and circumstances.

The board performs certain functions prescribed by statute and is involved in considering significant strategic issues facing the corporation. For the most part, management determines what specific matters are put before the board. To a lesser extent, the directors themselves make this determination through standing resolutions, guidelines or by-laws initiated by the directors.

Effective corporate governance requires each board of directors to assume responsibility for the stewardship of the corporation. NP 58-201 recommends that a board adopt a written mandate in which it acknowledges responsibility for stewardship of the corporation, including responsibility for:

- Satisfying itself as to the integrity of the Chief Executive Officer and other executive officers;
- Adopting a strategic planning process;
- Identifying the principal risks of the corporation's business and ensuring implementation of systems to manage these risks;
- Succession planning;
- Adopting a communication policy;
- Internal control and management information systems; and
- Developing the corporation's approach to corporate governance.

The board's responsibility for strategic planning and monitoring opportunities and risk is critical. This responsibility involves more than merely adopting a strategic planning process. The board should be responsible for developing the corporation's strategic direction by approving a strategic plan that identifies business opportunities and business risks. The board should oversee management's systems for managing business risk and periodically review the strategic environment with management.

Among the matters generally put before a board are financial statements; business plans; major financial activities, including major capital expenditures and raising capital; executive hiring; compensation; assessment and succession; issues relating to the corporation's products or services (such as quality and safety); organizational restructurings; and acquisitions and divestitures.

In order for a board of directors to discharge its responsibilities, it must not only be aware of and approve the general direction and plans of the corporation, it must also be satisfied that the plans that it has approved are being effectively implemented and that appropriate internal and external monitoring and audit systems are in place to ensure that the corporation's affairs are being run responsibly. This is done, in part, by reviewing and approving materials such as strategic plans, operating plans and budgets, and by seeking and relying on the advice of experts, both from within the ranks of the corporation's management and from outside the corporation.

Boards have adopted comprehensive audits of particular aspects of corporate operations as an integral part of effective monitoring. Boards have always used audits in the accounting context; however, audits are now used by boards in other areas. For example, environmental audits are common. Audits of sales and pricing policies are often done to ensure compliance with competition laws, as are audits of purchasing procedures to confirm the integrity of tender processes.

Implementing appropriate audit procedures, particularly in areas involving the principal risks to the corporation's business, is important even if there are no issues of immediate concern. Such procedures allow the board to satisfy itself about the day-to-day operations of the corporation's business and other aspects of management's activities that the board cannot realistically expect to oversee or review. In addition to being an effective and necessary part of the monitoring process, these procedures will, in many cases, prove vital in any defence mounted against claims alleging that directors have fallen short of their legal obligations in discharging their duties.

The manner in which a board of directors carries out its mandate depends on the particular corporation, its business, size and geographic scope, and the nature of delegation to management. In some corporations directors may be involved in making major business decisions, while in others decision-making may be more decentralized. In some cases directors may be expected to craft the corporation's long-term strategic plan, while in others this may initially be the responsibility of a sophisticated strategic planning department or the Chief Executive Officer. Boards also establish committees to assist in carrying out their roles and responsibilities.

Part of the directors' contribution is the unique perspective they bring to corporate management. This applies in particular to outside directors. It may be difficult, for example, for management to take a long-term view of the corporation's business, particularly if remuneration is tied to short-term performance. Some investors also tend to have a short-term orientation, and therefore the price of a corporation's securities is driven to some extent by short-term rather than long-term results. Directors may be able to provide a tempering influence by introducing a longer-term perspective into the corporation's actions.

The dynamics of the board may depend on the extent to which specific shareholder interests are represented on the board. In Canada, to a higher degree than in the United States, large corporations may have a controlling shareholder. Such shareholders may determine who sits on the board and may advise the directors on the action it wishes the corporation to take. In most cases, directors will be able to reconcile the interests of the controlling shareholder, which will normally want the corporation to be successful, with their fiduciary duties to the corporation and the right of the minority to be treated fairly. If one corporation is a wholly owned subsidiary of another, if the directors act in the best interests of the subsidiary, they will generally be acting in the best interests of the corporate shareholder. In any event, directors should be aware that the law charges them with the same responsibilities and subjects them to the same liabilities, whether the corporation they serve is closely controlled or widely held.

The objectivity that directors and, in particular, outside directors contribute to the governance of a corporation is supplemented, in some cases, by an advisory board. An advisory board is typically composed of a number of senior business, professional and/or scientific people selected to provide an additional perspective on the business and plans of the corporation. An advisory board usually meets on an ad hoc basis and has no legal responsibilities to the corporation.

2. Standards of Performance

Directors derive responsibility and liability from a variety of sources. The corporation's governing statute (most often a corporate statute, but, in some cases, separate legislation such as that governing the banking or loan and trust industry) gives directors certain powers, imposes certain responsibilities and prescribes a standard of conduct. For public companies, securities and stock exchange requirements also impose duties of fairness and skill on the decisions reached by directors. These general principles are outlined in this section.

In addition to the corporate statutes, a wide array of other statutes dealing with specific matters such as income tax or the environment impose personal liability on directors if the corporation breaches those statutes. Further, directors may, in some restricted circumstances, be liable under general principles of common law for breach of contract or negligent misrepresentation as a result of actions taken in their capacity as directors. Directors may only be liable if they acted in such a deliberate and reckless way that they made the wrongful acts their own as distinct from the company's. For example, in *M&L Travel Ltd.*, the Supreme Court of Canada held the directors of a private corporation personally liable for a breach of trust by the corporation because they had full knowledge of the actions of the corporation and, thus, knew of the breach of trust. In *ADGA Systems v. Valcom*, the Ontario Court of Appeal concluded that directors are responsible for their own individual tortious conduct even if they claim they pursued the conduct on behalf of the corporation.

The corporate statutes impose two principal duties on directors: fiduciary duty and duty of care. Directors cannot contract out of these responsibilities and may be personally liable for any breach of these duties.

(a) Fiduciary Duty

Directors are fiduciaries of the corporation they serve. This long-standing common law principle governs all aspects of the directors' relationship to the corporation and is codified in the corporate statutes by the requirement that directors act "honestly and in good faith with a view to the best interests of the corporation" in exercising their powers and discharging their duties.

In *BCE Inc.*, the Supreme Court of Canada confirmed that the directors' fiduciary duty requires a director to act in the best interests of the corporation. In determining whether they are acting in the best interests of the corporation, directors may consider the interests of various stakeholders. The directors' fiduciary duty comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. Directors must therefore think carefully about whether a course of action will benefit the corporation, while ensuring they have also considered the impact of that course of action on those whom it will affect.

The fiduciary relationship dictates a strict standard of conduct which includes loyalty and good faith. The Supreme Court of Canada described the content of the directors' fiduciary duty in *Peoples Department Stores* as follows:

> *The statutory fiduciary duty requires directors and officers to act honestly and in good faith vis-à-vis the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. Directors and officers must serve the corporation selflessly, honestly and loyally.*

Most directors, particularly independent or outside directors, have interests and activities beyond their function which could, on occasion, give rise to a conflict of interest or the appearance of such a conflict. Notwithstanding the general principle, the corporate statutes prescribe a procedure for directors to deal with a limited number of circumstances in which their outside interests come into conflict with the corporation's interests. These are discussed in Part III.

A director's responsibilities to the corporation are not diminished, and may not be compromised, by other relationships the director may have. This applies to directors who are nominated by particular parties such as a major shareholder, a class of shareholders, a creditor or employees. The overriding principle governing a director's behaviour is that the director has a fiduciary responsibility to the corporation, rather than to one or more shareholders or any other constituency.

Holding multiple directorships may also put a director in a position of conflict. A director who serves on more than one board must be constantly vigilant about potential conflicts. Directors are not legally precluded from accepting several appointments, but they must carry out their fiduciary obligation to each corporation they serve. Such directors may find themselves in a position of conflict of interest at some point, resulting in a potential breach of their fiduciary duty to one corporation or the other. Specific requirements apply when there are dealings between corporations that have mutual directors.

The Ontario Court of Appeal decision in *PWA v. Gemini* demonstrates the difficult position in which directors with conflicting interests may sometimes find themselves. PWA's nominees on the Gemini board of directors were involved as representatives of PWA in negotiating a transaction with another party that would have adversely affected Gemini in a "vital aspect of its business." A majority of the Court concluded that, although PWA's nominees did not have to disclose all aspects of their negotiations, they were required to disclose that part of the negotiations that would have a serious and adverse impact on Gemini. By failing to disclose this information, PWA's nominees breached their fiduciary duty to Gemini. The Court also held PWA responsible for this breach because it instructed its nominees to act contrary to their fiduciary duty. The PWA nominees were truly in a difficult position because they owed a conflicting duty to PWA to keep the negotiations confidential. In order to avoid liability to Gemini, the alternatives available to the PWA nominees were either to resign from the Gemini board before becoming privy to the information they ultimately had a duty to disclose to Gemini, or to adopt procedures that would have prevented them from becoming privy to such information in the first place.

Inside directors, typically the Chief Executive Officer of the corporation and one or more other senior executives, have the same fiduciary duty to the corporation as independent directors. While all directors may be in the uncomfortable position of having to resist the wishes of a controlling shareholder, this position may be particularly challenging for inside directors. Although corporate statutes and courts pay considerable attention to the participation of outside directors in board matters because of their objectivity and independence, this focus on outside directors does not diminish the obligation of inside directors to adhere to the same fiduciary standards.

(b) Duty of Care

In discharging their duties, directors must "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." This standard of care can be achieved by any director who devotes reasonable time and attention to the affairs of the corporation and exercises informed business judgment.

The standard of care is measured against the objective standard of what a reasonably prudent person would do in comparable circumstances. This requires directors to devote the necessary time and attention to bring their own judgment to bear on the matter and make an informed decision.

A notable example of a board which failed to meet this standard of care was the board of Trans Union Corporation. In the leading U.S. case of *Smith v. Van Gorkom*, this board's conduct in considering a merger led the Court to conclude that the directors had been grossly negligent and were, therefore, personally liable. The Trans Union board met and approved a merger proposal after a 20-minute presentation and a two-hour discussion. The directors had no prior notice that the meeting would be considering the proposed merger and had not informed themselves about how the merger price had been determined or about the intrinsic value of the corporation. Furthermore, the board did not request or receive any legal advice or a fairness opinion, nor did it consider or reserve the right to solicit higher offers.

In applying the standard of care, the courts' concern has been primarily one of process rather than result. If the directors have sufficient information concerning the issue before them, examine the information critically and take the time to make an informed decision, the courts are very reluctant to interfere with the result. If the directors make a decision which may be debatable from a business perspective or if the matter simply turns out badly, the courts will not normally criticize the directors. This broad principle, discussed below, is sometimes referred to as the "business judgment rule." On the other hand, directors may find themselves liable for failing to meet their standard of care if there is evidence that they did not give sufficient thought to the decision or were otherwise not diligent.

For example, in *Peoples Department Stores*, the Supreme Court of Canada confirmed that the duty of care is tested against an objective standard and that the standard is not perfection. The Court stated as follows:

> *Directors and officers will not be held to be in breach of the duty of care ... if they act prudently and on a reasonably informed basis. The decisions they 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.*

Having to be diligent in discharging their duties does not mean that directors will be liable for every error. Rather, they must discharge their duties with the same diligence as a reasonably prudent person would use in comparable circumstances. Failure to meet the standard often stems from passivity and a failure to inquire. Rather than relying on their personal knowledge about the matter before them, directors must ask for, and are entitled to receive, all the information they believe necessary to make careful decisions. Diligence requires actively questioning management and advisors, as well as engaging experts where necessary and carefully reviewing their reports. Directors who ask questions and are misled or misinformed will still have acted diligently if it was reasonable for them to expect that they could rely on the responses. Under many statutes, behaving diligently provides directors with a defence to liability. Directors are also entitled to dissent from any decision of the board and to have that dissent recorded. Under many statutes, this will relieve the director of any liability for the results of that decision.

The skill that directors must exercise in discharging their duties is that of a reasonably prudent person. There is no requirement for a director to have any particular level of education, experience or professional designation. However, directors must employ whatever ability, education, experience and training they possess in the manner in which a reasonably prudent person would employ those skills in comparable circumstances.

This is not to suggest that professionals who serve on boards of directors are required to provide professional advice. For example, the role of a lawyer on a board is to offer business advice and judgment, not to give legal advice. Legal advice should properly be provided by counsel to the corporation who is an expert in the relevant area of law. However, lawyers who are directors may not ignore legal issues which they recognize or fail to use their legal training to question closely the legal advice given by the corporation's counsel.

Inside directors and directors who serve on committees of the board are faced with similar concerns. These directors will be better informed about some aspects of the corporation's affairs, and this knowledge must be applied in testing management's recommendations and reaching decisions about the corporation's affairs.

In *Standard Trustco*, the Ontario Securities Commission, a regulatory body that has asserted the right to review directors' conduct in some circumstances, stated that directors who were members of the audit committee should bear somewhat more responsibility than other directors for a compliance deficiency in the corporation's financial statements. This increased responsibility arose, not because the members of the audit committee were subject to a higher standard of care, but because they had more opportunity to obtain knowledge about, and to examine, the affairs of the corporation than did other directors. As a result, the Ontario Securities Commission decided more was expected of them in overseeing the financial reporting process and warning other directors about problems.

Similarly, in *YBM Magnex International Inc.*, the Ontario Securities Commission considered the skill, access to information and degree of participation of each individual director in assessing whether the director was entitled to a due diligence defence in connection with inadequate prospectus disclosure.

(c) Business Judgment

American courts have developed a presumption that directors have acted properly in making a business decision if they acted with due care, good faith and in the best interests of shareholders, and their decision can be attributed to a rational business purpose. If the party challenging a board's decision rebuts any element of the presumption, the directors must prove the fairness of their decision. The result is that U.S. courts do not interfere when the directors have made careful, informed decisions. Further, they assume directors have done so until the contrary is proven.

There are two differences between the Canadian and U.S. business judgment rules. First, the Canadian rule requires directors' actions be in the best interests only of the corporation and not of the shareholders or creditors, although Canadian law requires that these groups be treated fairly in a board's decision-making process in circumstances where they will be affected. Second, in the U.S. rule, the directors will be protected if their decision is "rational," while in the Canadian rule the directors' decision must be "reasonable." A "rational" decision test is based on a gross negligence standard while a "reasonable" decision test is based on an ordinary negligence standard. While these concepts are different, their practical application may not be.

In both *BCE Inc.* and *Peoples Department Stores*, the Supreme Court of Canada confirmed the existence of a Canadian "business judgment rule" under which courts will defer to directors' reasonable business decisions so long as they are within a range of reasonable alternatives. Courts defer to decisions of directors taken in good faith in the absence of conflicts of interest provided the directors undertook reasonable investigation and consideration of the alternatives and acted fairly. Courts will not subject the directors' business judgment to microscopic examination and will not substitute their view for that of the directors, even if subsequent developments show that the directors did not make the best decision.

The decision in *KeepRite* is a good example of how a court may review a business decision by a board of directors, but will not interfere with it if the decision was properly made and was not oppressive. In that case, minority shareholders challenged the corporation's decision to acquire assets from one of its subsidiaries. An independent committee of the board had concluded that the decision was fair to the corporation as a whole, including the minority shareholders. The Court placed a great deal of weight on the process by which the board came to its decision and in particular took into account the fact that the matter had been considered by an independent committee of the board. The Court consequently found no reason to question the business judgment of the directors. The trial judge, supported by the Ontario Court of Appeal, stated:

> *Business decisions, honestly made, should not be subjected to microscopic examination. There should be no interference simply because a decision is unpopular with the minority.*

By contrast, the decision in *Repap* shows how a court may interfere with a board's decision if its process is flawed. In *Repap*, the Ontario Court of Appeal upheld the trial judge's decision to set aside an executive compensation package. Even though the package was approved by an independent committee that considered an expert report, the trial judge found the process was seriously flawed and the board's decision fell outside the range of reasonableness. The board did not fully inform the expert and the committee only spent five to seven minutes deliberating about the package.

Two contested takeover bids in 1998 —*Pente Investment Management Ltd v. Schneider* and *CW Shareholdings Inc. v. WIC* — also gave Ontario courts an opportunity to state their views on how boards of directors, special committees and senior management should conduct themselves in the context of M&A transactions. The courts, including the Ontario Court of Appeal in *Schneider*, specifically laid down a business judgment rule as the standard to be applied by a court to the conduct of directors. If the directors have acted honestly and reasonably, the court will not substitute its own business judgment for that of the board. The Court of Appeal also said that, where a board avoids conflicts of interest by establishing a special committee of disinterested directors who act independently, the burden of proof remains on the plaintiff to establish that the directors acted improperly. There is no reason to shift the burden to the directors to prove they were adequately informed and acted reasonably.

When reviewing the merits of a board's business decision, a court may ask whether the directors had an honest belief, on reasonable grounds, that the transaction in question was in the best interests of the corporation. In other words, there must have been a legitimate business purpose for the transaction. Some courts have understandably required more than a mere assertion of good faith on the part of the directors. If challenged, directors will likely be required to demonstrate that they considered and based their actions on what they truly believed were the best interests of the corporation.

The Supreme Court of Canada in *Danier Leather Inc.* made it clear that disclosure obligations under securities laws were matters of legal obligation and the business judgment rule does not apply to qualify or undermine the duty of disclosure.

The Canadian business judgment rule does not offer quite the same protection as its American counterpart, largely because of the availability in Canada of the oppression remedy (discussed below), which is likely available whether or not a board follows the proper process in making a decision. This remedy is available to shareholders, creditors and others who can show that a board's decision is oppressive or unfairly prejudicial to, or unfairly disregards, their interests. In determining whether a particular decision of a board was oppressive, the court must necessarily assess the impact of the business decision made by the board.

In *Palmer v. Carling O'Keefe*, Carling O'Keefe amalgamated with a company established by Elders to acquire Carling O'Keefe. The Court was asked to consider the impact of the amalgamation on the holders of the preference shares of Carling O'Keefe. The object of amalgamating the two companies was to move the debt incurred to make the acquisition into Carling O'Keefe. In order to protect the interests of the preference shareholders, sufficient funds to redeem the preference shares were set aside in a separate trust account. The Court decided that the transaction had no business purpose for Carling O'Keefe. It concluded that the transaction served the interests of the controlling shareholder and was unfairly prejudicial to, and unfairly disregarded the interests of, the preference shareholders and that the directors of Carling O'Keefe had breached their duty to act for the benefit of the corporation as a whole. The oppression remedy is discussed in greater detail in Section 7 of this part of the chapter.

In *Ford Motor Co.*, the Ontario Court of Appeal concluded that Ford Canada and its majority shareholder, Ford U.S., oppressed Ford Canada's minority shareholders by using an unfair transfer pricing system that caused losses to Ford Canada. The Court considered the potential application of the business judgment rule in an oppression action but concluded that Ford Canada could not rely on the rule because its board brought little judgment to bear on the system. The Court stated that Ford Canada simply accepted the system put in place by Ford U.S. The board did not discuss the system in any detail and had little understanding of the system and its impact on the corporation's profitability.

3. To Whom are Directors Accountable?

Directors are required by corporate statutes to discharge their fiduciary duty "with a view to the best interests of the corporation." The Supreme Court of Canada in both *BCE Inc.* and *Peoples Department Stores* stated that directors owe their fiduciary duty to the corporation and that the best interests of the corporation must not be confused with the interests of any of the corporation's stakeholders. Directors, however, may consider various stakeholder interests in determining whether they are acting in the best interests of the corporation. In resolving competing interests, directors should act to make the corporation a "better" corporation.

(a) Interests of the Shareholders

Directors owe a duty to the corporation and not its individual shareholders. However, if a shareholder believes that the actions of the corporation have been unfairly prejudicial to its interests, it has recourse to the oppression remedy described in further detail below. In many instances, the distinction is not significant, since what is good for the corporation will also benefit its shareholders. Maximizing the return to shareholders is also, in many cases, consistent with the best interests of the corporation.

Nevertheless, there may be instances where the interests of the corporation and its particular shareholders or classes of shareholders diverge. The interests of the common shareholders may lie in realizing a short-term gain on their investment, a goal which the directors may conclude is not necessarily in the long-term best interests of the corporation. Additionally, the interests of majority shareholders may not be the same as the interests of the corporation. A controlling shareholder may want the corporation to take certain action that may be in its interest, but not necessarily in the best interests of the corporation. The right solution to these kinds of issues depends very much on the facts of each situation.

(b) Interests of Other Stakeholders

Directors recognize that their decisions have an impact beyond the corporation and its shareholders. Employees and the community will be affected by a decision to close a plant. Debenture holders may be affected by high-risk business strategies or by corporate reorganizations. The national interest may be affected by a decision to move operations offshore.

In both *BCE Inc.* and *Peoples Department Stores*, the Supreme Court of Canada stated that directors may consider various stakeholder interests in determining whether they are acting in the best interests of the corporation, including the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.

Some statutes require directors of the entities they regulate to take into account the interests of specific stakeholder groups. For example, loan and trust legislation requires directors to have due regard to the interests of the depositors and the persons for whom the corporation acts in a fiduciary capacity, as well as the interests of the shareholders, in considering whether a particular course of action is in the best interests of the corporation as a whole. Directors of these corporations must, therefore, take these interests into account, and may also consider the interests of the other stakeholders in formulating a course of action.

4. Confidential Information

(a) Corporate Opportunity

Directors must not appropriate an opportunity that belonged to the corporation. If directors take advantage of an opportunity that they discovered by virtue of their position as directors and that opportunity is one that the corporation might conceivably have been interested in pursuing, the directors have acted counter to their fiduciary duty to the corporation.

The leading Canadian case on corporate opportunity is *Canaero*. The discussion of the Supreme Court of Canada in this decision captures the essence of the fiduciary nature of the relationship between directors and the corporation. The Court found that two senior officers were in breach of their fiduciary duty to the corporation for taking personal advantage of an opportunity that they learned about through their relationship with the corporation. The Court held that they had breached their fiduciary duty to the corporation even though they had resigned prior to taking up the opportunity. It did not matter that the corporation was not in a position to take on the contract at the point it was awarded to the two former officers and that the corporation, therefore, suffered no loss. The Court decided that it was necessary to strictly apply the fiduciary standard against directors and senior management in recognition of the degree of control that their positions give them in the corporation's operations.

(b) Duty of Confidence, Insider Trading and Tipping

Directors also have a duty of confidence towards the corporation. They must not disclose information obtained from the corporation by virtue of their position on the board. A duty to keep such information confidential arises where the information is confidential by nature and was communicated in confidence. Ultimately, the best interests of the corporation will dictate the manner in which directors can use information received in their capacity as directors.

Coupled with this duty of confidence is the statutory prohibition on insider trading. Directors may not trade while in possession of inside information, or disclose that information to others, until that information has been publicly disclosed. The requirements of the insider trading rules and the associated penalties are described in Parts IV and V.

5. Reliance on Management, Financial Statements and Advisors

In discharging their responsibilities, directors are not expected to have firsthand knowledge of all aspects of the affairs of the corporation. The board delegates to management and is entitled to rely on information prepared by management, including the financial statements. Similarly, directors are not required to be experts in technical areas of the corporation's business. They are entitled to rely on reports of experts, such as lawyers, accountants and appraisers.

The corporate statutes expressly exempt directors who rely on financial statements or expert advisors in the circumstances described below from liability for a number of breaches of those statutes, including breach of their fiduciary duty and duty of care. The Ontario statute does not extend this protection to breach of the directors' fiduciary duty and duty of care.

(a) Reliance on Management

The law recognizes that, since directors must delegate much of their responsibility to the corporation's management and since directors are dependent on management for virtually all of the information they have about the corporation, the directors must be entitled to rely on management and what it tells them when it is reasonable to do so. Directors may assume that the officers have performed their duties honestly, but only if they have no grounds for suspecting otherwise. The Ontario Securities Commission's *Standard Trustco* decision emphasized that directors should not rely on management unquestioningly when they have reason to be concerned about the integrity or ability of management or when they have reasonable grounds for doubting management's ability to make objective recommendations to the board on a particular issue. In those circumstances, directors must ensure they are justified in relying on the information being provided to them.

(b) Reliance on Financial Statements

Many of the decisions made by a board of directors are based on their understanding of the financial condition of the corporation. In assessing the corporation's financial condition, directors are dependent, not only on the integrity of the internal financial systems, but also on management which prepares the financial information or statements, and on the auditors who review that process and the statements. The role of the board of directors in ensuring that the financial statements are accurate is discussed in Part III.

Under the corporate statutes, directors are entitled to rely on the financial statements under two conditions. First, their reliance must be in good faith. That is, they cannot know or suspect the statements are in error. Second, the financial statements must have been represented to the directors to fairly reflect the financial condition of the corporation, either by an officer of the corporation or in a written report of the auditor of the corporation.

(c) Reliance on Advisors

Just as they are entitled to rely on the financial statements of the corporation, directors are entitled to rely on the corporation's advisors, and will avoid certain liability under the corporate statutes for actions taken in reliance on these advisors. Again, this reliance must be in good faith. Moreover, directors may only rely on a report of a person "whose profession lends credibility" to the statements made by that person. Lawyers, accountants, engineers and appraisers are examples given in the corporate statute, but other types of financial advisors as well as environmental consultants can also be included in this category.

The Supreme Court of Canada in *Peoples Department Stores* held that an officer of a corporation does not qualify as an expert by virtue of holding such office. The Ontario statute was amended in response to this decision to permit directors to rely on management who are not professionals.

Directors should confirm that the expert or advisor is qualified to give the advice sought and that the expert or advisor had access to, and considered the information relevant to, the advice. Directors may not be entitled to rely on other directors with expertise in a given area unless the director is specifically retained for that purpose. Reliance on the views of a lawyer on the board, for example, will not provide directors with a defence unless that lawyer is also retained as counsel.

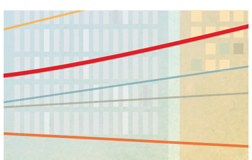
It is incumbent upon the directors to question outside advisors closely about their advice. In one American decision, for example, a court found that it was not sufficient for directors to rely on an oral opinion of the corporation's investment bankers about whether the option price for certain assets was within a range of fair value. The directors did not request a written fairness opinion, nor did they inquire what the range was, or about the effect of the transaction on the corporation's future.

In some situations, the board must hear directly from outside advisors rather than delegate responsibility for seeking outside advice to management. This may be the case, for example, when the issue is a material one to the corporation or when management has some interest in the advice being given.

In some cases, the directors should hear from and question the advisors in the absence of management. The 1994 TSX Report suggested that every board of directors should implement a system to enable an individual director, subject to appropriate board committee approval, to engage an outside advisor at the corporation's expense in appropriate circumstances. The report recognized that individual directors may wish to dissent from a board decision, may believe that the direction the board is taking is wrong, or may otherwise be concerned about their personal liability for corporate actions and may, therefore, need to consult with independent legal, financial or other advisors. Securities instruments require audit committees to be authorized to retain external advisors and recommend that nominating and compensation committees also be authorized to do so.

6. Reasonable Diligence

The *Canada Business Corporations Act* and several other corporate statutes provide directors with a defence of reasonable diligence against liability for certain breaches of the statute, other than breach of the directors' fiduciary duty and duty of care. These statutes exempt directors from liability if they exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances. Diligence includes relying on financial statements or expert advisors. The Alberta statute extends this defence to breach of the directors' fiduciary duty and duty of care.



7. Taking Action Against the Directors

The corporate statutes provide three ways for shareholders and other interested parties to take action against directors. The first is the oppression remedy, available to parties who believe they have been unfairly dealt with by a corporation. The second is the derivative action, which allows a third party to require the corporation to take action against the directors. Finally, a third party may apply to the court for an order compelling the directors to comply with the corporation's articles, by-laws or governing statute.

(a) Oppression

The oppression remedy is a very broad remedy available to a complainant where the corporation, the board or the corporation's affiliate has acted in a manner that was oppressive or unfairly prejudicial to, or that unfairly disregarded that person's interests. The Supreme Court of Canada in *BCE Inc.* described the remedy as giving a court "broad, equitable jurisdiction to enforce not just what is legal but what is fair." The Court looks beyond legality to what is fair given all the interests at play.

A complainant may be a current or former security holder, creditor, director or officer of the corporation or any of its affiliates, or any other person who the court agrees is a proper person to bring an oppression action. The oppression remedy permits parties to protest corporate action which they consider unfair. If a court finds oppression, it may make any order it considers appropriate to remedy an oppressive or unfair situation.

The object of the oppression remedy is to protect the "reasonable expectations" of shareholders and other corporate stakeholders. In *BCE Inc.*, the Supreme Court of Canada stated that courts should ask two questions in determining an oppression claim: (1) does the evidence support the reasonable expectation of the complainant?; and (2) does the evidence establish that the reasonable expectation was violated by conduct falling within the terms "oppression," "unfair prejudice" or "unfair disregard" of a relevant interest? The Court also stated that factors courts look at to determine whether a reasonable expectation exists include the following: the nature of the corporation; the relationship between the parties; past practice; steps the complainant could have taken to protect itself; representations and agreements; and the fair resolution of conflicting interests between corporate stakeholders.

The corporate statutes do not provide any objective definition of oppression, but the courts have developed a list which, though not exhaustive, provides some guidance about what constitutes oppressive behaviour. Oppression may be held to exist where there is:

- Lack of a valid corporate purpose for a 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 a corporation;
- Discrimination between shareholders that benefits the majority shareholder to the exclusion or detriment of the minority shareholder;
- Lack of adequate and appropriate disclosure of material information to minority shareholders;
- A plan or design to eliminate the minority shareholder; or
- Conflict of interest between the interests of the corporation and the personal interests of one or more directors.

As discussed above, the oppression remedy is particularly important for directors because their decisions may be censured if the court finds them oppressive or unfairly prejudicial, even though, in some instances, the court may also find that the directors acted in accordance with the law, the articles and by-laws of the corporation, and their fiduciary duties. There need not be evidence of bad faith on the part of directors for a finding of oppression. While a court will consider the integrity of the process by which the transaction was approved and undertaken, it will also consider the substantive effects of the transaction on the complainant.

In *Westfair Foods Ltd.*, the directors approved the payment of dividends, constituting all the earnings of the corporation, to the holder of all the corporation's common shares. That shareholder then loaned the money back to the corporation. Both the payment of dividends and the borrowing of money was within the power of the directors, and the Court did not find that these powers were exercised improperly or that the Court was entitled to question the business decision to pay out dividends and then finance expansion by borrowing. The Court did find, however, that in the circumstances, the board's decision exemplified an unfair disregard for the interests of the other shareholders who were entitled only to fixed dividends, but who shared rateably with the common shareholder on liquidation. This is also an example of what is now known as a related party transaction. Such transactions may require particular procedures to be followed by the board to assist in being able to demonstrate that it acted in good faith.

In *Palmer v. Carling O'Keefe*, discussed above, the Court found that there was no bad faith involved in the decision to amalgamate the two companies, and that the board, composed of experienced business people acting upon independent advice, had exercised its best business judgment with respect to the transaction. The Court concluded that the impugned conduct nevertheless constituted oppression because it was unfairly prejudicial to the interests of the holders of preference shares and because it only served the interests of the controlling shareholder and not the interests of the corporation.

In *Budd v. Gentra*, the Ontario Court of Appeal concluded that an oppression claim for damages against a director personally must meet the following two requirements. First, the claim must allege specific acts against a named director which, in the context of the entire pleading, could support a claim that the corporation acted oppressively. Second, the claim must disclose a reasonable basis by which a court could decide that the alleged oppression could be properly remedied by a damages award against a director.

In *Ford Motor Co.*, the Ontario Court of Appeal concluded that Ford Canada and its majority shareholder, Ford U.S., oppressed Ford Canada's minority shareholders by using an unfair transfer pricing system that caused losses to Ford Canada. The Court concluded that the minority shareholders had reasonable expectations based on Ford Canada's public statements that Ford Canada and Ford U.S. would negotiate prices for products, that their prices would be determined at arm's length and that Ford Canada management would act in the best interests of the corporation and take all reasonable steps to enhance the corporation's profitability by changing the transfer pricing system.

In *BCE Inc.*, the Supreme Court of Canada rejected a claim by BCE's debentureholders that a leveraged buyout was oppressive because it had a negative impact on the investment grade of their debentures. The debentureholders' evidence did not establish a reasonable expectation that the investment grade of their debentures would be maintained. The evidence did establish a reasonable expectation that their interests would be considered; however, the Court concluded that this expectation was fulfilled. BCE's directors considered the interests of the debentureholders and concluded that while the corporation would honour the contractual terms of the debentures, no further commitments could be made. The evidence did not establish a reasonable expectation that a better arrangement could be negotiated that would meet the corporation's objectives while better preserving the trading value of the debentures.

(b) Derivative Action

There may be circumstances in which a shareholder or creditor wishes to seek redress on behalf of the corporation for the directors' breach of the corporation's rights. Since the shareholder or creditor would not be considered an aggrieved party, it could not bring an action itself. For example, where the directors have breached their fiduciary duty to the corporation, a shareholder could arguably not launch a suit since the fiduciary duty is owed to the corporation and not the shareholder. However, the shareholder may still be able to sue the directors on behalf of the corporation by way of a derivative action.

A court will not give a complainant leave to bring an action unless the complainant first gives the directors reasonable notice of its intention to bring a derivative action and the directors do not cause the corporation to bring and diligently prosecute the action. The court must further be satisfied that the complainant is acting in good faith and in the best interests of the corporation.

The derivative action is used far less extensively than the oppression remedy.

(c) Compliance Orders

If a corporation or a director, officer, employee or agent of the corporation breaches its governing corporate statute or the articles, by-laws or a unanimous shareholder agreement of the corporation, a complainant may apply to a court for an order directing compliance or restraining the breach. Most often, petitions for compliance orders are coupled with oppression actions, and the judgments have tended to be based on oppression rather than compliance.

II. Role of Shareholders

II. Role of Shareholders

Part II briefly describes the role of shareholders. Some transactions are so fundamental that corporate and, in certain cases, securities laws require shareholder approval. Shareholder dissent rights will arise in connection with many such transactions. Dissent rights allow shareholders to require the corporation to repurchase their shares for fair value. Part II also describes shareholder annual meeting procedure and how shareholders may attempt to use a meeting to change the board.

The directors and not the shareholders are responsible for the management of the corporation. However, under the corporate statutes, certain matters are considered so fundamental that they require the approval of the shareholders. Under the *Canada Business Corporations Act* these matters include:

- Continuing the corporation under another corporate statute;
- Effecting certain amalgamations or reorganizations;
- Selling all or substantially all of the corporation's assets;
- Adding or removing any restrictions on the business that the corporation may carry on;
- Changing the corporation's share capital;
- Changing the articles to increase or decrease the number of directors or the minimum or maximum number of directors;
- Confirming by-laws; and
- Adding or changing restrictions on the issue, transfer or ownership of shares.

If a fundamental change affects holders of certain series or classes of shares differently than others, the change must also be approved by a majority of the series or class of shares whose existing rights may be affected by the change, whether or not such shares otherwise carry voting rights.

As noted above, public corporations must also comply with the requirements of the provincial securities commissions and the stock exchanges which impose requirements for shareholder approval.

Finally, there may be issues that the directors determine should be put to the shareholders as a matter of good corporate governance, whether or not they are legally required to do so. The issue of whether shareholder approval was necessary to put a shareholder rights plan in place was commonly debated when shareholder rights plans first came into use in Canada. A number of boards of directors determined that the advice of the shareholders through a shareholders' vote was desirable well before the view of the regulators to the same effect was known. Similar considerations will continue to arise in the context of other decisions facing public companies.

1. Shareholder Meetings

Annual meetings of shareholders are required by law. The items for consideration at an annual meeting include the election of directors and the appointment of auditors. While the financial statements are not approved by shareholders, these are usually presented to them in conjunction with the annual meeting. Other matters on the agenda at an annual meeting are determined by the board of directors or submitted by shareholders as proposals. The annual meeting is also the opportunity for the Chief Executive Officer and the chair to address the shareholders and for the shareholders to question the management and board.

Publicly traded corporations and certain widely held private corporations are required to send out a management proxy circular soliciting proxies from their shareholders with respect to any meeting of the shareholders. The management proxy circular provides information to shareholders about the corporation, the directors and the matters that will be put to the shareholders at the meeting. A large part of this information deals with executive compensation. The materials sent to shareholders must provide shareholders with sufficient detail about the matters to be considered at the meeting to permit them to make a reasoned judgment about those matters.

Special meetings may be called at any time and are normally called by the directors to seek shareholder approval for a particular matter prior to the next annual meeting. Shareholders holding at least 5% of the corporation's shares may require the directors to call a special meeting of the shareholders, and if the directors fail to do so, these shareholders may call the meeting themselves.

Shareholders may require the corporation to put a proposal before the shareholders and to have it set out in the management proxy circular. There are certain limitations on this right which are designed to prevent shareholders from using the annual meeting as a forum to promote personal agendas. However, within the statutory limits, shareholders are entitled to have their proposals put to the other shareholders, even though these proposals may not be supported by the directors.

If notice of a matter has not been put in the meeting materials, there is very limited scope for the shareholders to request the meeting to deal with the matter. At the meeting, shareholders may ask the board to consider a matter and request it be put to a vote. In many instances, this request can be ruled out of order by the chair of the meeting because notice of the matter was not given in the management proxy circular. If there is a vote on the matter, it is only advisory in nature and not binding on the directors.

While experience indicates that most individual shareholders do not usually express their views on corporate performance or board decisions at meetings of shareholders, large institutional investors do communicate their views to management, in some instances, in response to questions from management. Senior representatives of corporations often meet with their institutional shareholders to explain financial results or major corporate changes. While such meetings are an accepted practice, it is important that the corporation not release previously undisclosed material information selectively to one or more institutional shareholders because of "tipping" rules and a concern by securities regulators that shareholders be treated equally. Large institutional investors will also publicly state their views on particular issues such as rights plans and executive compensation.

2. Shareholder Ability to Change the Board

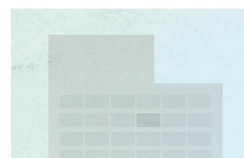
Shareholders who are dissatisfied with how the directors are running the corporation may remove the directors or refuse to re-elect them. In practice, this may be a difficult course to take, particularly where the shares of the corporation are widely held. Although many shareholders do not have the time or resources required to counter a management proposal, there are legal tools available to enable shareholders to mount a proxy battle over the election of directors, and distribute a dissident proxy circular if necessary. For example, the corporate statute requires a corporation to provide a list of shareholders to any shareholder, and the securities rules permit anyone to request information respecting the identity of, or cause the delivery of materials to, beneficial owners of shares. Some large institutional investors have, on occasion, made their voices heard at annual meetings or in private meetings with representatives of a corporation prior to a shareholder meeting. In addition, activist investors may agitate for changes and, if necessary, commence a proxy battle to seek replacement of the board of directors.

Canadian corporate law allows a shareholder to nominate additional candidates as directors at a shareholder meeting without advance notice to the corporation. However, numerous corporations have adopted advance notice by-laws requiring a shareholder to submit "advance notice" of the shareholders' intention to introduce the nomination of director candidates at a shareholder meeting to ensure an orderly process and to allow the board sufficient opportunity to respond to proxy battles.

3. Dissent Rights

Finally, there are a number of transactions and corporate changes in which the shareholders have a right to dissent. Where shareholder approval is required for a corporation to effect a fundamental change, such as an amalgamation or continuation of the corporation into another jurisdiction, shareholders are entitled to formally dissent and to be paid the fair value of their shares. This ensures that a shareholder who opposes the transaction or corporate change is not required to accept the consequences of that change simply because two thirds of the shares are voted in favour.

The dissenting shareholder and the corporation must first follow a prescribed statutory process to attempt to agree on the fair value of the shares. If they do not, application may be made to the court to determine the fair value.



4. Shareholder Approval Under Securities Laws or Stock Exchange Rules

Shareholder approval of certain transactions may be required under securities laws or stock exchange rules, whether or not required under corporate law.

For example, although the corporate law empowers the directors to issue shares from the corporation's authorized share capital without consultation with the shareholders, in some circumstances the issuance of shares will nevertheless be subject to shareholder approval under the rules of the Toronto Stock Exchange (TSX).

The TSX will typically require shareholder approval for transactions that could materially affect control of the corporation or where the transaction has not been negotiated at arm's length. The TSX requires that all security-based compensation arrangements involving newly issued shares (e.g., a stock option plan) be approved when instituted by a majority of the issuer's directors and, subject to limited exceptions, by the issuer's security holders. Furthermore, if such plans do not provide for the issuance of a fixed number of securities, shareholder approval will be required every three years.

The TSX also requires shareholder approval for private placements and acquisition transactions which would result in the corporation issuing a number of shares exceeding 25% of its already outstanding shares.

The related party rules applied by certain securities commissions may also give rise to the need for minority shareholder approval. For example, Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions* (MI 61-101) (discussed in greater detail in Part IV) may require minority shareholder approval of a particular transaction. Depending on the involvement in a transaction by insiders of the corporation, either the TSX or the securities regulators may require the corporation to obtain the approval of a majority of shareholders other than such insiders and not just that of the shareholders as a whole.

III. Corporate Governance

III. Corporate Governance

Part III describes the corporate governance processes that allow boards of directors to discharge their responsibilities. Board (and audit committee) composition must comply with corporate and securities laws, including the requirements and criteria for independent directors. Informed participation at board meetings is central to the discharge of directors' obligations. Directors are entitled to receive notice of board meetings and, subject to conflicts of interest, to participate in discussion and decision-making at such meetings. Directors are entitled to the corporate information necessary to discharge this decision-making function, and boards must have systems in place to ensure that directors receive such information. Subject to certain limits, directors may delegate decision-making to board committees or management. All public companies must have an audit committee that complies with corporate and securities law requirements dealing with the company's financial reporting.

Good corporate governance is integral to directors discharging their responsibilities appropriately. In a general sense, "corporate governance" refers to the process and procedures used to manage the business and affairs of a corporation. It relates to internal matters such as the operation of the board as well as external matters such as the corporation's relationship and dealings with shareholders.

The 1994 TSX Report defined corporate governance as the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The process and structure should ensure that the board can function independently of management.

The way in which corporate governance issues are handled depends on the corporation in question and its circumstances at the time an issue is being considered. However, some general guidelines for dealing with these issues can be distilled from the corporate statutes, the case law and the standard of good practice that has developed in Canada and elsewhere. This part of the guide describes corporate governance issues and outlines certain guidelines for dealing with them.

1. Membership of the Board

(a) Number of Directors

The size of a board is dictated by the needs of the corporation and norms developed in certain industries. A board should have enough directors to represent a variety of skills and perspectives and to provide experience useful to the board in managing the corporation. It may also be necessary or desirable to represent a number of constituencies on the board – for example, representatives from different provinces, industries or shareholder groups. There must be enough directors to serve on various committees of the board without overburdening any individual director or making it impossible for directors to effectively discharge their responsibilities. However, a board should not be so large that its meetings become unwieldy. There may also be a danger of individual directors losing their sense of direct responsibility if they are part of a very large board where they do not have sufficient opportunity to make the contribution they feel is appropriate.

According to the *Spencer Stuart Board Index 2013* report, boards of large Canadian public corporations average 11 members, two of whom are normally inside directors, such as officers of the corporation or an affiliate. The report also identifies an increasing trend of boards with members in the six-to-10 range. Boards of foreign-owned subsidiaries tend to be smaller. Boards of public companies tend to be larger than boards of private companies.

The 1994 TSX Report expressed some concern about the size of many boards. Since then, many corporations have been controlling their board size. NP 58-201 suggests that every board of directors should consider the appropriate size of the board with a view to facilitating effective decision-making.

(b) The Independent Director

The ability of the board of directors to exercise independent judgment is of fundamental importance to the governance of public companies. As a result, most public company boards have a combination of "inside" and "independent" or "outside" directors. Independent directors and the role they play in ensuring that the board is able to exercise independent judgment have been a focus of those concerned with accountability in corporate governance. Rules for the determination of who may be considered to be an independent director are set out in corporate and securities legislation and stock exchange listing requirements. In addition, some institutional shareholders set their own standards for assessing director independence.

Increasing the number and responsibilities of independent directors has become an accepted way of addressing many corporate governance issues. Independent directors are perceived to be in a better position than inside directors to make objective decisions and to assess management recommendations because they have less personal interest in those decisions and recommendations and may be less hesitant to act when they disagree with management.

The corporate statutes define an independent director as any director who is not employed by the corporation or one of its affiliates. Under this definition, a variety of persons, including retired employees of the corporation and representatives of a controlling shareholder, major creditors, customers or suppliers of the corporation, would qualify as independent directors, notwithstanding their potential conflicts of interest. Further, the term "affiliates" involves the concept of control and, therefore, directors or employees of a major, but not controlling, shareholder are technically independent under the corporate statutes.

The *Canada Business Corporations Act* requires public companies to have no fewer than three directors, two of whom must be independent directors. Other statutes are more restrictive. For example, Ontario's *Business Corporations Act* requires that at least one third of the directors of a public corporation not be officers or employees of the corporation or any of its affiliates. The *Bank Act* requires that at least one third of the directors have no affiliation with the bank. The number of bank employees who may sit on the board is also limited.

For publicly traded companies under securities laws, the meaning of the term "independent director" is different from the definition in the corporate statutes. Furthermore, securities legislation applies different definitions of "independent director" for different purposes.

Director independence is important for audit committee composition and corporate governance purposes. The board must consider whether there is a material relationship between the director and the corporation which could, in the board's view, be reasonably expected to interfere with the exercise of that director's independent judgment.

The definition of "independent director" for audit committee composition and corporate governance purposes applicable to Canadian public companies is contained in NI 52-110. However, there are specific "bright-line" tests which serve to automatically disqualify a director from being considered independent.

Subject to the application of the bright-line tests, under NI 52-110, the determination of whether a director is independent is a board decision. In making its determination, the board must consider all direct and indirect relationships between a director and the corporation – past, present and anticipated – both individually and collectively. Director independence in fact and appearance is important to shareholder confidence. However, the application of too stringent a test may limit the ability of many talented and capable individuals from contributing fully to board decision-making. As a practical matter, the determination of whether an individual is an independent director requires a careful balancing of concerns.

For audit committee and corporate governance purposes, subject to certain exceptions, directors who meet any of the following "bright-line" tests will automatically be treated as not independent:

- An individual who is, or within the prior three-year period has been, an employee or executive officer of the issuer;
- An individual whose immediate family member is, or within the prior three-year period has been, an executive officer of the issuer;
- An individual who is, or has been, or has an immediate family member who is, or has been, a partner or employee of a current or former internal or external auditor of the issuer, or personally worked on the issuer's audit within the last three years as a partner or employee of that audit firm;
- An individual who is, or has been, or whose immediate family member is, or has been within the last three years, an executive officer of an entity if any of the issuer's current executive officers serve or served at the same time on that entity's compensation committee;
- An individual who received, or whose immediate family member who is employed as an executive officer of the issuer received, more than $75,000 in direct compensation from the issuer during any 12-month period within the last three years; and
- For purposes of the foregoing, an "issuer" includes any parent or subsidiary entity.

For audit committee composition purposes only, an individual also will be treated as not independent if he or she:

- Accepts, directly or indirectly, any consulting, advisory or compensatory fee from the issuer or any subsidiary entity of the issuer, other than as remuneration for acting as a board member or as a part-time chair or vice-chair of the board; or
- Is an "affiliated entity" of the issuer or any of its subsidiary entities. The definition of "affiliated entity" for purposes of assessing the independence of potential audit committee members is quite broad and includes entities within a controlled group as well as executive officers of such entities and individuals who serve as both a director and as an employee of an affiliated entity.

Similar audit committee independence requirements apply under U.S. securities laws for the members of the audit committee and compensation committee of companies listed on a U.S. stock exchange. There are also additional independence requirements under U.S. stock exchange rules, which apply to the composition of the board and certain committees. Those stock exchange requirements include bright-line tests which can disqualify a director from being considered independent. For example, a director who is employed by a company that has made payments to, or received payments from, the listed company for property or services valued at more than the greater of US$1 million or 2% of that company's consolidated gross revenues in any of the last three fiscal years, would be disqualified from being independent under the NYSE's independence requirements. In addition, proxy advisors and institutional investors use additional tests for purposes of making their own assessments as to whether a director should be considered independent.

Director independence is also a concern in the context of special transactions (including insider bids, issuer bids, business combinations and related party transactions). MI 61-101 recommends or, in some instances, requires the use of a special committee comprised of "independent directors" when considering such transactions. The use of a special committee comprised of independent directors is a potential safeguard against an interested party receiving an unfair advantage in connection with the proposed special transaction. For the purpose of these instruments, independence is a question of fact and there are transaction-specific bright-line tests for determining when an individual is not independent which differ from those used to determine independence for corporate governance or audit committee composition purposes.

(c) Chair of the Board

The prime responsibility of the chair is to provide leadership to the board to enhance board effectiveness. Most boards appoint a chair who is responsible for, among other things, managing the board, setting the agenda, ensuring that directors are kept informed and running the meetings. The chair is a key liaison between the board and senior management. The specific responsibilities of the chair will also depend on whether or not the Chief Executive Officer serves as chair. Growing concern about board accountability and process has increased pressure on corporations to separate the positions of chair of the board and Chief Executive Officer so that the board is able to carry out its responsibilities independently of management.

While there is no legal requirement to separate the two functions, NP 58-201 recommends that the chair of the board should be an independent director. Where this is not appropriate, an independent director should be appointed as lead director. NP 58-201 also recommends that either an independent chair or an independent lead director should act as the effective leader of the board and ensure that the board's agenda will enable it to successfully carry out its duties. Further, NI 58-101 requires issuers to disclose whether or not the chair is an independent director and, if not, to disclose whether the board has a lead director. If there is no independent chair or independent lead director, a corporation must then disclose what the board does to provide leadership for its independent directors.

(d) Qualification

Convincing qualified candidates to serve on a board of directors can be difficult. In part, this is because of the time commitment involved and some concern about potential personal liability.

The corporate statutes impose minimal qualifications for directors. Any individual who is 18 or over who has not been found by a Canadian court to be of unsound mind and who does not have the status of a bankrupt is qualified to be a director of a Canadian corporation. Where a director has been convicted of certain offences, a court or a regulatory authority may prohibit that person from serving as a director for a period of time.

Although no longer common practice, the articles of a corporation may require directors to hold shares of the corporation. However, since the shareholdings of directors are required to be set out in management proxy circulars provided to shareholders, it is considered good form in many public companies for directors to hold a significant number of shares or share equivalents to demonstrate confidence and interest in the corporation and its management. In order to align directors' interests with shareholders' interests, an increasing number of corporations pay annual director retainers, at least in part, by issuing shares or share equivalents, and most larger public corporations now impose minimum share ownership requirements on their directors.

Some Canadian corporate statutes require a majority of directors of the board and committees to be resident Canadians. The *Canada Business Corporations Act* only requires 25% of directors to be resident Canadians. As discussed above, a specified number of directors must be independent directors if any of the corporation's securities are publicly held.

Corporations look for a number of qualities in their independent directors. Experience and judgment are foremost among those qualities. Independent directors are often successful business people, with experience either spanning a number of industries or in an area relevant to the corporation. They may also be from government, politics or academia, depending on the needs and interests of the corporation. Although directors are not expected to have the necessary expertise to directly manage the business themselves, it is important that some, if not most, have some background in the issues which face the corporation. Corporations also seek to build a board with a diverse range of experience, backgrounds and personal characteristics, such as gender, age and geographical representation, and have adopted board diversity policies to reflect the need for diversity. Public companies which are reporting issuers in Ontario will soon be required to disclose their practices to increase the representation of women on their boards.

A key focus of corporate governance reform has been board recruitment. NP 58-201 makes detailed recommendations about the nomination of directors, including a recommendation that the board should appoint a nominating committee composed entirely of independent directors. In making its recommendations, the nominating committee should consider the competencies and skills that the board as a whole should possess.

Since the Canadian business community is comparatively small, many board appointees are recommended by other directors or by senior officers of the corporation. There are also several executive search firms that assist in locating and selecting new board appointees, particularly where the corporation wishes to have a special constituency or a person with particular experience represented on the board.

NP 58-201 recommends that all new directors receive a comprehensive orientation. They should fully understand the role of the board and its committees as well as the contribution individual directors are expected to make. They should also understand the nature and operation of the corporation's business. The Institute of Corporate Directors offers world-leading director education programs and the ICD.D certification designation to qualified directors, and also administers a directors register containing profiles of a diverse array of qualified director candidates.

(e) Election and Term

Directors are usually elected by shareholders at the annual meeting. The corporation will propose director nominees in a management information circular that is approved by the directors and which must accompany the proxy form sent to shareholders for the annual meeting. Under corporate law, shareholders may vote for (or withhold votes from) a proposed slate of directors or vote for (or withhold votes from) individual candidates. However, for corporations listed on the TSX, shareholders must have the opportunity to vote for (or withhold votes from) directors individually. While it is open to the shareholders to propose and solicit proxies for other nominee directors and to nominate persons at the annual meeting, in practice this happens infrequently. If it does, such person faces challenges being elected because the proxy solicitation procedures usually result in the majority of votes being given to management and, therefore, being voted in favour of the corporation's proposed nominees. Many corporations have enacted advance notice by-laws requiring a shareholder to submit "advance notice" if a shareholder intends to nominate director candidates. Finally, in many Canadian corporations, a controlling or majority shareholder will effectively elect the proposed slate.

Directors are elected on a plurality basis, meaning that those nominees who receive the most votes are elected until all positions are filled. In an uncontested election, all of the corporation's nominees will be elected. TSX-listed corporations, other than controlled companies, are required to implement a 'majority voting policy' that is designed to ensure that only those directors who receive more *for* votes than 'withhold' votes remain on the board. Under this policy, a director who receives a majority of 'withhold' votes, must tender his or her resignation for consideration by the board. The board will generally accept that resignation, absent exceptional circumstances, and will publicly announce its decision by news release.

The articles of a corporation may provide for cumulative voting for directors. In this case, the articles must provide for a fixed number of directors rather than simply stipulating a minimum and a maximum number, which is permitted where there is no cumulative voting. Cumulative voting entitles each shareholder to cast one vote for each share held, multiplied by the number of directors to be elected. By casting all of these votes in favour of one candidate, a shareholder (or a group of shareholders) with sufficient voting shares will be able to elect at least one director even though the shareholder does not control a majority of the votes. This helps shareholders, particularly minority shareholders, to elect directors representative of their interests in proportion to the percentage of the voting shares they control. Very few Canadian corporations have adopted cumulative voting.

The articles of a corporation may also provide for a particular class of security holders, such as preferred shareholders, to elect one or more directors. For the most part, however, these shareholders only have the right to elect a representative if there has been some unusual event, including, for example, failing to pay dividends on preferred shares for a specific period.

Agreements among major shareholders may also affect the election of directors. Shareholders sometimes agree to support each other's nominees for election to the board, usually in proportion to their overall shareholdings. Occasionally, majority shareholders may also agree to support one or more representatives of the minority shareholders.

Under corporate law, directors may be elected for terms of up to three years and need not all be elected at the same time or for the same length of time, but they may be elected for staggered terms. Such practices are rare, however. TSX-listed corporations must elect all directors annually. Even with respect to corporations which are not TSX-listed, staggered terms for director are rare, principally because shareholders always have the right to remove a director and elect a replacement at any time and regardless of the term for which the director had been elected.

Surveys show that directors tend to serve for a number of terms. Most directors serve for at least five years and many serve for 10 years or more. Some corporations limit the number of terms of service for directors and others have compulsory retirement for their directors. Ontario may soon require public companies to disclose their director retirement policies or, if they do not have one, explain why not.

(f) Remuneration

Directors' remuneration is usually set by the board. Independent directors are normally paid an annual retainer along with a certain amount for each board meeting or committee meeting they attend. Chairs of boards and committees receive extra remuneration. Inside directors are not normally remunerated separately for their service on the board. Directors' fees have increased in view of the time spent by conscientious directors on the affairs of the corporation and, in particular, the potential liability to which they are exposed.

The 1994 TSX Report expressed concern about the increasing risk associated with being a director, as corporate and director accountability are treated ever more seriously by the investing public. The report also noted that the public's increasing expectations of directors is leading to greater demands on a director's time. Accordingly, the committee stated that each board should review the adequacy and form of the compensation paid to its directors to ensure the compensation reflects the responsibilities and risks associated with being an effective director.

The 2001 TSX Report echoed the 1994 TSX Report, stating that boards should continue to be concerned that their total remuneration packages are competitive. In particular, the independent board leader and committee chairs should receive compensation that adequately reflects their responsibilities. The 2001 TSX Report also suggested that some form of minimum shareholding requirement for directors is appropriate in aligning director and shareholder interests.

(g) Vacancies

If there is a vacancy on the board, the remaining directors may continue to transact business as long as there is a quorum. If they wish, the remaining directors may fill the vacancy unless the articles, by-laws or corporate statutes provide otherwise. If the board is left without a quorum, the remaining directors must call a special meeting of shareholders to elect the required number of directors.

If a class or series of shares is entitled to elect certain directors and a vacancy occurs among those directors, the other directors elected by that class or series may normally fill that vacancy. If there are no other directors elected by that class or series, a holder of those shares may call a meeting to fill the vacancy.

(h) Resignation and Removal

Directors cease to hold office when they die, resign or are disqualified under the corporate statute or removed from office. A resignation is effective at the time the director sends it to the corporation or at the time specified in the resignation, whichever is later, but it cannot be effective prior to the time it is tendered. Directors may make a written statement to the corporation about their reasons for resigning that the corporation must either send to the shareholders or include in the management proxy circular. If a director of a financial institution governed by the *Bank Act* resigns as a result of a disagreement with other directors or officers, the director must submit a written statement to the Superintendent of Financial Institutions describing the disagreement.

Directors may be removed from office by a majority of shareholders at a meeting of shareholders. The directors themselves may call a shareholder meeting for this purpose, or shareholders holding at least 5% of the issued and outstanding shares may requisition such a meeting. If the articles of the corporation provide for cumulative voting, a director may not be removed from office if the votes cast against removal would be sufficient to elect that director at an election where the full number of directors required by the articles was being elected. Similarly, directors elected by one class of shareholders may only be removed by a vote of that class. Directors who are being removed may submit a written statement to the corporation giving reasons why they oppose this action and the corporation must provide this statement to the shareholders as it would if the director had resigned.

Although shareholders have the ability to remove directors, as a practical matter, directors of public companies are seldom removed in this way except in the face of a proxy battle or other hostile transaction.

2. Board Meetings

(a) Frequency

The frequency with which a board meets will vary from one corporation to the next. It will also depend, in part, on the particular corporate activities requiring specific board attention and on the number of matters dealt with by committees of the board as opposed to the full board. Most companies schedule their full board meetings at regular intervals, such as each quarter, often coinciding with the need to deal with matters such as quarterly financial information and dividends. If a corporation is involved in a major restructuring, financing or acquisition, it may be necessary for the board and perhaps one or more of its committees to meet more frequently to consider and approve a particular course of action. The various committees meet around these general board meetings as required to satisfy their particular committee mandates.

Regular meetings of a board are often half-day or day-long events. If a meeting has been called for a specific purpose, it may be quite brief or it may last significantly longer than a regular meeting. Many boards also have annual strategic planning retreats.

(b) Notice of Meeting, Attendance and Written Resolutions

All directors are entitled to receive notice of all meetings of the board and no director may be excluded from such meetings. Except for certain matters specified by the corporate statutes and subject to the corporation's by-laws, there is no general requirement to specify in notices the matters that will be discussed at the meeting. However, as a practical matter, notices do specify such matters and include considerable detail and background. Unless notice is given in accordance with the corporation's by-laws or statutory requirements, the board meeting is not duly constituted and the business conducted at that meeting is of no effect. For this reason, where a board meeting must be called quickly and there is not sufficient time to give the required notice, the corporation may ask directors who were not present at the meeting to sign a waiver of notice. A director's presence at the meeting constitutes waiver of the notice requirements.

Participation in board meetings is central to the discharge of a director's responsibilities. Dates of meetings of the board are normally set well in advance in order to allow directors to schedule all their affairs. Unless directors attend meetings, participate in discussions with other members of the board and question management, they are unlikely to be fully informed about the affairs of the corporation and cannot expect to be in a position to meet the standard of care and diligence imposed on them. Corporations are also required to disclose in their proxy materials how many meetings each director attended.

Directors should also bear in mind that they will be deemed to have consented to any board resolution passed in their absence unless they dissent in the manner prescribed by statute (described under "Voting" below), and that they will be liable, along with all the other directors who did not dissent, for the acts and omissions of the board.

In Canada, unlike many jurisdictions outside North America, directors may not appoint proxies to act in their place. Although less common for public companies, directors may act by way of written resolution of all the directors.

(c) Location and Telephone Meetings

Meetings are often held at the corporation's head office, but many boards make it a practice to vary the location of their meetings. Where directors do not all live locally, board meetings may be moved around to accommodate them. Holding meetings in a variety of locations may also permit directors to visit and meet with management located away from head office or with local business and government officials. Some provincial corporate statutes require that a majority of meetings be held in Canada.

Most corporate statutes permit meetings to be held by conference telephone or by electronic or other means, such as video conferencing, to permit all persons participating in the meeting to communicate simultaneously and instantly. Depending on the governing corporate statute, the directors may be asked to consent to telephonic or electronic meetings when they first agree to act as directors, or they may need to consent each time such a meeting takes place. In spite of the convenience of such meetings, there is a value to directors meeting in person. If a number of directors are participating by telephone, it may be difficult to determine who is speaking or how the participants are reacting to the comments of others. Meeting in person around a board table is often preferable to a conference telephone or electronic meeting because it is more likely to facilitate frank and open debate.

(d) Quorum

A quorum must be present at any board meeting for business to be conducted at the meeting. Provisions of the articles or by-laws will set out quorum requirements and will typically provide that no business may be conducted at a meeting of the board unless there is a quorum present. If they do not, the quorum requirements set out in the corporate statues will apply. In addition to requirements respecting the overall size of the quorum, many Canadian corporate statutes also require that a minimum number of the directors present at a board meeting be resident Canadians. Generally, the statutory requirement is that a majority of those present be resident Canadians, but the *Canada Business Corporations Act* only requires 25% of those present to be resident Canadians. The Ontario statute does not impose such a requirement. If the requisite number of resident Canadians are not present at a meeting, the action of the board or committee will be effective if subsequently ratified by enough Canadian resident directors.

(e) Voting

Unless the articles or by-laws provide otherwise, action is normally taken by a board on the basis of a simple majority vote by the directors who are present. However, circumstances may arise in which the board decides it is appropriate or desirable to have a more significant majority or even unanimous approval of the board before proceeding.

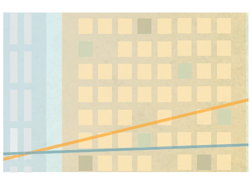
The minutes of a board meeting will often simply record the passage of a motion. Directors who disagree with the decision must be aware that they are deemed to have consented to the action unless they dissent. In most jurisdictions, abstaining does not constitute dissent. A director who has abstained from voting will be deemed to have consented to the resolution, except in the case of certain conflicts of interest where abstention is permitted by statute. A director's dissent must be recorded in the minutes, or the director must request that it be recorded. Alternatively, the director may send a written dissent to the secretary of the meeting before the meeting is adjourned, or to the corporation after it is adjourned. If a director was not present at a meeting at which the board took certain action with which the director disagrees, the director must either have a dissent placed with the minutes of the meeting or send a written dissent to the corporation within seven days after becoming aware that the resolution was passed.

A director who dissents in accordance with the procedures prescribed by statute will avoid certain liability. For example, the provisions of the corporate statutes making directors liable to the corporation for issuing shares improperly or paying dividends or redeeming shares contrary to the statutes only impose liability on directors who voted for, or consented to, the action.

(f) Minutes

The corporation is required to keep minutes of board meetings and directors are entitled to see the minutes. The minutes will provide evidence of who was present and what was done at a meeting. It is, therefore, important that they accurately reflect the meeting. It is also important that minutes be circulated promptly after a meeting has been held. This allows directors who were present to confirm the accuracy of the minutes while the meeting is still fresh in their minds and permits directors who were absent to register their dissent, if necessary, as promptly as possible.

From time to time, there has been debate about the extent to which discussion at a meeting should be recorded in the minutes. Minutes are seldom an exhaustive record of everything said at a meeting. However, some description of the nature of the discussion is necessary for the minutes to provide evidence that the board's consideration of an issue was thorough and thoughtful. If the board received advice from experts or advisors, this should be noted in the minutes. They should also indicate any dissent expressed by a director.
The minutes of a meeting of directors will be very persuasive evidence in any subsequent proceeding challenging the directors' conduct in respect of a particular decision.



3. Delegation

As noted at the outset, the board of directors is not usually in a position to directly manage the day-to-day affairs of the corporation and it, therefore, delegates to others. It delegates not only to management, but also to committees of the board and sometimes to other committees composed, in whole or in part, of non-board members. In delegating their responsibilities, directors must be satisfied, from a business perspective, that the task is delegated to the person or committee who/which is capable of performing the delegated task.

Certain responsibilities are generally considered sufficiently important that directors may not delegate them to a committee of the board. Under the *Canada Business Corporations Act* these include:
- Making changes to the by-laws (which would be subject to shareholder approval in any event);
- Approving the annual financial statements, a management proxy circular, a takeover bid circular or directors' circular;
- Issuing securities (except on terms already approved by the board);
- Declaring dividends; and
- Purchasing or redeeming shares of the corporation.

Some corporate statutes also prohibit directors from delegating the appointment or removal of the Chief Executive Officer, Chief Financial Officer, president and chair of the corporation. Regardless of the responsibilities delegated to a committee of the board, certain matters falling within the mandate of that committee may nevertheless be matters which should properly be returned to the full board for consideration and approval, such as matters of policy or issues outside the ordinary course of the corporation's business. In practice, the committees of many boards do not formally approve the matters before them, but return the matter to the full board with their recommendation.

(a) Board Committees

Committees of the board allow directors to share responsibility and to devote the necessary resources to a particular issue or area. Committees consisting solely of independent directors are constituted to address particular board matters, so that board deliberations on such matters are, and are perceived to be, independent. Notwithstanding this delegation of responsibilities to board committees, the board retains its ultimate responsibility for all matters assigned to the committee for consideration and resolution.

All public corporations are required by statute to have an audit committee, and private corporations frequently choose to have an audit committee as a matter of good practice. Most public companies have committees that deal with compensation matters and director nominations. Corporations with larger boards may also have an executive committee. Some corporations also have other committees such as a corporate governance committee, an environmental health and safety committee, a planning committee or a pensions committee. Boards also strike ad hoc or special committees from time to time to address specific issues or transactions.

The size of the committee will depend on its mandate. While a committee needs to have enough members to represent different perspectives and a variety of backgrounds, it must also be an efficient working group with its membership ideally confined to as few members as possible.

A committee's composition will depend on the nature of the committee. Subject to limited exceptions, an audit committee must consist solely of independent directors under NI 52-110. Corporations may also wish to comply with recommended best practices under NP 58-201 with respect to the composition of any nomination or compensation committee. If an independent committee is struck for a particular transaction, the board should appoint those directors who are completely at arm's length from the matter the committee is considering and, if applicable, those directors who meet the definition of "independent director" under securities laws or policies relating to such a transaction, such as MI 61-101. If the committee is studying some aspect of the corporation's business or a specialized area, such as environmental issues, the members of the committee should be those directors most familiar with or best qualified to deal with the matter.

A committee of the board will normally be established by a resolution of the board. That resolution should set the mandate for the committee and describe the scope of its authority. NI 52-110 requires that an audit committee have a written charter and that the audit committee be assigned certain responsibilities and have certain authorities. NP 58-201 recommends that nominating and compensation committees have written charters establishing the committee's purpose, composition, responsibilities and authorization. Committees will often be entitled to determine how their meetings are conducted, what the quorum is to be and how often they will meet, absent any requirements in the corporation's by-laws or applicable securities laws dealing specifically with such matters.

(b) Audit Committee

The company's financial statements are a vital source of information about the corporation's affairs. As a result, the role of the audit committee in the financial reporting process receives scrutiny. The auditor reports to the audit committee and the relationship between the audit committee and the auditor must be one of trust and candor. The audit committee is responsible for overseeing the work of the company's external auditor and the auditor's qualifications and independence. The audit committee typically evaluates the performance of the external auditor and makes recommendations to the board of directors on the reappointment or appointment of the auditor to be proposed at the company's annual shareholder meeting. The auditor is appointed each year by the shareholders at the annual meeting. Only the shareholders may remove an auditor from office. If there is a vacancy in the office of auditor, the directors are required to fill the vacancy, unless the shareholders have done so at the meeting at which they removed the auditor or unless the corporation's articles stipulate that only the shareholders may fill a vacancy in the office of auditor. If an auditor resigns or is about to be removed or replaced, the auditor may submit a written statement to the corporation giving the reasons for its resignation or why it opposes being removed or replaced. Public companies must also comply with the reporting requirements of NI 51-102 and must disclose any disagreement between a corporation and its auditor that has been a contributing factor to the resignation or termination of the auditor.

Under corporate statutes, the audit committee is responsible for reviewing the corporation's annual financial statements before they are presented to the full board for approval. This provides further assurance that the annual financial statements present a fair and balanced view.

NI 52-110 requires the audit committee to assume responsibility for reviewing the corporation's ongoing financial disclosure, including all financial statements, management's discussion and analysis, and annual and interim earnings press releases, before this information is publicly disclosed. Securities legislation also requires the audit committee to review, and the board to approve, all financial statements (including interim financial statements), although the board may delegate approval of the interim financial statements to the audit committee.

Other responsibilities assigned to audit committees under securities legislation include:

- Pre-approving all non-audit services to be provided to the company by the corporation's external auditor;
- Establishing procedures for the receipt, retention and treatment of complaints received regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters; and
- Reviewing and approving the company's hiring policies regarding present and former employees and partners of the company's external auditor.

Audit committees have responsibility with respect to the oversight of internal control over financial reporting and the activities of internal auditors. Internal auditors typically focus on financial controls and internal operating information. In order to monitor their activities, the audit committee must understand and approve the objectives of the internal auditors, their annual audit plan and their areas of emphasis. The audit committee should question management about its risk assessment, environmental and security controls, compliance with regulatory requirements, and general standards of business conduct.

As part of its oversight of financial reporting, the audit committee should assess the reliability of the reported results and the quality of reported earnings. For example, the audit committee should:

- Assess how aggressive or conservative management has been in preparing the financial statements and, in particular, whether management's assessment of materiality for financial statement purposes is appropriate on both a quantitative and a qualitative basis;
- Be sensitive to significant accounting and reporting developments and issues and their impact on financial reporting;
- Review the appropriateness of significant accounting policies and consider alternative treatments under applicable generally accepted accounting principles;
- Review significant estimates made by management in preparing the financial statements, the process used to develop them and the impact of those estimates on the financial statements; and
- Review significant financial reporting risks, including fraud risks, and plans to mitigate them.

Different accounting policies can have very different effects on reported financial results. The audit committee should assess whether the company's accounting policies are reasonable and appropriate and whether any change in accounting policy is warranted. Changes in accounting policies may be mandated by new accounting or regulatory rules or may be appropriate based on business practice. The rationale for any proposed change in accounting policies and the impact of the change on reported financial results should be assessed, as should the impact of the change in financial results in the way the information is used by the corporation.

Estimates require the exercise of judgment based on assumptions about present and future courses of action and economic conditions. As a result, they are susceptible to change and the risk of error. Audit committees also need to be alert to the risk of manipulation of estimates and reserves in order to manage reported earnings.

In assessing the quality of reported earnings, audit committees should be particularly alert if a proposed transaction has been established primarily to achieve a particular accounting treatment without there being some other business purpose associated with the transaction. Risk management policies, procedures and limits should be reviewed in consultation with the internal and external auditors with a view to identifying any aggressive or questionable financial reporting practices by management.

Under the corporate statutes, public companies are required to have an audit committee composed of at least three directors, a majority of whom must not be employees of the corporation or any of its affiliates. NI 52-110, however, requires that audit committees of public corporations be composed of at least three members, all of whom must be "independent directors," as defined in that instrument.

NI 52-110 also requires that all members of the audit committee must be "financially literate" in that they have the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the company's financial statements. Furthermore, while there is no requirement in Canada that members of the audit committee have any expertise in financial matters, corporations must disclose the education and experience of each audit committee member that is relevant to the performance of his or her responsibilities as an audit committee member.

Audit committees usually meet four times a year, but the frequency of their meetings has increased in many corporations because of greater expectations imposed on them. The audit committee typically meets with management and the auditor before the annual audit begins and again before the financial statements are approved by the board. Meetings of the audit committee are normally attended by the corporation's Chief Financial Officer and the auditor as well as by the committee members. However, the audit committee should also meet separately with management and the auditor. The audit committee should require the Chief Financial Officer to report at each of its meetings on matters relevant to the financial state of the corporation. The auditor also has a key role to play in the process, helping the audit committee understand the quality and extent of the information provided by management for inclusion in the corporation's financial statements. The auditor also assists the audit committee by reviewing and assessing the financial systems and controls designed to ensure the integrity of the financial information.

(c) Compensation Committee

Most public companies have established a board committee responsible for compensation matters. NP 58-201 recommends that a board should appoint a compensation committee composed entirely of independent directors. The committee should adopt a written charter setting out its responsibilities and manner of reporting to the board, and should have the authority to engage and compensate outside advisors. NP 58-201 recommends that a compensation committee be responsible for reviewing and approving corporate goals and objectives relevant to Chief Executive Officer compensation; evaluating the Chief Executive Officer's performance in respect of those goals and making recommendations to the board with respect to the Chief Executive Officer's compensation based on this evaluation; making recommendations to the board with respect to other compensation packages, and incentive compensation and equity-based plans; and reviewing executive compensation disclosure before the issuer publicly discloses this information. Public companies are required to disclose publicly on an annual basis the processes by which a board determines compensation for the company's directors and officers; whether the committee responsible for compensation matters is composed entirely of independent directors and, if not, what steps the board takes to ensure an objective process for determining such compensation; the responsibilities, powers and operation of the compensation committee; and the identity and mandate of any advisors retained by the committee in the past financial year.

Executive compensation for senior executives is required to be disclosed annually in the corporation's proxy circular. Armed with such information, investors have raised concerns respecting the form and quantum of executive compensation and have criticized and, in the *Repap* case, successfully challenged, the determination of the compensation committee. It is not uncommon for compensation committees to retain advisors on executive compensation matters or advisors independent of those retained to assist management.

Increasingly, shareholders are seeking greater input on compensation decisions. For example, many large public corporations in Canada provide their shareholders with the opportunity to vote on a non-binding 'say on pay' resolution respecting the corporation's executive compensation practices.

(d) Nominating Committee

Canadian securities administrators have recommended that boards constitute standing nominating committees composed entirely of independent directors. NP 58-201 recommends that the committee have a written charter setting out its responsibilities and manner of reporting to the board. The nominating committee should have authority to engage and compensate outside advisors. As part of its processes for measuring its effectiveness, the board should consider the appropriate size of the board and the nominating committee should be responsible for identifying individuals qualified to become new board members and recommending to the board the new director nominees for the next annual meeting of shareholders.

NP 58-201 also recommends that, before nominating or appointing individuals as directors, the board, with advice and input from the nominating committee, should consider the competencies and skills that the board, as a whole, should possess; the competencies and skills of each existing director; the competencies and skills of each new nominee; and whether the new nominee can devote sufficient time and resources to his or her duties as a director. Public companies are required to disclose publicly on an annual basis the process by which the board identifies new candidates for nomination; whether the committee responsible for director nomination is composed entirely of independent directors, and if not, what steps the board takes to ensure an objective nominating process; and the responsibilities, powers and operation of the nominating committee.

(e) Special Committees

A special committee is an ad hoc committee of the board established to consider a particular issue. If the committee is to consider an issue involving a conflict of interest for certain directors, the committee will usually be composed entirely of directors who are independent for the purposes of the issue under consideration. Special committees have become one of the most important vehicles a board of directors can use to establish that it has gone through the appropriate process and given an issue thorough, balanced, unbiased consideration before reaching a decision.

Special committees have long been used as a matter of good corporate governance. MI 61-101 also recommends the use of a special committee where the corporation is considering certain transactions with a related party. The *Bank Act* requires that a special committee composed of independent directors be established on a standing, rather than an ad hoc, basis to establish procedures for the review of related party transactions.

Establishing a special committee is not, of course, in and of itself, sufficient to discharge the board's duty to carefully and independently review a matter. The composition of the special committee, the time it has to consider a matter, its access to information and its use of advisors will also be factors in determining whether the board has discharged its duty through the use of the special committee. In *YBM Magnex International Inc.*, the Ontario Securities Commission strongly criticized the composition and procedures of a special committee struck to investigate rumours respecting a connection between the company and certain alleged organized crime figures.

The decision in *KeepRite* highlighted the important role that special committees play in good corporate governance. In that case, KeepRite was proposing to acquire assets from a subsidiary. The KeepRite special committee reviewed the proposed transaction and made a recommendation to the board that the transaction was fair to the corporation and to minority shareholders. The corporation sought and obtained shareholder approval, but the minority shareholders who were opposed to the transaction sued nevertheless. One of the reasons the Court gave for concluding that the transaction was not oppressive was the consideration given to the matter by a committee of independent directors.

In *Schneider*, the Ontario Court of Appeal said that, where a board avoids conflicts of interest by establishing a special committee of disinterested directors who act independently, the burden of proof is on the plaintiff to establish that the directors acted improperly. The Court did not suggest that the burden would ever shift.

The Ontario courts have also accepted that senior management may be involved in the negotiation process for a transaction as long as it did nothing inappropriate. Management involvement is permissible as long as the special committee gives directions to management and the special committee makes the final decision to recommend the transaction to the board.

4. Directors' Conflict of Interest

Directors may have a number of relationships that will put them in a position of conflict or give rise to an obligation to disclose details of a relationship.

(a) When Does a Conflict Arise?

Directors who have an interest in a contract or proposed contract with the corporation must consider the matter carefully. If the contract is material from the perspective of either the corporation or the director, the director will be under a statutory obligation to declare his or her interest and, with some exceptions, to refrain from voting on the matter.

The corporate statutes require directors to disclose in writing to the corporation their interest in any material contract (whether the contract is material will be determined with reference to the materiality threshold of the corporation or the director) or to request that the interest be entered in the minutes of a meeting of the board. The nature of a director's interest must be disclosed in sufficient detail to allow the other directors to understand what the interest is and how far it goes. A director's interest must also be disclosed within the time frame prescribed by the relevant corporate statute.

Under the corporate statutes, directors have an interest in a contract not only if they themselves are a party to the contract, but also if they have a material interest in any person who is a party to the contract or are directors or officers of such a person. The statutes do not define when a director has a material interest in a person, but material interest is generally interpreted to mean an interest which is sufficient to result in some benefit to the director.

Directors who are also substantial shareholders of the corporation are not automatically in a position of conflict. Such directors must, however, separate their role as directors from their interests as shareholders. In voting on matters in their capacity as shareholders, those directors may, of course, vote without regard for the interests of other shareholders. In voting as directors, however, they must still act in the best interests of the corporation in respect of any matter before them.

(b) Voting and Abstaining from Voting

Directors usually cannot vote on a contract in which they have a material interest. Under some corporate statutes they also cannot attend the part of the board meeting dealing with the contract. There are exceptions for contracts that involve the directors' remuneration or an indemnity or insurance in which they have an interest. Exceptions are also made if the contract in question relates to an affiliate of the corporation. As a result of this last exception, directors who serve on boards of affiliated corporations are not required to refrain from voting on contracts between the two corporations that they serve.

Two results may flow from a director's failure to disclose an interest in a material contract or, in some cases, from voting when not entitled to do so. First, the director may be required to account to the corporation or its shareholders for any gain or profit realized from the contract. Second, the corporation, its shareholders or, in some cases, securities regulators may apply to the court to have the contract set aside. Under some statutes, the director may nevertheless avoid these results if the contract is confirmed or approved by special resolution of the shareholders after appropriate disclosure of the director's interest in the contract. If the director failed to make the necessary disclosure and the contract was not reasonable and fair to the corporation at the time it was approved by the shareholders, there is no protection for the director under the corporate statute.

Directors should be aware that the specific provisions in the corporate statutes dealing with a director who is in a position of conflict apply only in relatively limited circumstances. They apply only to certain contracts or proposed contracts with the corporation and would, arguably, not include litigation, for example. Further, these provisions apply only to contracts that are material either to the corporation or the director, not to contracts that do not meet this threshold.

In practice, however, most directors apply the rules broadly. They do not confine the restrictions to the statutory requirements, but concern themselves with the issue of perceived and actual conflict and what seems to be the right thing to do. In practice, directors will take themselves completely out of the consideration of a particular matter where there may be a perception of conflict or a perception that they may not bring objective judgment to the consideration of the matter. In appropriate circumstances, directors will declare their position and absent themselves not only from the vote, but also the discussion. However, directors should be aware that abstaining from voting, except in certain limited circumstances, may not protect them from liability under the corporate statutes. In particularly difficult situations, it may be necessary or appropriate for a director to resign.

5. Information Management

(a) Information Provided to Directors

Since directors are responsible for overseeing the management of the corporation, they are entitled to have access to any information belonging to the corporation. The flow of information to directors is critical to the discharge of their responsibilities. A balance must be struck to keep the directors informed of significant issues facing the corporation and to provide them with the information needed to come to an informed view, on the one hand, and to guard against providing the directors with so much information, on the other hand, that their time is devoted to sifting through that information in an attempt to distill what is truly relevant. In his 1986 report on the collapse of the Canadian Commercial Bank and the Northland Bank, the Honourable Willard Estey found that the inability of the board of the Canadian Commercial Bank to perform its duty was directly related to the improper flow of information to the board:

> *If there is one key to the troubles encountered by the Board in directing the affairs of the bank, it was their composite failure to insist upon simple and straightforward regular and timely information from management. The institutions and processes were in place in the government of the day, but they did not function because management did not deliver and the Board did not demand a flow of the*

> *basic information necessary to the control of the affairs of the bank and to keep management within the policies as laid out by the Board.*

A board must have systems in place to ensure it receives key information. Frequently, it is the Chief Executive Officer of the corporation who, in the first instance, determines what information is provided to the board. The independent chair of the board or the lead director, as applicable, should also be involved in this decision. It is critical that the directors receive the information in sufficient time to allow them to read and digest it. The amount of time needed will vary depending on the volume and complexity of the information.

(b) Financial Reports

Responsibility for the corporation's financial reporting is one of the board's most significant responsibilities, as these statements are the primary means of communicating information respecting the operation and prospects of the corporation to shareholders and prospective investors.

Both interim and annual financial statements are prepared by management. Interim financial statements may be approved by the audit committee or the board, and annual financial statements must be reviewed by the audit committee and approved by the board before being submitted to the shareholders. The corporate statutes and securities laws require public companies to have annual financial statements audited and to establish an audit committee. Where interim financial statements are not reviewed by the company's auditor, the company's interim financial statements must be accompanied by a notice to such effect when they are submitted to shareholders and filed with securities regulators. These procedures are all intended to provide further assurance that the statements present a fair and balanced view.

The importance of the financial statements is reinforced by the regulatory requirement that a corporation explain much of what is contained in the financial statements in a narrative referred to as management's discussion and analysis of financial conditions and results of operation, or the "MD&A." Although the MD&A is described as management's discussion, under *National Instrument 51-102: Continuous Disclosure Obligations* (NI 51-102) the board of directors must review and approve the annual MD&A accompanying the annual financial statements and the board or the audit committee may review and approve the MD&A accompanying the interim financial statements. The role of the directors in the preparation of the MD&A is discussed in greater detail in Part IV.

The review of the financial statements by the board or the audit committee must be more than a pro forma perusal of statements prepared and reported on by management. It is incumbent on the directors to review the statements with a view to identifying any indications that the corporation is encountering difficulty. In its *Standard Trustco* decision, the Ontario Securities Commission criticized a board of directors for inappropriately approving financial statements and disseminating this information publicly.

The board should question members of the audit committee, management, the auditors and any other advisors about the financial statements. It might be appropriate, for example, for the directors to question the appropriateness of the corporation's accrual policy or management's decisions to write down certain assets or not to do so. Major accounting firms have developed sample questions for boards and audit committees to provide some guidance on the types of questions which will help directors shed light on the financial statements.

(c) Timely Disclosure

Because a key tenet of the public markets is equal access to material information, the timely public dissemination of information dealing with the operations and activities of a publicly traded corporation is one of the fundamental obligations of such corporations. Public companies must disclose certain information each year, some of which must be delivered to shareholders, and other information must be filed electronically with securities regulators so that the information is publicly available through the SEDAR website. The board should be satisfied that procedures are in place to ensure that the corporation is complying with its timely disclosure obligations and that the information being disseminated is true and accurate. These requirements are discussed in greater detail in Part IV.

6. Securities Law and Stock Exchange Requirements

Procedures followed in the past by some corporations as matters of good corporate governance are now prescribed for public companies by securities law and stock exchange requirements. These are frequently policies of general application to many of the corporation's activities and must, therefore, be considered when a board is formulating the appropriate procedure for dealing with certain issues.

(a) Stock Exchanges

Stock exchanges in Canada impose certain governance and disclosure requirements on public companies. In addition to regulating initial and ongoing listings, stock exchanges also have imposed requirements relating to corporate governance. These typically relate to the election of directors and to transactions involving the issuance of shares and may require, in some instances, shareholder, including minority shareholder, approval. The TSX also requires listed issuers to comply with the corporate governance disclosure requirements of NI 58-101. For the most part, the stock exchanges can enforce their rules because of their ability to refuse to list or to suspend trading in a corporation's shares. In many cases, they are also in a position to request that the appropriate securities commission take action against a corporation or its directors.

(b) Role of the Securities Regulator

While many of the legal requirements that affect directors and their corporations are found in the corporate statutes, Canadian securities regulators have been active in recent years in prescribing certain guidelines and rules for corporate conduct. Securities regulators have traditionally interpreted their mandate to protect the public interest to include ensuring that corporate practice and procedures accord with public expectations, even if they go beyond the existing statutory corporate law.

For example, MI 61-101 prescribes certain governance standards in connection with insider bids, issuer bids, business combinations and related party transactions.

Other initiatives of Canadian securities administrators have important implications for reporting issuers, their directors and officers and others involved in corporate governance and disclosure. Requirements have been implemented for the certification by Chief Executive Officers and Chief Financial Officers of annual and quarterly filings (*National Instrument 52-109: Certification of Disclosure in Issuers' Annual and Interim Filings* [NI 52-109]). Standards have been imposed on audit committee composition and practices (NI 52-110). Harmonized requirements for disclosure of information to investors have been implemented (NI 51-102). Corporate governance guidelines (NP 58-201) and corporate governance disclosure requirements (NI 58-101) have also been implemented. At the time of writing this edition, the Ontario Securities Commission is considering a proposed amendment to NI 58-101F1 to require disclosure of director term limits and representation by women on the board.

Most provinces have passed legislation introducing civil remedies for investors trading in the secondary markets in the event of misrepresentations made in written or oral disclosure by reporting issuers, their representatives and certain other parties or a failure to make timely disclosure of material changes.

Under the legislation, reporting issuers, their directors and certain officers, as well as influential persons (including promoters, controlling persons and certain other insiders), are personally liable to investors who purchase securities in the secondary market for misrepresentations in public disclosure and failures to make timely disclosure subject to certain statutory defences and monetary limits. Investors do not have to prove that they relied on the misrepresentations.

IV. Directors in Action

IV. Directors in Action

Part IV identifies a number of decisions that directors, typically public company directors, face and discusses the issues that should be of particular concern in making such decisions. Decisions relating to financing are among the most critical decisions, including whether to raise capital or to incur debt, and whether to access capital markets to do so. If the company accesses capital markets, decisions relating to ongoing public disclosure obligations become of central importance. Events may occur during the directors' tenure that give rise to significant decision-making; for example, an environmental incident, a takeover bid, a transaction involving a significant shareholder or financial distress. In such cases, directors must inform themselves about applicable law and discharge their responsibilities in an informed manner in the best interests of the company.

Part I of this guide discussed the basic nature of the responsibilities of the directors to the corporation and the issues related to discharging those responsibilities. Part III outlined some of the basic corporate governance issues to which directors should be sensitive in order to ensure that their duties are being appropriately discharged. This part applies the principles discussed in Parts I and III with respect to some of the matters most commonly considered by a board of directors.

1. Financing

Financing decisions are among the most significant for a corporation. Funds may be raised either in the form of debt or equity capital. In certain circumstances, a corporation can enhance its ability to increase profits by increasing its leverage (or debt to equity ratio), but increased leverage also has the potential to magnify losses. If a corporation's capital structure is too highly leveraged or is otherwise inappropriate, it can threaten the stability of the corporation, especially during a downturn in the industry or economic cycle. On the other hand, while raising equity may contribute added stability, the dilutive effect on existing shareholders may not always be welcome. Financing decisions are generally made by the full board of directors, although there is some latitude to delegate some aspects of a financing to a board committee or specified executive.

(a) Issuing Debt

For most corporations the primary source of debt financing was traditionally bank financing. Depending on the corporation and its financing needs, these arrangements varied from straightforward operating and term loan facilities to much more varied and sophisticated arrangements. Many corporations now acquire financing by issuing bonds.

The board of directors must consider various factors in assessing specific and overall funding requirements of the corporation and sources from which this funding may be available. Financing decisions will be affected, for example, by the funds which management anticipates will be available from operations, by the level of planned capital expenditures and by the desirability of matching factors such as the life and location of assets with the term and currency of financing. The board should also consider the ratio of debt to equity that is appropriate for the corporation, the implications of additional debt on the ability to fund existing commitments and any impact on the corporation's credit rating. Most senior issuers will have their public debt and preferred shares rated by a Canadian or U.S. credit rating agency. These agencies will monitor the creditworthiness and other financial aspects of a corporation and attach a specified rating to each rated security. This rating, in turn, affects financings. The better the credit rating, the lower the cost of funds and the broader the range of potential investors.

The extent and source of debt and other capital requirements will, in the first instance, be recommended to the board by senior management, usually through the Chief Financial Officer. In evaluating a particular loan, directors should consider the rate of interest available, whether the interest rate will be fixed or floating, and whether the facility is to be short, medium or long term. Other features of a loan, such as the currency, any security which the lender requires, and any restrictive covenants, can be significant and should be carefully considered because they may have an impact on future financing and other corporate action. A feature of bonds may be the ability to convert the bonds to equity.

(b) Issuing Shares

The authority to issue shares of a corporation lies with the directors, although in some instances it may be necessary to obtain shareholder approval (for example, to authorize the creation of a class of shares). Shareholders cannot compel directors to issue shares and directors cannot delegate their authority to issue shares to a committee of the board unless the full board has authorized the manner and terms on which the shares will be issued. The two classes of shares that are most often issued are common shares and preferred shares.

Common shares are typically the corporation's voting shares. Holders of these shares elect the corporation's directors and vote on matters put to a shareholder vote as prescribed by statute and described in Part III. Generally they are also the "participating" shares, meaning that they are entitled to share in the profits of the corporation through dividends, if, as and when the directors may determine, and to share the residual equity of the corporation on dissolution. Traditionally, the common shares of the corporation had all three share attributes: the right to vote; the right to discretionary dividends; and the right to share in the residual equity of the corporation on dissolution. It is now not uncommon for these three attributes to be split. Non-voting common shares, for example, do not carry the right to vote, but are generally fully participating.

As the name implies, preferred shares have some form of preference or other priority over more junior classes of shares, including common shares. The priority usually relates to dividends and return of capital. Preferred shares may also have other features, such as a right of conversion into common shares, which, in effect, gives them some of the attributes of common shares, and a set dividend rate.

Preferred shares may be issued for an indefinite term. Alternatively, they may have a fixed-term, be redeemable at a specified time or times by the corporation or retractable at specified times by the holder. A fixed-term or a redemption right exercisable at the option of the holder, referred to as a "retraction right," can affect the characterization of the preferred share by accounting rules, credit rating agencies and the market generally. While preferred shares have traditionally been considered permanent equity, the use of fixed-term or retraction features have resulted in such preferred shares being viewed for some purposes as more akin to debt than equity and, therefore, a further factor to assess in considering the appropriate debt to equity mix.

The determination of the appropriate preferred share terms, including the dividend rate and whether the share should be permanent equity or have a specific term or retraction right, will be significantly influenced by variables in the marketplace and in the corporation's circumstances at the particular time of financing. To meet this need for flexibility in setting the terms of preferred shares, the articles of a corporation may authorize one or more classes of preferred shares and then empower directors to set the specific terms of the preferred shares, which can be issued in one or more series of the already established class, without the need for shareholder approval. This provides an important degree of flexibility to the corporation.

If a corporation has a limited amount of authorized capital, directors must be satisfied that there is sufficient capital to issue shares. Most Canadian corporations, however, are authorized by their articles of incorporation to issue an unlimited number of common shares. Directors must also be satisfied that shares are being issued for a proper business purpose. Most often, the purpose is to raise capital or acquire assets for the corporation, but some boards have used their ability to issue shares as a defensive tactic against a party who wishes to take control of the corporation. In situations where the directors believe, in good faith, that issuing shares to effect or to prevent a change of control is in the best interests of the corporation, the courts have accepted this as a proper business purpose. Issuing shares in order to entrench the existing board has not, however, been held to be a proper business purpose.

Directors must also be satisfied that shares are being issued for adequate consideration. This can sometimes be a problem when common shares are being issued because their value can be difficult to assess, even where there is a public market. There are a number of ways to value shares. The value of publicly traded shares will generally be based predominantly on their recent trading history, but market prices can be affected by a variety of factors that may not be completely reflective of their underlying value. Further, introducing additional shares into the market and the corresponding dilution of existing shares may have an impact on the price that new investors will be prepared to pay for those shares. The pricing of the shares is sometimes done with the advice of the corporation's financial advisors who are experts in the area.

If shares are being issued as consideration for property or past service, directors must be able to conclude that the property or past service is worth at least what the corporation would have received if the shares had been issued for cash. This applies, for example, where shares are being issued in exchange for assets being acquired by the corporation, or to employees or directors in lieu of cash compensation. Again, in making this determination, the directors may look to the advice of advisors or other experts. Failure to ensure that the value of the property or past service is adequate exposes directors, who voted for, or consented to the resolution, to personal liability under the corporate statutes.

(c) Accessing the Capital Markets

While bank financing remains a primary source of debt financing for most corporations in Canada, the private and public capital markets are also significant sources of debt and equity capital. Directors may face greater risk of personal liability when funds are raised from these sources.

The capital markets can be accessed either through a private placement or other exempt offering or through a public offering by prospectus. Each of these approaches has particular implications for the directors which are discussed below.

(i) Private Placements

For the most part, the private or exempt market is confined to sophisticated purchasers such as financial institutions and investment or pension funds. Issuers may sell securities to these investors without complying with the complex and detailed prospectus process. As a result, funds raised by way of private placement can generally be raised more quickly and easily than is possible in a public offering, albeit from a more limited group of investors.

If there is to be an offering document in a private placement, the directors typically approve it along with the terms of the securities to be offered and other aspects of the transaction. The corporation has responsibility for any such offering document and, under the rules in some Canadian jurisdictions, the directors may have personal liability for this document if it contains a misrepresentation. Nevertheless, in order to ensure the corporation meets its responsibilities and to deflect any possible claim against the directors for any common law responsibility they and the corporation might have in relation to the document, it is important for the directors to be satisfied that the proper process has been followed in preparing the document, that the information in the document is true and that it does not omit anything that makes items contained in it misleading.

(ii) Public Capital

Raising funds from the broader public market is a significantly more involved process than a private placement and has greater potential for liability to directors than does raising private capital. In order to access this market, which includes retail investors, it is necessary for a corporation to offer its securities under a prospectus. The prospectus must provide full, true and plain disclosure of all material facts relating to the securities that are being issued. This covers virtually all aspects of a corporation's affairs, including its financial results, its business, the industry in which it operates and its management.

A prospectus carries statutory civil liability not only for the issuer, but also for the officers who sign the document and for each of the directors of an issuer, who can be held personally liable if it contains a misrepresentation. For this purpose, a misrepresentation arises not only when a prospectus contains an untrue statement of a material fact, but also if it omits a material fact that was necessary to be disclosed in order to prevent a statement in the prospectus from being misleading. By contrast, in the private placement context, statutory director liability only arises in a few Canadian jurisdictions, and not in any of the provinces where there is typically significant institutional investor demand for securities.

In *Danier Leather Inc.*, the Supreme Court of Canada concluded that the issuer was not liable for a prospectus misrepresentation because the prospectus was accurate at the time of filing. The issuer was only liable for failing to disclose post-filing information if that information was a "material change." Since a change in the issuer's post-filing financial results did not amount to a change in the issuer's business, operations or capital, the change was not a material change. The Court also made it clear that the business judgment rule does not apply to disclosure obligations under securities laws.

Apart from the corporation and its directors, a number of other parties also have liability under the prospectus. Any shareholder who sells shares in the corporation under a prospectus will be liable. The underwriters of the offering as well as any other person who signs the prospectus, such as a promoter, is also liable. In addition, if reference is made in the prospectus to any report or opinion of an expert, such as an auditor's report on the corporation's financial statements, and a consent to such disclosure by the expert has been filed, that expert will be liable for this so-called "expertised" portion.

While the directors may incur personal statutory civil liability for a prospectus, they also have certain defences. The most significant defence available to directors is the "due diligence" defence. In this context, due diligence means that directors will not be liable if they conducted a reasonable investigation in order to have reasonable grounds for the belief that there was no misrepresentation. This, in turn, has been interpreted to require an appropriate degree of verification including, in appropriate circumstances, independent verification. All directors may not necessarily be able to take advantage of this due diligence defence. The conventional view is that inside directors will likely not be able in the normal course to utilize the defence given their more direct and day-to-day involvement in the corporation's affairs. The liabilities associated with the prospectus and the defences available are discussed further in Part V.

Particularly significant for the outside directors is the general view that the diligence, and related verification, may be delegated to someone else to perform on the directors' behalf. In practice, depending on the issuer and the nature of the offering, the diligence exercise is carried out by management working with a combination of outside or inside advisors who are effectively acting on the directors' behalf. It is important for the directors to be satisfied that the appropriate due diligence process is in place and has been followed.

This may be an issue when corporations are financing through a short form prospectus or other accelerated public offering techniques. As discussed below, in these circumstances, the opportunities for performing due diligence are more limited given the shorter time frame and there is, of necessity, generally more reliance on the corporation's internal procedures for review and preparation of prospectus-related materials.

(iii) Proceeding with a Public Financing – The Short Form Prospectus

Most capital is raised issuing the "short form" prospectus system. The short form system allows eligible issuers to use an abbreviated or short form of prospectus and incorporate by reference into that document disclosure documents previously filed with the securities commissions containing material facts about the corporation, such as the annual information form, the financial statements and MD&A. A corporation is eligible to use the short form prospectus system if it is a Canadian reporting issuer listed on a prescribed stock exchange which files electronically and is up-to-date on continuous disclosure.

New disclosure about the corporation in the short form prospectus will usually be confined to a "recent developments" section dealing with matters that have occurred since the corporation's last filing. As a result, there is usually relatively little information about the corporation itself in the short form prospectus. The balance of the short form prospectus will describe the securities being issued and the details of the offering. However, the documentation incorporated by reference should also be reviewed by directors to ensure it continues to be accurate, and to the extent it is not, further disclosure may have to be included in the short form prospectus. Directors are subject to liability for any misrepresentations in the information incorporated by reference into the short form prospectus.

A further refinement of the short form system is the "shelf" prospectus procedures, which can further accelerate and facilitate the public offering process. Under this system, a base or shelf prospectus is filed setting out in general terms the securities that can be issued. Once this base prospectus is filed and cleared, securities can be issued, or "brought down off the shelf," virtually immediately and without any further regulatory review. Shelf prospectuses are typically used for various forms of debt financing, such as medium-term note programs, which are sold in frequent intervals at prevailing market rates. However, they can be used for any type of debt or equity security.

In addition to permitting a shorter and simpler offering document, the short form system also significantly reduces or, in the case of the shelf system, effectively eliminates the time frame for regulatory review.

Short form prospectus financing are now typically conducted as a "bought deal" underwriting. Under this process, the underwriter commits to purchase the corporation's securities even before a preliminary prospectus is filed and without the "market out" clauses traditional in an IPO, which allow the underwriter to withdraw from a transaction if it is unable to successfully market it. The bought deal reduces the uncertainty that the issuer has during the marketing period in a conventional offering about whether it will receive the amount of money it is seeking on the terms the underwriter had proposed, and means that the underwriter has an increased need to eliminate its underwriting risk as quickly as possible. In order to do so, there is even further demand to prepare and file the prospectus documentation as quickly as possible.

All of these factors have assisted corporations in accessing the capital markets. However, notwithstanding the reduced time frame in which to conduct due diligence, the responsibilities of the directors and their potential statutory civil liability remain the same. This highlights the need for the directors to be satisfied that the system and process that the corporation has in place to ensure the accuracy of information that has been or may be incorporated into a prospectus are appropriate and provide not only appropriate disclosure to the marketplace, but also offer the directors a basis for establishing their due diligence defence.

(iv) Proceeding with a Public Financing – The Long Form Prospectus

The prospect of a public or other financing will often be discussed, at least in a general way, at meetings of the board of directors well in advance of a preliminary prospectus being prepared or filed. For example, potential financing sources are often indicated when the corporation's business plan or capital expenditure program are considered by the directors. While some corporations are in businesses that permit such financings to be scheduled, for the most part the markets are volatile and the exact timing of a public financing is difficult to predict very far in advance.

When a prospectus financing is to be undertaken, the preliminary prospectus is usually prepared by members of management with varying degrees of involvement by the underwriters and outside legal advisors. It is unlikely that any of the independent directors will see a draft of the preliminary prospectus until shortly before the meeting at which they will be asked to approve it. Nevertheless, the preliminary prospectus should be submitted to the directors sufficiently in advance of the meeting to allow them time to review it adequately. The amount of time required will depend on the circumstances, such as whether the corporation is a first time or infrequent issuer as compared to a seasoned or more frequent issuer that more regularly prepares or updates its prospectus related material.

If the corporation is undertaking its initial public offering (IPO), or if the corporation is public but is not eligible to use a "short form" prospectus, the prospectus will be in the traditional "long form."

The long form prospectus includes a great deal of information prescribed by securities regulations, including a comprehensive description of the corporation's business and its financial position as well as all other information about the corporation that could affect the price or value of the securities being offered. If the issuer is raising capital in the public markets for the first time, a careful review of the due diligence process and the prospectus is particularly important.

Directors must read the prospectus carefully and ask questions, as appropriate, of management, legal counsel, the auditors and any experts whose opinions are disclosed in the prospectus on any points with which they are unfamiliar or about which they wish confirmation. As noted, directors are not required to conduct their own full-scale review or audit of the matters disclosed in the prospectus in order to discharge their duties and will, of practical necessity, rely primarily on the efforts of the internal and external advisors. However, directors will be expected to have reviewed the prospectus carefully, including the financial statements and risk factors, and be satisfied with information disclosed or not disclosed through the assurances of management and advisors and, equally important, the process followed in its preparation and verification.

Counsel to the corporation will normally advise the directors of their obligations in connection with the prospectus and, particularly in long form offerings, will provide a form of directors' and officers' questionnaire to them posing a number of questions, both specific and general, about the prospectus.

After the directors have approved the preliminary prospectus, it is filed with the securities commissions for review. Once the comments of the securities regulators have been settled, a final prospectus is approved by the directors and filed with the commissions. It is not appropriate for the final prospectus to be approved by the board at the same time as the preliminary prospectus for two reasons. First, the directors must approve the changes made to the prospectus in response to the comments of the regulators. Second, the directors must confirm that nothing has occurred between the filing of the preliminary prospectus and the filing of the final prospectus which requires disclosure. Since a long form prospectus is usually a "marketed" deal, the board usually has to meet in any event to approve pricing and the underwriting agreement. In many circumstances it can be difficult for the entire board to meet again, either in person or even by conference call. In some circumstances the corporation and the underwriters will want to file a final prospectus as soon as the regulators' comments have been settled; however, the actual timing of settling these comments is always somewhat uncertain. In anticipation of this, a board may delegate, in accordance with applicable corporate law, the responsibility to approve the final prospectus to a committee of the board. Delegation of this function does not relieve the directors who are not on the committee of liability in the event that a misrepresentation appears in the final prospectus which was not in the preliminary prospectus approved by the full board. Further, while many matters may be delegated to such a committee, there are limitations in the corporate law on the powers of committees of a board to set the specific terms of a security to be offered. Depending on these limitations, it may be necessary to have the full board approve the final prospectus.

(d) Dividends

A key ongoing aspect of the financing process is the declaration of dividends on the corporation's shares. Dividends are declared at the discretion of the board of directors. The exercise of this discretion is subject to the directors' fiduciary duty and duty of care. In addition, directors may not declare or pay a dividend if there are reasonable grounds for believing that the corporation would not meet certain statutory solvency tests if the dividend were paid. If dividends are declared contrary to these statutory limitations, the directors can be jointly and severally liable to the corporation for any amounts paid and not otherwise recovered by the corporation. This is discussed in greater detail in Part V.

(i) Discretion to Declare Dividends

The directors are under no obligation to declare dividends – even on preferred shares whose terms include a cumulative dividend at a specified rate. This is an important distinction between a dividend on a share and an interest payment on a debt, which is a legal obligation of the corporation over which the directors have no inherent discretion. Shareholders cannot compel directors to pay a dividend. This is consistent with the principle that the corporation is an entity distinct from its shareholders, with interests and needs which may or may not be consistent with those of its shareholders. When funds are available, it is the board's prerogative and responsibility to decide whether to declare a dividend or to use the money for other corporate purposes.

Certain shares, such as preferred shares, may have a right to receive preferential dividends. This right is not a legal right to receive dividends. It is a right to receive a dividend, if it is declared by the directors, before a dividend is paid on certain other classes of shares. Once again, the directors cannot be compelled to declare these dividends. Similarly, the fact that a corporation has historically paid dividends on a particular class of shares does not create any legal obligation to continue to pay such dividends.

When cash is not available, directors may decide to borrow to finance a dividend. This may be done, for example, in order to keep the capital markets receptive to the corporation's securities. The directors will generally be acting properly in borrowing for this purpose, provided that the borrowing is in the best interests of the corporation and the corporation satisfies the solvency tests notwithstanding the borrowing and payment of the dividend. Courts have recognized that a corporation may have sufficient assets to justify the payment of a dividend, but not have the cash available to pay it.

The same dividends must be paid upon all shares of a given class, but where a corporation has different classes of shares, the board may declare dividends on one class of shares and not others, subject to whatever priority or other limitations are imposed by the articles of the corporation.

Subject to its commitments to pay dividends to its preferred or other prior ranking shareholders and provided it complies with the solvency tests, the corporation may pay any amount it so chooses as a dividend to the corporation's common or other participating shareholders. Decisions of this nature will be subject to the general duty of the directors to act in the best interests of the corporation. If the directors act in good faith in declaring a dividend, the courts are reluctant to interfere with the business decision of the board to pay dividends.

(ii) Declaring the Dividend

Before declaring a dividend, directors should review the corporation's financial statements and receive confirmation from someone on whom they can reasonably rely, such as the corporation's Chief Financial Officer, that there are no reasonable grounds for believing that the solvency tests will not be met. In relying on the advice of the corporation's financial officers, the board should question the officers to confirm that appropriate assumptions have been made about the realizable value of the corporation's assets. The nature of these assumptions is described in Part V under "Corporate Solvency Tests." In some circumstances, the directors may wish to obtain a certificate from the Chief Financial Officer or, in unusual circumstances, receive outside advice. The resolution declaring the dividend or the minutes of the board meeting should record the fact that the directors took the appropriate steps to address the solvency tests.

If the dividend is being paid in shares or property, rather than in cash, the directors must determine the value of the shares or property. While this does, in some circumstances, pose practical problems, the directors must have this information in order to be satisfied that the solvency tests are met.

2. Public Company Disclosure Obligations

One of the most significant implications for corporations that access the public markets is that they are subject to various ongoing disclosure obligations. The prospectus disclosure requirements are intended to ensure that all material facts are disclosed to investors at the time a public offering of securities is made. Corporations must also make ongoing disclosure of their affairs on a timely basis so that investors who participate in the secondary trading markets have appropriate information. Investors must have equal and timely access to material information concerning a corporation to ensure a fair and accurate trading market. As a result, public companies are subject to a collection of ongoing disclosure and reporting obligations which are intended to ensure the timely delivery of this information to the public markets whether or not a corporation is currently undertaking a financing.

(a) Timely Disclosure

Most of the ongoing information disclosed to the public marketplace is released or distributed on a periodic basis, for example, through the filing of annual or interim financial results. However, material developments may occur more frequently. One of the key aspects of the public disclosure system is a set of rules that ensure that these material developments are provided to investors on a timely basis.

NI 51-102 requires public corporations to disclose immediately any material change in the corporation's business, operations or capital, that would reasonably be expected to have a significant effect on the market price or value of any of the corporation's securities and to file a report providing details of the material change as soon as practical, and in any event within 10 days of its occurrence. If disclosure of a material change would be unduly detrimental to the interests of the corporation, the corporation may be able to temporarily file the information on a confidential basis, although this option is used infrequently.

Securities legislation defines the term "material change" as:

> *... a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believe that confirmation of the change by the board of directors is probable.*

National Policy 51-201: Disclosure Standards (NP 51-201) states that a fact is material when it (i) significantly affects the market price or value of a security; or (ii) would reasonably be expected to have a significant effect on the market price or value of a security.

NP 51-201 provides issuers with a detailed list of developments that may be considered material information, but it is ultimately the responsibility of the issuer to determine which information is material in the context of its own affairs.

The stock exchanges also impose timely disclosure requirements similar to those articulated in NP 51-201. The TSX, for example, requires a listed corporation to issue and file a press release disclosing material information (including material changes and material facts) with respect to an issuer immediately upon the information becoming known to management or upon the information becoming material to the corporation, unless immediate release of information would be unduly detrimental to it.

Determining when a matter has developed or crystallized to a point which requires disclosure is often a difficult judgment and one on which parties can reasonably disagree. It is also a matter that can be second-guessed in hindsight. Accordingly, many corporations have a policy that, where there is significant doubt, such doubt should be resolved in favour of disclosure. This approach is favoured by the Canadian Investor Relations Institute, which noted in its Model Disclosure Policy:

> *if it is a borderline decision, the information should probably be considered material and released using a broad means of dissemination. Similarly, if several company officials have to deliberate extensively over whether information is material, they should err on the side of materiality and release it publicly.*

Timely disclosure has received an increased focus under securities regulation in recent years. Chief Executive Officers and Chief Financial Officers are now required to certify in their personal capacity that they have designed or supervised the design of disclosure controls and procedures, and have evaluated the effectiveness of the disclosure controls and procedures annually. "Disclosure controls and procedures" include controls and procedures designed to ensure that information required to be disclosed by an issuer under securities legislation is "accumulated and communicated to the issuer's management ... as appropriate to allow timely decisions regarding required disclosure." In addition, statutory civil remedies for investors trading in the secondary markets provide investors with a statutory civil right of action in the event of a failure to make timely disclosure of a material change against, among others, the issuer and each officer or director who authorized, permitted or acquiesced in the failure to make timely disclosure (subject to any due diligence or other defence). These remedies are discussed below.

(b) Announcing a Transaction

One of the thorniest questions facing a public company is when it must disclose a major transaction. By the time a transaction is announced, there have often been months of discussions and negotiations. While cognizant of the timely disclosure obligations, a corporation and its directors will nevertheless be concerned about disclosing a potential transaction too soon. Premature disclosure may have a negative impact on the corporation's bargaining position during negotiations or on the corporation's position if the transaction does not proceed. Further, it may create undue expectations or uncertainty in the marketplace. Securities regulators have been critical not only of disclosure that is made too late, but also of disclosure that is made too early.

A threshold question is what roles or responsibilities directors have in making timely disclosure. While it is clear that disclosure is the corporation's responsibility and, therefore, the directors' responsibility, at least indirectly, securities regulators have suggested a more direct responsibility and involvement by board members in the process. The distinction is reflected in the statutory civil remedies for investors trading in the secondary market. In the event of a claim arising from a misrepresentation in a material change report, for claims against a director, the burden is on the plaintiff to prove and, for claims against an officer, on the defendant to disprove the defendant knew or was willfully blind to the fact that a material change report contained a misrepresentation or was guilty of gross misconduct in connection with the release of the material change report.

Three general principles provide the conceptual framework for determining when disclosure is required. First, material information may not be disclosed selectively. All investors should have simultaneous access to material information relating to publicly traded companies. Second, the legitimate corporate interest in confidentiality may be considered. Corporations must be allowed to pursue material transactions without disclosing the transaction until an appropriate point in time. Finally, while late disclosure of material information may put certain investors at a disadvantage, damage to the marketplace may also occur if the announcement of material information is premature. For this reason, securities regulators have taken the position that if a public corporation announces an intent to proceed with a transaction that could result in a material change, that announcement implies a present willingness and ability to carry out that intent.

If the transaction requires the agreement of another party, disclosure will not generally be necessary until the parties have entered into a binding agreement or have at least reached agreement on the principal terms. However, different parties to a transaction may have different thresholds for materiality. As a consequence, the actual timing of a disclosure may not be completely within the control of the corporation. On the other hand, if the matter is one which is completely within the control of the corporation, such as a commitment to a major new product or a plant closing, disclosure will usually be appropriate once the board has made the decision to proceed. Disclosure may also be appropriate if senior management has made the decision to proceed, provided that it reasonably expects the concurrence of the board of directors in this decision.

In *AiT Advanced Information*, the Ontario Securities Commission confirmed the market practice that, in normal circumstances, public disclosure is only required once both parties have received requisite board approvals and a definitive merger agreement is executed.

Determining the best course of action to take when a matter has leaked prematurely into the public market and reporters, regulators or others are asking for comment on the matter can be complicated. In these circumstances, the corporation must be very careful. In some instances, it may be satisfactory to state that there are no current developments which require disclosure. In other cases, a simple "no comment" may be more appropriate; however, the TSX may require disclosure if the matter has reached the stage of constituting material information.

As a further principle, until public disclosure is made, the information relating to material matters should be disseminated only on a "need to know" basis and only to those who are in a position to treat it confidentially. Where disclosure is made to third parties in the necessary course of business, the corporation should obtain assurance that the information will be kept confidential and that the recipient will not trade in the corporation's securities.

(c) Financial Statements

Corporate statutes typically require companies to issue audited financial statements on an annual basis and to distribute them to their shareholders. These requirements have been supplemented by securities rules which require the issuance of unaudited interim financial statements on a quarterly basis. Financial statements are core documents giving rise to potential civil liability for directors under the new statutory civil remedies for investors trading in the secondary market.

Public companies must have procedures in place for the preparation and release of these interim and annual financial statements. The role of the board of directors in this regard, in particular through the audit committee, is to ensure not only that the financial statements are properly prepared, but that adequate time has been allocated for the preparation and release of the financial statements. Although the interim financial statements are not audited, the corporation must have its auditors review the interim financial statements, or state that this review has not been done. The board of directors is required to review and approve both the interim and annual financial statements before they are filed and delivered to shareholders. However, Canadian securities laws and most corporate statutes permit the board to delegate the approval of interim financial statements to the audit committee.

Pursuant to NI 52-109, a reporting issuer must also file annual certificates signed separately by its Chief Executive Office and Chief Financial Officer certifying the accuracy of the annual financial statements and related MD&A and the annual information form, if applicable. Chief Executive Officer and Chief Financial Officer certificates must also be filed with respect to the quarterly financial statements and related MD&A. Among other things, the Chief Executive Officer and Chief Financial Officer must certify that such documents do not contain a misrepresentation and they fairly present in all material respects the financial condition, results of operation and cash flows of the corporation.

(d) Annual Information Form (AIF)

An annual information form or "AIF" is the key annual disclosure document intended to provide material information about a reporting issuer and its business at a point in time in the context of its historical and possible future development. The AIF describes the company, its operations and prospects, risks and other external factors that impact the company specifically. The underlying principle is that, quite apart from the conventional annual report, all large public issuers should prepare at least an annual update on the disclosure of their business.

The AIF is a core document giving rise to potential civil liability for directors under statutory civil remedies for investors trading in the secondary market. As a result, it is essential for the directors to ensure that the AIF is prepared in a way that ensures its accuracy. It is particularly important for the directors to satisfy themselves that the corporation's procedures include steps to support due diligence, on which the directors will base their defence to any claim.

The AIF forms a key element of disclosure under the short form prospectus system. As discussed, once a short form prospectus financing occurs, the AIF becomes incorporated by reference into the short form prospectus. When this occurs, directors will also have the potential for personal statutory civil liability in relation to the AIF under prospectus rules.

(e) Management's Discussion and Analysis (MD&A)

MD&A is a narrative supplement to the annual and quarterly financial statements of a corporation. It is specifically intended to be a narrative that allows investors to see the financial position of the corporation "through the eyes of management" by explaining how a company performed during the period covered by the financial statements, and by explaining the company's financial condition and future prospects. The Ontario Securities Commission has made it clear that it would be prepared to take action in circumstances where it believes corporations have not adequately complied with the MD&A requirements, and has done so.

One of the aspects of the MD&A requirement that differs from the traditional approach to disclosure in the public markets is that, in addition to an analysis of historical information, the MD&A mandates certain prospective information. The issuer must consider whether there are any known trends, uncertainties and risks that could be material, that have affected the financial statements and that are reasonably likely to affect them in the future. As a result, there is a forward-looking element which is to be considered in preparing part of the ongoing publicly filed material. This can be a particularly difficult judgment. In hindsight, it is often easy to judge such disclosure, or a lack of it. The Ontario Securities Commission has observed that the risk and uncertainties part of the MD&A often lacks depth. Risks and uncertainties can relate to industry or price competition, changing technology, foreign exchange rates, interest rates, raw material costs, increased environmental regulation, the effects of NAFTA or similar treaties, and possible negative outcomes in litigation or tax reassessments.

While the material contained in the MD&A is described as "management's" discussion and analysis, the board must also be satisfied that it adequately meets the level of disclosure imposed on the corporation. NI 51-102 requires the board to approve a company's annual MD&A before it is filed, and either the audit committee or the board to approve all interim MD&A. MD&A is also incorporated by reference in a short form prospectus and the MD&A is a core document under statutory civil remedies for investors trading in the secondary market. Accordingly, directors may face liability if they have not appropriately diligenced the statements contained in the MD&A.

(f) Statutory Civil Liability in the Secondary Market

Most provinces' securities legislation imposes civil liability for misleading, insufficient or late corporate disclosure in the secondary market.

Investors who purchase securities in the secondary market can sue "responsible issuers," directors, and certain officers, experts and influential persons (such as promoters, controlling persons and certain other insiders) for:

- A misrepresentation in a document such as an Annual Information Form, Management Discussion & Analysis or press release;
- A misrepresentation in a speech, conference call or other public oral statement; or
- A failure to make timely disclosure of material changes.

A "responsible issuer" means a reporting issuer or an issuer whose securities are publicly traded outside the province if the issuer has a substantial connection to the province.

Investors may sue each director of a responsible issuer for a misrepresentation contained in a document or those directors who authorized, permitted or acquiesced in a misrepresentation in a public oral statement or in a failure to disclose.

"Misrepresentation" is broadly defined to include untrue statements of material fact and omissions to state material facts that are necessary to make the statements not misleading in the circumstances.

Unlike at common law, an investor does not have to prove that the investor acquired or disposed of securities in reliance on the particular misrepresentation or failure to make timely disclosure in order to establish liability. This is similar to the "fraud-on-market" model that has applied in the U.S. for decades. For a "core" document, such as an Annual Information Form, Management Discussion & Analysis or financial statement, once an investor proves that a misrepresentation has been made, the defendant must establish certain statutory defences in order to avoid liability. For "non-core" documents, public oral statements and failures to make timely disclosure, an investor generally has the higher burden (with certain exceptions) of proving knowledge, wilful blindness or gross misconduct by the defendant before the defendant has to establish its defence.

The legislation provides two key defences, among others:

- A due diligence defence if, after a reasonable investigation, the defendant had no reasonable

grounds to believe that a misrepresentation had been made or that there had been a failure to make timely disclosure; and
- A "safe harbour" for forward-looking information, which is only available if the issuer complies with the specific requirements of the safe harbour.

The essential element of the due diligence defence is a "reasonable investigation." In determining whether the defendant's investigation was reasonable, the legislation requires the court to consider "all relevant circumstances" including a list of specified factors. One such specified factor is "the existence, if any, and the nature of any system designed to ensure that the issuer meets its continuous disclosure obligations." A well-documented and effectively administered corporate disclosure policy is very important in establishing a due diligence defence.

The safe harbour for forward-looking information applies to both documents and public oral statements. In the case of documents, prescribed cautionary language must be proximate to the forward-looking information and the information must be identified as such. The cautionary language must set out material "risk factors" that might cause actual results to differ from a forecast or projection. It must also set out material assumptions or factors applied in making particular forecasts or projections. The defendant must also have a reasonable basis for making a particular forecast or projection.

In the case of public oral statements, before giving the statement, a speaker must give a warning that it will contain forward-looking information. The speaker must state that actual results could differ materially from any forecasts or projections and that certain material factors or assumptions were applied in making the forecasts or projections. The speaker must also refer to the full discussion of material risk factors and assumptions in a readily available document and identify the document or portion of the document.

Many issuers are accustomed to taking steps to avail themselves of the safe harbour for forward-looking statements under U.S. securities law; however, issuers will likely be required to take additional steps in order to take advantage of the safe harbour under securities legislation in Canada. In particular, the Canadian safe harbour requires the issuer to state the material factors or assumptions applied in presenting the forward-looking information, which is not required under U.S. securities law.

The legislation also sets out a prescribed formula for calculating damages in the event of a misrepresentation or failure to make timely disclosure.

Where an investor acquires or disposes of securities after a misrepresentation has been made or a failure to make timely disclosure has occurred, damages are based on the difference between the value of the securities at the time they were acquired or disposed of (when the disclosure record of the corporation was inaccurate or incomplete) and the value of the securities once a correction or required disclosure has been made. (The method of calculation differs somewhat depending on the timing of any subsequent trade.)

The presumption is that any difference in share price resulting in a loss for the investor that occurs in the relevant period was caused by the misrepresentation or failure to make timely disclosure. In other words, it is presumed that the investor's loss is attributable to an artificial inflation of the trading price due to the misrepresentation, followed by a drop in price caused by the correction.

To avoid liability for the full amount of damages, the defendant must demonstrate that some or all of the investor's losses were unrelated to the misrepresentation or failure to make timely disclosure. Effectively, defendants must disentangle the many factors that influence the price of a security and prove that some other factor caused the price change – a task that may be difficult and onerous.

Damages are subject to liability caps, unless the defendant (other than a responsible issuer) had knowledge of or participated in a misrepresentation or failure to disclose. For example, the cap for a responsible issuer is no more than the greater of

5% of market capitalization and $1 million. The cap for a director of a responsible issuer is 50% of the aggregate of the director's compensation from the issuer and its affiliates. It is unclear how broadly "compensation" should be interpreted.

The provincial civil liability regime is similar to the one that applies in the United States; however, the Canadian regime goes further by dispensing with the need to prove any wrongful state of mind by the defendant or gross misconduct in respect of core documents. The Canadian regime also diverges from the approach taken to "loss causation" in the U.S. Supreme Court decision in *Dura Pharmaceuticals v. Broudo*.

In *Dura*, Justice Breyer held that an inflated purchase price of a share does not itself constitute or proximately cause the relevant economic loss. Shares are ordinarily purchased with a view to later sale and any number of factors will influence their future price. The most that can be said is that an inflated purchase price will *sometimes* play a role in bringing about a future loss. In Justice Breyer's view, the civil liability regime should provide investors with a remedy for economic loss *actually* caused by misrepresentation, not insurance against losses in the market more generally. As a result, a plaintiff in a securities fraud action must prove both causation and economic loss.

Canada has taken a different path by presuming loss causation by reason only of a difference in share price during the relevant period, unless the defendant can prove otherwise.

An issuer can protect itself against statutory civil liability in the secondary market by taking steps such as:

- Reviewing and revising its formal corporate disclosure policy with respect to the review and release of oral and written company information;
- Assessing disclosure policies and other disclosure controls or procedures in light of the need to lay groundwork for the defences;
- Considering the need to establish a formal disclosure committee that includes senior officers with responsibility for overseeing public corporate disclosure, if none is in place, or reviewing the composition and mandate of any existing committee;
- Reviewing and revising practices for the treatment of forward-looking information in existing corporate disclosure, both oral and written, in light of the "safe harbour";
- Preparing forward-looking corporate disclosure in a manner which will ensure that it satisfies (and is sensitive to the differences in) the requirements of the "safe harbour" in both Canada and the United States;
- Reviewing procedures respecting timely flow of information in the corporation, particularly potentially material information;
- Reviewing corporate practices regarding document production, record keeping and record retention;
- Evaluating the implications of the regime for directors' and officers' insurance coverage and indemnification arrangements.

(g) Executive Compensation

The securities and corporate rules require disclosure, on an annual basis, of all direct and indirect compensation provided to the Chief Executive Officer, Chief Financial Officer and the next three highest paid executive officers for or in connection with services provided to the company or a subsidiary to help investors understand how decisions about executive compensation are made. Much of the information must be presented in tabular form. The statement of executive compensation must also include disclosure respecting compensation paid to the company's directors, directly or indirectly by the company and its subsidiaries, in any capacity.

The compensation committee of a public company should be composed entirely of independent directors and should review the company's executive compensation disclosure prior to its public disclosure.

(h) Proxy Rules

A key element of the corporate governance process as it relates to shareholders is the requirement that public companies solicit proxies, or voting instructions, from their shareholders whenever a shareholders' meeting is to be held. These requirements are intended to help shareholders participate in the shareholder approval process. In addition to a requirement to solicit a proxy from each shareholder, corporations must provide shareholders with a management proxy circular which sets out, in adequate detail, the matters to be decided at the meeting. For most annual meetings, the information is fairly routine and relates primarily to matters such as the election of directors and the remuneration of officers. However, for more complex matters which are dealt with at special meetings of shareholders, the corporation can be required to include in the management proxy circular very detailed disclosure about a transaction and its implications for the corporation. Directors should satisfy themselves that the disclosure in the management proxy circular is sufficient to enable shareholders to make a reasoned judgment on the matter and does not contain a misrepresentation. A related point is the need for the corporation to have proper procedures in place for conducting meetings of shareholders that give shareholders an appropriate opportunity to express their views. The opportunities available for shareholders to express their views are discussed in Part II.

(i) Insider Reporting and Trading

Directors are included in the category of "insiders" of a public company. This means they are considered part of the group of people that would reasonably be expected to have access to material information about a public company. In order to protect the integrity of the marketplace and ensure that the secondary markets are based on the principle of equal access to material information, various rules are imposed on insiders, including prohibitions against trading with knowledge of material changes or material facts which have not been generally disclosed and against informing others of such material changes or facts except in the necessary course of business, and an obligation to report trades in securities of the corporation. These matters are dealt with in detail in Part V.

3. Dealing With a Controlling Shareholder

Most directors of Canadian public corporations are generally familiar with the procedures involved in so-called related party transactions. This familiarity is a by-product of the fact that the typical Canadian public corporation has a controlling or significant shareholder. While there are some widely held corporations in Canada, they constitute a minority among Canadian public corporations. Directors must understand their relationship, and that of the corporation, to the controlling shareholder. This is relevant on a day-to-day basis and particularly when the corporation proposes to enter into a transaction with its controlling shareholder. These topics are discussed below. The issues facing directors who are in positions of potential conflict when they act, for example, as directors for both the corporation and its controlling shareholder are discussed in Part III.

(a) Ongoing Relationship with the Controlling Shareholder

As a practical matter, the economic interest of a controlling shareholder in a corporation generally results in the shareholder taking a particular interest and having a significant involvement in the operations of the corporation. This relationship will be reflected in a variety of ways, in particular through representation on the board of directors. It is also generally in the corporation's interest to maintain a strong relationship with its controlling shareholder for many reasons; however, as discussed more fully below, definitions of "independence" make it difficult for a controlling shareholder to have nominees on the board of a subsidiary who serve as independent directors for board and committee purposes.

The board must balance the desirability of a good relationship with the corporation's controlling shareholder and its obligation not to treat the controlling shareholder more favourably than other shareholders. A key element in the relationship is managing the information provided to the controlling shareholder. As a general matter, the board must bear in mind that it is inappropriate to provide information to one shareholder or group of shareholders which is not being provided to all shareholders. However, the corporation may, in its best interests, discuss initiatives with the controlling shareholder and in the course of these discussions, necessarily communicate confidential information. The corporation may do this, provided it is satisfied that the information will not be misused.

(b) Transactions Between the Corporation and the Controlling Shareholder

In Canada, any transaction, such as an acquisition, financing, change of control or reorganization, is classified as a related party transaction if a significant shareholder is a party to the transaction. It can also be considered a "related party transaction" if the significant shareholder is affected differently than public shareholders or has had a different and more direct role in the development of the transaction from that of public shareholders.

The corporate statutes do not provide specific direction to the directors on how to deal with these transactions, apart from providing a procedure for directors with a conflict of interest. Specific procedures and guidelines have, however, been developed under the securities laws which reflect a large measure of business common sense, some judge-made law and the concern of Canadian securities regulators for fair treatment of the investing public. The procedures are designed not only to achieve substantive fairness, but also to be perceived by the investing public to be fair.

For the reasons discussed above, related party transactions are not uncommon in Canada. Often, the transaction is proposed by the significant shareholder who may want to transfer an asset to the corporation, acquire securities of the corporation, cause the corporation to reorganize so that the shareholder's interest is held differently or enter into a joint venture with the corporation in a new business. In these circumstances, the board of the corporation must ensure that the transaction is in the best interests of the corporation and that the terms of the transaction are at least as favourable as the terms which would result from an arm's-length negotiation. Achieving this objective will generally require the board to appoint a special committee of members who do not have any material interest in the transaction and who can objectively judge whether the transaction is in the best interests of the corporation and the fairness of its terms. The fact that a director is recruited and nominated by the significant shareholder does not in itself disqualify that director from participating on a special committee. However, the director's obligation is to judge what is in the best interests of the corporation and not to act in the best interests of any particular shareholder.

The special committee may retain its own legal counsel and financial and other experts. Legal experts assist the committee with the process and financial experts may provide independent evidence to support the committee's judgment, such as a valuation of an asset involved in the transaction or an assessment of the fairness of the transaction "from a financial point of view." The judgment the special committee is obliged to exercise does not extend solely to the financial fairness of the transaction. The special committee is obliged as well to take into account other strategic considerations in judging the transaction.

MI 61-101 imposes certain procedural requirements in connection with related party transactions, issuer bids, insider bids and business combinations because the related party, issuer or insider may have, or be perceived to have, an advantage in terms of access to information as well as an ability to influence the decision-making process in entering into a transaction with the corporation. Depending upon the transaction, these requirements may include an independent formal valuation, formation of a special committee of the board, as well as minority shareholder approval.

In designing the governance approach appropriate to a particular transaction, directors should first determine which steps they believe may be necessary to achieve substantive fairness and to ensure that directors are perceived as having effectively represented the interests of the shareholders as a whole. This determination should then be analyzed in light of the requirements of securities commissions' regulatory instruments.

In some instances, directors may want to go beyond these requirements; in others, they may believe that such instruments prescribe requirements which are inappropriate to the transaction and decide to seek exemptions.

The legal advisor for a transaction should also advise the board on the requirements of any of the stock exchanges on which the corporation is listed, although compliance with securities commissions' regulatory instruments will generally result in compliance with the stock exchange requirements.

(c) The Controlling Shareholder's Participation on the Subsidiary's Board of Directors

As noted in Part III, the definition of "independent director" for audit committee composition and corporate governance disclosure purposes as well as for purposes of the corporate governance guidelines in NP 58-201 requires that the bright -line tests for director independence be read as if references to "issuer" include a parent. This requirement constituted a significant departure from the TSX rules as previously applied to controlled companies. Previously, relationships arising from shareholdings did not disqualify a director from being considered an "unrelated director." Now an employee of a parent company cannot be considered to be an "independent director" on the board of the subsidiary for any board, audit committee or other committee purposes.

Moreover, for audit committee composition purposes, persons (including individuals) who are considered to be an "affiliated entity" of an issuer or any of its subsidiary entities are, subject to limited exceptions, prohibited from serving on the audit committee.

4. Takeover Bids

A common form of takeover bid is one in which the controlling or significant shareholder either offers to acquire more shares or one in which that shareholder offers to sell its shares to a third party, who then offers to acquire the remaining shares from the public shareholders. There can also be a bid for a widely held company, but this is generally a less frequent occurrence in Canada.

Often, the significant shareholder will not agree to a sale until it is satisfied that all potentially interested parties have had an opportunity to bid. In order to facilitate the sale process, the selling shareholder will usually want to provide interested parties with access to information concerning the corporation and its management, which will require the board of the target corporation to consider a number of issues.

The first issue the corporation's directors face is whether the corporation is "in play" and whether it should publicly disclose its knowledge that the corporation is "in play." This is a difficult judgment. The directors must balance the interest of the selling shareholder in preventing the market price of the target corporation's shares from rising prematurely to reflect a transaction not yet negotiated (thereby discouraging other bidders) against the interest of the corporation in informing its public shareholders of the potential sale. One way to balance these interests is for the corporation to negotiate a transaction with the initial bidder subject to the corporation being allowed to pursue subsequent higher offers upon paying the initial bidder a break fee.

The second issue is the desire of the selling shareholder to allow interested purchasers to "kick the corporation's tires." If the corporation provides sensitive information to potential purchasers, this must be done under the protection of a confidentiality agreement which protects the corporation from misuse of the information. Directors of the corporation who are also directors or officers of the selling shareholder must be careful not to be a source of information about the corporation if this would be a breach of their duty to the corporation.

Another issue normally faced by the corporation's directors is their advice to the corporation's shareholders on the fairness of the offer. If the offer is made to the controlling shareholder but is not extended to the public shareholders, the board's role will be limited. Indeed, in these circumstances, most, if not all, of the directors, will resign to enable the new controlling shareholder to constitute its own board.

If the offer is extended to the public shareholders (securities legislation precludes a sale of the significant shareholder's position at more than a 15% premium to market without extending the offer to the public), the board of the corporation will be expected to recommend acceptance or rejection of the offer. The recommendation will generally be supported by the opinion of a financial advisor engaged by the corporation's board. This will be a "fairness" or "unfairness" opinion from a financial point of view. A favourable recommendation from the corporation's board is of great value to the acquirer and provides some scope for negotiation by the board of the target corporation and the opportunity to move the offering price into the corporation's fairness range. The leverage of the target corporation's board increases with the desire of the bidder to acquire 100% of the corporation's shares.

The development of the board's response to the offer will generally be assumed by a committee of the board made up of non-management directors other than those interested in the success of the offer through a relationship with the controlling shareholder. As discussed in Part III, where a board avoids conflicts of interest by establishing a special committee of disinterested directors, the burden of proof will remain on a complainant to establish that the directors acted improperly.

If the purchase price for the control or significant block of shares is at a premium to market (more than 15% over market), the offeror must make the offer to all shareholders at the same time. The offeror may not take up and pay for any shares unless all shares deposited, including the control or significant block, are taken up and paid for at the same time. If more shares are tendered than the offeror is willing to acquire, the shares which are tendered must be taken up proportionately to the number of shares deposited by each shareholder.

Directors of a widely held corporation which is the target of an unsolicited takeover bid have more options in responding than directors of a closely held corporation who are informed by its significant shareholder that it has agreed to sell its shares of the corporation. In the widely held context, the target corporation's directors may employ tactics intended to oblige the acquiror to negotiate with the directors and seek the agreement of the directors before the acquiror may proceed to acquire control.

Directors of a widely held corporation will not normally have much notice that the corporation is to be the subject of a takeover bid. Accordingly, they should generally try to establish a legal framework or plan in advance of any bid to enable the corporation to respond efficiently and effectively to a bid. A number of major Canadian corporations plan defensive strategies in anticipation of a potential hostile or unsolicited takeover bid, including the advance preparation of a manual outlining defensive tactics.

A commonly adopted tactic is a shareholder rights plan or so-called "poison pill." It is a device that many widely held corporations have adopted prior to a bid being made for the corporation's shares. The device is a contract between the corporation and a trustee for the shareholders in which the corporation agrees to issue shares to all holders, except to the bidder, at a substantial discount if the bidder acquires shares in excess of a specified threshold (e.x., 20%). A bidder, therefore, faces the prospect of significant dilution should it proceed with its bid without the plan having been removed. The directors of the target corporation are normally given the power, under the terms of the plan, to waive the application of the plan once they are satisfied that it has fulfilled its purpose.

The securities regulators expect a rights plan, which typically becomes effective when adopted by the board, to be confirmed by shareholders within a reasonable period, usually a matter of months. It is possible for a board of the target corporation to adopt a plan in response to a bid, provided the board takes the plan to the shareholders as soon as reasonably possible. Such a strategy gives the board more time than would be available under the securities laws to consider and pursue its options. A board adopting a plan in response to a bid may well find itself before a securities commission justifying its action. In past bids in which a bidder has challenged the continued application of a plan, Canadian securities regulators have been willing to address and determine the circumstances under which the plan may remain in place and to issue orders cease trading the rights. In contrast with U.S. courts, the question for Canadian regulators has been not whether, but when the plan should go. Generally, a plan will be cease-traded within 40 to 60 days after the commencement of the bid, unless there is a major regulatory approval condition which has not yet been met.

While in the closely held situation, the directors' response to a bid is effectively limited to commenting on the value of a bid, in the widely held situation, the directors have a broader range of responses available to them. The target directors will first make a judgment as to whether the bid has put the company "in play," that is, whether a change of control is likely. Most bids for widely held corporations will have this effect, but this change of status is not automatic. For example, the conditions in the bid may not be achievable in the judgment of the board of the target corporation. The board may also conclude that the value of the consideration offered is not sufficient and, therefore, refuse to open negotiations with the offeror. Taking a hard line with an offeror may attract the attention of, among others, the securities regulators who generally favour giving the shareholders the opportunity to reject an inadequate offer, rather than having the directors effectively preclude the shareholders from judging the offer.

The judgment of whether the target corporation is in play will assist the target board in setting out its priorities. If the board believes that the corporation is in play, in general terms the board should undertake a strategy designed to increase the value to be realized by shareholders. However, the Supreme Court of Canada in *BCE Inc*. clearly stated that the board's duty continues to be a duty to act in the best interests of the corporation, not simply the interests of the shareholders. The Court rejected the argument that the U.S. decision in *Revlon* supports the principle that where the interests of shareholders conflict with those of other stakeholders, the interests of shareholders prevail. The corporation and shareholders are entitled to maximize profit, but not by treating individual stakeholders unfairly. Accordingly, a board will wish to structure a process that allows it to consider the impact of the transaction on affected stakeholders.

Normally, the board will engage an investment banker to manage a sale process. The sale process will normally require more than the minimum time an offeror is obligated to provide the offeree shareholders to accept the offer. A rights plan may serve the purpose of extending the time an offeror has to keep its offer open and afford the board of the target corporation the opportunity to ensure that, if a change of control is going to occur, it occurs on the most favourable terms.

The Ontario Court of Appeal in the *Schneider* case stated that the U.S. decision in *Revlon* requiring an auction in a change of control situation is not the law in Ontario. Instead the Court chose to be guided by the test in the U.S. case of *Paramount Communications v. QVC Network Inc.*, which recast the obligations of directors where there is a bid for a change of control to an obligation to seek the best value reasonably available to shareholders in the circumstances. In doing so, the Court of Appeal stated that there is no single blueprint, such as an auction, that a board must follow.

If it is considered necessary to induce a bidder to enter into the transaction, the directors may agree to pay the bidder a "break" fee if a third party subsequently makes a superior offer which is successful. The directors may also grant the bidder an option to acquire either assets or shares of the corporation on favourable terms which may be exercised in the event the bidder's offer is ultimately defeated by a superior offer. Such arrangements must strike a reasonable commercial balance between their potential positive effect as auction stimulators and their potential negative effect as auction inhibitors. Directors should seek financial and legal advice before putting such arrangements in place.

Most directors will be aware of the "just say no" response to a takeover bid. In this response, the board of the target corporation takes steps to try to ensure that the bid will not succeed. This response is much more prevalent in the United States than in Canada as rights plans in the United States provide greater protection than in Canada. While certain defensive tactics are subject to the scrutiny of securities regulators, the ability of the board of a Canadian company to adopt such a strategy has not been tested by the securities commissions or the courts. A board undertaking such a strategy would do so on the basis that the change of control contemplated by the offer is not in the best interests of the corporation. That is, the board has decided that the corporation should not go into play and the board must act to protect the corporation's best interests. Such circumstances would include a situation where the corporation is in the midst of a business plan which the offeror would terminate or unwind.

During a takeover bid, the spotlight will be focused on the board of the target corporation. One or more of the target constituencies, for example, the public shareholders, the failed bidder or the institutional shareholders, may be disappointed by the outcome of the process and may consider taking legal action against, amongst others, the directors of the target corporation. The process the board of the target corporation adopts in responding to the bid will be carefully analyzed. As discussed in Part III, courts will defer to the board's business judgment if the directors have acted honestly and reasonably.

On September 11, 2014, the Canadian Securities Administrators (CSA) announced that it will be proposing a new harmonized regulatory approach for takeover bids in Canada.

5. Environmental Matters

The environment has increasingly become an area of public focus, resulting in greater regulation of activities which may have an impact on it. In Canada, matters affecting the environment are regulated not only federally and provincially but also, increasingly, municipally. Legislation in most Canadian jurisdictions allows the courts and environmental authorities to sanction not only a corporation which has contravened legal requirements, but, in certain circumstances, the directors of that corporation as well. The legislation often gives regulatory bodies the power to issue remediation and other orders against directors and officers of corporations as persons in management or control. A discussion of the legislation is set out in Part V.

The extent to which a board of directors should focus on environmental matters will depend, in part, on the nature of the industry in which the corporation operates. For example, a waste management company will need to have more exhaustive procedures in place to ensure ongoing compliance with environmental laws than will an insurance company. However, even an insurance company faces potential environmental concerns whenever it acquires, leases or invests in real estate, and it is incumbent upon the board of directors to satisfy itself that procedures are in place to ensure the corporation's obligations are being discharged and its interests are being protected. In some cases, the faultless owners of property adjacent to a source property have been required to remediate contamination originating from the adjacent property.

Directors should understand the environmental issues relevant to the corporation they serve. They should also be aware of what others in their industry are doing to prevent environmental problems. Before they join the board, directors should ensure that they are aware of the environmental issues facing the corporation and the procedures in place to deal with those issues. Directors joining the board of a corporation with historical contamination on adjacent properties have been required to personally pay for corrective action when the corporation became insolvent. They should keep themselves informed of such issues as they evolve.

Directors also have personal obligations under many provincial environmental statutes, and those obligations vary from province to province. The legislative approach in Ontario will be used to illustrate the general nature of directors' and officers' obligations under environmental legislation.

The potential liability arising from those obligations may be penal or monetary. Penal liability may arise when there is a breach of a director's duties. Monetary liability may arise when a regulator issues orders to directors in their personal capacity requiring monitoring or remediation steps be taken to protect the environment.

The deliberations of the board and its commitment to sound environmental practices should be reflected in the minutes of board meetings and similar documents, both as a matter of internal record keeping and to support a defence of due diligence in the event the corporation or a director is charged under an environmental statute. However, due diligence is generally not a defence to an environmental order.

(a) Ongoing Compliance

Many corporations have developed environmental management systems (EMS) to deal with environmental matters and to prevent contraventions of applicable environmental legislation. In Ontario, regulations require that spill prevention and contingency plans, important elements of most EMSs, be developed in some industrial sectors, and the regulations specify in detail what such plans must address. In most cases, having an effective EMS can help protect the directors from allegations of negligence and provide a defence of due diligence if the directors are charged with an environmental offence.

Directors should seek to ensure that the corporate EMS is effective by ensuring that corporate officers understand their responsibilities under the system and ensure that they report back periodically to the board on the operation of the system, and more frequently if specific environmental concerns are identified, or where there is a significant occurrence. As discussed in Part I, directors are justified in placing reasonable reliance on reports provided to them by corporate officers, consultants, counsel or other informed parties. However, this may not fully relieve directors of potential responsibility. In many cases directors have a statutory duty to take "all reasonable care" to prevent the corporation from committing environmental offences. At the very least, if the directors become aware of a specific environmental concern, or if they recognize that the EMS is not working effectively, they must take corrective action immediately.

In general, an effective EMS will ensure that:

- Those responsible for operating and supervising corporate activities that may affect the environment are educated, trained and monitored on an ongoing basis;
- Problems and potential risks are identified on an ongoing basis;
- Such problems and risks are properly communicated to those responsible so that they can be dealt with;
- Any identified problems and risks are promptly and adequately addressed;
- Appropriate records are kept; and
- The EMS is regularly reviewed and continuously improved.

The board should be advised regularly of the progress made on any remedial action underway and on the results of audits of environmental programs. In order to discharge their duties, directors must review environmental compliance reports and satisfy themselves that they can rely on those reports. The board must be satisfied that the corporation has committed adequate resources to the environmental program and that responsibility for the program has been assigned to one or more responsible members of management who have the requisite authority to ensure that the program is being implemented. The directors must be satisfied that the officers are promptly addressing environmental concerns brought to their attention by government agencies or other concerned parties. If a board fails to monitor the corporation's reporting structure, it runs a serious risk of a court imposing liability on the basis that the failure to comply with its own internal structure "permitted" a breach of applicable environmental legislation. Moreover, a director's lack of knowledge of a contravention by the corporation will not be a defence unless the board has reasonable systems in place to ensure that directors are informed of possible contraventions. The establishment and operation of appropriate systems will support an argument on behalf of the directors that they took "all reasonable care" to prevent the corporation from causing or permitting environmental damage.

Information reported to the board should be presented in a "closed loop." This means that information should not be presented in a way that requires the board to consent or agree to a particular course of conduct unless the particular issue is one that requires board agreement. At the same time as information is presented regarding a concern, solutions should also be presented so that board members are satisfied that the concern is being adequately addressed. Follow-up reports should also be made to ensure that the board is aware that the solutions which were implemented are effective. In industries where environmental issues are significant, it is advisable for a committee of the board to be struck and specifically mandated to devote the necessary attention to these issues. Since all of the directors are subject to potential liability, the full board should be advised on a regular basis of the status of the corporation's environmental programs. The role of an environmental committee should be to advise and monitor, to report back to the full board, and to recommend to it systems and measures that not only raise awareness of environmental issues at the board level and throughout the corporation, but that reinforce the commitment of the board to environmental safety and compliance as an element of all decisions of the board.

The establishment of such a committee may be seen by courts and concerned members of the public as a commitment by the corporation that environmental matters receive the utmost care and attention. Directors serving on an environmental committee will be expected to have more detailed knowledge of environmental risks and have greater responsibility for ensuring that the EMS is effective.

In situations that may lead to material expenses, the board should consider if a reserve should be established that would not be part of the corporation's assets (estate) if the corporation becomes insolvent. By establishing such a reserve, the directors may minimize personal exposure to liability.

As part of the corporation's commitment to environmental compliance, the board or the environmental committee should consider commissioning an environmental audit and site assessment program to determine the nature of existing problems, if any, the adequacy of the systems to ensure compliance and the extent of compliance. While an environmental audit and site assessment may take different forms, the audit and site assessment are often commissioned by a lawyer who has been retained by the board to provide legal advice to the board regarding environmental risks. The results of the audit and site assessment are provided to the lawyer who then presents the results and the legal implications of any issues identified by the audit to the board in writing. The board will often invite the lawyer and, in some cases, the environmental auditor or assessor to attend a meeting of the environmental committee or the full board to answer specific questions arising from the report. The audit and assessment report and deliberations of the board should lead to the development of an action plan for any necessary corrective or remedial action.

(b) Specific Occurrences

Notwithstanding any ongoing systems, the corporate officers responsible for environmental matters must be instructed to report any substantial non-compliance by the corporation to the board of directors in a timely manner. Each director should react immediately to satisfy themselves that the appropriate action is being taken and should not simply assume management or other directors will ensure that the matter is being addressed. If an order is made by environmental authorities, the board must ensure, in consultation with legal counsel and environmental advisors, that the corporation takes the necessary action to comply with the order. Failure to respond promptly to any breach of an environmental statute or to the corporation's own environmental standards could lead a court to conclude that the directors had permitted a violation and committed a violation themselves.

(c) Acquiring an Interest in Real Estate

Potential environmental liability must be considered whenever the corporation acquires an interest in real estate, both directly and indirectly. A corporation may acquire an interest in real estate in a number of ways. It may acquire the property directly, it may acquire an interest in a company owning real estate, it may lease the property from the owner or sub-lease it from another lessee, or it may make an investment or take security in the property. When considering the acquisition of an interest in real estate, the directors should require management to ensure that proper systems are in place to conduct appropriate pre-purchase environmental site assessments of the property which are designed to identify conditions that may result in liability. Any material issues that are identified should be brought to the board's attention, if the purchase is to proceed. In some circumstances, it may be prudent to also have an environmental compliance audit conducted to assess compliance with environmental regulatory requirements and best practices related not just to the property but also to any activities undertaken at the property.

(d) Corporate Disclosure

In some jurisdictions (notably the State of New York in the United States), there have been formal legal actions taken by government authorities to compel appropriate disclosure in securities filings of the corporate financial risks that may result from climate change. In Canada, the Canadian Securities Administrators has issued an Environmental Reporting Guidance (CSA Staff Notice 51-333) setting out advice for environmental disclosure. Climate change disclosure was included in the discussion. Given the increasing awareness of climate change issues and risks, increased expectations regarding understanding and disclosing climate change matters will inevitably continue to develop.

6. Facing Financial Difficulties

A corporation is insolvent when it is unable to pay its liabilities as they come due. Insolvency does not normally occur unexpectedly. There should, therefore, be time for the board of directors to address the problem as it develops. However, directors often do not recognize the signs of impending insolvency until it is too late. This happens for a number of reasons. First, cash flow difficulties may not be readily apparent from the financial statements. Second, it is often difficult for both management and the board to come to grips with the fact that the corporation's problems have progressed to a level such that the term "insolvency" becomes appropriate.

When a corporation is facing financial difficulties, several courses of action are possible. Such actions can generally be characterized as either restructuring or recapitalization alternatives, or liquidation alternatives. In Canada, an insolvent corporation may continue to operate with the indulgence of its creditors for a period of time. This is different from some jurisdictions outside of Canada where a corporation which is insolvent must stop carrying on business to prevent it from incurring further liabilities. In addition, a corporation may decide to, or the corporation's creditors may require it to, restructure its operations, recapitalize its balance sheet or divest certain assets to generate additional cash, under either a private agreement, under the restructuring provisions of the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*, or under the recapitalization provisions of the business corporations statute. Alternatively, steps may be taken to liquidate a corporation's assets by secured creditors of a corporation or by the corporation itself. Secured creditors may take steps to have a receiver or receiver-manager appointed, with a view to realizing on and liquidating assets. Similarly, a corporation, or its creditors, may also take steps to have the corporation declared bankrupt. The directors' ability to manage or to supervise the management of the business and affairs of a corporation is typically lost in receivership and bankruptcy scenarios.

A corporation that is facing financial difficulty is of concern to directors on three levels. First, directors will be concerned about the role they should play in guiding a corporation back to solvency. Second, in fulfilling this role, directors may wonder whether their accountability shifts from the corporation to the corporation's creditors. Finally, in view of the level of publicity surrounding the liability of directors of insolvent companies, directors will be concerned about their personal exposure when a corporation becomes insolvent.

(a) The Role of the Board

In the context of a restructuring or recapitalization to address an insolvency, the role of the board is to ensure that the appropriate management team is in place and that management is developing and implementing a carefully thought out plan of action. The board also has a responsibility to authorize the course of action which the directors view as being in the best interests of the corporation. In order for the board to fulfill its role most effectively, it should consider appointing a special committee and possibly a Chief Restructuring Officer. The committee should be composed of outside directors and the President or Chief Executive Officer, and should monitor closely management's decisions about the ongoing operation of the business and any restructuring or recapitalization steps.

One of the first tasks for the board or its special committee will be to determine whether any changes to the management team are required. A new management group, which could be viewed as a "work out team," may have more credibility with the corporation's creditors since it will not be associated with the decisions and policies that led to the insolvency.

Once it is determined who will be part of the management team during the corporation's recovery phase, a clear course of action for dealing with the issues must be developed and implemented. It is usually the role of management, rather than the board, to develop a plan for dealing with the insolvency, including the way in which the corporation will deal with its bankers and other creditors. The approval of the board of directors will, of course, be necessary before any major decision on the future of the corporation may proceed. The board or its special committee should consider engaging qualified outside financial consulting services to advise it in its deliberations.

While discussions with the creditors are proceeding, the directors should monitor the progress of those discussions, but typically they will not be involved in the day-to-day discussions. Board members may be called upon to participate in certain strategic meetings.

Directors should also be cognizant of insolvency legislation which permits the court to remove a director for unreasonably impairing the viability of a proposal or acting inappropriately in the circumstances. The court may also remove a director from the board if the director is likely to impair a proposal or act inappropriately in the future.

(b) To Whom Directors Owe Their Duty

The second area of concern for directors is where their allegiances lie in a situation of insolvency. The Supreme Court of Canada has confirmed in both *BCE Inc.* and *Peoples Department Stores* that in an insolvency the fiduciary duty of directors remains with the corporation and does not shift to creditors. The Court noted, however, that creditors have available to them a powerful statutory oppression remedy which they can use against directors to complain about prejudicial behaviour. Thus, in determining what is best for the corporation, directors will need to take into account and balance the interests of its various stakeholders, including creditors to ensure they are not unfairly prejudiced in the circumstances. In resolving any competing disputes, directors should try to act in the best interests of the corporation by creating a "better" corporation. The increased leverage that creditors may have over the corporation may, in any event, align the interests of the corporation quite closely with the interests of the creditors. If a receiver manager is appointed by a court, the responsibilities and powers of the directors will be suspended until the receiver-manager is discharged. Until that time, the receiver-manager will have the power to carry on the business of the corporation as the court appointed officer in order to protect the interest of the corporation's stakeholders. The appointment of a trustee in bankruptcy usually signals the end of the corporation as a going concern.

While the duties of directors do not change upon the insolvency of the corporation, directors should be particularly conscious of the actions they take when the financial stability of the corporation is in question, both for the best interests of the corporation and the likelihood the actions of the directors may be challenged. This will be the case with respect to actions which have the result of moving assets out of the corporation, particularly into the hands of the shareholders. For example, any dividends paid, shares redeemed or financial assistance given prior to the corporation's insolvency will be reviewed very carefully by the receiver-manager to ensure that such action did not precipitate the insolvency. Where the receiver-manager is able to demonstrate that such actions did precipitate insolvency, the receiver-manager will have the authority to bring an action to hold the directors personally liable to return the expended funds to the corporation. Similarly, any payment made to a creditor may be scrutinized to determine whether it constituted a fraudulent preference. Additionally, a trustee in bankruptcy or a monitor to review any transfers at undervalue to arm's-length or non-arm's-length parties.

(c) Personal Liability

Statutes under which directors of a corporation may incur liability for amounts which the corporation does not pay or remit are outlined in Part V. The most significant sources of potential liability in a situation of insolvency relate to the failure to make contributions to pension plans when due, potential liability under environmental legislation, statutory obligations to pay employee wages, and the withholding obligations for taxes and other source deductions associated with wages and vacation pay.

Where a sponsor does not make a contribution to a pension plan when it is due, directors or agents of sponsors may incur personal liability for that missed pension payment if (for registered plans in all jurisdictions) the director authorizes or acquiesces in that missed pension payment or if (for registered plans in Ontario) the director fails to take reasonable care to prevent the missed payment. In addition, directors may assume the fiduciary duties that administrators of pension plans have in relation to such plans if the administrators have delegated the responsibility for pension oversight to the directors. When exercising these duties, the directors are not acting as directors but rather as agents and employees of the applicable plan administrator. Accordingly, directors will need to be mindful of their fiduciary duties to plan members when making decisions which could affect the quantum of contributions payable to the pension plans, including decisions relating to the timing of the filing of valuation reports and the assumptions used.

With respect to potential liability under environmental legislation, recent case law in Ontario advises that present and former directors and officers of insolvent companies are at risk of being named in environmental protection orders and being exposed to personal liability for costs regardless of whether they were directors or officers at the time of the contaminating events. In addition to ensuring that appropriate environmental compliance and contamination mitigation measures are being utilized, it would be prudent to proactively consider obtaining directors' and officers' insurance that specifically includes coverage for environmental liability to help protect against the risk of personal liability under environmental protection orders.

Under certain corporate statutes and employee protection legislation, directors may also be liable to employees for up to six months' wages and 12 months' vacation pay if left unpaid by the corporation. This liability does not extend to termination pay in most provinces. Liability for wages, vacation pay and source deductions may arise in situations where the directors thought adequate provision had been made. For example, cheques may have been issued to cover these amounts, but before the cheques clear, the bank decides to take action against the corporation and, as a result, refuses to honour the cheques.

Directors are only liable for those amounts that accrued during the time they were actually directors. As a result, when it becomes clear the corporation will not be in a position to make those payments in the future, some directors have chosen to resign. While this may be the only prudent course of action in some circumstances, other steps may be taken to avoid the necessity of entire boards resigning.

Procedures can be designed to minimize the potential liabilities of directors by supporting due diligence defences (where available) and, to the extent possible, ensuring payment of statutory amounts especially in circumstances where directors may be strictly liable for non-payment. For instance, directors should monitor the financial situation of the corporation carefully and obtain officer certificates on a monthly or more frequent basis confirming payment of all statutory amounts. Directors may consider establishing a trust account so that money will be available for payments. This presupposes, of course, that the funds are available to be paid into that trust account. In some circumstances, an existing creditor may advance these funds rather than see the directors resign to ensure the corporation has the benefit of experienced leadership during a period of restructuring. Other possibilities include arranging for letters of credit from a bank to fund such payments or to fund the payment of an indemnity by the corporation to the directors if they have personal liability for such payments. As well, a court may grant a protective charge and lien against the assets of the corporation in favour of directors to protect them against obligations and liabilities that they may incur following the commencement of formal restructuring proceedings. These arrangements and issues related to their validity are discussed in greater detail in Part VI.

Directors must be wary of relying on any directors' and officers' insurance to cover these payments. Before basing any decision on the existence of an insurance policy, the directors should ensure that the policy covers the particular payments in question and that the policy is still in force.

The *Canada Business Corporations Act* and Ontario's *Business Corporations Act* deal with the situation in which an entire board resigns. Each act provides that any person who manages the corporation will be deemed to be a director and, thus, have all the duties and responsibilities of a director. Included in an exception to this deeming provision is an officer who manages the corporation under the direction of a shareholder or other person, and a lawyer, accountant or other professional who participates in the management solely to provide professional services.

V. Statutory Liabilities

V. Statutory Liabilities

Directors' two principal duties are their fiduciary duty and duty of care. Part V describes some of the additional statutory duties imposed on directors under corporate, securities and other laws, including environmental, employment, pension and tax laws, the penalties associated with a breach of those duties and the defences available to directors. There are a large number of federal and provincial statutes that impose liability on directors, and the statutes that are most relevant to directors will depend on the particular corporation and its business. Few statutes impose absolute liability on directors, but instead most statutes provide them with a due diligence defence. This defence allows directors to avoid liability if they have followed appropriate procedures, such as making necessary enquiries, reviewing relevant material, putting appropriate controls and procedures in place, consulting experts, and giving informed consideration to the matter.

Parts I and III of this guide have outlined general duties assigned to directors under the corporate law and certain of the additional requirements imposed on directors of public corporations by securities regulations and stock exchange rules. There is also a broad array of statutes which either charge corporate directors with additional responsibilities or make them directly liable for the actions or inactions of the corporation. This part outlines some of these statutory responsibilities, the potential liabilities associated with them and the standard of conduct necessary for directors to discharge those responsibilities.

In addition to the full range of statutory liabilities, it is possible for the directors to be held liable for certain common law breaches arising from the actions of the corporation. Directors may only be liable if they acted in such a deliberate and reckless way that they made the wrongful acts their own as distinct from the company's. For example, in *M&L Travel Ltd.*, the Supreme Court of Canada held the directors of a private corporation personally liable for a breach of trust by the corporation because they had full knowledge of the actions of the corporation and, thus, knew of the breach of trust. They also participated and assisted in the breach. In *ADGA Systems v. Valcom*, the Ontario Court of Appeal concluded that directors are responsible for their own tortious conduct even if they ostensibly pursue the conduct on behalf of the corporation. Because directors are faced with these potential common law liabilities infrequently as compared to the other liabilities described in this guide, they have not been outlined here. However, directors should at least note that, if their conduct as directors causes damage to a third party, that third party may, in some restricted circumstances, have a common law right of action against them personally.

From a policy perspective, imposing personal liability on directors is intended to create an incentive for those individuals responsible for managing the corporation's business to ensure that the corporation fulfills its legal obligations. Liability is imposed on the directors in recognition of the fact they have the ability to significantly influence the corporation's conduct.

In broad terms, statutes impose liability on directors in one of three ways. For some offences, liability is imposed whether or not the director intended to commit the offence and, indeed, whether or not the director even knew the offence was being committed. This is the least common type of directors' liability and is often referred to as "absolute liability," meaning that a director may be liable under a statutory provision simply because the offence in question occurred. The fact that a director was not aware that the offence was being committed or even that the director had taken all available action to prevent the offence from being committed may not be a defence. Liability for employee wages and vacation pay, under certain provincial employment standards legislation, is one example of this type of liability.

The second type of offence imposes liability on directors unless they were diligent. This type of liability is typically imposed for regulatory or public welfare offences. The "due diligence defence" allows directors to avoid liability if they have followed appropriate steps or adopted adequate procedures, such as making the appropriate inquiries, reviewing the documentation provided to them, ensuring that appropriate controls or procedures are in place, consulting experts where necessary and giving thoughtful consideration to the issue. The due diligence defence is available for a broad range of offences, including prospectus liability under provincial securities laws and certain environmental offences.

The third type of offence imposes liability on directors who "authorized, permitted or acquiesced" in the commission of an offence by the corporation. This wording implies knowledge that the action constituting the offence was being committed and appears in many statutes. These offences are quite similar in their operation to the offences which specifically provide a due diligence defence. A defence is available to directors who can prove that they took all reasonable care to comply with their obligations and that they had an honest and reasonable belief that they had done so, even if this belief was mistaken.

Certain of the statutes under which directors are most commonly exposed to liability are discussed below. Directors should look to their legal advisors to outline their particular exposure to liability under these and other statutes in the context of the corporation's business and the business of its subsidiaries. Directors should also ensure appropriate procedures are put in place to promote compliance with statutory requirements and that these procedures are periodically reviewed to confirm compliance.

1. Impairment of Capital and Corporate Solvency Tests

(a) Types of Payment

The corporate statutes seek to maintain the financial integrity of the corporation by prohibiting certain actions by the corporation if it does not meet the solvency tests set out in the statute. These solvency tests are described below. Directors who vote for or consent to a transaction when the corporation does not meet the solvency tests may be liable for amounts paid out by the corporation which it does not otherwise recover. In other words, the directors who cause or allow the corporation to take certain action which leads to its insolvency are required to restore to the corporation the funds which the corporation expended in the course of this action. The list of transactions for which directors could incur this type of liability includes:

- Issuing shares for property or past services which have a fair market value less than the money the corporation would have received if it had issued the shares for money (unless the director did not and could not reasonably have known that the corporation would have received more if the shares had been issued for money);
- Purchase, redemption, retraction or other acquisition of its shares by the corporation in contravention of the statutory solvency tests;
- Payment of a dividend in contravention of the statutory solvency tests;
- Under some corporate statutes, provision of loans, guarantees or other financial assistance to

certain related parties in contravention of the statutory solvency tests; and

- Payment of an amount to a shareholder who has exercised statutory dissent rights in contravention of the statutory solvency tests.

Since directors only incur liability for these transactions if they vote for or consent to the resolution authorizing the transaction, they should bear in mind that they will be deemed to have consented to a resolution unless their dissent is registered in the manner and within the time prescribed by statute. The procedure for registering a dissent is described in Part III.

An action against a director for authorizing the types of transactions listed above must be commenced within two years of the date of the resolution authorizing the unlawful act.

(b) Corporate Solvency Tests

The corporate statutes prohibit a corporation from taking certain actions if the corporation would fail to meet two tests after taking that action. These tests are commonly referred to as solvency tests, although one deals with solvency and the other deals with impairment of capital. The two tests are discussed here in the context of the declaration of dividends, but a version of these solvency tests also applies to the redemption or retraction of shares and the other types of transactions listed above. In the case of dividends, the solvency tests are intended to prevent directors from declaring dividends out of the corporation's capital or otherwise distributing to shareholders assets of the corporation which should remain in the corporation for the protection of creditors. While lenders do not usually rely exclusively on these statutory provisions to protect them from corporate actions which might jeopardize the corporation's ability to pay the creditors and may well require covenants which impose other or more stringent tests, the solvency tests are intended to provide a measure of protection against the corporate assets being stripped away.

The solvency test prohibits a corporation from declaring or paying a dividend if there are reasonable grounds for believing the corporation is unable to pay its liabilities as they become due or would be unable to do so after paying the dividend. The inability to pay liabilities as they become due will have different meanings in different circumstances. Generally, however, if a corporation could only satisfy its ongoing liabilities by liquidating assets fundamental to running its business, the directors could likely not conclude that the test had been met. If, on the other hand, the directors determine the corporation would need to sell one significant asset in order to meet a large and unusual liability, they might still conclude in good faith that this did not result in the corporation being unable to meet its liabilities as they became due.

The impairment of capital test prohibits the corporation from declaring or paying a dividend where there are reasonable grounds for believing that the "realizable value" of the corporation's assets would, as a result of the dividend, be less than the aggregate of its liabilities and the stated capital of all classes of shares. The manner in which assets are valued will depend on the corporation and its circumstances. It is generally reasonable to value the assets on a going-concern basis, unless there is some reason to believe that the corporation will be wound up or put into some form of insolvency-related proceeding in the near future, or that an urgent and significant disposition of its assets is planned. Because the test refers to the "realizable value" of the corporation's assets, as measured against its liabilities and stated capital, the value of the assets must be established on the basis of some sort of notional sale. While valuation should take into account taxes payable arising from the sale as well as legal and other costs associated with a disposition of assets, the directors are also entitled to assume that the sale will be implemented on a tax efficient basis, so long as that assumption is a reasonable one. Moreover, discounting such costs may be justified if disposition is not imminent.

Under some corporate statutes, the test is less stringent for corporations with wasting assets. These are assets which are necessarily consumed in the operation of the corporation's business. These provisions apply to corporations which have as their principal operations a producing mining or oil and gas property, or which have 75% of their assets of a wasting character. They also apply to corporations incorporated to acquire assets, liquidate them and distribute cash to shareholders. Such corporations are not required to meet the solvency tests imposed on other corporations. Rather, they are entitled to pay dividends out of funds derived from their operations even if the payment reduces the value of their assets to less than their stated capital so long as they can still meet their liabilities.

The tests are prospective, requiring directors to determine whether the corporation would be able to meet its obligations as they become due. No time frame is given and no guidance is provided for the definition of the term "liabilities." Since the term generally includes contingent liabilities, these liabilities must be included in applying the solvency tests. Directors must assess the nature of a contingent liability and the likelihood of the contingency occurring in assigning a value to the liability. The tests are also based on values which cannot be determined with certainty at the time the directors must decide whether to declare a dividend. The directors cannot (and are not expected to) determine with certainty the realizable value of the corporation's assets because this value can only be known when the assets are sold. Nor are they expected to predict future events. For example, after a corporation has paid a dividend, a significant depreciation in the value of a corporation's inventory – as has happened to corporations holding real estate – may call into question the ability of the corporation to satisfy its liabilities and may, with hindsight, make the payment of the dividend seem imprudent. The directors only need to be satisfied, at the time the resolution is passed to declare and pay the dividend, that there are no reasonable grounds for believing that the tests would not be met. If the directors determine in good faith that the corporation meets the tests, based on an estimate of the value of assets which they reasonably believe, in good faith, to be true at the time the dividend is declared and paid, the courts have indicated that the directors will not be liable if the value of those assets is subsequently lost.

(c) Defence and Penalty

Whether the corporation meets the solvency tests is a question which, in most cases, must be determined by the board. However, under the corporate statutes, the directors are entitled to rely on the corporation's financial statements which an officer of the corporation or a written report of the auditor represents to fairly reflect the financial condition of the corporation. In appropriate cases, directors may also rely on outside advisors. As discussed in Part I, such reliance must be in good faith and reasonable. Directors should note, however, that the solvency tests are not balance sheet tests. Although courts will have regard to a corporation's balance sheet in assessing solvency, they will apply the tests based on evidence as to the actual value of the corporation's assets and liabilities.

Directors will not be able to look to the corporation's auditors for opinions on whether the corporation meets the solvency tests. The chartered accountants' governing body has advised chartered accountants not to provide opinions, that is, positive or negative assurances, on matters relating to solvency. The rationale for this position is that solvency is a state of affairs which must be determined, at least in part, prospectively under the prescribed tests and, therefore, is not a matter on which accountants are prepared to opine. This position illustrates the challenge faced by directors in seeking to determine whether the tests have been met, particularly in circumstances where the corporation could be said to be near the margins of the test.

Directors who consent to any of the transactions described above when the corporation does not satisfy the solvency tests may be jointly and severally liable to repay to the corporation any amounts distributed or paid by the corporation as a result of that transaction. Any potential for liability ceases two years after the date of the resolution approving the transaction. Directors who are found liable are entitled to look to any other directors who also consented to the resolution for their share of the amount in question. Such directors may also apply to a court for an order requiring the person who received the money to repay that amount to the corporation.

2. Insider Trading

Regulation of insider trading is intended to promote fairness in the capital markets. Persons who have information about a corporation by virtue of their relationship with that corporation should not be in a position to use that information to trade in securities of the corporation or to assist others to trade in securities of the corporation before that information is publicly disseminated.

(a) Directors as Insiders

Directors are insiders of the corporation on whose board they serve, but they are also deemed to be insiders of any other corporation of which their corporation owns or controls more than 10% of the voting securities.

The insider trading rules have two aspects. First, as insiders, directors must publicly report their ownership of, and any trade they make in, securities of the corporation in which they are insiders. This is discussed in greater detail below under "Insider Trading Reports." In addition, because they are in a "special relationship" for securities law purposes to any corporation in which they are insiders, they may be liable if they trade in securities of that corporation with knowledge of a material fact or material change that has not been generally disclosed. In addition, directors may incur liability if they pass that information to someone else outside of the necessary course of business (commonly referred to as a "tippee"). This is discussed in greater detail below under "Use of Inside Information."

(b) Insider Trading Reports

Persons who hold securities in the corporation are required to file an insider report when they become insiders. When a person who holds securities of a corporation is appointed to the board of that corporation, for example, or when an existing director acquires securities of the corporation for the first time, that person must file an initial insider profile and report. The report must be filed within 10 days of the date on which the person became an insider. When directors trade in securities of entities in which they are insiders, generally they must file a report of that trade within five days of the trade. They must also report trades in related financial instruments, which would include security-based compensation arrangements, such as restricted share units, deferred share units, performance share units, phantom stock, stock appreciation and phantom options, and other hedging transactions or other transactions involving, directly or indirectly, a security of the reporting issuer or a related financial instrument if it has the effect of altering, directly or indirectly, their economic exposure to the reporting issuer.

The determination of who is an "insider" under securities laws and which "insiders" are subject to insider reporting as "reporting insiders" is a complex analysis. It is standard practice for most public corporations to have a memorandum prepared for their directors and senior officers to assist them in complying with these requirements. The regulators consider timely and accurate reporting a priority. Failure to file in an accurate and timely way can result in late filing fees or enforcement proceedings and penalties, including imprisonment. As a result, it is essential that directors fully understand the extent of the reporting obligation and that they comply with it in a complete and timely fashion.

Insider reports are filed on the System for Electronic Delivery by Insiders (SEDI). Insider reports are public information and are often tracked and reported by the financial press. As an internal administrative matter, the corporation's legal or administration department is frequently responsible for filing the insider trading reports for the corporation's directors, but directors should bear in mind that they, and not the corporation, will bear the liability for failing to file their insider trading reports as required.

(c) Use of Inside Information

Under both the corporate and securities statutes, directors are liable for using confidential or "inside" information about the corporation to trade in securities of the corporation or for passing such information on to someone else. The provisions and language used to describe these liabilities vary depending on the statute, but significant terms include "material fact," "material change," "material information" and "confidential information." Many, though not all, of these concepts may apply to directors who are insiders of private corporations as well as those who are insiders of public corporations. In order to comply with the prohibition against improper trading, a director must not buy or sell securities at a time when material information concerning the corporation has not been generally disclosed. In addition to actually being disclosed, the information must have been reasonably disseminated. As a result, it is not appropriate for insiders to trade immediately following the release of material information. It is necessary for the insider to allow some appropriate period of time to elapse before entering the market.

A director who trades with knowledge of such information or who provides that information to someone else may encounter liability on three levels. First, the director may be subject to a fine of the profit made or the loss avoided and not more than the greater of triple the profit or $5 million and up to five years in prison. If a corporation is convicted of insider trading in the securities of another corporation, every director who authorized or acquiesced in the offence is also guilty and is liable for damages resulting from the trade and for a fine of not more than $5 million and up to five years in prison. The director may also be liable to the person who traded with the director or with the person the director advised of an undisclosed material change or material fact. Damages may be up to the amount by which the transaction price was affected by the confidential information available to one, but not the other party. Finally, the director will be liable to the corporation for any gain realized by insider trading or tipping.

The *Criminal Code* includes indictable offences of "insider trading" and "tipping." The offence of insider trading differs in several ways from the insider trading prohibitions under Canadian securities legislation, in that the *Criminal Code* offence takes a much broader approach as it applies throughout Canada, without regard to the jurisdiction in which the trade occurred and whether the securities are listed for trading on a stock exchange or are privately held. The *Criminal Code* also makes it an offence for persons who possess or obtain inside information and knowingly convey that information with the knowledge that there is a risk that the recipient will use the information to buy or sell a security to which the information relates or may convey the information to someone else who may do so. In contrast to the parallel regulatory offence under provincial securities legislation, the Crown faces a much higher burden of proof when prosecuting the *Criminal Code* offence. This criminal offence of insider trading carries a penalty of imprisonment up to 10 years and the offence of tipping is punishable by a term of up to five years.

(d) Defences

There are a number of defences available to a director who has been charged with insider trading. Proof that a director reasonably believed that the information had been generally disclosed is a defence. Similarly, if the other party to the transaction knew about the undisclosed information or ought reasonably to have known, the director is not liable. Exemptions apply where trading took place under "innocent" circumstances such as the purchase of shares by a director in an automatic plan such as a dividend reinvestment plan or share purchase plan which was in place before the director became aware of the confidential information. Exemptions also apply where trading took place to fulfill a legally binding obligation entered into by a director prior to the acquisition of the undisclosed information. Directors will also have a defence where an investment constituted insider trading, but no director, officer, partner, employee or agent of the firm who was involved in the investment decision had actual knowledge of the inside information.

Similarly, a number of defences are available to a charge of tipping. For example, if a director informs a third party of an undisclosed material fact or a material change in the necessary course of business, that action does not constitute tipping. Even if a director informs a third party of an undisclosed material fact or material change other than in the necessary course of business, the director still will have a defence if the person who bought or sold shares of the corporation in a transaction with the third party knew or ought reasonably to have known about the information.

(e) When is Information Disclosed

The securities rules permit trading to commence when information has been "generally disclosed." Although securities legislation does not define the term "generally disclosed," information will usually be generally disclosed if two criteria are met. First, the information has been disseminated in a manner calculated to effectively reach the marketplace. Simply posting the information on the corporation's website will not be sufficient. Second, public investors have been given a reasonable amount of time to analyze the information. What constitutes a reasonable time period will depend on a variety of factors. For example, the circumstances in which the event arises, the nature and complexity of the information, the nature of the market for the corporation's securities and the manner used to release the information.

3. Liability for Offences Under the Corporate Statutes

The corporate statutes impose a number of obligations on the corporation. To ensure compliance by the corporation, the corporate statutes also impose personal liability on a director who knowingly authorizes, permits or acquiesces in the corporation failing to comply with certain provisions. The offences for which a director may incur such liability under the *Canada Business Corporations Ac*t include the following:

- Failure of the corporation to send a proxy to shareholders at the same time as they are given notice of a shareholder meeting as required by the CBCA;
- Failure by the corporation to send a management proxy circular to shareholders and to the Director under the CBCA before soliciting proxies; and
- The inclusion by the corporation of an untrue statement of a material fact in certain documents such as a management proxy circular required under the CBCA or the omission by the corporation of a material fact in such a document.

Directors may be liable for fines of up to $5,000 or prison terms of up to six months, or both, whether or not the corporation itself has been prosecuted or convicted for the offences described above. The defences available to directors will vary with the particular offence and the circumstances, but, in most cases, directors must have knowingly authorized, permitted or acquiesced in the commission of the offence before they will incur liability.

4. Environmental Legislation

Potential liability for environmental issues vies with liability for employee wages as the highest profile liability facing directors. Anyone may incur liability under any one of a number of statutes for causing or permitting damage to the environment or for being in management or control of property or an undertaking. In some provinces, directors may be directly exposed to orders to rectify environmental damage or to pay for rectification of environmental damage if the corporation fails to do so. In addition, many of the environmental statutes in Canada make directors potentially liable for at least some of the environmental offences committed by the corporations they serve. These are liabilities which are frequently identified as being of particular concern to directors who may have no particular direct knowledge of or control over corporate activities which may cause environmental problems.

There has been a significant increase in the number and severity of Canadian environmental laws. Much of this legislation has developed in a piecemeal fashion in response to particular concerns. As a result, environmental legislation, regulation, policy and guidelines are often neither consistent nor coherent. In addition to the general environmental protection statutes such as the *Canadian Environmental Protection Act, 1999* and Ontario's *Environmental Protection Act*, there are a host of statutes dealing with water, air, pesticides, mining, oil and gas, toxic substances, contaminated lands and waste management which impose specific environmental protection requirements. These requirements include among their sanctions, the imposition of penalties on the directors of a corporate offender.

(a) Regulatory Offences

(i) Nature of the Offences

The *Canadian Environmental Protection Act, 1999* (CEPA) provides a good example of director exposure to penalties for regulatory offences committed by the corporation. Under CEPA, a director may incur liability for offences by the corporation if that director "directed, authorized, assented to, acquiesced in or participated in the commission of the offence." Under this provision, directors will be subject to liability as directors for regulatory offences committed by the corporation only if they had knowledge of the actions which constituted the offence.

In addition, CEPA imposes a duty on directors to "take all reasonable care" to ensure that the corporation complies with all provisions of CEPA and the regulations under CEPA. Breach of the duty is an offence. Under this provision, ignorance is not a defence. Directors must proactively take all reasonable measures to ensure that the corporation is in compliance and they must be able to prove that they took such measures if corporate non-compliance occurs.

(ii) Due Diligence Defence

The liability of directors for environmental regulatory contraventions by the corporation is typically not absolute. In most cases, directors may avoid such liability if they are able to show that they took all reasonable care (referred to as "exercising due diligence") to ensure that the corporation complied with environmental legislation.

The ability to successfully raise a due diligence defence will depend on the steps taken by directors prior to the commission of the offence. A director's diligence is founded on an understanding of the issues, formulation of appropriate corporate policies, delegation to qualified personnel of the responsibility for implementing the policies, provision of the resources necessary to implement the policies and ensuring compliance by establishing a monitoring system which enables the director to confirm that the policies established are being followed and employee concerns addressed. These actions should be appropriately documented in board minutes as well as reports from experts and from management. A discussion of the procedures a board should consider implementing to ensure that it has met the requisite standard of care is set out in Part IV.

It should be noted that a due diligence defence is generally not available for regulatory orders under provincial environmental legislation.

(iii) Regulatory Penalties

Upon conviction for a regulatory offence, directors may be subject to substantial fines or imprisonment. Depending on the severity of the violation, fines may range up to $6 million per day for directors and up to $10 million per day for the corporation. Directors may also face imprisonment of up to five years less a day for more serious offences. Under CEPA, a director is subject to the punishment provided for the particular offence committed by the corporation. The factors that a court will take into account when imposing a sentence include the nature of the offence, the deliberateness of the action, prior convictions, the harm that resulted, the extent of co-operation with officials, whether commitments have been made to achieve compliance, and the speed and efficiency of rectification.

(b) Criminal Code Offences

For certain matters, such as intentional or reckless disregard for an environmental disaster, or for the lives and safety of others, charges can be brought under the *Criminal Code*. In addition, under changes enacted after 26 coal miners died in the Westray mining accident, any person who has "the authority to direct how another person does work" has a duty to take all reasonable care to prevent bodily harm to any person arising from that work, and breach of this duty is an offence. If convicted of an offence under the *Criminal Code*, there is no maximum limit to the fine that can be imposed, and there is a possibility of imprisonment for life.

(c) Orders

In some cases, directors may be named in orders to, for example, prevent discharges or implement cleanup. In other cases, they may be required to pay the costs of complying with an order if the corporation fails to do so. Orders of this nature are not intended to be punitive, and if the corporation is financially capable of complying with the orders, and actually takes steps to comply, it is unlikely that such orders will be issued against the directors. However, where corporations are slow to comply with such orders, or the corporation is insolvent, regulatory authorities may issue orders against directors personally. At least in some circumstances, such orders may be based solely upon corporate documentation showing the directors had "management and control" of the corporation, and through it, a corporation's property or activities. Therefore, it should be borne in mind that legislation may impose positive duties upon directors to act in the public interest, and such duties may transcend a director's duty to the corporation to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Moreover, the regulatory duty may not always be fulfilled by reliance in good faith on the report or advice of an officer of the corporation. Such orders do not depend on fault or lack of diligence.

As a result, decisions made and actions taken by the corporation in response to a regulatory order should be carefully scrutinized by corporate directors, and appropriate indemnity agreements and insurance policies should be in place to limit their personal liability. Such measures should, if possible, remain in force even after a director ceases to hold a position in the corporation. In situations that may lead to material expenses, the board should consider if a reserve should be established that would not be part of the corporation's assets (estate) if the corporation becomes insolvent. By establishing such a reserve, the directors may minimize personal exposure to liability.

(d) Statutory Liability for Damages

Liability for losses or damages resulting from environmental events such as spills may arise under some statutory schemes. For example, a director could be liable to a third party who suffered damage as the result of a spill if the director had ownership, charge, management or control of a pollutant immediately before it was spilled. Even where a statute does not impose civil liability on a director, liability could conceivably arise under the common law.

5. Pension Matters

Pension regulators are focused on pension governance and funding of pension plans. For directors this means the possibility of increased scrutiny of their actions in respect of the pension plan.

Under pension benefits legislation, the corporation is frequently the "administrator" of the employee pension plan. In such cases, the task of overseeing the corporation's fulfilment of its obligations as administrator in relation to the plan and the pension fund falls to the board of directors. In most cases, the board delegates all or a portion of that task to a committee of the board or to a committee which may be composed of board members, employees of the corporation (e.g., individuals employed in the company's finance or human resources departments) and outside advisors.

Where the corporation is acting as administrator of an employee pension plan, the board is responsible for overseeing the corporation's fulfillment of its fiduciary obligations to beneficiaries of the plan. In such cases, there is potential for a conflict of interest to arise between the duties owed to plan beneficiaries and the board's duties to the corporation. The Supreme Court of Canada's decision in *Sun Indalex Finance, LLC v. United Steelworkers* highlighted that a plan administrator has a duty to consider whether the corporation's interests come into conflict with its duties as plan administrator, and if so, to take action to ensure that the pension plan beneficiaries' interests are protected when such a conflict arises. The Supreme Court of Canada noted that "[t]he solution has to fit the problem, and the same solution may not be appropriate in every case."

Where a director is a member of a committee to which the board has delegated particular pension plan administrator tasks, when acting as a member of that committee, the director can be viewed as not acting as a director but rather as an agent or employee of the corporation. As a result, protections or indemnities that may have been granted to the director in the director's capacity as director could potentially not apply in relation to that person's actions as a member of that committee.

While the board is justified in delegating to others, it is prudent for the board to require periodic reports on those matters it has delegated as board members continue to have ultimate responsibility. These reports should cover the administration of the liabilities under the plan as well as the investment performance of the pension fund. In addition to their duty as fiduciaries of the corporation, the directors must ensure that the corporation fulfills its obligation with respect to the pension plan and pension fund to "exercise the care, diligence and skill that a person of ordinary prudence would exercise in dealing with the property of another person." If directors in that capacity take on any role in relation to the administration of a plan or the administration and investment of the pension fund in some jurisdictions such as Ontario, they must use all relevant knowledge and skill that they possess or, by reason of their profession, business or calling, ought to possess in undertaking that role.

The board must determine the degree of delegation of responsibility for carrying out pension plan functions which is appropriate. The board should ensure that individuals with appropriate skill and experience are designated to deal with pension matters and that there are a systematic set of procedures and evaluation measures in place to supervise and track the performance of those responsible for the plan. In most provincial jurisdictions, the plan administrator or its delegate must develop a set of investment guidelines and review, confirm or revise those guidelines annually.

In respect of pension plans registered in Ontario, a director of a corporation commits an offence if that person fails to take all reasonable care to prevent the corporation from committing an offence. Also, for Ontario registered plans, where a corporation commits an offence under the pension benefits legislation, any director who participated in the offence is also liable and is subject to a fine. In addition, where a corporation commits an offence of failing to submit payment to a pension fund or insurance company, any director who participated in that offence can be made personally responsible for the outstanding payment in addition to any fine.

6. Employee-Related Matters

Liability for amounts not paid to the corporation's employees is among the most significant liabilities a director may incur. Without a systematic and reliable audit and reporting system, it is also among the most difficult liabilities to avoid if the corporation becomes financially unstable. Because individual directors are generally only liable for payments which should have been made while they were directors, the prospect of this liability has prompted directors to resign when they recognize that the corporation might not be able to make these payments in the future. The nature of directors' liability for employee wages, including vacation pay and termination pay, as well as directors' liability for various source deductions and health and safety violations, is discussed below. Liability for the corporation's obligation to deduct and remit income taxes on behalf of its employees is discussed under the heading "Tax Liabilities" in this part.

(a) Wages, Vacation Pay and Termination Pay

Many of the corporate and employment standards statutes impose liability for unpaid employee wages, including accrued vacation pay, on directors. Under the *Canada Business Corporations Act*, for example, directors may be liable for all debts, up to a maximum of six months' wages, payable to each employee for services performed while they were directors. While "wages" and "debts" have been broadly construed, and may include contributions to benefit or pension plans, the courts have generally held that directors are not liable for termination pay or pay in lieu of notice under corporate statutes unless the wording of an employment agreement or collective agreement gives rise to such liability. Few provincial employment standards statutes impose liability on directors for unpaid statutory termination pay, although the federal legislation can impose such liability, as discussed below.

In Canada, the activities of a corporation (and the corporation's relationship with its employees) are subject either to provincial or federal legislation. For example, broadcasting and some financial institutions are under federal jurisdiction, while manufacturing and most other industries would generally be subject to provincial jurisdiction. In provincially regulated industries, employees may claim against directors in one of two ways if they are not paid wages that they have earned. First, they may file a claim with the provincial employment standards branch under the applicable provincial employment standards legislation. If that branch believes the claim is valid, it will pursue recovery of the claim with the corporation and the directors on behalf of the employees. Second, the employees themselves may institute an action against the corporation or the directors under the relevant corporate statute. If the business of the corporation is under federal jurisdiction, employee relations are governed by the *Canada Labour Code*, which imposes liability on directors for base wages and other amounts (including vacation, termination and severance pay) up to a maximum amount equal to six months' wages. The entity's governing corporate statute may also impose liability for wages, and the *Bank Act* may impose liability for unpaid wages on directors of a bank.

The corporate statutes that impose liability for employee wages on directors also impose certain procedural requirements if an employee wishes to sue the directors. Under the CBCA, for example, directors will not be liable for amounts owing to employees unless they are sued while they are still directors, or within two years of the date on which they ceased to be directors. Directors may not be sued for these amounts unless:

- The corporation has been sued successfully within six months of the date when the wages were due and the corporation did not satisfy the judgment in full;
- A claim for the wages was proved within six months of the date on which the corporation was dissolved or on which it commenced liquidation and dissolution proceedings (whichever is earlier); or
- A claim for the wages has been proved within six months of the date on which the corporation made an assignment, or a bankruptcy order was made against it, under the *Bankruptcy and Insolvency Act*.

Directors are jointly and severally liable with all of the other directors for these amounts, meaning liability for the entire amount may be imposed on a single director, on several of the directors or on all of them. Any director who has paid an employee claim under these provisions is entitled to look to the other directors to contribute their share of the amount paid.

Due diligence defences are not available to directors in most jurisdictions. This means directors can be at risk even if they have taken reasonable steps to try to have outstanding amounts due to employees paid.

The *Wage Earner Protection Program Act* facilitates the pursuit of claims against directors for unpaid wages. Where an employer is bankrupt or in receivership, a terminated employee may look to the government for payment of wages owing in the six months immediately prior to (i) the bankruptcy, (ii) the first day on which a receiver was in place; or (iii) the date on which proceedings under the *Companies' Creditors Arrangement Act* are commenced. The government is subrogated to the rights of the individual as against the directors of the corporation, and may maintain an action in the name of the individual.

(b) Source Deductions

A corporation is required to deduct certain amounts from its employees' wages or salaries and to remit those amounts to various levels of government. These are payments which the corporation makes on behalf of the employees. Typical source deductions include income taxes and employees' premiums for employment insurance and contributions to the Canada Pension Plan (or Québec Pension Plan for employees in Québec). If the corporation fails to deduct and remit these amounts, those individuals who were directors at the time the amount should have been remitted may be jointly and severally liable for these amounts as well as for interest and penalties.

A due diligence defence may be available to directors who have taken the steps necessary to ensure that source deductions are being made and remitted. Some corporations have adopted a procedure requiring senior management, such as the Chief Financial Officer, to certify to the board on a regular basis that source deductions have been remitted and paid by the corporation to the appropriate authority. When a company is experiencing no financial difficulty it may be sufficient to do this on an annual basis, perhaps coincident with the approval of the annual financial statements. When signs of financial instability appear, this certificate or other confirmation should be obtained more frequently. Advice should also be obtained about whether other steps should be taken to establish a due diligence defence, such as those described in the next section on "Tax Liabilities."

(c) Occupational Health and Safety Matters

Provincial occupational health and safety legislation is designed to ensure that employees work in an environment that is safe and free of hazards and liability. In most provinces, a corporation's failure to comply with health and safety legislation may result in director liability. In Ontario, for example, directors must take all reasonable care to ensure that the corporation complies with the provincial health and safety legislation and applicable orders and requirements from the governmental authorities. While requirements of this nature impose an obligation on directors to take active steps to ensure compliance, they also allow a defence of diligence for any director charged under the legislation. The test of due diligence is a factual one and the meaning of "reasonable care" may depend on the industry in which the corporation operates. In most cases, the care taken by directors should include ensuring that management has identified areas of operation in which precautions should be taken to protect workers from human error and from other sources of possible harm. Training employees and supervisors will also be critical to the discharge of this responsibility.

It is generally accepted that a director will not be held personally liable if employees and supervisors, who have received the appropriate training and education and who have been properly instructed and supervised, are derelict in their own duties.

If there is a standard of care that is recognized for a particular operation or industry, directors should ensure that the corporation, at a minimum, adheres to that standard. However, this standard of care may not be sufficient if the circumstances warrant increased care. In assessing the level of care that is reasonable, the factors that should be considered include:

- The gravity and the likelihood of the harm that could result; and
- The alternatives available to a corporation to minimize both the possibility of a contravention occurring and the potential harm which could result.

Penalties will vary from province to province. In Ontario, directors who fail to comply with their obligations under the *Occupational Health and Safety Act* may be subject to fines of up to $25,000 and prison terms of up to one year.

Directors can also face possible criminal charges for health and safety violations under the *Criminal Code*. Anyone who has authority to direct how another person does work is under a legal duty to take reasonable steps to prevent bodily harm to that person. If convicted, a director could face a fine and imprisonment.

7. Tax Liabilities

(a) Source Deductions and Other Remittances

Under the *Income Tax Act*, individual directors of a corporation can be held personally liable if the corporation fails to deduct or remit to the Canada Revenue Agency (CRA) the prescribed amounts for certain payments by the corporation including:

- Salaries, wages, pension benefits, retiring allowances and certain other amounts paid to employees or former employees; and
- Amounts paid or credited to non-residents of Canada that are subject to Canadian withholding tax.

Actions against a director must be commenced within two years after the date on which a person ceased to be a director of the corporation that failed to make the payment and can only be commenced if the CRA has first taken certain specified steps to attempt to collect the liability from the corporation. Furthermore, the courts have generally only imposed liability when the corporation's failure to withhold and remit occurred before the individual ceased to be a director.

Individual directors are not liable for the corporation's failure to withhold and remit the required amounts from employee wages and payments to non residents if they are able to demonstrate that they exercised the degree of care, diligence and skill to prevent the failure to withhold or remit that reasonably prudent persons would have exercised in comparable circumstances. The CRA has taken the position that the due diligence defence requires directors to take positive steps to ensure that the corporation makes the required remittances. Positive steps may include establishing controls for proper withholding and requiring reports from the Chief Financial Officer on the implementation of those controls, as well as confirming that remittances have been made during all relevant periods. Where the corporation is in financial difficulty, the CRA is of the view that directors should obtain, from the financial institution extending funds for the payment of salaries and wages, an enforceable undertaking to pay all related source deductions when due or, if this is not possible, establish a separate payroll trust account for the deposit of the gross payroll. Payments would be made to both the employees and to the CRA from this account.

There has been considerable litigation surrounding the standard of care required to establish the due diligence defence. Consistent with the CRA's published position, directors have generally been held to a high standard of care by the courts. Therefore, directors must take a "hands on" approach to seeing that source deductions are made, since a failure on the part of a director to take positive steps will likely make the director liable. Moreover, the responsibility to ensure that source deductions are remitted cannot be delegated to other directors or officers of the corporation.

The courts have stated that, while other statutes may permit directors to undertake risks in running a business, the *Income Tax Act* does not allow for any risk taking in respect of source deduction obligations.

(b) Offences of the Corporation

In addition to the other liabilities discussed in this section, the *Income Tax Act* imposes liability on a director for any offence committed by the corporation under the *Income Tax Act* if that director "directed, authorized, assented to, acquiesced in or participated in" the commission of the offence, whether or not the corporation has been prosecuted or convicted.

(c) Clearance Certificates

The *Income Tax Act* generally requires certain persons, including an assignee, liquidator, administrator or other "like person" to obtain a clearance certificate from the CRA before distributing any property of the corporation under that person's control. Failure to obtain a clearance may result in that person being liable for the unpaid taxes, interest and penalties of the corporation. Whether a director of a corporation is a "like person" will depend on the circumstances of each case and, in particular, upon whether the director, in approving the distribution, is in fact acting in a capacity similar to the specified positions. Accordingly, where the director may be acting in such a capacity, advice should generally be obtained about whether the corporation should apply for a clearance certificate before the directors approve any significant distribution of property.

(d) GST/HST

A director may also be held liable for any net goods and services tax (GST) or harmonized sales tax (HST) required to be remitted by the corporation under the *Excise Tax Act*. This liability is based on similar provisions to those contained in the *Income Tax Act*. Liability is imposed only on remittance obligations which arose during an individual's tenure as a director, and a director may avoid liability by establishing a "due diligence defence." The *Excise Tax Act* also contains offence provisions which are similar to those in the *Income Tax Act* outlined above.

8. Foreign Corrupt Practices

The Canadian equivalent of the U.S. Foreign Corrupt Practices Act is the *Corruption of Foreign Public Officials Act* ("CFPO Act"). The CFPO Act applies to bribery activities that have a real and substantial connection to Canada. The Act authorizes criminal prosecutions against Canadian individuals or corporations who bribe (or use agents to bribe) foreign public officials to get or keep business opportunities. The Act does not apply to certain payments; for example, "facilitation payments" made to obtain routine government services. Conviction may result in a fine or imprisonment for up to five years. The amount of the fine is in the court's discretion.

Historically, there have been few prosecutions under the CFPO Act; however, the Act has recently attracted increased enforcement activities. Risk oversight for boards of international companies should include an appraisal of geopolitical legal and reputational risk, including familiarity with foreign corrupt practices laws.

VI. Managing the Risk

VI. Managing the Risk

Part VI describes the ways that directors can reduce their risk of personal liability.

In addition to diligently discharging their duties, the principal ways in which directors can protect themselves are indemnities and insurance. There are three sources of indemnity: the corporate statute, the by-laws and contract. Directors should ensure the by-laws mandate the broadest indemnity permitted by the statute; however, directors cannot be indemnified for breach of their fiduciary duty. Directors should also obtain an indemnity agreement from the corporation, and should require the corporation to have directors' and officers' liability insurance in place. Insurance generally provides broader coverage than an indemnity; but more importantly, insurance provides coverage in circumstances in which the corporation cannot honour its indemnity because it is insolvent.

In agreeing to act as directors of corporations, individuals accept significant responsibilities and, along with those responsibilities, the risk of being exposed to a host of potentially significant liabilities. Many of these liabilities have been canvassed in this guide. Individuals will continue to accept the responsibility of acting as corporate directors if they are able to minimize the degree of risk to which they are personally exposed. In most cases, this can be accomplished through an appropriate risk management strategy which is consistently implemented.

A risk management strategy for directors should be designed to meet two broad objectives. First, it should limit the potential liability to which the directors are exposed. Both the common law and statutes offer a number of opportunities for directors to limit this liability based principally on the directors' diligence. This and certain other methods of limiting liability are discussed in Section 1 below. Second, the risk management strategy should seek to shift as much of the remaining risk as possible away from the directors. In this regard, indemnities or insurance policies are discussed in Sections 2 and 3 below.

While the law subjects corporate directors to a number of potentially onerous liabilities, it also seeks to protect directors who have acted in a manner consistent with their fiduciary duties. The fact that diligence protects a director in many circumstances from liability and the fact that the corporate statutes permit a corporation to protect its directors from personal liability through indemnities and insurance indicate that it is not the intention of the legislators, the regulators or the courts to penalize directors if they exercise their business judgment diligently, honestly, in good faith and with a view to the best interests of the corporation.

1. Limiting the Risk

The most effective way for directors to limit their liability is to perform their duties diligently, both individually and collectively as a board. In addition, certain other actions may protect directors in circumstances where diligence is not enough. For example, in the case of non-public companies, the implementation of a unanimous shareholder agreement, where appropriate, will limit certain liabilities. The segregation of funds into trust accounts to cover directors' liabilities may ensure that the necessary funds are available to protect the directors from personal exposure. In certain extreme cases, only the resignation of directors from the board may prevent the directors from being liable for an event which has not yet occurred, but is expected to take place. Each of these methods of limiting liability is discussed in this section.

(a) Discharge of Responsibilities

The risk of liability is minimized if directors ensure that all duties are discharged fully and all statutory requirements imposing specific liability on directors have been met. Minutes of directors' meetings should be carefully crafted to demonstrate that the directors complied with their duties. As a general matter, directors should commit themselves to attending all meetings of the board. If absence from a meeting is unavoidable, they should obtain all details about the meeting and form a view about whether they approve or disapprove of the actions taken. If they disapprove, they should ensure their dissent is recorded since liability under the corporate statutes for certain actions is imposed only on directors who voted for or consented to the action. In certain potentially contentious situations, directors should consider protecting themselves by obtaining professional advice on their duties and responsibilities and acting in reliance on such advice. Directors should insist that management inform them, on a timely basis, of all significant or exceptional circumstances that may expose them to liability. A more extensive list of suggestions to help directors discharge their responsibilities is set out at the end of this guide. A director's focus should be on careful attention to the business and affairs of the corporation and on the establishment and operation of early warning systems to identify potential problems for senior management and, where necessary, for the board before they become real problems.

Whatever the conduct of an individual director, there are many situations in which the conduct of the board as a whole will come under scrutiny. Although duties are imposed on directors individually, directors act collectively as a board, making decisions for the corporation which no individual director would have the authority to make. In 1986, the Honourable Willard Estey commented on this aspect of directors' liability in the report of the Royal Commission on the failure of the Canadian Commercial Bank and Northland Bank:

> *It is each director, not the Board, who is under certain duties, and the conduct of directors can only be assessed individually. Thus it is most unfair to lump all directors together in any assessment of Board action. Some longtime members of the CCB Board swam against the management current through many years. Some recent additions to the Board recognized many of the problems of the past. Others seemed to make little contribution. The Board here, of necessity and for the purposes of the Commission's mandate, must be assessed and adjudged as a unit over the life of the bank. Individual members may well suffer from a description that does not fit their individual records as directors.*

It may, therefore, not be enough for directors to ensure that they have satisfied their duties on an individual basis. It is incumbent upon each director to ensure that the board as a whole observes responsible principles of corporate governance, making decisions in a well-informed and thoughtful manner.

The 1994 TSX Report recognized the risks associated with being a director in its review of corporate governance. In an attempt to permit directors to control this risk, the report suggested that every board of directors should implement a system to enable an individual director to engage an outside advisor at the corporation's expense in appropriate circumstances. The report recognized that individual directors may wish to dissent from a board decision, may believe that the direction the board is taking is wrong, or may otherwise be concerned about his or her personal liability for corporate actions and may, therefore, need to consult with independent legal, financial or other advisors. In addition, NI 52-110 requires audit committees to have authority to engage independent counsel and other advisors. NP 58-201 recommends that nominating and compensation committees should be authorized to engage outside advisors.

(b) Unanimous Shareholder Agreements

Outside the public company setting, if there is a single shareholder or very few shareholders, it may be appropriate to implement a unanimous shareholder agreement to insulate the directors from certain liabilities.

A unanimous shareholder agreement is an agreement entered into by all the shareholders or the sole shareholder of a corporation under which the shareholder(s) assume some or all of the powers and responsibilities of the directors and the corresponding liabilities. The unanimous shareholder agreement does not eliminate the responsibilities and liabilities imposed on directors under the corporate statutes, but rather shifts them to the shareholder(s). Although a unanimous shareholder agreement is clearly impractical in a public company context, it is often put in place for wholly owned subsidiaries of public corporations. For example, if a foreign parent corporation wishes to control the day-to-day operations of its Canadian subsidiary, it may appoint certain individuals to the board of the subsidiary in order to meet the Canadian residency requirements of that subsidiary's corporate statute. In order to protect those individuals from directors' liability in a situation in which those individuals in fact have no influence over the corporation, the parent corporation may put a unanimous shareholder agreement in place.

Directors may still have reason to be concerned when they are asked to serve on the board of a corporation which is subject to a unanimous shareholder agreement. The agreement may not eliminate liability under any statute other than the corporate statute and, therefore, may leave directors liable for certain actions of the corporation over which they have no control. They may, for example, retain liability for source deductions or for environmental offences. Directors who agree to serve in this capacity should ensure that both the corporation and its ultimate parent provide them with a comprehensive indemnity and include them in any directors' and officers' insurance coverage carried by either corporation.

(c) Trust Accounts, Letters of Credit and Directors' Charge

As discussed in Part IV, the financial condition of the corporation will have ramifications for its directors. In some cases, it may not be possible for directors to discharge their duty to ensure that the corporation makes certain payments because the corporation is insolvent. In other cases, the insolvency of the corporation may mean that it will not be in a position to pay amounts to which the directors are entitled under their indemnities. In these situations, it may be possible for a corporation to put in place arrangements to shield directors, at least to some degree. For instance, the corporation may establish trust accounts to cover liabilities for employee wages and source deductions and to support the directors' indemnities from the corporation. A letter of credit may be obtained for the same purpose.

Whether a trust account is established or a letter of credit is put in place, the obvious issue is how the trust account or letter of credit will be funded. Funds may be provided by the corporation, but if there is any question about the corporation's financial stability, that action may be subject to challenge. In one instance, a court sanctioned a trust fund prior to the corporation filing under the *Companies' Creditors Arrangement Act* where there was evidence that the services of the directors were required to effect a corporate reorganization. By contrast, a court refused to sanction a trust fund in similar circumstances where there was no evidence the directors would have resigned and been unavailable to assist the company with its reorganization. Another court refused to sanction a trust fund where it was clearly established on the eve of bankruptcy to limit the personal liability of directors.

A third party such as a bank may be prepared to fund the trust account or letter of credit if it believes that the corporation could become viable again and wishes to ensure that capable, experienced individuals remain on the board. Also, as discussed earlier, a court in *Companies' Creditors Arrangement Act* proceedings may grant directors protection during the restructuring period.

Beyond these practical issues, if the action is being taken at a time when the corporation is in a precarious financial situation, directors will need to reconcile a decision to dedicate funds to a trust account or letter of credit intended to protect the directors with their duty to act in the best interests of the corporation. While these two interests may be reconciled by noting that it is in the best interests of the corporation not to lose its entire board at a very delicate time in its existence, a challenge to such action on the basis of a breach of the directors' fiduciary duty could nevertheless be expected. Action of this nature is better considered at a time when the corporation is not in financial difficulty. The practical reality may be, however, that where there are no storm clouds on the horizon, directors will be unlikely to devote corporate assets to trust accounts or letters of credit which will only be required in a situation which at present seems remote.

The *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act* provide directors with relief from liabilities incurred only after the commencement of insolvency proceedings. This legislation permits the court to order a director's indemnity charge which ranks prior to other secured creditors but behind certain super-priority charges such as source deductions, unpaid wages and unpaid pension contributions. The court may refrain from ordering such a charge where the director could obtain indemnification insurance at a reasonable cost.

(d) Resignation

In spite of the best efforts of a director, situations may arise in which the only means of avoiding personal liability is to resign from the board. This may be the case where there is a risk that certain statutory requirements cannot be met; for example, if the corporation is insolvent and cannot meet its obligations to its employees. In certain highly publicized cases, entire boards have resigned. Directors should note that their resignations do not absolve them of responsibility for any actions taken before their resignations. It only protects them from exposure to any liability for events after they resign.

The *Canada Business Corporations Act and Ontario Business Corporations Act* deal with the situation in which an entire board resigns. The Acts provide that any person who manages the corporation will be deemed to be a director and, thus, have all the directors' duties and responsibilities. Included in exceptions to this deeming provision is an officer who manages the corporation under the direction of a shareholder or other person, and a lawyer, accountant or other professional who participates in management solely to provide professional services.

2. Indemnities

One of the principal means of shifting risk away from directors is by way of an indemnity. The corporate statutes in Canada permit a corporation to indemnify its directors, both past and present, in virtually any circumstance in which the directors have acted in good faith with a view to the best interests of the corporation. In some instances, these statutes actually require the corporation to indemnify its directors. The statutes also permit directors to be indemnified by a corporate shareholder or creditor that appointed them to the board.

(a) Limitations

In considering the potential scope of the corporation's indemnity, four caveats must be noted. The first is that the indemnities permitted by the corporate statutes are limited largely to indemnities for negligence. No indemnity will cover a breach of a director's fiduciary duty. Where a director fails to act honestly and in good faith with a view to the best interests of the corporation, the corporation is prohibited by statute from indemnifying the director. In the absence of actual deceit or fraud, most directors will satisfy the honesty and good faith aspects of this test. Of greater concern is whether the director has acted in the best interests of the corporation. The most common breach of fiduciary duty dealt with in the case law disallowing indemnities is the misappropriation of corporate opportunities.

In one case where a director acted specifically on the directions of the controlling shareholder, a court decided that the director did not act in the best interests of the corporation and was, therefore, not entitled to an indemnity.

The second caveat is that a corporation suing a director may not indemnify the director for costs without the approval of the court and may not, in any event, indemnify the director for an amount paid by the director to settle the action or satisfy the judgment. This limitation is most likely to arise in a derivative action where a shareholder or creditor has sued the director on behalf of the corporation. Prohibiting an indemnity for judgments against directors in derivative actions is based on the argument the corporation would be reimbursing directors for amounts which directors were required to pay to the corporation. In this and other circumstances in which the corporation is not certain whether it is permitted by statute to provide an indemnity to its directors, the corporate statutes allow the corporation – or a director – to apply to the court for an order approving the indemnity. In that circumstance, the court may not only approve the indemnity, but may make any other order it thinks fit.

The third caveat is that a corporation is permitted to indemnify the director for fines in criminal or administrative proceedings only if the director had reasonable grounds for believing that the impugned conduct was lawful. Moreover, even if the director did have reasonable grounds for believing the conduct was lawful, it is conceivable that a court could strike down the indemnity as being contrary to public policy, since the punitive effect of the fine is lost if the director is not required to pay it. However, the Ontario Court of Appeal in the decision in *Bata* appears to have concluded that such indemnities should be available to directors in accordance with the code set out in the corporate statutes.

The final caveat is that an indemnity is only as good as the corporation's ability to honour it. An insolvent company will likely not be in a position to indemnify its directors, and directors entitled to an indemnity which the corporation is unable to pay will be unsecured creditors of the corporation. An indemnity from a parent corporation or major shareholder would assist in this regard.

(b) Tax Treatment

An issue of concern to directors is the income tax treatment of an indemnity payment they receive from the corporation. The CRA's administrative practice is generally that indemnification of a corporate director will not give rise to a taxable benefit for that director, provided that such indemnification meets the requirements of the corporate statutes. The CRA's administrative practice is further that where a corporation purchases liability insurance for its directors and the risks covered by the policies are inherent and normal occurrences in carrying out the duties of the insured as a director, neither the premiums paid under the policy nor any proceeds that may be payable under the policy will generally be considered a taxable benefit to the directors. While these administrative practices are not binding on the CRA as a matter of law, they provide useful practical guidance as to the CRA's likely assessing practice on audit.

(c) Mandatory Indemnity

Corporations are required by statute to indemnify their directors in certain circumstances. This mandatory indemnity extends to past and present directors of the corporation and any person who, at the corporation's request, acts as a director of another entity of which the corporation is a shareholder or creditor.

Where a director acts honestly, in good faith and with a view to the best interests of the corporation, the corporation is required to indemnify the director for all costs relating to litigation in which the director was involved as a result of having been a director. In most corporate statutes, mandatory indemnification is subject to the condition that the director must have been substantially successful on the merits in defending the action or proceeding. However, in the *Canada Business Corporations Act* and the Ontario statute, the condition is that the director was not judged by the court to have committed any fault. The mandatory indemnity would cover common law actions against directors by third parties, as well as civil liability imposed on directors under securities legislation or corporate statutes.

There are a number of costs and expenses which may not be covered by the mandatory indemnity. For example, there is no statutory requirement for a corporation to indemnify directors for amounts they are required to pay to settle an action or satisfy a judgment. The mandatory indemnity in most corporate statutes does not expressly cover expenses incurred by a director in connection with an investigation. However, the *Canada Business Corporations Act* and the Ontario statute have been amended to make it clear that such investigative costs are covered by the mandatory indemnity.

It is open to the corporation to reimburse the director, either voluntarily or through the by-laws or a separate indemnity contract beyond those costs and expenses covered by the mandatory indemnity, subject to the limitations discussed above.

(d) Indemnities Contained in By-Laws

Indemnities contained in by-laws usually repeat the statutory provisions mandating the indemnity which corporations are permitted to extend to their directors. These indemnities may not be sufficient in all circumstances. In some jurisdictions, where a corporation contravenes its by-laws, a director may apply to the court for an order directing the corporation to comply with a by-law. In jurisdictions where this is not permitted, a director may be in a better position with a contractual indemnity which the director may enforce against the corporation, unless the director can argue successfully that the indemnity terms of the by-law are indicative of a separate oral contract. In addition, a contract between a corporation and a director can only be amended by the agreement of those two parties, while the by-laws of a corporation can be amended over the objections of an individual director. Finally, since by-laws normally follow the language of the corporate statute, there may be little opportunity for the corporation, the directors or their counsel to improve on the words of the statute to clarify the scope of the indemnity or to customize it to suit the corporation's particular circumstances. Examples of improvements which may be made on the statutory scheme are set out below.

(e) Contractual Indemnities

Many corporations provide separate contractual indemnities for their directors in addition to indemnities contained in the by-laws. Directors are well advised to obtain such an agreement. From a director's perspective, the terms of any contractual indemnity with a corporation should be as broad as possible and should require the corporation to indemnify the director fully, regardless of any limitations in the corporation's insurance, such as deductibles and policy limits. The indemnity should extend to all claims and should cover acts and omissions of the director as well as acts and omissions of the corporation for which the director may be vicariously liable. Typically, an indemnity will explicitly exclude a claim if directors have been found, by the express terms of a final judgment, to have breached their fiduciary duty. A director should ensure that any such exclusion is tied to an objective standard, such as a finding by a court or tribunal that the director was guilty of such breach. Otherwise, the standard may become the subject of dispute if the corporation does not wish to honour the indemnity.

Directors should also ensure the indemnity deals with the circumstances in which the corporation may advance defence costs to the directors. The *Canada Business Corporations Act* and many other statutes expressly allow a corporation to advance defence costs subject to repayment of such costs if it subsequently turns out the director was not entitled to indemnification. Some other corporate statutes do not contain a similar provision. In these jurisdictions, an indemnity for defence costs must balance the director's interest in receiving such costs against the potential prejudice to the directors who permit the advance in circumstances in which it subsequently turns out the director was not entitled to indemnification. Directors who permit the corporation to pay an indemnity in breach of the corporate statute are personally liable to restore the amounts to the corporation.

The indemnity should also include agreement by the corporation to maintain directors' and officers' insurance, to provide the directors with a copy of the policy, to keep the insurance in place for a specified period after an individual ceases to be a director, and to arrange with the insurer to notify directors in the event premiums are not paid in order to allow the directors to pay such premiums themselves.

The indemnity should survive after the director has ceased to be a director because many potential liabilities will not expire for a number of years. Directors should obtain advice on the period of time for which an indemnity should survive given the activities of the particular corporation.

3. Insurance

Notwithstanding any indemnities which the directors may have received from the corporation, insurance is often advisable to address situations where an indemnity may not be available, either because indemnification is prohibited by the corporate statute or the corporation's articles or by-laws, or because the corporation has become insolvent.

The corporate statutes permit a corporation to purchase insurance against any liability which may be incurred by past and present directors and any person who, at the corporation's request, acts as a director of another entity of which the corporation is a shareholder or a creditor. Some corporate statutes prohibit a corporation from acquiring insurance that covers a director's failure to act honestly and in good faith with a view to the best interests of the corporation. This prohibition would not prevent a director from obtaining individual insurance to cover circumstances where the corporation is statutorily barred from indemnifying or insuring. In such cases, however, the issue is more likely one of the availability and cost of such insurance.

There are relatively few situations in which standard insurance will cover more than an indemnity. It may protect a director in circumstances where a derivative action is brought and there is no court order approving indemnification of the directors by the corporation. It may also cover situations of breach of fiduciary duty where the corporate statutes permit or, where they do not permit, situations of "honest negligence," where there is no breach of the director's fiduciary duty, but the duty was discharged without the requisite care, diligence or skill. The principal benefit of insurance is to protect directors if the corporation becomes insolvent and the directors become liable for various amounts such as wages and vacation pay associated with employees.

(a) Acquiring Insurance

Directors' and officers' insurance is currently available in Canada through different insurers. In some cases, a corporation may wish to consider placing its insurance with a captive insurance company, that is, one with which it is affiliated. In principle, there is no corporate reason why this cannot be done, although there may be some concern from a tax perspective about whether such insurance is truly insurance and whether the premiums are, therefore, deductible. Before making the decision to place the corporation's insurance with a captive insurance company, the board should obtain legal advice to confirm that this is the best choice for the corporation.

The decision to acquire directors' and officers' insurance will normally be made by the board itself. Given the self interest inherent in that decision, directors must be cognizant of the requirement to act in the best interests of the corporation. Insurance may be difficult to justify economically because the insurance premiums may be prohibitively expensive. The reality is that premiums charged in Canada tend to reflect, at least to some extent, experience in the United States.

Once the decision has been made to acquire insurance the corporation should work with its insurance broker to make sure it is getting the best possible coverage for its premiums. High-profile corporate bankruptcies have raised coverage issues that should be addressed in insurance policies. For example, the corporation should consider whether it is appropriate to include a priority of payments endorsement in the policy which requires an insurer to pay amounts owed to directors under their liability coverage first, ahead of amounts owed to the corporation. Also, the policy should include a provision stating that the "insured versus insured" exclusion found in most policies, which applies if a corporation sues its own directors, does not apply to directors who are sued by the corporation's trustee in bankruptcy.

It is important that the application form be completed accurately. The statements made in the application are considered to be warranties and a breach of those warranties may lead to a loss of certain coverage or the voiding of the entire policy. Directors may wish to consider reviewing the application before it is submitted to the insurer.

(b) Terms of the Policy

Directors' and officers' insurance typically covers both the corporation (to reimburse it if it is required to pay indemnities) and the directors and officers (to indemnify them directly) under a single premium, although the premium can be allocated between the two types of coverage. Under the corporate reimbursement portion of the policy, the corporation is covered for any amounts paid to indemnify its officers and directors other than any indemnification prohibited by the corporate statutes. If the directors themselves pay the premium for the part of the policy which will cover them personally, the policy may be able to cover more than the types of losses for which certain corporate statutes permit the corporation to carry insurance. Directors' and officers' personal coverage protects directors and officers directly where the corporation chooses not to, or is unable to, indemnify the officers or directors. However, directors should note that, since the policy is between the insurer and the corporation, they will not necessarily be notified if the policy is cancelled unless the policy specifies such notice.

As with any insurance policy, a careful review of the specific terms is necessary, since the coverage from one insurer to another can vary dramatically. Standard form policies can be tailored to suit the particular needs of the corporation, often for an additional premium. Advice should be sought from the corporation's officers responsible for risk management or from an insurance broker. The corporation's legal advisors may be consulted to determine what types of risks should be addressed.

The first issue to consider is who will be covered by the policy and in what capacity. Directors and officers should be covered both during their tenure and for a period of time after they cease to hold office. Since most liabilities expire a number of years after an individual ceases to be a director, the policy must be renewed annually beyond the date on which directors and officers cease to hold office. Alternatively, a separate policy must be purchased for resigning directors and officers, cost permitting. Advice should be sought about the period of time appropriate to the particular corporation. The directors and officers of the corporation's subsidiaries should also be covered. If the corporation asks its employees to sit on boards of other corporations, such as those in which the corporation has made an investment, the board may consider extending the policy to those individuals.

The "wrongful acts" that are covered by a policy are normally quite broad and include any actual or alleged error or misstatement or misleading statement; any act, omission, neglect or breach of duty by the directors or officers individually or collectively; and any other matter (other than one which is specifically excluded) claimed against a director or officer solely by reason of being a director. The definition of "loss" is also important and should be carefully reviewed by directors or their advisors. Does the policy cover settlements or only damages and judgments? Will preliminary investigations by a regulatory body such as a securities commission be covered, or is coverage limited to formal proceedings only or to situations where charges have been laid? Most importantly, perhaps, are all statutory liabilities covered?

Particularly important is coverage for the "absolute liabilities" discussed in Part V, such as liability for employee wages and vacation pay under certain statutes, since directors will not always be able to prevent a situation from arising in which they would incur such liability.

A number of exclusions which are typical of most policies are identical to the exclusions under indemnities. Often, insurance will exclude claims arising from the dishonesty of a director or from derivative actions where the director received a direct benefit as a result of using inside information. As in the discussion about indemnities, any exclusion for dishonesty should apply only where dishonesty is proven. Most insurance will not cover claims in actions where the directors obtained a personal profit or advantage to which they were not legally entitled. Some policies cover derivative actions, but not actions commenced by the corporation itself against the directors. A policy will often cover judgments, settlements, and investigative and legal costs, but not fines or penalties imposed by law, punitive or exemplary damages or matters which the law may determine to be uninsurable.

Other common exclusions are often covered by contractual indemnities. For example, many policies will not cover claims arising out of pollution incidents or claims made by principal shareholders of the corporation. Directors should ensure that they are aware of any special endorsements in the insurance policy which would limit the directors' coverage in high-risk areas associated with the corporation's business, because these may be precisely the areas in which the directors require insurance. Where the corporation's business involves particular risks, coverage beyond the standard coverage may be advisable and may be available for an additional premium. However, if there is no concern about the ability of the corporation to honour its indemnity to the directors, the premium payable with respect to high-risk areas may not be warranted.

Directors should note that, in all probability, the policy only covers directors and officers "acting in their capacity as directors or officers." If a director also has some other relationship to the corporation (for example, as an advisor to the corporation), the policy will likely not cover the director if the claim relates to an incident in which that person was acting as advisor. The delineation of roles may not always be clear and may be a source of disagreement between the insured and the insurer.

Directors should be aware that policies are usually written on a "claims made" basis and will not cover those claims made outside the policy period, even though the event which gave rise to the claim occurred during the policy period. If the claim is made after the expiry of the policy, the director will not be insured. It is desirable to include an "extended reporting period" or "discovery period" clause that provides that, if the insurer terminates or refuses to renew the policy, the corporation or its directors may, upon payment of a specified premium, extend the coverage for a specified period for claims arising out of "wrongful acts" attempted or committed before the effective date of termination.

Consideration should also be given to how much a policy will pay when a claim is made. Directors may wish to ensure that their indemnity with the corporation covers any deductible. Insurance may include a co-insurance provision, whereby the policy does not cover the entire loss, but only a certain percentage of any loss in excess of any deductible. Directors may be content to rely on the indemnity with the corporation to cover them for the remainder, but they should do so only on an informed basis. Any policy will have a limit, likely the aggregate liability for each policy year rather than liability for each individual claim. If the directors seek to rely on insurance when they become liable as a result of a significant occurrence, such as an environmental accident, they may find that the insurance proceeds are insufficient to cover their exposure.

Defence coverage is another issue which directors should consider. This aspect may be dealt with in one of two ways. "Duty to defend" coverage requires the insurer to provide a defence for the director. "Defence expense" provides for reimbursement of defence expenses incurred by the insured. This latter type of coverage gives the directors the ability to retain defence counsel of their own choice (normally subject to the consent of the insurer) and to control the defence of the action, and is the more usual clause in policies.

Settlement coverage should also be considered. Since most claims against directors are settled before trial, the scope of coverage provided for settlement is particularly important. The policy may provide that no settlements shall be made without the insurer's consent and that the insurer will not be liable for any settlements to which it has not consented.

Geographic scope may be an issue if the corporation carries on business outside Canada. The policy should also be reviewed to ensure that coverage is available for claims made outside Canada.

Once the insurance is in place, directors must ensure that the necessary action is taken to keep the insurance in good standing and to make claims under the policy as appropriate. Payment of premiums when due is an obvious measure, but directors will not necessarily know if the corporation has stopped paying premiums or if the policy has been terminated for any other reason. It is important to be aware of the time-frame within which claims must be reported in order for the corporation and the directors to get the greatest possible benefit from the policy. Directors should advise the corporation's risk manager on a timely basis of any claims of which they become aware. It is equally important that directors advise the risk manager of any circumstances which could give rise to a claim as soon as they become aware of such circumstances.

4. When an Action is Brought

Directors who are named in a lawsuit or who are subject to investigation in their capacity as directors should consult independent counsel. When directors plan to enforce an indemnity against the corporation, the interests of the corporation and the directors may diverge, and the directors should seek advice from someone other than the corporation's counsel. For example, the corporation may take the position that costs incurred by a director in connection with an investigation by a regulatory authority where no charges are ultimately laid may not be covered by the mandatory statutory indemnity. There may be some questions about whether such costs are covered by any separate indemnity or insurance and directors will need to ensure that their interests are protected.

VII. Conclusion

VII. Conclusion

The essence of director responsibility is the duty to act honestly, in a diligent manner, in good faith and in the best interests of the corporation. Layered on top of this duty are a host of statutory and regulatory obligations imposed on directors to ensure accountability and to promote social goals. These legal obligations are intended to shape the way in which directors discharge their duties. Directors who are well versed in the scope of their responsibilities will be in a position to discharge their duties in a manner that limits the extent of their potential liability. In addition, directors may be able to shift potential risk through the use of indemnities and insurance, although neither of these will cover a breach of a director's duty to act in good faith and in the best interests of the corporation.

As a result of the current focus on directors' duties, it is incumbent upon directors to be aware of their duties and to understand the ramifications of failing to discharge them properly. In agreeing to serve as a director, an individual makes a commitment to devote sufficient time to be able to act in good faith, in an informed manner and in the best interests of the corporation. Discharging these obligations will usually mean being prepared to ask difficult questions and to make difficult decisions.

The following is a list of certain considerations which will help directors to minimize the risks associated with sitting on a board:

a) On being invited to join a board, individuals should inform themselves about the nature of the corporation's business and satisfy themselves that the corporation and the board function in a way which allows the directors to fully discharge their responsibilities.

b) Directors must thoroughly understand their duties and responsibilities and the liabilities and penalties associated with failing to discharge those duties and responsibilities.

c) Directors must act honestly and in good faith with a view to the best interests of the corporation and apply care, diligence and skill in discharging their responsibilities.

d) Directors must prevent their own interests from conflicting with, or appearing to conflict with, the interests of the corporation.

e) The appointment of the Chief Executive Officer and other members of senior management and the relationship of management to the board are critical. The board must have confidence in the integrity of these individuals and in their willingness to keep the board informed.

f) The board must have sufficient information to allow it to reach informed decisions. The information must be detailed enough to give the directors the complete picture, but not so detailed that the directors cannot absorb it. The information must be provided far enough in advance of board meetings to allow directors time to review and consider it. Directors must not misuse confidential information.

g) Directors should ensure adequate minutes are kept of board meetings. Directors should avoid missing meetings of the board. If this is unavoidable, they should inform themselves about what occurred and have their dissent recorded if they disagree with any action taken at that meeting.

h) The board should delegate to committees when appropriate. For example, environmental committees are common. Directors who serve on a committee should be aware that their exposure to liability may increase with respect to matters within the mandate of that committee.

i) Appropriate reporting requirements should also be put in place. For example, directors should require the corporation's Chief Financial Officer to provide assurance at appropriate intervals that all employee wages have been paid and all source deductions have been deducted and remitted as they became due.

j) Appropriate audit and other review procedures should be put in place to ensure compliance with all legal requirements imposed on the corporation and its directors. As examples, this guide details some of the procedures applicable to the preparation of a prospectus and to environmental compliance.

k) The board should consider consulting outside advisors in appropriate circumstances, particularly when the corporation proposes a major transaction such as an acquisition, divestiture, reorganization or financing.

l) Directors must be satisfied that reliance on the corporation's financial statements, its officers or outside advisors is warranted.

m) Directors should obtain an indemnity from the corporation and, where appropriate, from the parent corporation or major shareholder. A contractual indemnity should be used to complement one contained in the by-laws of the corporation.

n) The board should consider purchasing directors' and officers' insurance. The board must weigh the cost of insurance against the need to put insurance in place to attract and retain high-quality directors. Directors should be aware of the limitations of any policy that is put in place.

Although the duties and responsibilities of corporate directors are always under scrutiny, by following the steps set out in this guide, a diligent director can go a long way towards discharging the responsibilities and minimizing the risks associated with this role.

VIII. Directors' Duties in Practice

VIII. Directors' Duties in Practice

In this section of the guide, we identify key considerations for directors when exercising their duties over the life cycle of a Canadian public company.

While the duties of a director to (i) act honestly and in good faith with a view to the best interests of the company and (ii) exercise the care, diligence and skill of a reasonably prudent person, are constant over the life of a company, in practice, the application of these duties varies considerably. Similarly, issues of fundamental personal importance to all directors, principally liability for actions of the company and the director, change, sometimes dramatically, with the status of a company. Perhaps the most obvious change occurs when a company becomes a reporting issuer and the directors become exposed to new sources of personal liability under securities laws for the content of prospectuses, takeover bid circulars and directors' circulars and for secondary market liability. A public company also faces significantly increased risk of litigation against the company and directors through class actions and oppression claims.

No.	Stage of Company	Director Focus
1.	**Founding of the Company** *The company is incorporated by its founders in order to pursue a business idea. The founders decide as between themselves their ownership interests in the company, as well as the governance structures that will guide their relationship.*	• At these early stages, it would be unusual for a person not closely involved with the company's operations to serve as a director. Founders and, as the company grows, representatives of early investors typically comprise the board. As third parties join the board, directors will work closely with the management team. It's critically important to match director skill sets to identified management team needs and aptitudes. Directors can fill many roles — executive coach, business ambassador, industry advisor, lead contact for customer or supplier relationships. • Directors should ensure that the company pays all employee wages and effects all required statutory withholdings and remittances because they will otherwise be liable for these amounts. This liability (which includes salary deferral amounts) is a common and potentially large personal exposure for directors throughout the life of the company. Directors should request that management certify payment of such amounts on a regular basis (and at least at each board meeting). • Directors should ensure that the company properly records share issuances and option grants in the share and option registers (as appropriate) to avoid disputes over share ownership. • Directors should ensure that founders have properly documented their employment relationships with the company; for example, severance rights and non-competition obligations arising on termination. • Directors must have regard to conflicts of interest as many directors will also be shareholders, employees and creditors of the company and thus have potentially conflicting interests.

No.	Stage of Company	Director Focus
2.	**Early round financing** *The company has shown promise and now requires an injection of capital in order to fund the growth of the business. Investors at this stage may be venture capital firms, angel investors or private equity firms. Significant investors will likely require input into the governance of the company.*	• Directors should expect more process as new nominees of significant investors join the board. • A director nominated by an investor owes his or her duty to the company, not to the investor who appointed the director. Where an investor wants to exert control or influence over the relevant company, consideration should be given to ensuring that the relevant levers are provided to that investor in its capacity as a shareholder, and not to its nominee to the board. • A nominee director must be careful not to breach his or her duty of confidentiality to the company. Investors should ensure that they have negotiated the right to receive necessary information from the company as part of their investments. • Investors should consider having separate representatives who speak to management and the directors on behalf of the investors in the investors' capacity as lenders or shareholders. This permits the nominee directors to focus on their roles and duties as directors. • As employment ramps up, the concern over director liability for wages and statutory obligations increases.
3.	**Initial public offering** *The company continues to succeed and now seeks a broader capital pool by undertaking an IPO. Certain of the initial investors may also wish to exit their investment.*	• The IPO represents a significant transformation in both the roles and potential liabilities of directors. • Directors should review the company's directors' and officers' liability insurance to ensure they have adequate public company coverage. They should also review their indemnity arrangements with the company and enter into indemnity agreements if they have not already done so. • Directors must ensure that management is focussed on the adequacy of disclosure in the prospectus because they are potentially liable for any misrepresentation in the prospectus, subject to a due diligence defence. • Directors now face potential secondary market liability for misrepresentations in certain public disclosure documents. Effective internal control and disclosure control procedures are essential. • While directors still owe their fiduciary duties to the company, they will now be expected to consider the interests of minority shareholders. The minority will expect directors to not unfairly disregard their interests and may have recourse to the oppression remedy if directors do so. • Process becomes even more important as the board needs to follow regulatory requirements and best practices including establishing audit committees, compensation committees and other governance committees. • Whereas a board at a founding stage may be largely indistinguishable from management of the private company, the board of a public company exercises oversight over management. • The board must focus on the strategic direction of the company and the composition of the management team, including a well thought-out plan for management renewal and succession. *continued>*

No.	Stage of Company	Director Focus
		• The board should identify potential risks to the company and implement appropriate risk management strategies. • The board should also implement an effective public communications and investor relations strategy for the company to prepare management for ongoing public company reporting and regular communications with investors and the research analyst community. Things to consider include coaching and mentoring for first time public company management, use of internal and external investor relations resources, and processes for vetting public disclosure.
4.	**Public debt offering** *After its IPO, the company seeks more capital by accessing the public debt markets.*	• The board now needs to consider another class of stakeholders: bondholders. • While much of the work associated with any debt financing will be undertaken by management, the board should be kept apprised of the process so directors can ensure that the amount and terms of the debt are in the best interests of the company. • Directors should focus on the company's long-term business strategy to ensure the debt can in fact be repaid and that the terms of the debt do not preclude or impede future growth plans.
5.	**Financial distress** *Due to the impact of various market forces, the company is having difficulty accessing short-term liquidity.*	• Some of the most difficult decisions that directors have to take arise in the context of financial distress. Financial distress represents a life and death situation for the company. • While the directors owe their fiduciary duties to the company, they will now be expected to consider the interests of creditors, including bondholders, as creditors may have recourse to the oppression remedy if directors fail to do so. • Financial distress highlights the tensions between the interests of shareholders, who will want to maintain value of their investment, and bondholders, who may view themselves as the "real" owners of the company. • Creditor groups may have competing claims depending on the terms of their debt instruments. These groups may include secured bank debt, senior and junior unsecured lenders, employees, landlords, suppliers and pensioners. • Process becomes a critical consideration for directors, including receipt of expert financial and legal advice, and demonstrated consideration of the interests of all potentially affected stakeholders and the exercise of business judgment. • The existence of competing stakeholder interests means litigation is a frequent by- product of financial distress.

No.	Stage of Company	Director Focus
6.	**Balance sheet restructuring** *The company`s financial distress cannot be resolved by issuing additional equity or incurring more debt and concessions are going to be required from some stakeholders.*	• The board should retain expert financial and legal advisors and should consider a committee to deal with the restructuring. • Ideally, in a balance sheet restructuring, the directors can supervise a consensual transaction in which concessions are made on a voluntary basis by all affected stakeholders. • Often however, a court filing is necessary to impose a restructuring that will be binding on all stakeholders. • A CCAA filing will be a difficult decision for the directors as it may be time-consuming and costly, and will often result in the elimination or substantial dilution of the interests of shareholders.
7.	**Bear hug letter and defensive tactics** *The company has received an unsolicited offer from a hostile bidder to purchase all of the issued and outstanding shares of the company.*	• Most public companies will have anticipated the arrival of a bear hug letter in a defence manual that will have been prepared for this event. With a defence manual in place, the directors will be properly prepared to consider and respond to the unsolicited offer. • If possible, directors should convene a meeting to consider a response. The directors should be mindful that they, not management, control the response. • The directors' response should demonstrate business judgment and be informed by expert financial advice as well as legal advice as to their duties in order to protect them from potential claims from shareholders. • There is no mandated response to any particular bear hug letter, nor is there any duty to engage with a party sending a bear hug letter. However, if the offer is compelling, depending on the financial and legal advice received, it may be prudent for directors to engage with the bidder. • Directors will also have to consider whether a special committee should be formed, and if so, its composition and mandate. • Directors will also have to consider public disclosure obligations. As a matter of tactics, the directors may decide to disclose the bear hug letter even if public disclosure is not legally required.
8.	**Regulatory crisis** *The company has received reports that certain of its customers' private information has been improperly accessed from its servers and must consider the appropriate response to protect its customers and also reassure the marketplace.*	• Each circumstance is unique. Directors therefore must ensure that systems and processes are in place to appropriately handle complaints, identify threatening circumstances and situations, and move information promptly to the appropriate parties responsible for addressing risks, including the board, its chair and/or an identified committee. • The board needs to take steps to ensure the matter has been fully investigated and that any investigation is properly pursued by, and accountable to, the appropriate parties, whether that be management, the chair or a pre-existing or special committee of the board. • There is no "one size fits all" response to threatening situations when they arise: the board needs to be fully apprised of all of the facts, and understand the rights and consequences of the situation, and any response to it. This way the approach that a board pursues will be *continued>*

No.	Stage of Company	Director Focus
		appropriately strategic and made in accordance with the "best interests of the corporation," as required. • Directors need to ask the right questions of management, professionals and other experts to ensure decisions are made in a manner that discharges their duties. This imperative needs to be pursued at every stage of the matter, from charting the investigation strategy to assessment of the problem and considering various options and potential consequences. • In assessing responses and consequences, directors must consider the impact of options on the variety of stakeholders who could be affected; stakeholders include not just shareholders, but customers, employees, creditors and the public as a whole. The particular regulatory and legal environment must also be considered, since each industry, or form of business (such as a public company) has its own range of obligations and responsibilities (such as public disclosure, reporting to regulators on proactive remediation compliance requirements) for which directors have supervisory responsibilities. • The board should always seek out and obtain the advice of experienced professional advisors, both in terms of the process to be followed in pursuing an investigation and obtaining the "facts on the ground," and also in assessing the responsive options and potential consequences.
9.	**Friendly merger or acquisition** *The company has identified a potential merger partner that offers combined business synergies.*	• Directors' duties do not change when faced with a friendly bid or acquisition proposal. The fiduciary duty is owed to the corporation and not to its shareholders or any particular stakeholder. • That said, shareholders will clearly have a great deal at stake in circumstances where a change-of-control transaction appears inevitable or where the board chooses to explore the possibility of a sale of the business. Although the *BCE* decision rejected the notion that directors have a duty to maximize shareholder value in a change-of-control transaction, as a practical matter, directors should make shareholder value a primary consideration in evaluating and negotiating an acquisition proposal that ultimately requires shareholder approval, in addition to considering the interests of other stakeholder groups. • The board should take proper steps to ensure that the directors (and not management) are ultimately seized with supervising the transaction. To this end, the board may choose to form a special committee of independent directors to oversee the process, negotiate the deal and explore transaction alternatives. • The board should always obtain the advice of experienced financial and legal advisors in the discharge of their duties. • There is no single blueprint that directors must follow in selling the business. The choices, strategies and tactics available to a board will be significant and diverse. Among other things, whether a board engages *continued>*

No.	Stage of Company	Director Focus
		in a single-bidder strategy, pre-signing market check, post-signing market check (through a go-shop contract or otherwise) or conducts a formal auction, will depend on the dynamics and circumstances of any given situation. • These decisions are a function of business judgment. Provided the directors act in good faith and on an informed basis, and decisions made are within a range of reasonable alternatives, the response to, and the decision to enter into, an acquisition proposal should be entitled to judicial deference under the business judgment rule.

OSLER

Institute of Corporate Directors
Institut des administrateurs de sociétés
Better Directors. Better Boards. Better Business.™

About Osler, Hoskin & Harcourt LLP

Osler is a leading business law firm uniquely positioned to advise Canadian, U.S. and international clients on an array of domestic and cross-border legal issues. Osler is recognized for providing business-critical advice and counsel in key industry sectors, and in transactions and litigation for some of the world's largest enterprises. Its "one firm" approach is based on collaboration, and the team is dedicated to providing clients with innovative, solution-oriented advice in a practical and cost-effective manner. Founded in 1862, Osler has over 400 lawyers working together from offices across Canada in Toronto, Montréal, Calgary and Ottawa and an office in New York.

For more information, please visit www.osler.com

To obtain an electronic copy of *Directors' Responsibilities in Canada*, please visit www.osler.com/directors

About The Institute of Corporate Directors (ICD)

The Institute of Corporate Directors (ICD) is the definitive 'go-to' resource and voice for Canada's directors and boards in the for-profit, not-for-profit and Crown sectors. As the national community for directors, the ICD is a not-for-profit, member-based association with a network of 11 chapters across Canada. Representing the interests of directors, the ICD fosters the sharing of knowledge and wisdom through education, professional development programs and services, and thought leadership and advocacy to achieve the highest standard of directorship.

For more information, please visit www.icd.ca

Toronto
Box 50, 1 First Canadian Place
Toronto, Ontario, Canada M5X 1B8
416.362.2111 MAIN
416.862.6666 FACSIMILE

Montréal
Suite 2100,
1000 De La Gauchetière Street West
Montréal, Québec, Canada H3B 4W5
514.904.8100 MAIN
514.904.8101 FACSIMILE

Ottawa
Suite 1900, 340 Albert Street
Ottawa, Ontario, Canada K1R 7Y6
613.235.7234 MAIN
613.235.2867 FACSIMILE

Calgary
Suite 2500, TransCanada Tower
450 – 1st St. S.W.
Calgary, Alberta, Canada T2P 5H1
403.260.7000 MAIN
403.260.7024 FACSIMILE

New York
620 8th Avenue
36th Floor
New York, New York, U.S.A. 10018
212.867.5800 MAIN
212.867.5802 FACSIMILE

osler.com