BUSINESS ORGANIZATIONS

Table of Contents

The Building Block
The Law of Agency……7
Formation of Agency
Basile v H&R Block, Inc (2000)
Governance between Principal and Agent
Food Lion Inc v Capital Cities/ABC Inc (1999)
Binding the Principal to Third Parties
Liability in Tort……8
Fisher v Townsends, Inc (1997)
Liability in Contract
CSX Transp Inc v Recovery Express Inc (2006)
Agent's Liabilities to Third Parties
Agency in Economics
The Unincorporated Forms
Partnership……9
The Nature of Partnership
Origins and the Partnership Act
Definition and Existence of Partnership
The Common Law
Cox & Wheatcroft v Hickman (1860)
Pooley v Driver (1876)……10
Statute
Modern Common Law Considerations of the Definition of Partnership
AE LePage Ltd v Kamex Developments Ltd (1977)
Volzke Construcion v Westlock Foods (1986) ……11
Lansing Building Supply (Ontario) Ltd v Ierullo (1989)
The Legal Status of Partnerships
The Common Law
Re Thorne and New Brunswick Workmen's Compensation Board (1962)
The Partnership as a "Firm" ……12
Relationship Between Partners: Formation and Governance: The Partnership Act and a Partnership Agreement
The Default Provisions
Relationship Between Partners and Third Parties
Liability of Partners in Contract and Tort
BC Partnership Act: ss. 1.1, 4, 7-12, 14, 21, 22, 27, 28, 31-33, 36
LP & LLP
Limited Partnership: Introduction and Overview of Features
Tax Considerations
Statutory Provisions and Features
Maintaining Limited Liability and Management of the Business……13
Haughton Graphic Ltd v Zivot (1986)
Nordile Houldings Ltd v Breckenridge (1992)
Relations Among the Partners
Limited Liability Partnerships: Introduction and Background……14
Robert W Hamilton, "Registered Limited Liability Partnerships: Present at the Birth (Nearly)" (1995)
Deborah L Rhode and Paul D Paton, "Lawyers, Ethics and Enron" (2002)
LLP Structures and Statutory Provisions
Conclusion
BC Partnership Act: ss. 51, 53, 55, 56, 58, 60, 63, 64, 66, 67, 74, 104
The Incorporated Form
Basic Corporate Characteristics
Overview of Corporate Characteristics……15

Corporations....15
Introduction: The Corporation as a Legal Person....16
The Corporate Entity: The Corporation as "Separate Legal Entity"
Salomon v Salomon & Co Ltd; Salomon & Co Ltd v Salomon (1899)
Limited Liability: Theories and Consequences....17
Frank Easterbrook and Daniel Fishel, "Limited Liability and the Corporation (1985)
Corporate Personality....18
Corporate Political Participation Policy – Canada and the US (Tim Hortons)
Corporate Personality Disregarded
A Corporation Is Distinct from Its Controlling Shareholders
Lee v Lee's Air Farming Ltd (1961)
A Corporation Owns Its Own Property
Macaura v Northern Assurance Co Ltd and others (1925)
Kosmopoulos v Constitution Insurance Co (1987)....19
Disregarding the Corporate Entity: Piercing the Corporate Veil
Clarkson Co Ltd v Zhelka (1967) 20
Big Bend Hotel Ltd v Security Mutual Casualty Co (1980)
Rockwell Developments Ltd v Newtonbrook Plaza Ltd (1972) 21
642947 Ont Ltd v Fleischer (2001)
De Salaberry Realities Ltd v Minister of National Revenue (1974)
Smith, Stone and Knight Ltd v Birmingham Corporation (1939) 22
Alberta Gas Ethylene Co v Minister of National Revenue (1990)
Gregorio v Intrans-Corp (1984)
Walkovszky v Carlton (1966)
ADGA Systems International Ltd v Valcom Ltd (1999) 23
Choc v Hudbay Minerals Inc (2013)
Canadian Business Corporations Act: ss. 15(1), 45(1), 102(1), 146(1)
How to Create a Corporation
Incorporation Process....24
Introduction: Why Incorporate?
Steps in the Incorporation Process....25
Existence of the Corporation and Pre-Incorporation Contracts....26
Post-Incorporation Steps Under the *CBCA*....27
Pre-Incorporation Contracts
Pre-Incorporation Contracts: The Common Law Position
Kelner v Baxter (1866)
Christopher Nicholls, "Corporate Law" (2005)
Newborne v Sensolid (Great Britain) Ltd (1953)....28
Black et al v Smallwood & Cooper (1966)
Wickberg v Shatsky (1969)
Sherwood Design Services Inc v 872935 Ontario Ltd (1998)....29
Canadian Business Corporations Act: ss. 5, 9, 14
How to Get Money into the Corporation
Financing....30
Financing: Introduction
Christopher Nicholls, "Corporate Law" (2005)
The Share: What is a Share?....31
Christopher Nicholls, "Corporate Law" (2005)
Sparling v Quebec (Caisse de depot et placement du Quebec) (1988)
Formalities of Capitalization
Pre-Emptive Rights....32
Stokes v Continental Trust Co (1906)
Re Bowater Canadian Ltd v RL Crain Inc (1987)
Preferred Shareholders....33
P Hunt, C Williams and G Donaldson, "Basic Business Finance," (1974)
Dividends
Canadian Business Corporations Act: ss. 6(1), 24, 25, 27, 28, 29, 34-36, 39(6), 42, 43(1), 49(1)

How and Who to Manage a Corporation

Introduction to Corporate Governance………34
The Wealth Maximization Theory
Richard A Posner, "Values and Consequences: An Introduction to the Economic Analysis of Law" (2007)
Richard A Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1980)
William W Bratton Jr, "The New Economic Theory of the Firm: Perspectives from History" (1989)
The Corporation as a Mediating Hierarchy………35
Margaret M Blair and Lynn A Stout, "A Team Production Theory of Corporate Law" (1999)
Introduction and Different Perspectives on Governance of the Corporation……………………………………………………………36
Adolf Berle and Gardiner Means, "The Modern Corporation and Private Property" (1932)…………………………………………37
Lawrence Mitchell, Ed "Progressive Corporate Law" (1995)
Robert Yalden, "Competing Theories of Corporation and Their Role in Canadian Business Law (2003)
The Corporation as a Nexus of Contractual Relations
Daniel Fischel, "The Corporate Governance Movement" (1982)…………………………………………………………………………38
Team Production Theory
Margaret Blair and Lynn Stout, "A Team Production Theory of Corporate Law" (1999)
Agency Costs as Analytical Tools
Strategies to Reduce Agency Costs……39
Agency Costs Strategies and Efficient Capital Markets
Corporate Social Responsibility
Dodge v Ford Motor Company (1919)
Peoples Department Store v Wise (2004)………40
BCE Inc v 1976 Debentureholders (2008)
BC Business Corporations Act: Part 2.2
Powers of Directors and Officers
Qualification Requirements for Directors
Election and Removal of Directors
Bushell v Faith (1970)
Authority and Powers of Directors……41
Appointment and Compensation of Officers and the Delegation of Powers
Removal of Officers
Directors' Meetings……42
Outside Directors
Janis Sarra, "Class Act: Considering Race and Gender in the Corporate Boardroom" (2005)
Christopher Nicholls, "Corporate Law" (2005)
The Ultra Vires Doctrine
Ashbury Ry Carriage & Iron Co v Riche (1875)……………………………………………………………………………………………………43
Legislative Abolition
Authority of Agents to Contract for the Corporation
Actual Authority
Defective Appointments……44
Ostensible Authority: The Indoor Management Rule
Canadian Business Corporations Act: ss. 6(4), 1, 17, 18, 102(2), 105, 106, 108, 109, 111, 114-117, 121-123, 171
How do Shareholders Exercise Voting Rights
Shareholders' Voting Rights
Shareholders' Voting Rights
Christopher Nicholls, "Corporate Law" (2005)
Shareholder Residual Powers
Automatic Self-Cleansing Filter Syndicate Co v Cunninghame (1906)…………………………………………………………………45
Unanimous Shareholder Agreements
Shareholder Proposals
Election of Directors
Amendment of Bylaws
Fundamental Changes
Class Voting Rights………46
The Distribution of Voting Rights
Voting Restrictions

Jacobsen v United Canso Oil & Gas Ltd (1980)……46
Cumulative Voting……47
Canadian Business Corporations Act: ss. 6(3)(4), 24(3), 102(1), 103, 106(3)(4), 107, 109, 137, 140, 173, 176, 183, 188, 189, 190, 211
Mechanics of Shareholders' Meetings
Annual Meetings
Special Meetings
Ordinary and Special Resolutions
Place of Meeting……48
Quorum
The Principle of Notice
Conduct of Meetings
Re Marshall (1981)
Blair v Consolidated Enfield Corp (1993)……49
Shareholder Voice
Meetings Requisitioned by Shareholders
Meetings by Order of the Court
Intervention on the Basis of Fault……50
Widely Held Corporations
Re Canadian Javelin Ltd (1976)
Constitutionality Requirements
Charlebois v Bienvenu (1968)
Access to the List of Shareholders
Shareholder Passivity and The Growth of Institutional Investment……51
Institutional Investor Monitoring
Canadian Business Corporations Act: ss. 132(2), 133-135, 138, 139(1), 143-145, 153
Regulations: 43, 44
Voting Arrangements and Governance in Closely Held Corporation……52
Closely Held Corporations
Corporate Governance Modifications for Closely Held Corporation
Re Barsh and Feidman (1986)
Different Treatment Under Modern Canadian Statutes……53
Shareholders' Agreements
Ringuet v Bergeron (1960)
Binding the Directors' Discretion……54
Share Transfer Restrictions
The Choice Between a Closely Held and a Widely Held Corporation
Conclusion……55
Canadian Business Corporations Act: ss. 2(1), 21(1), 102(2), 145.1, 146, 149(2), 160, 162(1), 163(2)(3), 171, 174, 247, 214(1)(b)(i)
Regulations 2(1)
Facebook Case Study
Proxy Solicitation
Proxy Solicitation and Corporate Governance
Mary Condon, Anita Anand and Janis Sarra, "Securities Law in Canada" (2005) ……56
Canada, Senate, "Report of the Senate Standing Committee on Banking, Trade and Commerce on Corporate Governance" (1996)
The Proxy Process Prior to Regulation by Statute
L Getz, "The Alberta Proxy Legislation: Borrowed Variations on an Eighteenth Century Theme" (1970)
Legislative Developments in Proxies……57
Requirements for the Form of Proxy
Who Must Solicit Proxies
Compliance with More Than One Set of Proxy Solicitation Rules……58
The Meaning of Solicitation
Restriction on Soliciting Proxies and Exceptions to Allow for Shareholder Communication
Janis Sarra, "The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?" (2003)
OBOs and NOBOs

Adequacy of Disclosure……58
Wotherspoon v Canadian Pacific Ltd (1982)
Materiality Standards in Proxy Solicitation……59
Harris v Universal Explorations Ltd (1982)
Express Statutory Remedy
Canadian Business Corporations Act: ss. 135(5)(6), 139(1), 147-149, 150(1)(1.1)(1.2), 151, 153, 154(1), 172
Access to Management's Proxy Circular and Shareholder Proposal
Access to Management's Proxy Soliciting Materials: Shareholder Proposals
Scope of Proposals Has Been Broadened
Varity Corp v Jesuit Fathers of Upper Canada (1987)
Information Rights and Financial Disclosure……60
Access to Records and Financial Disclosure
Access to Records
Financial Reports
Auditing of Financial Statements
Kripps v Touche Ross and Co (1997)
Certification of Disclosure
Certification Requirements
Proposed Reform……61
Certification and Fair Presentation
Mary Condon, Anita Anand and Janis Sarra "Securities Law in Canada" (2005)
The Role of Audit Committees
Independence of Audit Committees……62
Temporary Exceptions to Independence Requirements
Financial Literacy
Non-Audit Service to Be Approved
Exemptions
The Role of Corporate Counsel
Paul Patton, "Corporate Counsel as Corporate Conscience: Ethics and Integrity in the Post-Enron Era," (2006)……63
Conclusion
Canadian Business Corporations Act: ss. 20(1), 21, 135(5), 137, 155(1), 159, 161
Regulations s. 47
What are Directors' Duties and How to Enforce Them?
Duty of Care and the Business Judgment Rule
Introduction
Liability and Management Misbehaviour
Richard A Booth, "Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)," (1998)……64
Liability for Failing to Exercise Appropriate Skill and Care
Shirking
Re Equitable Fire Insurance Co Ltd (1925)
Barnes v Andrews (1924)……65
Peoples Department Stores Inc (Trustee of) v Wise (2004)
Peoples Department Stores Inc (Trustee of) v Wise (2004)
Joint Stock Discount Co v Brown (1869)……66
UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc (2002)
Expulcation
No Expulcation……67
Smith v Van Gorkom (1985)
Shiftable Liability: Indemnity and Insurance
Globus v Law Research Service Inc (1969)
Canadian Business Corporations Act: ss. 122-124
Conflict of Interest Transactions……68
Liability for Misappropriation of Corporate Assets
Looting: Interested Directors' Contracts
Aberdeen Ry Co v Blaikie Brothers (1854)
North-West Transportation Co v Beatty (1887)

UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc (2002)……69
Looting: Corporate Opportunities
Regal (Hastings) Ltd v Gulliver (1942)
Zwicker v Stanbury (1953)……70
Peso Silver Mines Ltd v Cooper (1966)
Irving Trust v Deutsch (1934)
Abbey Glen Property v Stumborg (1978)……71
Canadian Aero Service Ltd v O'Malley (1974)
Canadian Business Corporations Act: s. 118-120, 122
Enforcement Using Derivative Actions……72
Foss v Harbottle (1843)
Issues in Enforcing Managers' Duties
Shareholder and Corporate Remedies
Primex Investments Ltd v Northwest Sports Enterprises Ltd (1995)……73
Re Northwest Forest Products Ltd (1975)
The Role of the Board in Derivative Litigation
Auerbach v Bennett (1979)……74
Zapata Corp v Maldonado (1981)
Canadian Business Corporations Act: ss. 238-240, 242
Oppression Remedy……75
Christopher Nicholls, "Corporate Law," (2005)
Comparison with the Derivative Action
Relationship with Directors' Obligations
Clitheroe v Hydro One Inc (2002)……76
First Edmonton Place Ltd v 315888 Alberta Ltd (1988)
Downtown Eatery (1993) Ltd v Ontario (2001)……77
BCE Inc v 1976 Debentureholders (2008)
Defining Zone of Protection: Oppression, Unfair Prejudice and Disregard……78
Scottish Co-Operative Wholesale Society Ltd v Meyer (1959)
Ferguson v Imax (1983)
Naneff v Con-Crete Holdings Ltd (1993)
Naneff v Con-Crete Holdings Ltd (1995)……79
Canadian Business Corporations Act: ss. 238, 241
What are Directors' Duties and Shareholders' Rights in Mergers and Acquisitions?
Mergers and Acquisitions: Friendly……80
Formal Aspects of Mergers and Acquisitions
Sale of Shares
Sale of Assets
M Gannage, "Sale of Substantially All the Assets of a Corporation" (2000)
Amalgamation……81
R v Black and Decker Mfg Co (1975)
Other Merger Techniques
Christopher Nicholls, "Corporate Law," (2005)
The Appraisal Remedy……82
Smith v Van Gorkom (1985)
Canadian Business Corporations Act: ss. 182-184, 186, 189, 190, 192
Mergers and Acquisitions: Hostile……83
Takeover Bids
Control Transactions
Defensive Tactics
Teck Corp v Millar (1972)
Poison Pills and Other Defensive Tactics……84
Hogg v Cramphorn Ltd (1967)

The Building Block

The Law of Agency

- Agency: "the relationship that exists between two persons when one, called the agent, is considered in law to represent the other, called the principle, in such a way as to be able to affect the principle's legal position by the making of contracts or the disposition of property"
- Sole Proprietorship:
  - Individual pursuing commercial activity and making ultimate decisions on their own
  - There is unlimited liability, the law doesn't distinguish between business assets and personal assets
  - Corporation has perpetual resistance, unlike the sole proprietorship, so that a corporation will continue to exist after the shareholders die or sell

Formation of Agency

1. Consent by the principle and the agent
2. Action by the agent on behalf of the principle
3. Control by the principle

Basile v H&R Block, Inc (2000)
F: H&R helped facilitate a loan with Mellon Bank for customers. If customer opted for this loan, H&R received a portion of the payment. Basile argued that this information should have been disclosed as they were acting as an agent.
I: Was H&R Block an agent of the customer?
R: There is a difference between acting as a principle and a third party. Agency relationships arise when one person acts on behalf of another – in this case both parties are representing themselves, therefore there is no agency relationship.
H: There was no agency relationship
Dissent:

- Direct evidence of specific authority is unnecessary, instead the relationship can be inferred from the circumstances of the case by looking at factors such as the relation of the parties and their conduct.

Governance between Principal and Agent

- Principal and agents owe duties to each other
- The principal has the duty to compensate and indemnify the agent under certain circumstances
- The agent as the duty of loyalty to the principal, the duty of care, the duty to act within authority, they duty of obeying instructions, and the duty of disclosure
- The agent's duty of loyalty to the principal is the hallmark of the law of agency – the agent has the duty to put the principal's interests ahead of his own
- The agent must not benefit from its efforts on behalf of the principal, may not use the confidential information that belongs to the principal for the agent's own benefit, may not act for anyone whose interests might conflict with the interests of the principal, and may not compete with the principal in any matter within the scope of the agency relationship
- Agents may not become the other party to a transaction with the principal unless the agent discloses his role and the principal consents

Food Lion Inc v Capital Cities/ABC Inc (1999)
F: Two ABC television reporters used fake resumes to get a job at Food Lion to secretly videotape poor food handling practices. Food Lion sues ABC for fraudulent gathering of information.
I: Did the ABC employees breach the duty of loyalty to Food Lion?
L: An employee does not commit a tort simply by holding two jobs or by performing a second job inadequately. However, if two employees are not direct competitors but their interests are adverse in a fundamental way, this can trigger a tort liability.
A: The tort of breach of duty of loyalty applies when an employee competes directly with her employer, either on her own or as an agent of a rival company. Second, the tort applies when the employee misappropriates her employer's profits, property or business opportunities. Third, the tort applies when the employee breaches her employer's confidences.
H: The ABC's conduct was sufficient to breach the duty of loyalty and trigger tort liability

Binding the Principal to Third Parties

- The creation of an agency relationship confers the agent the authority to act on behalf of the principal

- The agent has the power to bind the principal to third parties and to bind third parties to the principal

Liability in Tort

- The principal is liable for torts committed by an agent who is characterized as an employee or servant, but not liable for the act by an agent as an independent contractor
- The difference between an employee and an independent contractor depends on the degree of control by the principal

Fisher v Townsends, Inc (1997)

F: Vehicle accident where Fisher was seriously injured. At the time Reid was the driver of the truck, and that Townsends was vicariously liable for Reid's negligent conduct.

I: Is Reid an agent or independent contractor of Townsends?

L: When considering whether a tortfeasor is an employee or an independent contractor the following considerations should be taken into account:

- Extent of control, whether or no the one employed is engaged in a distinct occupation or business, the kind of occupation, the skill required in the particular occupation, whether the employer or the workman supplies the instrumentalities, tools, and the place of work to the person doing the work, the length of time employed, the method of payment, whether or not the work is part of the regular business of the employer, whether the parties believe they are creating and employer/employee relationship and whether the principal is or is not in business

A: When a third-party plaintiff's legal theory is based upon vicarious liability, several types of relationships must be identified: principal/agent, employer/employee, agent/independent contractor, and non-agent/independent contractor

H: Townsends is liable for vicarious liability as they asserted a degree of control over Reid.

Liability in Contract

- The principal will be binding on a contract between the agent and the third party when the agent acts with actual or apparent authority
- Actual authority is created by a manifestation from the principal to the agent that the principal consents to the agent taking actions on the principal's behalf
- Actual authority includes express actual authority and implied actual authority
- Express actual authority may be conveyed orally or in writing
- Implied actual authority is the power to do those things necessary to fulfill the agency
- Apparent authority is authority that a reasonable third party would infer from the actions or statement from the principal

CSX Transp Inc v Recovery Express Inc (2006)

F: CSX was duped by a fraudulent agent of Recovery in their use of their email domain name

I: Does the use of an email domain name suffice as "apparent authority" in agency law

L: By itself, no reasonable person could conclude that apparent authority was present with the domain name alone.

A: In this case there were means available to CSX to protect itself from fraud. One reasonably should have done more to inquire authority in the transferring of over $115,000 worth of goods.

H: Holding for Recovery. No apparent authority.

Agent's Liabilities to Third Parties

- Whether the agent is liable on contracts on behalf of the principal turns on whether the principal is disclosed.
- If the principal is disclosed, the agent is not liable on the contract
- If the principal is only partially disclosed, the agent is almost always liable on the contract
- Without knowing the identity of the principal, the third party enters into the transaction presumably in reliance on the trustworthiness and bona fides of the agent
- If a person purports to have authority to enter into a contract on behalf of another, the law implies a warranty of authority—a promise that the agent actually has the authority. If the purported principal is not bound, then the purported agent is liable for breaching the warranty of authority.

Agency in Economics

- An agency problem arises whenever the welfare of one party, termed the principal, depends upon actions taken by another party, termed the agent
- The problem lies in motivating the agent to act in the principal's best interest rather than simply the agent's own interest
- Almost any contractual relationship in which the agent promises performance to the principal, is potentially subject to an agency problem

- The core of the difficulty is that because the agent commonly has better information than does the principal about relevant facts, the principal cannot easily assure himself that the agent's performance is precisely what was promised
- As consequence, the agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal.
- The value of the agent's performance to the principal will be reduced, either directly or because to assure the quality of the agent's performance, the principal must engage in costly monitoring of the agent
- Three generic agency problems arise in business firms:
    1. Conflicts between the firm's owners and its hired managers
    2. Conflict between owners who possess the majority or controlling interest in the firm, and the minority or non-controlling owners
    3. Conflict between the firm itself and the other parties with whom the firm contracts.
- In each of these problems, the challenge of assuring agents' responsiveness is greater where there are multiple principals

The Unincorporated Forms

Partnership

The Nature of Partnership

- Partnership is not a legal entity separate from its partners, meaning that there can be unlimited liability of each of the partners for the debts and obligations of the partnership
- The essence of partnership is multilateral agency: each partner is the agent of all the other partners in matters relating to the business of the partnership

Origins and the Partnership Act

- Common law and the rules of equity are also important
- The statute is often said to provide a template partnership agreement for the parties, one which may or may not fit their particular circumstances
- Parties will often draft their own partnership agreement thereby contracting out of the statutory provisions

Definition and Existence of Partnership

- One of the most basic and sometimes difficult questions from a legal perspective is whether a partnership has in fact been formed
- The existence of a partnership is subject to application of both the common law and statute
    - Is co-ownership the same as partnership?
    - Is a joint venture a partnership, or something else?
    - Does an agreement by the parties that an arrangement does *not* constitute a partnership determine the matter, or is it simply strong evidence?
- Why does this matter? Because a partner faces unlimited liability for all partnership debts, contracts, and obligations, the question whether a partnership exists has very significant consequences which has attracted both statutory and common law attention

The Common Law

Cox & Wheatcroft v Hickman (1860) *BC Partnership Act: s. 4(b)(c)*

F: There was a trust indenture for how business was supposed to operate, which gave creditors rights. Hickman tried to claim not just against owners but also against creditors, who claimed that the creditors were partners because they were sharing profits

I: Was sharing profits evidence of a partnership?

L: Sharing of profits not sufficient proof

- Sharing of profits creates a rebuttable presumption of the creation of a partnership, and can be rebutted if the persons aren't acting as agents for each other

A: Sharing of profits not the correct test…the correct test was if one person was carrying on trade on another's behalf as an agent. Essence of a partnership was that each partner for business of carrying on trade, was an agent for the other partner, so each is liable for the actions of the other.

H: No, ruling for Cox. Creditors weren't agents.

Pooley v Driver (1876)

F: Borrett and Hagen entered into partnership agreement to manufacture grease. Complicated loan agreement gave lenders entitlement to share of profits which was determined by how much overall lending they had contributed. Pooley tried to sue Driver, but said they weren't partners carrying on the business, but just lenders

I: Was this a loan or a partnership agreement?

L: Intent irrelevant; instead, courts apply an objective test to determine part

- It's possible to have dormant partners even though they weren't actively carrying on business
- Courts will create partnerships even when the parties didn't intend to become partners

A: Court looks at ordinary debtor/creditor relationship and compares it to these facts

- Here, the loan agreement and partnership agreement lasted for same 14 year agreement
- Driver tried to have all benefits of partnership (profits and enforcement) without all the liability
- Therefore, it is a partnership because it had all the elements of a partnership

H: Partnership, even though partner is dormant

Statute

- As stated before, the partnership act of each common law province in Canada adopts in essence the language of the 1890 English *Partnership Act*
- In BC, a general partnership can exist without ever complying with the registration requirement for general partnerships (see s.4 below)
- *BC Partnership Act*, s.2: "Partnership is the relation which subsists between persons carrying on business in common with a view of profit"
  - At least 2 people
    - According to BC *Interpretation Act*, 'person' can be individuals, corporations, and partnerships
  - Must be carrying on business
    - No statutory definition, but dictionary definition is some commercial purpose to make money
  - Must be doing business in common
    - Complicated, but must be some level of activity between partners
    - *Volzke*: can be a partner without active participation, or without having control over the business
    - *Cox* and *Pooley*: difference between a passive investor (partner) and a creditor that has no interest in the profit and management of the firm (not a partner)
  - With a view of profit
    - Thus not a charity organization…must have a profit motive (but not actually make a profit)
- *BC Partnership Act* s.3 defines persons who are not a partnership, while section 4 contains rules for determining if a partnership exists:

  "The relation between members of a company or association that is

  (a) incorporated under an Act for the time being in force and relating to the incorporation of joint stock companies, or licensed or registered under an Act relating to the licensing or registration of extraprovincial companies, or

  (b) formed or incorporated by or under any other statute or letters patent or Royal Charter

  is not a partnership within the meaning of this Act"
- Thus when business is carried on through a corporation, then the particular corporate statute applies and the *Partnership Act* does not apply

Modern Common Law Considerations of the Definition of Partnership

- While statutory codification of the common law provides guidance into when a business association is a partnership the legal definition of partnership is still not always clear, as the next few cases indicate

AE LePage Ltd v Kamex Developments Ltd (1977)

F: One member of a syndicate signed an exclusive listing agreement without authorization. Property was sold by an agent, and LePage wanted commission…Kamex refused to pay it because the agent had no authority. LePage argued agent was a partner and therefore all were responsible for payment

I: Were the real estate agents partners? Is owning property in common sufficient to have a partnership?

L: Co-ownership didn't create partnership

- The mere fact that one owns property in common and that profits are derived from the ownership of the property doesn't automatically create a partnership

A: No partnership here, as partners intended to preserve certain rights that partnership destroyed. Demonstrates that the courts

don't apply an automatic checklist when finding a partnership, but instead look at the circumstances as a whole
H: No, it was an ownership in common, not a partnership

Volzke Construcion v Westlock Foods (1986)
F: Bonel and Westlock enter into joint agreement at shopping mall to make improvements to the mall ie: joint cheques, bank account, introduced as partners, took out a mortgage, etc. Both parties had a dispute, and when creditors came, Westlock claimed they were just co-owners based on the *Kamex* case
I: Was there joint ownership or partnership?
L: Co-ownership created partnership

- Finding of partnership can go both ways depending on the evidence

A: TJ concluded that there was no intention to enter into a partnership, and since Westlock had no control over the business, it couldn't be a partnership…CA disagrees because:

- Control has nothing to do with the existence of a partnership (ie: silent partners)
- Agreement to 80-20 sharing of profits on developing the business
- Parties spoke of each other as partners

Similar to *Kamex* in joint ownership and management. However, this is distinguished because the profit share as well as the previous evidence (see facts) was sufficient evidence to prove a partnership existed
H: For Volzke, there was a partnership

Lansing Building Supply (Ontario) Ltd v Ierullo (1989)
F: Lansing entered into credit agreement against a joint venture…action against 1 owner failed, and then Lansing sued the other 2 owners. Owner's lawyers drafted an agreement specifically stating that they weren't partners. However, profits distributed amongst them, owner representatives were involved in active managing, co-owned property, had restricted rights for building in land
I: Did the draft prohibit the creation of a partnership?
L: Co-ownership created partnership

- Co-ownership by itself is not enough; instead, court looks at situation as a whole to try to find evidence of the owners are carrying on business as a partnership within the meaning of s.2 of the *BC Partnership Act*

A: In *Kamex*, owners aim was just trying to flip a building; here, something more (ie: carrying on business) was involved (ie: rights to deal with land are restricted).

- In *Kamex*, intention of co-owners was simply to invest in property and resell it at a profit
- *Kamex* co-owners could deal separately with their independent interest in the real estate.

Here, parties to the co-ownership agreement formed a joint venture for the purpose of developing real estate into commercial and residential condo units.

- Since the property of the partnership is held by all of the partners, there is no right to deal with the property separately.
- Thus, arrangement here, in contrast to *Kamex*, is clearly one in which the parties are "carrying on business" within the meaning of s.2 of the *Partnership Act*.
- Also, no doubt parties entered into this joint venture with a view to profit

H: No, for Lansing, partnership created

The Legal Status of Partnerships

- The legal existence of partnerships is simple: none, partnerships have no separate legal existence
    - Partners are bound by the law of mutual agency
- Two consequences of this legal status:
    - Calculation of income for tax purposes: Under s.96 of the *Income Tax Act*, partnership firm is not taxed; instead, income is allocated between the partners and partners are taxed individually on their shares of partnership income
    - Joint and several liability for the partners: Can sue partnership in it's own name without having to sue all partners individually. The outcome is binding on all of the partners, even if not named and not served in the action

The Common Law

Re Thorne and New Brunswick Workmen's Compensation Board (1962)
F: Thorne was hurt at a mill and claimed for workers compensation, but was turned down. At trial, court held that he wasn't an employee even though partnership paid him a salary
I: Was Thorne a workman employed by the partnership and therefore entitled to compensation?
L: A partnership firm is not a separate legal entity

- Partnership is not a legal entity and unlike the corporation has no separate legal existence

A: When a partnership contracts an employee, the K is between the employee and the individual partners, therefore you can't contract with yourself to be an employee and an employer
H: No, can't be a partner and employee because a partnership is not a legal entity

The Partnership as a "Firm"

- The partnership is not recognized as a separate legal entity despite its presence in partnerships acts of reference to an entity called a "firm"
- The court in *Thorne* said that the presence of this rule did not mean that a partnership was a separate legal entity. It simply provides a convenient means of commencing an action against partners concerning claims arising our of the conduct of the partnership business

Relationship Between Partners: Formation and Governance: The Partnership Act and a Partnership Agreement

- The *BC Partnership Act* gives only the default rules, they can be altered by an agreement

The Default Provisions

- Default provisions of the *BC Partnership Act* cover many grounds:
  - Partnership Property – ss. 6, 23(1), 24
  - Capital, Profits, Losses, Management, Admission of New Partners, Recordkeeping – ss. 27
  - Removal of Partners – ss. 28, 29(1)(2)
  - Fiduciary Duty – ss. 22(1)(2), 31, 32(1), 33
  - Assignment of Partnership Interests – ss. 34(1)(2)
  - Dissolution – ss. 35(1), 36(1)(2)(3), 37, 38(1)

Relationship Between Partners and Third Parties

- The relationship between the partners and persons affected by contracts entered into in connection with the partners or torts committed in the conduct of the partnership business is also critical in the statute
- There are two kinds of liability:
  - Joint liability: Each partner is liable for the same set of facts. Ie: if you sue B, you can't sue C, D, E, etc…suing one is a bar to suing the others
  - Several liability: Each partner is liable, but facts must be proven individually and only liable for your facts. Ie: can sue one at a time without being barred from suing others

Liability of Partners in Contract and Tort

- Sections 7-11 of the *BC Partnership Act* set out the contractual liability for partners
- Sections 12-19 of the *BC Partnership Act* set out liability in tort and breach of trust for a partnership

LP & LLP

Limited Partnership: Introduction and Overview of Features

- This is a statutory rather than a common law creation that is halfway between partnership and corporation in terms of its structure and rights/liabilities of the partners.

Tax Considerations

- Happens when you want the tax advantages of a partnership but the protection of a corporation

Statutory Provisions and Features

- Features:
  - Like a corporation:
    - Must be registered with the registrar of companies, and there are more formalities required than a partnership, as it doesn't exist only by virtue of people carrying on business together. Also, the partners have limited liability, so there isn't the same degree of risk (similar to shareholders)
  - Like a general partnership:
    - As with general partnership, income and losses are not taxed as separate entities
- There are two kinds of partners in a limited partnership:

- General partners
  - Must be at least one, they have unlimited liability and can be involved in management
  - Generally the general partner is a corporation
- Limited partners
  - Must be at least one, but creditors can only go after assets they contributed to the partnership
  - Generally they are investors, and they can't take part in management operations

- Features of a limited partnership:
  - Must be registered
    - Can't be created by the court, as it's a creature of statute
  - Anti-deception
    - Must be clear who the general partners are as distinct form the limited partners
- Therefore creditors have more info than a general partnership to balance the fact that creditors can't go after the limited partners' personal assets and therefore carries more risk

Maintaining Limited Liability and Management of the Business

- Limited partners are precluded from taking part in management of the business at the risk of losing the limitation on their liability
- Common structure for limited partnership is to have a corporation as the general partner
- The promoters of the business will be made officers of the corporation and perform the management functions of the limited liability partnership business on behalf of the general partner corporation
- This raises the question whether limited partners who are officers in the general partner corporation are in fact liable as general partners on the basis that they have taken part in the management of the business.

Haughton Graphic Ltd v Zivot (1986)

F: Zivot and Marshall were limited partners of Printcast (limited partnership), Lifestyle Magazine corporation was general partner, of which Z said he was President and M said he was Vice-President. Haughton Graphic, a creditor of P, printed 5 issues, but only got payment for 2 since P went bankrupt. H then went after Z and M, who knew P was a limited partnership but didn't know what that meant. All they knew is that Z represented himself as President and M represented himself as the Vice-Prez.

I: Is Zivot liable as a general partner of Printcast?

L: Limited partners taking part in management

- Limited partners taking part in management will be liable as general partners by the courts

A: Since Z and M were limited managers involved in management, they lost LP protection. Doesn't matter what creditor's believed…it's the actions of the partners that's significant. Doesn't apply to someone whose sole role in and connection with the limited partnership is that of an officer, director, or other controlling mind of the general partner

H: Yes, he was liable

Nordile Houldings Ltd v Breckenridge (1992)

F: B and R were limited partners of Arman Rental LP, and Arbutus corp. was the general partner. Brecekridge and Rebiffe were officers of Arbutus. Nordile, vendor, sold property to Arman in return for cash and a 2nd mortgage

I: Are B and R liable as general partners?

L: Creditor alerted to limited partners weren't liable

- Even if you are a limited partner, and have a role to play in managing, if you are managing solely as directors and officers of the general partnership, you are OK

A: Nordile had no excuse, as the purchase and sale agreement made it clear that no one but the limited partnership or the general partnership were to be liable

H: No, not liable

2 distinguishing factors from these 2 cases:

- Representation
  - In *Zivot*, Z and M appeared to be performing management duties in the general partnership
- Documentation
  - In *Nordile*, Nordile was specifically made aware by the purchase and sale agreement that B and R were acting solely as directors and officers of the general partnership

Relations Among the Partners

1. Separation of Ownership and Control *BC Partnership Act* ss. 56, 58

2. Other Aspects of the Relations Among Partners
    a. Right to inspect books
    b. Assignment of limited partnership interests *BC Partnership Act* ss. 51, 66
    c. Restriction on the admission of additional partners *BC Partnership Act* ss. 51, 54, 56, 65
    d. Share of profits *BC Partnership Act* ss. 61

Limited Liability Partnerships: Introduction and Background

- Only in 2004 that the *BC Partnership Act* allowed for the creation of Limited Liability Partnerships
    - Created in Texas in US during savings and loans scandals in the 1980s over fear that huge negligence actions and large damage awards could destroy large partnerships
- This allows professionals to avoid unlimited liability unless:
    - They took part in negligence, or
    - They knew about it and didn't take reasonable steps to correct it
- Must contain the suffix LLP on the name of the firm, and must be properly registered
- Provisions contained in Part 6 of *BC Partnership Act*
- In BC, anybody can enter into an LLP; in Ontario, it's limited to professional legal bodies

Robert W Hamilton, "Registered Limited Liability Partnerships: Present at the Birth (Nearly)" (1995)

- LLP is the newest form of modern business enterprise in the US
- The original conception of an LLP – is that it provides what might be described as "peace of mind" insurance for innocent partners
- LLP is designed to avoid the fear by a partner that her personal assets may be at risk because of negligence or malpractice by a partner over whom she has no control
- A basic principle of general partnership law is that each individual partner is personally liable for all partnership obligations to the extent they exceed the assets of the partnership
- This means not only that innocent partners may be required to discharge partnership obligations from their own personal assets, but also that they may be required to make contributions from their personal assets to the partnership to enable it to discharge all of its liabilities
- The original LLP concept, all partners have the benefits, responsibilities and potential liability of general partners except that partners have no responsibility for malpractice claims or for liabilities arising from negligence or misconduct in which they were not personally involved.
- This is commonly referred to as "the shield of limited liability."

Deborah L Rhode and Paul D Paton, "Lawyers, Ethics and Enron" (2002)

- It would be possible, and desirable, to reconsider certain specific ethical rules that contribute to debacles like Enron.
- One is the absence of appropriate standards of third-party liability for lawyers who passively acquiesce in client fraud
- In some states, privity requirements now bar non-clients from suing attorney's for "willful blindness" to client misconduct
- LLPs are another example of rules designed by and for the profession that deserve a closer look
- The legislation effectively eliminated personal financial exposure for partners in firms implicated in malpractice proceedings
- LLPs absolve non-supervising lawyers of any financial responsibility for their colleagues' ethical violations, and deprive victims of remedies if those who commit the violations lack adequate assets or insurance coverage.
- In essence, LLPs privilege professional over public interest
- Moreover, the benefits of this system flow disproportionately to the largest law firms, which could most readily prevent and spread costs of misconduct.
- Reducing this insulation from accountability could give the lawyers greater incentives to address collegial misconduct and to establish the internal oversight structures that can check abuses

LLP Structures and Statutory Provisions

- Canadian jurisdictions enacting LLP legislation have generally limited the use of LLPs to "eligible professionals," those that are regulated under the act, such as doctors, lawyers, and accountants
- In 2005, BC adopted LLP legislation that places no restrictions on the types of businesses able to register

Conclusion

- While the apparent simplicity of formation, flexibility and tax treatment, and lack of formality of partnerships make them and attractive form of business organization, the review of the common law and statutory rules demonstrates that partnership is a choice not to be taken lightly
- The rules governing the relationships between the parties themselves, and between partners and third parties with whom they deal need to be considered precisely and carefully.
- The apparent advantages of partnership over incorporation are often outweighed by one thing: the inability in a partnership to limit liability.
- The key is that partnership is a relationship of trust: partners are personally liable for the contracts entered into on behalf of the partnership business and for torts committed in carrying on the partnership business
- Limited partnerships and limited liability partnerships may afford some limited protection to investors, and recent amendments may serve to transform the way they are used in Canadian business.

The Incorporated Form

Basic Corporate Characteristics

Overview of Corporate Characteristics

Corporations

- Corporations have three key features:
  - Separate existence (or separate legal entity/personality)
  - Limited liability
  - Perpetual existence
- The equity investors in for-profit corporations are referred to as shareholders and the business is managed or supervised through a board of directors

1. Separate Existence (Separate Legal Entity/Personality)

- A corporation is recognized as a separate legal entity
- The corporation can enter into contracts with other persons and is liable in the event that it breaches those contracts
- Corporation can borrow from other persons and it can buy goods on credit
- Corporation can have creditors
- Corporations can also be liable for torts arising from carrying on the business conducted through the corporation
- Corporations can own assets
- Corporation normally owns the assets used in the business

2. Shareholders

- Normally, corporations will have several equity investors, however, more than one is not required in Canada
- The interests of equity investors in for profit corporations are divided into shars, and the equity investors are typically referred to as shareholders
- These shares consist of bundles of legal rights that investors can assert primarily against the corporation
- These shares do not give shareholders legal title to the assets of the corporation

3. Limited Liability

- The liability of shareholders in a corporation is typically limited to the amount of their investment
- Position of shareholders is similar to limited partners in a limited partnership
- There is no constraint on the extent to which shareholders can become involved in the management of the business

4. Perpetual Existence

- Corporate statutes typically do not imposes length requirements – thus a corporation recognized as a legal entity could exist indefinitely

5. Management (or Governance) Structure

- Shareholders can be directly involved in management and they are typically involved in the management of corporations that have relatively few shareholders
- In corporations with many shareholders it is common to have a management team that holds very few shares in the corporation (or possibly even none)
- The basic framework for the management of corporations is that shareholders elect a board of directors
- The board of directors then appoints officers of the corporation who either manage the day-to-day business of the corporation themselves or delegate various management responsibilities to other persons they hire

- Corporations have no physical existence, so it cannot negotiate contracts or conduct business without the assistance of human beings
- A corporation must act through its board of directors or through agents appointed by the board of directors
- Corporations can also hire employees
- If the business grows and seeks additional funds, it may need to raise a portion of those funds through equity investments
- The usual legal model for the management of a corporation involves shareholders voting to elect directors who then manage the corporation or supervise the management of the corporation. The directors of the board appoint officers who manage day-to-day affairs of the corporation. These officers would normally also be given authority to hire employees on behalf of the corporation and perhaps also delegate some aspects of their authority to these employees.
- The legal model allows for the creation of a hierarchical management structure that can be a simple structure or a very large and complex structure. It allows for a considerable degree of flexibility in the corporate management structure, thus allowing the corporate structure to respond to a very wide range of circumstances varying from a corner stone to a multinational, multi-billion dollar enterprise

6. Political Choice

- All things related to features and formation of a corporation are attributed to political choices

Introduction: The Corporation as a Legal Person

- The corporation is a creature of statute in Canada, and has a separate legal existence (or personality) from those incorporating it
- Modern corporations law statutes provide the framework of rules for establishing a corporation and for the rights and responsibilities of both the organization and its directors, officers, shareholders and the public

The Corporate Entity: The Corporation as "separate legal person"

- The House of Lords decides that once a company has been legally incorporated, it must be treated like any other independent person, with rights and liabilities appropriate to itself
- The fact that all of the shares in the company are held by one person does not matter, and is irrelevant to the purpose of discussing the rights and liabilities of the company
- *Salomon v Salomon:* Confirmed the separate legal personality of the corporation
- *Salomon* remains the watershed case in the history of modern corporate law as we know it in Canada

Salomon v Salomon & Co, Ltd; Salomon & Co, Ltd v Salomon (1895-1899)

F: Salomon had a boot and shoe trade business which he ran as a sole proprietorship. He formed a company, and the memorandum of association created 40,000 shares, each with a par value of 1 pound each…gave one share to each of his six family members and he kept the rest. He got 20,000 shares plus 16,000 pounds in cash or debentures. Salomon had financial problems, and mortgaged debentures to Broderick for 5000 pounds to keep business afloat, as well as loaning own cash to company. However, company couldn't pay interest on debentures, went bankrupt, and liquidator was appointed to try an determine priority of the creditors who wanted to realize on the assets. Broderick and Salomon got priority on assets during liquidations due to debentures. Creditors challenged this, alleging that the business transfer of debentures was fraudulent. TJ sided with creditors/liquidator, saying Salomon employed the company as his agent, the signatories were 'mere dummies', and he was liable to the other creditors. CA also thought transaction was contrary to the meaning of the *Companies Act*, and that the company was acting like a trust, so Salomon as beneficiary must pay its debts to the other creditors

I: Is Salomon liable to the creditors?

L: The corporation is a separate legal entity from its shareholders

- Corporation's legal personality is separate and independent from the shareholder's personality

A: HL notes 2 major things:

- **Company properly incorporated**
  - *Companies Act* says in order to form a company limited by shares, it requires that a memorandum of association be signed by 7 persons, who are each to take one share at least
    - Complied with here…nothing in *Act* indicated subscribers must be independent or equal
- **Company has a separate legal personality**
  - It is born the second the change in business format is completed
  - Contrary to trial and CA, the company is neither the agent or trust of Salomon…holding it to be an agent or trustee would undermine the concept of limited liability established in the *Companies Act*
  - Since there was no abuse of the corporate creditor/debenture process, Salomon the creditor and the corporation were seen as separate legal entities
  - Even if there is a "one-person company", you can relate to the company in more than one capacity

- Here, Salomon was both creditor and shareholder to the company
- In law, there is **no limit on "one-person companies" absent fraud**

- This is still good law today, as corporate liability is limited to the company and not the shareholders

H: No, for Salomon

Limited Liability: Theories and Consequences

- Some academic commentators have problems with the rule coming from *Salomon*
- Khan-Freund said that the courts have failed to give protection to the business creditors which should be the corollary of the privilege of limited liability
  - As a remedy he suggests a minimum stated capital requirement, aka, on incorporation the corporation would be required to receive at least a stipulated amount as consideration for the issuing of new shares
- The most apparent benefit of limited liability is that it permits the risk of default from the organizers or promoters of a corporation to the shoulders of creditors
- An economic analysis of the situation posits that the separation of ownership and control in widely held corporations introduces what is well known as an "agency cost" problem, since firm managers (as agents) have imperfect incentives to maximize the interest of al claimholders (as principles).
- Halpen, Trebilcock and Turnbull argued that limited liability is functionally equivalent to shareholder liability insurance because the effect of limited the liability of shareholders is to shift risk of loss from shareholders to creditors

Frank Easterbrook and Daniel Fischel, "Limited Liability and the Corporation"

A. Limited Liability and the Theory of the Firm

- We know from the survival of large corporations that the costs generated by agency relations are outweighed by the gains from separation and specialization of function
- Limited liability reduces the costs of this separation and specialization
  1. Limited liability decreases the need to monitor
  2. Limited liability reduces the costs of monitoring other shareholders
  3. By promoting free transfer of shares, limited liability gives managers incentives to act efficiently
  4. Limited liability makes it possible for market prices to impound additional information about the value of firms
  5. Limited liability allows more efficient diversification
  6. Limited liability facilitates optimal investment decisions

B. Limited Liability and Firms' Cost of Capital

- Limited liability does not eliminate the risk of business failure
- Limited liability is an arrangement under which the loss largely lies where it falls. Loss is swallowed rather than shifted.

1. *The Extent of Common Interests*
   - The argument that firms' cost of capital does not vary with the liability rule depends on the assumption that the benefit to stockholders from limited liability is exactly offset by the detriment to creditors. This assumption is false…
2. *Relative Monitoring Costs*
   - Shareholders have less reason to incur costs in monitoring managers and other shareholders under limited than under unlimited liability
3. *Relative Information and Coordination Costs*
   - Another reason why shareholders pay creditors to assume more of the risk of business failure might be that the creditors possess a comparative advantage in monitoring particular managerial actions
4. *Attitudes Toward Risk*
   - Both equity and debt investors can diversify their holdings, thus minimizing the risk of investing in any one firm

C. Insurance as an Alternative to Limited Liability

- The advantages of limited liability suggest that, if it did not exist, firms would attempt to invent it

In sum the problem all along has been: is it better to allow losses to lie where they fall, or to try to shift those losses to some other risk bearer?

- The equity investors bear more risk than the debt investors, but debt investors continue to bear substantial risk, and the risk of all investors is limited to the amount they sink at the start.

Corporate Personality

Corporate Political Participation Policy – Canada and the US (Tim Hortons)

- Tim Hortons has a well-established history of community involvement
- They have adopted a transparent process of participating in public policy matters which align with the overall business' direction and vision
- Corporate Contributions
  - Tim Hortons makes contributions in support of national, state, provincial or local issue advocacy efforts where the issues aligned with company interests and objectives
  - In Canada, Tim Hortons cannot make corporate donations to federal political parties or candidates but may support provincial and municipal political activities
  - Tim Hortons encourages its franchisees to take part in local, political activities
  - Tim Hortons complies with disclosure requirements when making donations
- Regulatory Framework
  - Federal: Federal legislation prohibits corporations from making political contributions to federal political parties and candidates for federal office
  - Provincial: Applicable provincial laws relating to public policy matters are not uniform and should be considered in each case
  - Municipal: Generally any person or corporation may make a political contribution to a candidate in a municipal election.
  - In BC records of contributions over $250 are on the Elections BC website

Corporate Personality Disregarded

Other Consequences of Incorporation and Separate Legal Identity

- In addition to limited liability, other consequences that flow from conception of corporation include the perpetual succession of a corporation, the distinction between a corporation and its controlling shareholders, and separate ownership by the corporation of its own property

A Corporation is Distinct from its Controlling Shareholders

Lee v Lee's Air Farming Ltd (1961)

F: Lee was sole shareholder (one share to wife), director, president, and employee of the company. He died while doing aerial topdressing, and widow wishes to be compensated under the *Workers Compensation Act* of New Zealand for the loss of her husband through his employment. Board argues his position as governing director of company meant he couldn't be an employee

I: Did Lee's position as sole governing director preclude him from being an employee of the company?

L: Affirms *Salomon* where one person may function in two capacities

- Principle shareholders in corporations are able to appoint themselves as employees, and therefore directors may be employees of the corporation

A: Court notes that Lee was employed by the company, not by himself

- Mere fact that the company acts through its directors and officers doesn't mean that those are the personal acts of those directors and officers
- Also, the statute had nothing to say against dual roles or one shareholder having overwhelming share
  - Court affirmed *Salomon*, which also permitted one person to function in dual capacities
- Different than a partnership situation because the corporation in law is a separate person
- Here, he was acting in his function as an employee…what if he was injured in his function as a manger? Unclear result…probably would depend on the language of the statute
- Additionally, note that the case held that an overlap of functions is OK (as Lee did everything)

H: No, for Lee

A Corporation Owns its Own Property

Macaura v Northern Assurance Co Ltd and others (1925)

F: Macaura is owner of estate and owned almost all shares of a company. He sold the timber on the estate to the company, of which

he was main shareholder and creditor. When the timber burned down, he tried to claim fire insurance for the estate. However, the insurance companies declined liability because the insurance wasn't for the company
I: Can a creditor or shareholder have an insurable interest in a company?
L: Shareholders and creditors have no legal or equitable interest

- Creditors and shareholders have no insurable interest in a corporation; rather the corporation owns its own property

A: Creditors, regardless of relationship to the company, have no insurable interest for policy reasons. Shareholders have a right to a share of profits and a right to residual assets on liquidation once all of its debts have been paid

- However, shareholders have no legal or equitable claim over any company assets

Didn't make any difference that Macaura was principle shareholder

- Same principle applies regardless of amount of shareholders; assets are the property of the company rather than the shareholders
- Basically, you can't take insurance on land you don't own
- Also, while it's certain that insured will suffer loss when he is the only shareholder and there is only one asset, not certain when there are lots of assets and lots of shareholders

H: No, for insurance companies

However, the next decision overwrites *Macaura* on the definition of insurable interest only in a one-person corporation…

- While the business owns assets, shareholder has insurance, and court holds that assets are still assets of company rather than shareholder, although the court does allow claim because shareholder had an insurable interest

Kosmopoulos v Constitution Insurance Co (1987)
F: Kosmopolous had a leather goods business, and incorporated with himself as director and sole shareholder to protect his assets. Confusion, as all assets, bills, leases were in his name, not the business name. He took out fire insurance, but the policy was in his individual capacity as sole proprietor. There was a fire, he tried to claim, insurance company declines liability based on *Macaura* principle. TJ noted that *Macaura* doesn't apply because company was a legal fiction, and insurance company didn't do due diligence to make sure right party was on the insurance policy.
I: Can a sole shareholder have an insurable interest in the assets of the company?
L: Sole shareholder may have insurable interest

- Sole shareholder can have an insurable interest in the company's assets, but the company still owns the assets and is legally distinct from its shareholders

A: SCC held that the corporation was not a mere fiction…it was legally distinct and not "window dressing" or the mere agent of Kosmopolous

- Instead, corporate veil should only be lifted where the interests of third parties would suffer as a result of the choice to incorporate
- People that incorporate must assume benefits and also corresponding liabilities of incorporation

However, he receives protection because SCC redefines what "insurable interest" is in the context of insurance law

- Company owns the assets, but in these circumstances, he can have an insurable interest even though he has no legal or equitable interest in company property
- Thus decision doesn't overwrite corporate law, as shareholder doesn't own assets of company
- However, the moral certainty he would've suffered a detriment if the assets were destroyed by fire leads to him to recover
- Similar to life insurance, where you don't control/own the life but there's a moral certainty that you would be affected by the loss of it

H: Sometimes, as here for Kosmopoulos

The preceding case has been criticized:

- Ignores separate legal existence of corporation, as if you say there is an insurable interest if only one shareholder, why is there no interest when there are 2 shareholders, even when one shareholder owes 99% of the shares?
- In Canada, there is no coherent theory of when we find the corporation to be a separate legal entity - - This decision is just making things more confusing, adding an exception to *Salomon*

Disregarding the Corporate Entity: Piercing the Corporate Veil

- *Kosmopoulos*: The idea of the separate legal identity of the corporation might be disregarded is possible in cases where the courts decide to "pierce" or "lift" the veil of corporate personality, particularly where it would be "too flagrantly opposed to justice" to apply the principle from *Salomon.*
- *Littlewoods Mail Order Stores v IRC:*

  - Denning: "The doctrine laid down in *Salomon v Saloman & Co…*has to be watched very carefully. It has often bee supposed to cast a veil over the personality of a limited company through which the courts cannot see. But that is not true. The courts can and often do draw aside the veil. They can, and often do, pull off the mask. They look to see what really lies behind. The legislature has shown the way with group accounts and the rest. And the courts should follow suit."
- Instances where the court relaxes the strict application of the principle from *Salomon* are rare
- Rather than adhering to a rigid rule or overruling *Salomon* altogether, courts have crafted various judicial "exceptions" to its application. By doing so, courts have in certain cases imposed personal liability on the shareholders of a corporation despite the formalities of separate legal personhood; in other cases, the courts have granted some right or interest to an individual shareholder that, strictly speaking, would belong to the corporation itself.
- Categories that group together cases where courts have found it appropriate to disregard the separate legal personhood of a corporation for instrumentalist reasons include:
  1. Cases that involve allegations of fraudulent or objectionable purpose on the part of a company's principles
  2. Cases where a company existed as a "shell" and was clearly undercapitalized to meet its reasonable financial needs
  3. Cases that involve tort claims against the company, particularly where a director, shareholder, or employee has committed an intentional tort, or the tort of inducing breach of contract
  4. Cases where the company was no incorporated for bona fide business reasons but for other purposes, often to avoid taxation
  5. Cases that involve non-arm's length transactions between parent and subsidiary companies; and
  6. Cases where courts determine that equity or the interests of justice are better served by disregarding the corporate form.
- Attempting to predict with any certainty when courts will pierce the veil is not easy
- Categories are far from "watertight compartments," and more recent Canadian veil-piercing cases "appear to reflect a more holistic approach to the question."
- The cases in which courts have lifted the veil often beg the question whether the same result might have been reached by means other than piercing the veil.

Clarkson Co Ltd v Zhelka (1967)

F: Selkirk was real estate developer who operated through a maze of corporations. He went bankrupt, but before liquidation he transferred one property he owned to his sister who then took out a mortgage on the property. The trustee in bankruptcy wanted the land held for the benefit of creditors and wanted the deal struck down as a fraudulent conveyance.

I: What was the effect of the land transfer to his sister? Will the court pierce the corporate veil?

L: Court refused to pierce corporate veil despite shady dealings

- Courts will not pierce the corporate veil if there is no fraud being perpetrated on the creditors
- Although courts rigidly adhere to the separateness of the corporate personality, they have refused to accept it in some situations (ie: inequitable to third parties, fraudulent purpose, agency, ect…)
- As a summary, most times courts do not pierce the corporate veil, but there is no one standard set of conditions to guarantee that they will…however, there are some common themes from the cases:
  - ie: **<u>Protection of Third Parties</u>**
    - Particularly in fraud, or whether there's a need for recovery for tort claimants
    - If company is a "sham" being used for fraudulent purposes, it's a good reason
    - If third parties are misrepresented, there can be a reason

A: Court holds that the land was property of the corporation. Even though there was an "aura of suspicion", the company still has limited liability, and the company and its shareholders are distinct. Therefore P has not shown that the corporations were the alter ego of S or his mere agent for the conduct of his personal business or for the purposes of the conveyance to Z. Though close to the line, the company was not merely an agent for Selkirk, so *Salomon* upheld

H: For Selkirk and Zhelka

Big Bend Hotel Ltd v Security Mutual Casualty Co (1980)

F: Kumar was sole shareholder of K & S Enterprises, which owned and operated Big Bend Hotel (and previously Fort Hotel, which burned down). When his 2nd hotel also burned down, the insurance company denied paying out fire benefits because Kumar failed to disclose his loss record. They claim had they have known about the previous hotel, they wouldn't have accepted the risk

I: Is the fire loss suffered by K & S Enterprises sustainable?

L: Can't use company as a shield for fraud

- Equity will not allow an individual to use a company as a shield for improper conduct or fraud

A: Section 14 of the *Insurance Act* claimed K is void if "misrepresentation or failure to disclose is material to the contract"

- D uses this to deny liability
- P argues that K & S and Big Bend are legally distinct entities, and he had no legal duty to disclose the burning down of the Fort Hotel
- However, the court holds that Kumar omitted to disclose a fact which he knew was material to the insurers, and such failure to disclose a material fact was fraudulent
- Can't lift corporate veil when there is fraud
- The fact that there was a second company didn't change court's conclusion that he failed to disclose the prior loss because he knew from previous cancellations that if he did so he would be unable to obtain insurance for the hotel
- Court also holds that a reasonable insurer would have declined to accept the risk if known

H: No, for insurance companies

Rockwell Developments Ltd v Newtonbrook Plaza Ltd (1972)

F: Rockwell was to buy land from Newtonbrook, but the deal fell apart and Rockwell (purchaser) ended up owing legal costs to Newtonbrook (vendor). N tried to get Kelner, a solicitor, to personally pay their costs of action brought about by R. TJ held that Kelner was driving the litigation and Rockwell was only a nominee to hold title, so that Kelner was only an agent or trustee for Rockwell. Ie: money coming from Kelner's account, not R's, and no appropriate corporate record keeping

I: Could Kelner be held personally liable for N's costs as being the actual contracting party?

L: Benefit doesn't mean piercing

- Absent allegations of fraud, simply because a shareholder benefits from and carries out a corporate transaction doesn't justify piercing the corporate veil

A: -Although Kelner would ultimately benefit from the contract, K was made with the company alone. Kelner couldn't have sued upon it, nor could he himself have been sued. Court holds that corporations must be run by human beings. Simply because he gave instructions to its solicitors doesn't justify that he's an actual litigant. Also, there is no allegation of fraud

H: No, for Rockwell

642947 Ont Ltd v Fleischer (2001)

F: There was a fight over a property purchase between two sophisticated developers. Sweet Dreams, owner of property got an injunction to delay the sale, but there was a loss in the delay. Two individuals in Sweet Dreams, Halasi and Krauss, were held liable on the loss, and they appealed

I: Did any damages flow from the injunction? Should H and K be held personally liable?

L: No undertakings if corporation is undercapitalized

- Undertakings can't be given lightly to the Court to selfishly protect self-interest of parties giving the undertakings

A: Court unsympathetic for two reasons:

- In situations where a company is seriously and intentionally undercapitalized (not enough assets to cover potential liability). The developer was entitled to rely on the undertaking without looking into Sweet Dreams. Court holds it was misconduct on behalf of H and K, as officers, to get an injunction from the court even though they knew the company had insufficient assets. Not court or purchaser's duty to investigate
- This was an undertaking given to the court by a lawyer. Although they were in capacity as officers of the corporation, they should've known better

Laskin J.A. said that the court can set aside the veil when "those in control expressly direct a wrongful thing to be done", and in this case the directors would not be allowed to make a hollow undertaking, knowing the corporation had no assets

H: No losses from the undertaking, but they should be held personally liable

De Salaberry Realities Ltd v Minister of National Revenue (1974)

F: 2 rich families had a complex corporate structure that looked like this:

Parent		**Subsidiary**		**Sub-subsidiaries**
Cemps. Investment	→	Cemps Holding	→	Sister companies
Steinberg Ltd	→	Ivanhoe Corp.	→	Sister companies

This structure was set up for the purpose of purchasing property. For every property purchased, the families incorporated a new company. Sub-subsidiaries had no money and every time they needed money, they needed it from parents. Only way sisters exist is by control of parent company, as all directors of all businesses were the same people

I: Were sub-subsidiaries carrying on the business of trading parcels of land, or were they simply set up for capital gains? Should court lift the corporate veil?

L: Puppet companies for tax

- Courts are more willing to pierce the corporate veil where there is a thinly capitalized corporation entirely controlled by

parent corporations that is created solely for tax purposes

A: Since parent companies were carrying on the business of the sister companies, the sister companies were simply puppets of the dominant company. The thin capitalization, and the dominance by the parent company, meant that the appellant was an instrument of a big land trading scheme, and was itself a trader in land. Therefore the profit was a profit from trading land, not a capital gain

H: For Minister, as sister companies were only incorporated for tax, not business purposes

Smith, Stone and Knight Ltd v Birmingham Corporation (1939)

L: Often cited for the proposition that an exception to the *Salomon* principle arises when a corporation is simply the agent of a corporate shareholder, by satisfying the following 6 tests:

1. Were the profits treated as profits of the parent company?
2. Were the persons conducting the business appointed by the parent company?
3. Was the parent company the head and brain of the trading venture?
4. Did the parent company govern the trading venture, decide what should be done, and what capital should be embarked on the venture?
5. Did the parent company make profits by its skill and direction?
6. Was the parent company in effectual and constant control?

Note: The problem is these 6 criteria describe the classic parent-subsidiary relationship, but the "veil" is not lifted in every such relationship.

Alberta Gas Ethylene Co v Minister of National Revenue (1990)

F: To obtain a lower rate of interest from US lenders, AGEC incorporated ASCO, a Delaware corporation. ASCO then borrowed from US lenders on AGEC's behalf, and AGEC borrowed from ASCO. The tax collector assessed AGEC for taxes on interest payments made to ASCO as a non-resident of Canada. AGEC argued for "veil piercing", saying the
court should look at the substance of the transaction, to save itself from the tax liability.

I:

1. Is ASCO just a "sham" or "shell company" that is no more than a borrowing arm of AGEC?
2. Is ASCO just the agent of AGEC according to the six tests from Smith, Stone and Knight? (see text p 194)

A: You can't just consider the 6 criteria (from *Smith*) and when they are all met (as they are in this case) ignore the separate legal existence of the subsidiary. You must ask for what purpose & in what context it is being ignored.

H: AGEC has to pay taxes as if ASCO had a separate legal existence.

Note: It would appear that "purpose" and "context" includes whether the separate legal existence of the subsidiary helps or hinders the government's tax collection. Tax man gets to have it both ways—see *De Salaberry Realties Ltd v Minister of National Revenue*

Gregorio v Intrans-Corp (1984)

F: Gregorio bought a Peterbilt truck from Intrans-Corp. Intrans bought it from Paccar Canada Ltd. Paccar Canada is the Canadian subsidiary of Paccar Inc, the US-based manufacturer of the truck. Gregorio sued Intrans-Corp for breach of warranty and also claimed against Paccar Canada for negligent manufacture of the truck.

I: Can the "corporate veil" be pierced to make Paccar Canada responsible for the negligent manufacture of the truck given that the truck was really manufactured by its parent company, Paccar Inc?

A: Laskin JA:

> "Generally, a subsidiary, even a wholly owned subsidiary, will not be found to be the alter ego of its parent unless the subsidiary is under the complete control of the parent and is nothing more than a conduit used by the parent to avoid liability. The alter ego principle is applied to prevent conduct akin to fraud that would otherwise unjustly deprive claimants of their rights.

H: Gregorio can't sue Paccar Canada Ltd for negligent manufacture of the truck (no veil pierce).

Walkovszky v Carlton (1966)

F: Carlton had 10 corporations, each of which operated 2 cabs and had minimum liability insurance. W was seriously injured by a negligent cab driver, only received the minimum insurance, so he goes after the sole shareholder

I: Is Carlton personally liable?

L: No piercing of corporate veil even though undercapitilized

- An enterprise doesn't become fraudulent merely because it consists of many small corporations set up to avoid tort liability

A: Majority: Carlton not personally liable. Even though the corporation was undercapitalized and the assets were intermingled, there was no evidence that he was carrying on business in his personal capacity. The fact that the fleet was split up amongst many corporations doesn't make it fraudulent. Policy – afraid of floodgates opening, as if Carlton was found to be operating the business personally, individual drivers working for corporations would also become personally liable. Problem is that minimum insurance is

too low, not undercapitalization of corporations
H: No, for D (but with dissent)
Dissent: Carlton personally liable. Whole purpose of statute was to ensure accident victims receive adequate compensation. Shareholder set up several corporations in order to avoid tort liability, which goes against the intent of the act. Shareholder of corporation vested with a public interest that undercapitalizes to meet liabilities that are certain to arise in ordinary course of business may be personally liable

ADGA Systems International Ltd v Valcom Ltd (1999)
F: In a bidding contest between 2 rival firms where employee disclosure was required, D raided P's technical staff by inducing breach of contract and working for them, and successfully got the bid. P sued the director and 2 employees of D in their personal capacity for involvement in raiding P's technical staff, which caused economic damage
I: In addition to Valcom being liable, could the officer and 2 employees be personally liable?
L: Additional liability for officers

- Liability can be extended to officers as well as the corporation if officers committing intentional tortuous behaviour induce breach of K, even if done in pursuance of corporate interests

A: Officers tried to rely on *Said v. Butt* exception, which stated that an employee is not generally liable for wrongful acts which are done at the behest of the company

- Basically, if you do your job in good faith, and you induce breach of K, not personally liable
- However, a worker that takes part in or authorizes torts such as assault, trespass to property, nuisance or the like may be liable in damages

Court holds that officers committed intentional tortuous actions

- No basis for protecting directors on basis that conduct was in pursuant of company interests
- However, limits exception to cases involving the tort of breach of contract

Here, piercing of corporate veil not the issue, as P isn't going after the shareholder

- Instead, it's trying to establish an independent cause of action against officers for inducing a breach of fiduciary duty in addition to the cause of action against the corporation

H: Yes, for ADGA

Choc v Hudbay Minerals Inc (2013)

- Important precedent in placing responsibility with the parent company
- This was the first time that the responsibility of a foreign subsidiary was recognized by Canadian law

Piercing the Corporate Veil

- The defendants characterize the plaintiffs' claims as an attempt to pierce the corporate veil, and argue that the plaintiffs have failed to establish that this is an appropriate case in which to do so
- The plaintiffs' claims are based primarily on the direct liability of the defendants
- Since *Salomon v Salomon & Co,* Anglo-Canadian law has recognized that a corporation is a legal entity distinct from its shareholders. A parent corporation is also a legal entity distinct from a wholly-owned subsidiary
- *Gregorio v Intrans-Corp:* The Court of Appeal stated with respect to the separate legal personality of a parent and subsidiary

  > "Generally, a subsidiary, even a wholly owned subsidiary, will not be found to be the alter ego of its parent unless the subsidiary is under the complete control of the parent as is nothing more than a conduit used by the parent to avoid liability. The alter ego principle is applied to prevent conduct akin to fraud that would otherwise unjustly deprive claimants of their rights."

- Ontario courts have recognized three circumstances in which separate legal personality can be disregarded and the corporate veil can be pierced: (a) where the corporation is "completely dominated and controlled and being used as a shield for fraudulent or improper conduct" (*642947 Ontario Ltd v Fleischer*); (b) where the corporation has acted as the authorized agent of its controllers, corporate or human (*Parkland Plumbing & Heating Ltd v Minaki Lodge Resort 2002 Inc*); and (c) where a statute or contract requires it (*Parkland Plumbing*)
- First and second exceptions are applicable in this case
- First exception discussed in *Transamerica Life Insurance Co of Canada v Canada Life Insurance:*

  > "The courts will disregard the separate legal personality of a corporate entity where it is completely dominated and controlled and being used as a shield for fraudulent or improper conduct. The first element, "complete control," requires more than ownership. It must be shown that there is complete domination and that the subsidiary company does not, in fact, function independently…
  > The second element related to the nature of the conduct: is there "conduct akin to fraud that would otherwise unjustly deprive claimants of their rights."

- The plaintiffs in the Choc action plead that "CGN is completely controlled by, subservient to and dependent to and dependent upon Hudbay Minerals"
- *Shoppers Drug Mart Inc v 6470360 Canada Inc:*

  "The separate identity concept is foundational to Anglo-Canadian law, and applies even where the evidence demonstrates that the corporation has been involved in impropriety. It is not permissible to lift the veil simply because a company has been involved in wrong-doing, in particular simply because it is in breach of contract (*Dadourian Group International Inc v Simms*)

  The corporate veil should be pierced not where a corporation has misappropriated funds, but where the very use of the corporation is to hide that misappropriation. It would make undue inroads into the principle of Salomon's case if an impropriety not linked to the use of the company structure to avoid or conceal liability for that impropriety was enough (*Trustor AD v Smallbone and others*)"
- The fact that Hudbay allegedly engaged in wrongdoing through its subsidiary is not enough to pierce the corporate veil. The plaintiffs would have to allege that Hudbay had used CGN "as a shield for fraudulent or improper conduct," that the very use of CGN was to avoid liability for wrongful conduct that it carried out through CGN.
- CGN "is an agent of Hudbay Minerals" By doing so, the plaintiffs have pleaded the second the second exception to the rule of separate legal personality
- If the plaintiffs can prove at trial that CGN was Hudbay's agent at the relevant time, they may be able to lift the corporate veil and hold Hudbay liable. Therefore, the claim based on piercing the corporate veil in the Choc action should be allowed to proceed to trial.

How to Create a Corporation?

Incorporation Process

Introduction: Why Incorporate?

- There are several advantages to incorporation, but they may not be particularly significant advantages and may in fact be overridden by other considerations, particularly tax considerations:
  - Limited Liability
    - Not much practical benefit where sole proprietor or partner have to provide a personal guarantee to a bank or other lender in order to secure a loan to provide a significant portion of capital to the new incorporated business
    - However, significant against tort claimants, except where court lifts the "corporate veil"
    - Therefore, especially in closely-held corporations, its prudent to purchase insurance against tort claims arising out of the conduct of the business
  - Perpetual Succession
    - Not always an advantageous over a sole proprietorship or partnership, as in those cases, assets and major contracts can go to a successor through careful drafting
    - Partnership contracts can be drafted to anticipate retirement, death, bankruptcy, or the addition of new partners as well
  - Ease of Transfer of Shares
    - General rule is that shares are freely transferable unless there is an express restriction on the transfer of shares in the corporate bylaws
    - However, securities laws often put restrictions on the initial distribution and subsequent transfer of shares, particularly in closely-held corporations where shareholders take part in management and want to avoid costs of compliance with securities law
    - Therefore, since restrictions on shares in closely-held corporations resembles partnership restrictions, there's no major advantage
  - Shareholders Alone Cannot Bind the Corporation
    - However, in closely-held corporations, the individual shareholders are usually the officers and authority is delegated to them as agents to bind the corporation in certain capacities
    - If a shareholder is an officer and are constrained in authority, they must be careful that they are not cloaked with ostensible authority and carefully put third parties on notice of restraints
    - Also, corporation is vicariously liable for torts committed by its officers, agents, and employees, much like liability of fellow partners for torts
  - A Shareholder Can Contract With a Corporation

        - While this is true, partners can contract with fellow partners in ways that are both separate from and in addition to the partnership agreement as well
    - Facilities for a Body Corporate to Secure Additional Capital
        - These include shares and debentures
        - Raising equity capital in a partnership can be done in a way that closely resembles shares
        - Debentures are simply evidence of indebtedness
            - Not sold by the corporation like shares, but simply evidence a debt owed by the person issuing the debenture
            - Similar conditions to bank loans, so sale of debentures to numerous persons is, in effect, like getting a loan from numerous persons on terms not unlike those one would find in a bank loan
        - Even if there are advantages to the sale of shares and debentures to raise capital, there is always the issue of compliance with securities legislation when such instruments or other similar investments are sold broadly to the public
        - Thus, sale of shares and debentures restricted in a way that will not make them any more ready than partnership interests or units in a limited partnership
    - Tax Advantages
        - May be tax advantages, but also possible tax disadvantages
        - Advantage is double-taxation…*Income Tax Act* solves problem of when a corporation is taxed on income, but then same income is taxed again in the hands of shareholders when it is distributed
        - Also, international competitive pressures have led to a reduction in corporate tax rates in Canada so that corporate tax rates may be less than individual tax rates
        - Small business can also get a "small business deduction"
        - However, partnership and sole proprietorship also has advantages…i.e.: losses often incurred at startup, which can be passed through to investors and written off on investor's income tax
    - Costs of Incorporation
        - Includes initial incorporation fee, legal fees, filing of annual reports, filing of additional tax return, corporate record keeping, etc.

Steps in the Incorporation Process

- To incorporate: *Canadian Business Corporations Act* s. 5(1)
    - "One or more individuals not one of whom
      (a) is less than eighteen years of age,
      (b) is of unsound mind and has been so found by a court in Canada or elsewhere, or
      (c) has the status of bankrupt,
      may incorporate corporation by signing articles of incorporation and complying w/ section 7"
- There are 4 essential requirements, all of which can be done online:
  Filing Articles of Incorporation: *Canadian Business Corporations Act* s. 6(1)
    - "Articles of incorporation shall follow the form that the Director fixes and shall set out, in respect of the proposed corporation,
      (a) the name of the corporation;
        - When deciding whether to use a regular name and using a numbered company is the **speed of incorporation**…using the next number available avoids doing a corporate search or using words prohibited by regulation
        - When law firms incorporate "shelf companies" to have corporations immediately available for use by clients, they use numbered companies
        - s.10(5) – Corporate name and accompanying suffix (ie: Ltd., Inc., Corp.) must be included in all contracts, invoices, negotiable instruments, ect…
        - s.10(6) – *CBCA* explicitly permits numbered company to carry on business under a business name or style
      (b) the province in Canada where the registered office is to be situated;
        - Not necessarily where the company is carrying on business
        - Office is usually the law firm for efficiency with dealing with legal work
        - If it changes, you must file a notice of change of offices with the director
      (c) the classes and any maximum number of shares that the corporation is authorized to issue, and
        (i) If there will be two or more classes of shares, the rights, privileges, restrictions and conditions attaching to each class of shares, and

(ii) If a class of shares may be issued in series, the authority given to the directors to fix the number of shares in, and to determine the designation of, and the rights, privileges, restrictions and conditions attaching to, the shares of each series;
- Small issuers usually only incorporated with common shares w/o restrictions
- Often articles say "Corp is authorized to issue an unlimited number of [common/preferred/series X] shares"

(d) If the issue, transfer or ownership of shares of the corporation is to be restricted, a statement to that effect and a **statement as to the nature of such restrictions**;
(e) The **number of directors** or, subject to paragraph 107(a), the minimum and maximum number of directors of the corporation; and
- s.102(2) – Must have at least one director, but size of board of directors need not be set
- Don't need to tell rest of the world who shareholders are, but name of directors and their addresses must be released to the public

(f) A**ny restrictions on the businesses** that the corporation may carry on"

Additional provisions in articles *Canadian Business Corporations Act* s. 6(2)
- "The articles may set out any provisions permitted by this Act or by law to be set out in the by-laws of the corporation"…ie:
  - s.28(1) – pre-emptive rights for existing shareholders to acquire new shares of the company before they are offered to outsiders
  - s.34(1) – restrictions on the repurchase of shares by the company
  - s.107 – cumulative voting
  - s.6(3) – special majorities for votes of directors or shareholders to effect action
  - s.111(4) – provision for filling vacancies among directors
  - s.114(2) – quorum of directors at less than a majority
- Most small companies will simply have common shares, flexible number of directors, and no restrictions on the business, so the process is simple
- Advice is to keep articles simple, as a significant majority of shareholders is needed in order to change the articles

Existence of the Corporation and Pre-Incorporation Contracts
- Ottawa/Victoria is required under the *CBCA* to issue a certificate of incorporation when the articles of incorporation are received
  - s.9, *CBCA*: "corporation comes into existence on the date shown in the certificate of incorporation"
  - After, under s.104, directors must meet to make bylaws, appoint officers, issue shares, etc…
- However, the date of incorporation is important because of contracts made on behalf of the company before the business is incorporated
- Q: How is an artificial entity that is not in existence when the contract was made legally bound by such an agreement?
- Section 14 of the *CBCA*:

  14(1) Personal Liability
  - "Subject to this section, a person who enters into, or purports to enter into, a written contract in the name of or on behalf of a corporation before it comes into existence is personally bound by the contract and is entitled to its benefits"
  - Effectively overrules the common law in that the promoter is now liable, but look for s.14(4) exception

  14(2) Pre-incorporation and pre-amalgamation contracts
  - A corporation may, within a reasonable time after it comes into existence, by any action or conduct signifying its intention to be bound thereby, adopt a written contract made before it came into existence in its name or on its behalf, and on such adoption
    (a) the corporation is bound by the contract and is entitled to the benefits thereof as if the corporation had been in existence at the date of the contract and had been a party thereto; and
    (b) a person who purported to act in the name of or on behalf of the corporation ceases, except as provided in subsection (3), to be bound by or entitled to the benefits of the contract"
  - Reasonable time and written K requirements for corporation ratification
  - If corporation ratifies, promoter loses his rights under the K

  14(4) Exemption from personal liability
  - "If expressly so provided in the written contract, a person who purported to act in the name of or on behalf of the corporation before it came into existence is not in any event bound by the contract or entitled to the benefits thereof"

  - Thus if pre-incorporation K says so, promoter isn't bound by it

Post-Incorporation Steps Under the *CBCA*

- Once a corporation has been incorporated there are a number of post-incorporation steps that need to be taken.
- S. 104 of the *CBCA* provides that after the issue of the certificate of incorporation a meeting of the directors shall be held at which the directors may:
  1. Make bylaws
  2. Adopt forms of security certificates and corporate records
  3. Authorize the issuance of shares
  4. Appoint officers
  5. Appoint an auditor to hold office until the first meeting of shareholders
  6. Make banking arrangements, and
  7. Transact any other business

Pre-Incorporation Contracts

Pre-Incorporation Contracts

- As noted above, the question of how to address activities undertaken on behalf of the corporation prior to its formal birth has posed great problems for courts and legislatures
- *CBCA* s.14 above modifies the common law position
- However, sometimes provincial statutes don't follow the *CBCA*, and there are interpretation issues, so knowledge of the CL position is still important

Pre-Incorporation Contracts: The Common Law Position

- 3 different situations that arise with pre-incorporation contracts:
  - Both the promoter and the contracting party know the corporation is not yet formed
  - Only the promoter knows
  - The promoter mistakenly thinks it has, and tells the contracting party
- Q: Should liability depend on if the contracting party made reasonable enquiries?

In the cases, these factors have been held to be significant:

a) **<u>Form of the Signature</u>**
- On behalf of v. signing personally for

b) **<u>Third Party Knowledge</u>**
- Did they know the company was properly incorporated?
- *Kelner*: third party knew it wasn't, so everybody knew K wasn't with the corporation

Kelner v Baxter (1866)

F: K was to be manager of new hotel, and contracted for goods before incorporation with D's. D had no principal…they entered into K on behalf of the hotel

I: Does entering on behalf of the hotel prevent the defendants from being bound by the K?

L: K entered into before incorporation generally not binding on a corporation

- General common law position is that the corporation cannot enter a contract before it is formed; therefore, if a member signs on behalf of a company that doesn't exist, they may be bound personally

A: Court relates to agency law:

- Claims that general rule of agency where a K is signed by one who professes to be an agent, but who has no principal existing at the time, and K would be inoperative unless binding upon the person who signed it, he is bound thereby
- Cannot be an agent if principal does not exist, and this does not change just because a "principal" later ratifies the contract
- Must be two parties to a contract, rights and obligations cannot be transferred to a third that does not yet exist

H: No, for P…the "agent", having no "principal", is personally liable

Christopher Nicholls, "Corporate Law" (2005)

- Straightforward reading of the *Kelner* decision is that the individual defendants were liable because it was clear that all the signing parties…the defendants as well as the plaintiff…had intended the contract to be legally enforceable.
- Agency law would not prevail: and agent cannot act for a non-existent principal. Nor would it even be possible for a

corporation to subsequently to ratify a pre-incorporation contract previously entered into on its behalf.
- As a matter of law, a party can only ratify a contract into which it could have legally entered in the first place
- Because a non-existent person cannot validly make the contract, the corporation could not have entered into the pre-incorporation contract on the date it was made, and therefore could not validly ratify it on some later date either.
- So there were only two alternatives:
    - Either this pre-incorporation contract was nullity, or it was enforceable against the individual defendants who had signed it.
    - Because the parties to the contract had clearly not intended that it be a nullity-they had meant for it to be enforceable against someone-they must have intended it to be personally binding no the individual signatories

The next two cases are cited as authorities for the "rule of construction" approach:
- That the form of signature adopted by the promoter is determinative and that promoters are only liable if it was intended in the circumstances that they themselves were to be parties to the contract

Newborne v Sensolid (Great Britain) Ltd (1953
F: Foreigner entered K to sell tinned ham before incorporation using stationary of company name. D didn't accept the goods when the tinned ham market collapsed. Both parties were under the mistaken belief that the company had been formed. P then tries to sue, relying on *Kelner* and suing in D's individual capacity
I: Was there a legally binding K?
L: Third parties stuck if promoters didn't intend to be parties to the K
- Promoters are not making a contract as agent or principals, but rather for the company, when they sign for the company, and if the company doesn't exist when the contract is signed, there is no contract

A: P's counsel relies on *Kelner v. Baxter* to say that if the contract was not with the company, it must have been with the person who signed on its behalf
- However, P was signing as the director of the company, not "on behalf" of the company
- Since he wasn't signing as an agent, he was neither bound by K nor able to enforce it

Also, in *Baxter*, both sides had an intention to be bound by K, as both knew company didn't exist
- Here, **both parties had mistaken belief** that the company existed

The signature here just confirmed the corporation's willingness to contract
J: No, for D, contract was a nullity

Black et al v Smallwood & Cooper (1966)
F: Both parties sign K for the sale of land with mistaken belief that the company came into existence. Vendors sue for specific performance
I: Are the purchasers bound?
L: Distinguished from *Kelner* because no intention D pays personally
The fundamental question in pre-incorporation contract cases is what the parties intended or must be understood to have intended
A: High Court of Australia holds that *Kelner* doesn't stand for the proposition where a person on behalf of a non existent principal is liable for the contract
- In *Kelner,* the parties intended that the corporation would pay, but also intended that if the corporation did not, then the D would pay personally – the D was the buyer of the goods
- Buying "on behalf of" another party does not mean that you are not buying them, you are
- Here it was not the intention of the D to be bound personally…ie: both parties thought the company existed

Instead, intention of the parties to be bound is critical
- Court looks for anything in the writing inconsistent with the conclusion that the defendants should be bound personally
- Here, intention of the parties was not that the individuals would be bound, and since it was with a corporation, a K with a non-existent entity is no K at all
- Note P may have succeeded in a claim for breach of warranty of authority, but didn't plead it

H: No, for D, contracting party didn't exist, so K was a nullity, and claim for specific performance fails

Wickberg v Shatsky (1969)
F: D's were shareholders in an old company, set up a new company to take over but wasn't incorporated. Before this, they hired P as manager with letterhead for this new company that didn't exist. Later, P was fired over a dispute on commission when company went into financial difficulty. P sues for wrongful dismissal, where P must prove employment K existed. P argues D, who signed on the letter, was personally liable because letter had non-existent company

I: Was D personally bound?
L: Third parties can get remedy through breach of warranty of authority

- If there is no ratification, and the company never comes into legal existence, promoters that act falsely may be sued for breach of warranty of authority if loss flowed from the misrepresentation

A: Two approaches to *Kelner v. Baxter*:

- Rule of Law Approach
  - Promoters automatically liable when they sign as agent on behalf of non-existent company
- Rule of Construction Approach
  - Liability depends on whether it was intended that promoter be a party to the contract
  - This is the approach the court takes here
  - Here, like *Black v. Smallwood*, neither party intended that the defendant be personally liable

However, he was successful with his breach of warranty claim

- D knew the new company didn't exist and wrongfully told him he existed, even when they abandoned any intention of forming a corporation with that name
- However, even if company did exist, he wouldn't been able to collect damages from wrongful dismissal claim, as company was bankrupt
- Lost out because company went broke…not because of the misrepresentation/breach of warranty

Thus even if it's clear there was no intention to be bound, and corp never came into existence, third party still has a remedy not because of K but because promoter breached warranty of authority
H: No…although P got $10 of nominal damages for breach of warranty of authority

Summary of the common law position so far:

- If persons signing for the corporation were intended to be personally liable, they will be
  - However, if that wasn't the intention, they won't be personally liable
  - *Kelner*: parties intended that parties would be personally liable
  - *Newborne* and *Smallwood*: parties intended that promoters would not be personally liable
- *Kelner* – companies not in existence can't ratify a contract…need a new K
- Hard to explain imposition of promoter liability where both parties honestly believe that the firm is incorporated since everyone will then expect that the only K is with the firm
  - For this reason, promoters weren't personally liable in *Black* and *Newborne*.

Sherwood Design Services Inc v 872935 Ontario Ltd (1998)
F: P was company that was to be sold to individual persons in trust "for a company to be incorporated." D gets in touch with their lawyers who give them a "shelf company." Shelf companies are companies incorporated by a lawyer for the purpose of transferring to a client who needs a corporation fast. D's lawyer sent P a letter stating "872935 will purchase Sherwood." Individuals then decided against the purchase, never took the corporation, and the corporation was transferred to another client a year later. P wants to sue for breach, but doesn't want to sue individuals personally, as they have new assets. Instead, P sues corporation under new ownership that owns a valuable commercial building. TJ said letter didn't bind corporation because a corporation acts through its agents/corporate officers, and individuals never instructed the lawyer to draft the letter to authorize the purchase
I: Was the corporation bound by purchase agreement executed by individual respondents when the corporation had no legal existence? Did the lawyer's letter constitute "action" by the corporation signifying an intention to be bound?
L: Lawyer's letter adopted K

- No formalities are required to bring a company within the ambit of statutory provisions regarding adoption of pre-incorporation contracts; as long as there is a letter, it's enough for a third party to rely on

A: P argues that the legal effect of the lawyer's letter is ratification of the pre-incorporation contract

- Even though there is almost no link between the individuals and the current corporation, company adopted the contract according to P

There are two positions:

- Common Law
  - Company isn't bound by pre-incorporation K because it didn't exist, and promoters may/may not be liable depending if the signed as agents, and may be liable for breach of warranty
  - Still important because statutory reforms aren't in place everywhere (BC – see s.
- Statutory Reform of the Common Law
  - 3 propositions which formed the basis of legislation:
    i) Corporation should be able to adopt/ratify a pre-incorporation K made on its behalf
    ii) Prior to any such adoption, promoter should be personally liable on the contract and entitled to enforce it

iii) Court should have discretion, in appropriate circumstances, to apportion liability between the promoter and the corporation

H: Yes, for P (with big dissent by Borins J.)…clients who bought shelf company were liable because of letter written by solicitor which majority of court found was ratification of a pre-incorporation K

We get two judgments, representing different takes on the statutory provisions:

- Dissent – Borins J. – Corporation Not Bound
    - No evidence that D did anything indicating an intention to be bound by the agreement
    - *Act* has broad wording regarding ratification (ie: writing, conduct, ect…) but it must be an act of the corporation, which the evidence here doesn't support
    - P should have done an inquiry that the letter was unsigned, and can still go after individuals
    - Interprets statute narrowly to give corporation freedom to choose whether to accept or reject the pre-incorporation contract
- Majority – Abella J. – Corporation Bound
    - Letter was from company's lawyer, who acted as a representative of the corporation
      - Director instructed/allowed lawyer to write the letter (**C**: this is a legal fiction)
    - Doesn't matter that individuals weren't shareholders when letter sent…what matters is that the letter was an unequivocal expression of the company's adoption and intention to complete the agreement of purchase and sale (**C**: too generous an interpretation)
    - Interprets statute generously to protect third parties and make it easier for individual promoters to get off the hook

Case also relevant for solicitor's powers to bind a company

Comment: Again, don't forget that s.14 of *CBCA* changed this CL position, which states that promoter is personally bound unless K says otherwise, and corporation can ratify pre-incorporation K where intent to be bound

How to Get Money into Corporation?

Financing

Financing: Introduction

- Two kinds of financing for getting capital for the corporation:
    - **Debt Financing**
        - Corporation borrows money, with an obligation to repay the debt (ie: bonds or debentures)
        - This entitles you to repayment plus interest
    - **Equity Financing**
        - Corporation raises money by offering new shares to purchasers
        - This entitles you to a share of the profits, dividends, and residue during wind-up

Christopher Nicholls, "Corporate Law" (2005)

There are many differences between debt and equity:

- **Debt Ranks Ahead of Equity**
    - When a company that has borrowed money is wound up or liquidated, the assets are sold
    - Proceeds of sale go first to satisfy claims of outstanding creditors
    - Corporation's shareholders receive nothing unless every creditor is repaid any penny owed
- **Debt Must Be Repaid**
    - In contrast, money received from investors becomes part of the corporation's permanent capital
- **Interest Payment Deductibility**
    - Interest payments on any money borrowed can be deducted from the corporation's income calculated for tax purposes…result is corporation will pay less income tax
    - With equity, when corporation makes distribution to shareholders, that distribution – a dividend – is not deductible by the corporation in calculating its income for tax purposes
- **Dividend Payments**
    - Interest payments received by debtholders are taxed as ordinary income
      - Dividend payments benefit from *Income Tax Act's* "dividend tax credit"
- **"Dilution" of Ownership**
    - When a corporation raises money by issuing more shares, it also issues more votes

- However, there are many ways in which a corporation may raise equity capital without diluting the ownership or control of its existing shareholders (ie: no voting rights shares)

The Share: What is a Share?

Christopher Nicholls, "Corporate Law" (2005)

- A share is a legal, contractual relationship between a corporation and the shareholder, giving the shareholder a "bundle of interrelated rights and liabilities" (La Forest J. in *Sparling*)
    - In NA, a shareholder is frequently said to be an owner of the corporation
- Default position is that the shares confer:
  a) Voting rights – directors, changing articles of the company, etc…
  b) Profits – entitlements to dividends, profits, etc…
  c) Wind-up – get residual claims on assets during liquidation once creditor's claims are satisfied

Sparling v Quebec (Caisse de depot et placement du Quebec) (1988)

F: Caisse created by statute to manage and invest funds Quebec received under gov't programs. Owned 44.3% of Domtar, becoming an insider…once you own more than 10% of the shares in a corporation, you are an "insider" and must file insider reports. Caisse refuses to do this because they're a Crown corporation and get Crown immunity
I: Is the Crown bound by the *CBCA* when it purchases shares to which the *CBCA* applies?
L: A share is distinct from personal/real property

- **La Forest J: A share is not a piece of property so much as a bundle of rights and obligations**

A: Court uses the **benefit/burden exception to Crown immunity**:

- If the Crown claims a statutory right, it must also take the corresponding obligations upon it

La Forest J: "a 'share' and thus a 'shareholder' are concepts inseperable from the comprehensive bundle of rights and liabilities created by the *Act*. Nothing in the statute, common sense or the common law indicates that this bundle can be parceled out piecemeal at the whim of the Crown."

- Here, buying shares is taking advantage of the *CBCA*, so you must also accept its burdens

H: Yes, for Sparling

Formalities of Capitalization

- Some concepts from the text:
    - <u>**Authorized and Issued Capital**</u>
        - Authorized capital, which is usually stated in the corporation's articles, indicates **how many shares the corporation is authorized to issue**
        - By contrast, "issued" or "outstanding" capital refers to the shares actually issued
        - Nowadays, it is normal to issue an unlimited number of shares, but it is still possible to put restrictions on the issue of shares in the articles under *CBCA* s.6(1)(c)
    - <u>**Common and Preferred Shares**</u>
        - On incorporation, a decision must also be made as to how many classes of shares may be issued, since such classes must be stated in the articles (s.6(1)(c))
        - Two main kinds of shares:
            - **Common shares:** These are default shares, generally free of all preferences or conditions, entitles shareholder to one vote, has last priority of residue during wind-up, etc. s.24(3): 3 rights: **voting rights, dividend rights, and rights on liquidation**
            - **Preferred shares**: These actually give the shareholder some preference, such as return of capital, payment of dividends. Usually have better rights to dividends and dissolution, but generally don't have voting rights
        - There is an almost unlimited number of restrictions and conditions one can put on shares
        - *CBCA* doesn't require at lease one class of common shares…capital may consist solely of "Class A common" and "Class B common" shares, both with special rights
        - OK to have multiple classes of shares…theoretically infinite
        - Most closely-held corporations don't have multiple classes of shares (with exceptions)
        - Usually need multiple classes for tax purposes or to attract certain kinds of investors
        - <u>**Subscriptions for Shares**</u>
    - Subscription agreement is a contract in which a corporation undertakes to issue shares to subscribers

- These formerly used to be a source of litigation because it was possible to buy shares, pay only a portion of the purchase price, and agree to pay the balance later…scenario was shareholder would pay a portion, company would go bankrupt, and the liquidator would successfully purchaser

Pre-Emptive Rights

- When new shares are issued, existing shareholders get a right of first refusal to buy a percentage of those shares to preserve their relative position in the company
- This is how an existing shareholder may seek relief when watered stock is issued
- Prevents directors from diluting existing shareholders financial interest in the corporation

Following case states the United States common law position on pre-emptive rights, but is not the law in Canada, as the law developed differently

- In most jurisdictions, shareholders didn't have pre-emptive rights unless specifically provided for
- However, *Stokes* is useful for an analysis of general shareholder rights

Stokes v Continental Trust Co (1906)

F: D was banking corporation and wanted to issue 5000 new shares to another bank, which was approved by a majority of existing shareholders. P was part of dissenting group of shareholders opposing the plan, and sued D stating he was entitled to purchase his pro rata share in the number of shares…statute was silent

I: Did P have a legal right at common law to subscribe for a portion of these shares?

L: Pre-emptive rights to dissenting shareholders

- US common law position is that shareholders have absolute pre-emptive rights to maintain their financial position in the corporation

A: Court begins with analysis of shareholder rights and rights when they are outnumbered

- Share of dividends, right to vote on directors, right of surplus on liquidation are all mentioned

Right to increase shares is a right the corporation holds for every shareholder, not just majority

- However, the court holds that a shareholder has an inherent right to a proportionate share of new stock issued for money only, and although it can be waived, it cannot be taken away
- Policy underlying is to prevent the "tyranny of the majority"

Here, P had an absolute right to the new stock in proportion to his holding of the old, and he gave notice that he wanted it

- It was his property, and it could not be disposed of without his consent, and he didn't consent

H: Yes, for P

Re Bowater Canadian Ltd v RL Crain Inc (1987)

F: Company had common shares and special common shares, where special shares carried ten votes per share, but once shares were transferred, the transferee had only one vote. This "step-down" provision was the only difference between the shares. At trial, TJ severed provision and special common shares carried ten votes regardless of transfer

I: Can the provision stand against the *CBCA*?

L: All shareholders of class treated equally

- Rights constitutive of shares of a given class must be the same for all shares of that class

A: Court looks to *CBCA*, s.24(5), where "if a corporation has more than one class of shares, the rights of the holders of the shares of any class are equal in all respects"

- Each company must have at least one class of shares with regard to voting rights, share of dividends, and receive assets upon liquidation
- If company has only one class of shares, they will contain all of these rights, and a company can't have a set-up where no shareholders have voting rights
- Articles of incorporation sets out these different rights

Here, rights attach to the share, not the shareholder

- Thus a company cannot change the voting rights depending on whether they are held by the subscriber or the transferee
- If there were not equality of rights within a class of shareholders, there would be a great opportunity for fraud

Court also holds that the step-down provision can be severed without affecting the validity of the provision for ten votes for each special common share

Shows that while you can have many share classes, with a variety of rights and restrictions between them, corporations should have the same rights and restrictions attaching to each class of shares

- However, while the case stands for equality principles that apply to shareholders and/or shares, it's unclear which one they apply to, or both

H: No, for Bowater

Preferred Shareholders

P Hunt, C Williams and G Donaldson, "Basic Business Finance," (1974)
Preferred shares are **unlike debt securities**; they constitute ownership interest, much like common shares
- Doesn't contain any promise of repayment of the original investment
- No legal obligation to pay a fixed rate of return on the investment

However, common shareholders agree that preferred shareholders shall have "preference" or first claim in the event that the directors are able and willing to pay a dividend
- ie: Warren Buffet recently acquired large amount of preferred shares in Goldman Sachs

Companies may decide not to issue a dividend, but this is usually a very bad sign
- *Ford*: directors must make such a decision for valid purposes\

Shareholder agreements may assign different rights to different classes of preferred shares

Dividends
- *Black's Law Dictionary*: "dividend" is "a portion of a company's earnings or profits distributed *pro rata* to its shareholders"
- Everybody that has one class of shares must be paid the same amount of dividends
- A corporation may issue 3 kinds of dividends:
  1. **<u>Cash dividend</u>**
     - Most common
  2. **<u>Dividend *in specie*</u>**
     - Most common dividend *in specie* is the "spinoff", which involves giving shares that a corporation holds in a subsidiary, thus distributing a dividend in property rather than cash
  3. **<u>Stock dividend</u>**
     - Corporation issues more of the corporation's shares to its existing shareholders
     - Unlike the other two, there is no change in the assets of the corporation here
- Since every shareholder of a particular class must get the same dividend, their proportionate share in the company can't be affected…they just get more shares at a lower market value
- *CBCA* doesn't say much about dividends, except:
  - **s.43(1)** provides that "a corporation may pay a dividend by issuing fully paid shares of the corporation (stock) and …a corporation may pay a dividend in money (cash) or property (*in specie*)"
  - **s.102(1)** gives power to declare dividends as a power of the directors subject only to a unanimous shareholder's agreement
- There is no duty on the corporation, or on the directors, to declare dividends…they only declare a dividend if they think it is appropriate to do so based on:
  - **<u>Fiduciary Duty:</u>**
    - *Ford Motor*: Ford's decision to expand his production system for the greater benefit of society, not to generate more profit for the company, was a breach of the duty of the directors to act in the best interests of the corporation
  - **<u>Oppression</u>**
    - Directors may be obliged to pay a dividend where a failure to do so would be oppressive or unfairly prejudicial to, or would unfairly disregard the interests of, one or more shareholders
- In order for directors to pay a dividend, s.42 of *CBCA* provides that dividends cannot be declared or paid if the corporation is insolvent at the time or if payment would make the corporation insolvent:
  - **<u>Part V – Corporate Finance</u>**
    - **42 Dividends:** "Corporation shall not declare or pay a dividend if there are reasonable grounds for believing that
      (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
      (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes"
- Thus there is a 2-part test in section 42:
  - **<u>Liquidity Test</u>**
    - Are there enough assets to covert to cash to meet the corporation's liabilities?
  - **<u>Realizable Value Test</u>**

        - Could the corporation repay all its liabilities and return all capital upon liquidation?
- Also note section 118(2)(c) of the *CBCA*:
    - **Part X – Directors and Officers**
      118(2) Further directors' liabilities
        - "Directors of a corporation who vote for or consent to a resolution authorizing any of the following are jointly and severally, or solidarily, liable to restore to the corporation any amounts so distributed or paid and not otherwise recovered by the corporation:
          (c) a payment of a dividend contrary to section 42"
- Thus directors can be personally liable if they consent to a resolution declaring a dividend where there are reasonable grounds for believing that the corporation is insolvent or would become insolvent on the payment of a dividend
- Often directors will get an opinion from accountants as to whether s.42 tests are satisfied before declaring a dividend and before paying it

How and Who to Manage a Corporation

Introduction to Corporate Governance

The Wealth Maximization Theory

- Shareholder Wealth Maximization
    - Agency Theory
        - Managers are agents; shareholders as principles
    - Contraction Theory
        - Nexus of contracts – a web of interrelated contracts among various stakeholders
- Stakeholder Wealth Maximization
    - Team Production Theory

Richard A Posner, "Values and Consequences: An Introduction to the Economic Analysis of Law" (2007)

- The economic analysis of law, as it now exists not only in the United States but also in Europe, which has its own flourishing law and economics association, has both positive, that is descriptive, and normative aspects.
- It tries to explain and predict the behaviour of participants in and persons regulated by the law
- It also tried to improve law by pointing out respects in which existing or proposed laws have unintended or undesirable consequences, whether on efficiency, or the distribution of income and wealth, or other values.

Richard A Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1980)

- These characteristics of wealth maximization are not accidental … the perfectly free market, in which there are no third-party effects, is paradigmatic of how utility is promoted non-coercively, through the voluntary transactions of autonomous utility-seeking individuals.
- The system of wealth-maximization consists of institutions that facilitate, or where that is infeasible approximate, the operations of a free market and thus maximize autonomous, utility seeking behaviour.
- Because utility seeking in a market requires inducing others to enter those transactions advantageous to them, wealth is automatically transferred to those who have productive assets, whether goods or time.
- The system of wealth maximization outlined in this article could be viewed as one of constrained utilitarianism.
- The constraint, which is not ad hoc but is supplied by the principle of consent, is that people may seek to promote their utility only through the market or institutions modeled on the market

William W Bratton Jr, "The New Economic Theory of the Firm: Perspectives from History" (1989)

The nexus of contracts theory (proposed by William Bratton, p 41) is that the firm serves as a nexus for a set of contracting relations among individual factors of production. The theory is meant to stand in contrast to a management centred conception. The firm springs out of contracts in markets for corporate securities, managers, and other labour. Since the contracts are bilateral, management power and corporate hierarchy, as previously conceived, disappear. In a firm of bilateral contracts between free market actors, both parties possess equal power to contract someplace else.

The theory applies the principle of natural selection and posits that rational economic actors solve problems in the process of pursuing wealth maximization. One component of the theory is that firm contracts take forms determined by the imperative of agency cost reduction. Since rational economic actors know about agency costs, they charge these costs against their contracting

partners ahead of time. Given competition, the party that most reduces agency costs has the edge. Thus the lowest cost contract forms survive. Within the nexus of contracts theory, managers act as agents of shareholder principals and attempt to maximize shareholder wealth.

The Corporation as a Mediating Hierarchy

Margaret M Blair and Lynn A Stout, "A Team Production Theory of Corporate Law" (1999)
The mediating hierarchy theory (proposed by Blair & Stout on p 43 of the textbook) "builds on" the "contractarian" thinking of the nexus of contracts theory by "acknowledging the limits of what can be achieved by explicit contracting." Blair & Stout argue that an essential but frequently overlooked "contract" fundamental to public corporations is the "pactum subjectionis" under which shareholders, managers, employees, and other groups that make firm-specific investments yield control over both the investments themselves and the resulting output to the corporation's internal governing hierarchy. They say that the notion that shareholders "own" corporations is incorrect because shareholders rights are of such limited value that they are unlikely to influence the outcome except in extreme cases.

Corporate law thus leaves boards of directors free to pursue whatever projects and directions they choose.
The mediating hierarchy is a "team production analysis" of the public corporation. If corporate law is not designed primarily to protect shareholders—if, instead, it is designed to protect the corporate coalition by allowing directors to allocate rents among various stakeholders, while guarding the collation as a whole only from gross self-dealing by directors—then the rules of corporate law begin to make more sense.

- In recent years it has become common for both economic and legal theorists to view a corporation as a nexus of contracts, explicit and implicit
- This article discusses an approach to thinking about public corporations that does not reject the contractarian approach, but builds on it and acknowledges the limits of what can be achieved by explicit contracting
- Another possibility: assigning control rights not to shareholders nor to any other stakeholder in the firm, but to a third party – the board of directors – which is largely insulated from the direct control of any of the various economic interests that constitute a corporation
- Thus, an essential but generally overlooked "contract" fundamental to the nature of public corporations is the "pactum subjections" under which shareholders, managers, employees, and other groups that make firm-specific investments yield control over both those investments and the resulting output to the corporation's internal governing hierarchy.
- The mediating hierarchy model proposed explains many important aspects of corporate law much more robustly than alternatives, especially principal-agent theories premised on the notion that shareholders "own" corporations
- The mediating hierarchy approach suggest that shareholders' voting rights should be extremely limited, and that shareholders should be allowed to sue directors only when this serves the interest of the corporation as a whole, rather than serving shareholders' interests at the expense of other stakeholders.
- The mediating hierarchy approach offers three valuable lessons
    1. It highlights the importance of team production dynamics in the rise of the public corporation as a vehicle for dong business. When the central contracting problem investors face is the principal-agent problem, they do not need public corporations. Instead they can organize and manage their businesses using explicit contracts and alternative organizational forms – including partnerships, limited liability companies, and privately held corporations – that permit them to retain far more control over managers and employees
    2. Scholarly and popular debates about corporate governance need to recognize that corporations mediate among the competing interests of various groups and individuals that risk firm-specific investments in a joint enterprise. Future scholarship should explore in greater detail the internal and external political and economic pressures that affect the decision-making process in firms.
    3. A trend in corporate restructuring produced "leaner and meaner" corporations that are more attentive than ever to shareholders' desires, and returns from share ownership have correspondingly increased. At the same time, directors' new focus on shareholders' interests has adversely affected other corporate constituencies – especially rank-and-file employees – whose relative returns from participating in corporate enterprise seem to have shrunk even as shareholders have proposed.
- Corporate directors as mediating hierarchy enjoy considerable discretion in deciding which members of the corporate coalition receive what portion of the economic surplus members of the corporate coalition receive what portion of the economic surplus resulting from team production
- Mediating hierarchy model also suggests a second possible interpretation of this redirection of corporate wealth from employees to shareholders. The shift can be explained as a response to changing market forces which have altered various

team members' opportunity costs and thus, the minimum rewards they must receive to have an incentive to remain in the team.
- Our theory suggests that the shift in the balance of power in boardrooms toward shareholders is the result of directors' sudden recognition that shareholders are in fact "owners" of the corporation, however, but of changing economic and political forces that have improved shareholders' relative bargaining power vis-à-vis other coalition members
- If the driving forces are political, whether shareholders or employees receive a greater share of the rewards of the corporate enterprise may be a matter that raises primarily distributional concerns.
- If the shift reflect economic factors, however, it represents an efficient readjustment essential to continued team production.
- Emphasis should be placed on principal-agent problems in the corporate literature during the last two decades has been both excessive and misleading. Future debates about corporate governance will be more fruitful if they start from a better model that more accurately captures the fundamental contracting problem corporation law attempts to resolve. The mediating hierarchy is a first step toward that better view.

Introduction and Different Perspectives on Governance of the Corporation

- Corporation can only act through the decisions of real people, and the broad mandate given to directors and officers to oversee and manage the business and affairs of the corporation means that these corporate officers are ultimately responsible for the actions of the corporation and its various employees that engage in productive activity on behalf of the corporation
- While directors and officers have an obligation to act in the best interests of the corporation, the issue is whether that means that they are to be concerned with the interests of others that have investments in the firm, such as capital lenders, trade suppliers, and employees.
- Directors and officers have an obligation, in exercising their duties, to act honestly and in good faith with a view to the best interest of the corporation, and to exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.
- What are the best interests of the corporation?
- Who's interest should these entities have had had in mind? To whom, if any, do they owe responsibility? Who are affected by these corporate decisions?
- Come up with arguments for broader/narrower views on the responsibilities and duties of corporations and those who govern them…try to connect textbook theories with current global events
- Questions: (group discussion)
  - **Which groups are most directly affected by corporate acts/behaviour?**
    - Shareholders are the primary group affected…majority shareholders lose their entire life. Their interests should dominate because they assume risk and are said to "own" the company
    - Creditors are affected, as they provide money and don't receive any renumeration
    - Employees of the corporation
    - Public that can claim against the corporation in terms of tort liability
    - Consumers support corporation because they pay more than corporation pays to produce, so without them they wouldn't exist
    - Taxpayers that have to bail out corporations in trouble
    - Depends if analysis is on micro or macro level
  - **To whom do corporate managers/directors owe duties? What kinds of duties?**
    - Owe duty to corporation itself, and the main people affected there are shareholders
    - Owe duty to **shareholders alone**, and it's the government's responsibility to regulate themselves
    - Job is to maximize profits, but another is to maintain a caretaker role for the benefit of the company…they create externalities and create costs if not addressed by government action
    - Good managers don't forecast for the future to due to market unpredictability…they plan for now
  - **Consider arguments for narrower/broader definitions of corporate responsibility?**
    - Corporate vehicle should be for the corporate purpose only…other responsibilities should be left for other entities, such as government
    - In terms of environmental impact, shareholders often will attempt to be 36illfully blind in terms of environmental degradation and won't accept any costs to fix the problem
    - Broader definition is to go beyond stakeholders where it affects standard of life and community as a whole, not just because they are told to do something
- Under our legal system, officers of the corporation owe duties to shareholders and creditors principally
  - Shareholders elect directors, who set policy and are ultimately responsible for running the company

- Their obligations under *CBCA* are twofold:
  - **Duty of loyalty**
  - **Duty of care**
- These duties are to be interpreted as protecting shareholders and creditors alone

Adolf Berle and Gardiner Means, "The Modern Corporation and Private Property" (1932)

- Corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on. Though still much used for this purpose, the corporate form has acquired a larger significance. The corporation has, in fact, become both a method of property tenure and a means of organizing economic life. Grown up to tremendous proportions, there may be said to have evolved a "corporate system" – as there was once a feudal system- which has attracted to itself a combination of attributes and powers, and has attained a degree of prominence entitling it to be dealt with as a major social institution.

Lawrence Mitchell, Ed "Progressive Corporate Law" (1995)

- No institution (the corporation) other than the state so dominates our public discourse and our private lives. In our world, corporations make most everything we consume.
- This collective power also leads to the problems created by corporations. They pollute our environments, they impoverish our spirits with the never-ending message of consumerism.

Robert Yalden, "Competing Theories of Corporation and Their Role in Canadian Business Law (2003)

- If one stands back and looks at the parameters of the debate, one cannot help but be struck by the act that each side starts from a very different set of assumptions about whose interests most need protection.
- If these perspectives are to avoid simply talking past each other, then we need to develop a richer understanding of the theory of the firm that each is starting from and the extent to which our business law framework already reflects ideas fundamental to one or more of these competing theories
- Only if we get a clearer sense of the assumptions underlying these perspectives, as well as the extent to which public policy choices that shape our business law reflect assumptions of this kind, can we then hope to move forward toward both a shared understanding of those choices and a genuinely fruitful debate about the choices that need to be made in the future.

The Corporation as a Nexus of Contractual Relations

- One theory of the corporation that has had broad acceptance is the nexus of contractual relations approach, one of several contractarian approaches to corporate law that base their analysis on what they characterize as the contractual relationships between corporate actors.
- This theory of the corporation suggests that the corporation is a nexus of complex contractual relationships between a variety of inputs that produce an aggregate of goods and services, such as managers contracting with trade suppliers for raw materials or financial institutions for working capital.
  - Under this view, the role of corporate law is enabling; it should contain the terms that people would have negotiated in their contractual relationship with the firm, were the costs of negotiating at arm's length for every contingency sufficiently low.
  - A feature of this model is that markets and private contractual relations should govern the corporation, as opposed to public regulation, which should be facilitating only, in the sense that the goal of the law is to allow corporations to function more easily, not to restrict corporate activity
  - Under this model, shareholders are gien primacy as the residual claimants to the corporation's assets and as the parties that are least able, according to the theory's proponents, to contract to protect their inputs into the corporation.
- Under the nexus of contractual theory of the corporation, managers are agents of the corporation.
- Shareholders, as residual claimants, need to control the agency costs of managerial self-dealing or shirking, since increased agency costs detract from return to shareholders.
- While this approach to corporate law has the advantage of creating a simple paradigm, it fails to take into account of other stake holders who are equally unable to fully contract their relationship with the firm, and who, depending on the firm's solvency, may be the residual claimholders rather than the shareholders.
- **Under the nexus of contractual relations theory, the role of directors and officers is to maximize the wealth of shareholders**
- This approach does not align very well with the notion in our corporate law framework that directors have an obligation to act in the best interests of the corporation as a whole.

Daniel Fischel, "The Corporate Governance Movement" (1982)

- Those who argued that corporations have a social responsibility and, therefore, that managers have the right, and perhaps the duty, to consider the impact of their decisions on the public interest assume that corporations are capable of having social or moral obligations. This is a fundamental error
- A corporation … is nothing more than a legal fiction that serves as a nexus for a mass of contracts which various individuals have voluntarily entered into for their mutual benefit.
- Since it is a legal fiction, a corporation is incapable of having social or moral obligations much in the same way that inanimate objects are incapable of having social or moral obligations.
- Viewed as a contact issue, the question can be analyzed in much more concrete terms
    - Do investors, as long as corporations lawfully may be formed for profit, have any duty to sacrifice profitable opportunities to benefit from some other parties?
    - And do managers, acting as agents for investors, have any right or duty to sacrifice profitable opportunities to benefit some other party?
    - The answer to both questions: Manages should act to maximize the wealth of investors pursuant to the terms of the contract of their agency relationship

Team Production Theory

- This theory views the corporation as a team that includes managers, shareholders, employees, and creditors who pool their resources to produce goods or services for mutual gain
- Under this model, corporate officers are a "mediating hierarchy" in advancing the productive activities and interests of other team members
- The role of other members of the team is to maximize production but to act as a control on managerial shirking (failing to meet their duties and obligations) and rent seeking (managing in a manner that brings personal benefit to the managers rather than making decisions in the best interests of the corporation)

Margaret Blair and Lynn Stout, "A Team Production Theory of Corporate Law" (1999)

- The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decision-making process in hopes of sharing in the benefits that can be had from team production
- Because shirking and rent-seeking can erode or even destroy the gains that can be had from team production, it is also in the collaborative interest of team members to minimize such behaviour if the terms of the relationship among the team members call for them to share in any rents
- We believe, however, that our mediating hierarchy approach, which views public corporation law as a mechanism for filling in the gaps where team members have found explicit contracting difficult or impossible, is consistent with the "nexus of contracts" approach to understanding corporate law
- Thus, the primary job of the board of directors of a public corporation is no to act as agents who ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members. Rather, the directors are trustees for the corporation itself – mediating hierarchies whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together
- The notion of a mediating attempts to take account of multiple parties to the corporate relationship and to recognize the needs and interests of parties other than shareholders
- Critiques of team production theory have suggested that under the theory, allocation of the surplus is a matter of power, as participants compete to strike the best bargain with the board of directors; hence parties that are already vulnerable are likely to continue to be vulnerable to any misconduct by corporate officers.

Agency Costs as Analytical Tools

- Within theoretical approaches such as the nexus of contractual relations or team production theory, agency costs are one tool for understanding behaviour
- Agency costs analysis is an analytical tool, not a legal relationship
- As economic agents of the firm, directors and officers may justify particular decisions as cost-controlling measures
- Agency costs arise when one person relies on another to do something on her or his behalf. Unlike a sole proprietorship, where all the benefits and risks accrue to the individual engaging in economic activity, in the corporate structure there are employees and managers who are vested with various responsibilities. This separation of ownership and control of the corporation can give rise to agency costs in the same sense that corporate dealing transactions.

- The agents of a corporation are those who have the responsibility to make or to ratify decisions on behalf of the firm, and the principles are those who are thereby affects. The agent will only engage in bonding up to the point that the marginal cost of boding efforts just equals the marginal gain.
- Thus, some potential for actions by the agent that are not in the interests of the principal will remain where the marginal costs of monitoring or bonding outweigh the marginal gains from such activities.
- In the context of corporations with widely held shares, the agents will usually be its managers, and the principals will be various claimholders, such as its outside shareholders, operating lenders, suppliers, customers, employees, involuntary tort creditors, and other creditors.
- One aim of reducing agency costs is to create incentives for officers to maximize firm wealth and reduce self-dealing transactions
- Agency cost is an analytical tool developed by law and economics scholars as a means of understanding the relationships between corporate stakeholders.
- Agency cost theory assumes that managers are the agents of undiversified shareholders, and that governance can be measured by control of agency costs as a means of enhancing economic efficiency.

Strategies to Reduce Agency Costs

- A firm may adopt harm prevention measures aimed at lowering agency costs. Governance strategies can be viewed as harm prevention devices that reduce agency costs by attributing monitoring duties to claimholders or related parties; for example, granting voting rights to one set of claimholders or imposing gatekeeping responsibilities on directors and auditors.
- Liability strategies are bonding tactics in which firm mangers promise efficient performance, with the promise made more credible through the imposition of liability on breach of that promise. The managers' assets then serve as a bond of their fidelity to the promise
- Civil liability under securities legislation is a form of bonding, in that it gives investors an opportunity to seek damages from directors personally for particular kinds of conduct.
- Monitoring strategies need not, however, rest on liability rules. Thus, a firm might seek to reduce agency costs through its internal monitoring of employees, with the sanction for misbehavior found in the firm's hierarchal structures rather than in an action for breach of contract
- A further technique to reduce agency costs involves a firm's compensation decisions.

Agency Costs Strategies and Efficient Capital Markets

- Markets are frequently not efficient, in that stakeholders do not have full information and do not have the bargaining power to require the corporation to adopt efficient governance, liability and compensation strategies to reduce agency costs.
- If capital markets are efficient, then the firm will bear all agency costs and it would voluntarily agree to adopt optimal harm prevention strategies.
- If capital markets are informed of the agency costs of a particular firm, then that firm will bear them itself in its cost of capital and debt.

Corporate Social Responsibility

- The next case is a classic illustration that the purpose of a corporation is to protect and provide revenue for shareholders, not to fulfill other social goals
- However, critics say it doesn't actually reflect the way courts examine the purpose and decision-making of corporations in practice

Dodge v Ford Motor Company (1919)

F: P founded Dodge motor company and started producing chassis for Ford, and were "sick of living in the pocket of Henry Ford" after a while Henry Ford didn't want to provide dividends to shareholders, but rather put the funds back into the business, for the betterment of society

I: Can a corporation be operated for the primary purpose of benefiting someone other than the shareholders? Can a corporation reduce profits or not distribute profits in order to put those assets towards charitable works or reinvestment?

L: Main purpose of corporation is profit for stockholders

- A corporation is organized primarily for the profit of its stockholders, and directors cannot exercise their discretion in such a way that this primary goal is altered

A: Court notes that it's a principle of corporate law that it won't interfere in the decisions of corporations

- Even though the court notes they're not business experts, they order Ford to pay dividends

- However, they won't issue an injunction to halt expansion of the business

H: In part…court ordered dividends must be declared. Didn't find reinvestment for expansion to be problematic, but took issue that Ford wanted to lower price of cars (and thereby lower profits) out of a philanthropic urge

Peoples Department Store v Wise (2004)

- "in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment"

BCE Inc v 1976 Debentureholders (2008)

- "In considering what is in the best interests of the corporation, directors may look to the interests of, inter alia, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions."
- Further, "[w]here the conflict involves the interests of the corporation, it falls to the directors of the corporation to resolve them in accordance with their fiduciary duty to act in the best interests of the corporation, viewed as a good corporate citizen."

Powers of Directors and Officers

Qualification Requirements for Directors

- *CBCA* requirements:
    - **Part X – Directors and Officers**
    - **105(1) Qualifications of directors**

  "The following persons are disqualified from being a director of a corporation:
    (a) anyone who is less than eighteen years of age;
    (b) anyone who is of unsound mind and has been so found by a court in Canada or elsewhere;
    (c) a person who is not an individual; or
    (d) a person who has the status of bankrupt"

  105(2) Further qualifications

  "Unless the articles otherwise provide, a director of a corporation is not required to hold shares issued by the corporation"

  105(3) Residency

  "Subject to subsection (3.1), at least twenty-five per cent of the directors of a corporation must be resident Canadians. However, if a corporation has less than four directors, at least one director must be a resident Canadian"

  - *BCBCA* has no director residency requirements, making it more competitive in attracting firms, and in recognition of the global nature of many Canadian-based corporations

Election and Removal of Directors

- Regarding the election and removal of directors:

  a) **Election**

  - First election must hold for 18 months, must elect at each shareholders meeting
  - s.146(2) – Requirement of shareholder election of directors can't be waived, even by unanimous shareholder agreement

  b) **Term of Office**

  - No limits on reelection, directors terms up to 3 years

  c) **Filling of Vacancies**

  - Directors have power to fill vacancies on the board, subject to exceptions

  d) **Ceasing to Hold Office**

  - Ceases when dies, resigns, becomes disqualified, or is removed from office by a resolution of the shareholders

  e) **Removal of Directors**

  - *BCBCA*, s.128(3): shareholders may remove a director by special resolution, or in accordance with the memorandum or articles, which can specify a lesser vote than a special majority

Bushell v Faith (1970)

F: P and sister voted brother out…D (the brother) said art.9 of company's articles made the removal of him impossible, as agreement changed share rights when voting on removal of directors

I: Is this section valid and applicable and the brother therefore removed? Or is it overridden by s. 184 of the *Companies Act* which

provides that a director may be removed by an ordinary resolution notwithstanding anything in the articles?
L: Articles upheld that attached special weight to certain shares in priv. comp.
- Corporation statues do not operate to fetter the rights of corporations to deal with matters such as voting rights unless the statutory provision explicitly does so

A: In BC, default position is a simple majority needed to pass **ordinary resolutions**, but a 2/3 majority needed to pass a **special resolution** regarding fundamental change in the corporation, but it can be modified by the articles
- Here, *Act* required ordinary resolution to oust a director so that removal of directors was easier
- Court won't interfere with articles, as *Act* had no prohibitions regarding attaching special voting rights shares, so therefore they were OK

H: No, for P, clause valid and resolution defeated
Dissent: art. 9 aims to defeat s.184 and makes a mockery of the law, so art. 9 is invalid
Comment: shows that while directors usually ousted by resolution, corporations can successfully get around statutes in the articles of association by giving a director a special class with special voting rights

Authority and Powers of Directors
- It is the directors who have the authority to manage or to oversee management of the corporation. Corporate statutes often specifically allocate other powers to the directors.
- *CBCA* S.115(3) provides that directors cannot delegate their powers with respect to certain matters such as filling a vacancy among the directors, issuing securities, declaring dividends, purchasing, redeeming, or otherwise acquiring the shares issued by the corporation, or adopting, amending, or repealing bylaws of the corporation

1. *Adoption, Amendment, or Repeal of the Bylaws*
    - The *CBCA* and other corporate statutes also give the directors the power to adopt, amend, or repeal bylaws. The power of the directors to adopt, amend, or repeal bylaws is subject to the articles, the bylaws or a unanimous shareholder agreement.
    - The power of the directors with respect to the bylaws is also qualified by the requirement that any change the directors make in the bylaws must be put before the shareholders at the next annual meeting of shareholders.
    - A change in the bylaws made by the directors is effective until the shareholder meeting and is effective thereafter only if approved by the shareholders od approved as amended
2. *Borrowing Powers*
    - The directors also have power to borrow, subject to the articles, the bylaws or a unanimous shareholder agreement.
    - The directors may also delegate the power to borrow to a directors, a committee of directors, or an officer, subject to any restriction on this power to delegate in the articles, the bylaws, or a unanimous shareholder agreement
3. *Declaration of Dividends*
    - Directors have the power to declare dividends and, under most corporate statutes, this is a power that cannot be delegated.
    - *CBCA* s.115 specifies that the company may declare a dividend and s.171(1) adds that the directors can set the record date for dividends.
    - The declaration of dividends is subject to a solvency test.

Appointment and Compensation of Officers and the Delegation of Powers
- Some of the most significant powers of directors are designating and appointing officers of the corporation, determining the compensation of officers, and delegating management powers to officers. These powers are exercised subject to the articles, the bylaws, or a unanimous shareholder agreement.
- Widely held corporations are typically managed by officers appointed by the directors, leaving the directors largely to a supervisory role.
- However, the power of directors to appoint officers who manage the corporation remains a significant device since shareholders can exercise their voting powers to replace the directors, who can then replace the officers of the corporation

Removal of Officers
- Directors may also remove officers. The power to remove officers is key to the effectiveness of the election and removal of directors as a shareholder control device, because shareholders can express their dissatisfaction with the directors where the directors do not remove in a timely manner officers who are shirking or engaged in inappropriate conduct
- However, removing the officers may permit them to assert actions for wrongful dismissal
- There is a trade-off between preserving the removal of managers as a shareholder control device and providing managers with long-term contracts and compensation in the event that the long term contract is terminated.

- The corporation may benefit if the officer is willing to accept less compensation in return for the security of a long-term contract.
- With the hope of long term reward, managers may be more willing to invest their humans for premature termination, can be efficient, since the managers have a greater incentive to seek long term rewards in the firm

Directors' Meetings

- The mechanics of calling and holding board meetings are usually specified in the corporation's bylaws.
- Subject to the articles or bylaws, the quorum is a majority of the board or a majority the minimum number of directors in the articles.

Outside Directors

- *CBCA* s.102(2) requires that at least two directors of a publically traded corporation be outside directors
- *BCBCA* s.120 requires at least three directors for a publicly traded corporation, but does not have an outside director requirement
- "Independent" outside directors now comprise the majority of board membership in Canadian public corporations, and only one-quarter of board members of firms of all asset sizes are employees of the firm.
- On a narrower definition of outside director, excluding non-employee directors with a business or family relationship to the firm, they still amount to 55 percent of board membership, with a higher proportion for Canadian-owned, widely held corporations
- A subsequent study fond evidence of an increase in the number of outside directors with 64 percent of directors being neither full-time current or former employees nor representatives of parent shareholders
- Outside directors will frequently have had some business relationship with the firm prior to their appointment.
- In *CBCA* s.102(2) the statutory standard of what constitutes an outside director is persons who are "not officers or employees of the corporation or its affiliates," and this would be met by the corporation's retired executives, by its outside counsel, and other retained advisors such as investment bankers.
- Such directors may not be wholly independent of management's influence. However, the most useful kind of outside director is likely one with some relation to the firm, since the flow of information between the firm and its bankers, underwriters, and lawyers is thereby facilitated.
- If board composition might affect firm wealth, it should not be supposed that one kind of board is optimal for every firm. The best board composition may be more easily achieved with a minimum of mandatory rules

Janis Sarra, "Class Act: Considering Race and Gender in the Corporate Boardroom" (2005)

- Diversity on the corporate board can enhance corporate governance, in turn, increasing enterprise wealth maximization
- Overall, the study concluded that an increased number of women on corporate boards is likely to enhance the oversight of monitoring activities of corporate boards.
- Its research found that "diversity on boards… does change the functioning and deliberative style of the board in clear and consistent ways" and that "good governance improves organizational performance over the long term, financially and non-financially."

Christopher Nicholls, "Corporate Law" (2005)

- What role is the outside director expected to play?
- It has long been argued that outside directors are essential to protecting the interests of public corporations' shareholders, especially its non-controlling or minority shareholders.
- Because the board of directors is required to supervise the management of the corporation, if all board members were also executives of the corporation, directors would, in effect, be placed in the untenable role of supervising themselves.

The Ultra Vires Doctrine

- In corporate law, the *ultra vires* doctrine was developed by the courts as a rule that a **corporation had no legal capacity** to act in any fashion not specifically authorized by the incorporating documents
    - ie: if manager acted in disregard of restriction, the **action was *ultra vires* the corporation**
- This signified the manager went not only beyond the scope of his own authority, but also beyond the powers of a corporation as well
- Historically, two ways to form a company:

  a) **<u>Letters Patent</u>**

  - These had all the powers of a legal person…no issue here

b) **Memorandum of Association**

- These set out what the powers of a corporation were…if they went beyond, the act was a nullity
- This is where the *ultra vires* doctrine developed

Ashbury Ry Carriage & Iron Co v Riche (1875)

F: Directors of P wanted to carry out railway construction project, but shareholders said purchase of commission of railway and contracting out construction workers were *ultra vires* the corporation. MOA allowed "to carry on the business of mechanical engineers and general contractors"

I: Was the action within this wording in the Memorandum of Association?

L: Acts done outside the power of the company are ultra vires

- Common law position is that a corporation is restricted by its incorporating documents in the kinds of business it can engage in

A: Purchasing the commission of the railway wasn't within the MOA. It would have been OK if they constructed, but not if they contracted out the construction work

H: No, for D

Legislative Abolition

- Because of these considerations, *ultra vires* doctrine has been substantially abolished in Canada.
- *CBCA* s.15 provides that " a corporation has the capacity and, subject to this Act, the rights, powers and privileges of a natural person"
- Shareholders in small corporations might still sometimes want to restrict the authority of the majority of the board of directors. For this reason, *CBCA* s.16(2) provides that "a corporation shall not carry on any business or exercise any power that it is restricted by its articles from carrying on or exercising."
- The burden of monitoring for default is placed upon the shareholders: *CBCA* s.16(3) provides that "no act of a corporation … is invalid by reason only that the act … is contrary to its articles or this Act"
- While *CBCA* s.16(3) appears to prevent the corporation and persons with whom it contracts from raising an *ultra vires* defence in a breach of contract action, nonetheless a shareholder, a creditor, the director, and other interested parties may sue under *CBCA* s.247 to restrain a corporation and its officers and directors from engaging in activities beyond the scope of its articles
- Current practice in major business transactions is to ignore *CBCA* s.15 and to require a clear demonstration that the corporation with which one deals is in fact authorized to carry out the transaction. In practice, this results in the same demand for certified copies of corporate documents and opinion letters as occurred prior to the *CBCA*

Authority of Agents to Contract for the Corporation

- Assuming that it is within the powers of the corporation to embark upon a given transaction, questions arise to
  (1) who within the corporation has the capacity to contract for it; and
  (2) whether any necessary pre-conditions, such as the securing of shareholder approval for particular transaction, have been fulfilled
- The first issue, who can bind, is a matter of agency law as applied to corporations
- Agency may be created either by actual conferral of authority upon the agent by the principal (actual authority) or by representations made by the principal to a third party that give rise to a reasonable belief in the third party, upon which the third party acts that another is the agent of the principal, so that it would be inequitable to allow the principal to deny the agency (agency by estoppel or "ostensible" authority)
- Corporate transactions always give rise to agency questions since a corporation can act only through human agents

Actual Authority

- The actual authority of an officer of a corporation may be determined by the officer's contract of employment or by a formal board resolution.
- Apart from this, merely appointing a person to serve as an officer will clothe him or her with the actual authority to make the business decisions that a person in his position usually makes, unless that authority is expressly restricted in some way by the corporation.
- Actual authority will also be found to exist where an officer, without formal permission, exceeds the authority that usually attaches to his position, but does so with the knowledge and acquiescence of the corporation.

Defective Appointments

- Section 116 of the *CBCA* provides that where a properly appointed officer or director would have authority to bind the corporation in a particular matter, that authority remains intact even if there has been some irregularity in the appointment or election of the particular person. This amounts to a deemed actual authority to bind the corporation in dealings with third parties. The validity of corporate acts will not be open to wholesale retroactive attack where it later turns out, for example, that the board of directors has been invalidly elected because insufficient notice was given of the shareholders; meeting at which they were elected.
- Section 116 has limits. Factions within a corporation have sometimes fallen out, with two different boards, each claiming to be the validly elected board, acting on behalf of the corporation. Presumably, in such a case, s.116 would not validate the actions of both boards. In addition, there are limits to the extent to which s.116 can be used by one faction to usurp power from a second.

Ostensible Authority: The Indoor Management Rule

- The leading case for this is *Royal British Bank v Turquand (1856)*
  - The indoor management rule:
    - Where an outsider dealing with a corporation satisfies himself that the transaction is valid on its face to bind the corporation, he need not inquire as to whether all of the preconditions to validity that the corporation's internal law might call for have in fact been satisfied.
- The indoor management rule has been both codified and expanded in an important respect in the *CBCA.* Section 18(1) provides that a corporation may not assert as against a person dealing with it that:
  (a) the articles, by laws and any unanimous shareholder agreement have not been complied with,
  (d) a person held out by a corporation as a director, an officer or an agent … has not been duly appointed or has no authority to exercise the powers and perform the duties that are customary in the business of the corporation or usual for such director, officer or agent
  (e) a document issued by any director, officer or agent of a corporation with actual or usual authority to issue the document is not valid or genuine
- *CBCA* s.17 provides that no person is deemed "to have notice or knowledge of the contents of a document concerning a corporation by reason only that the document has been filed" publicly.

How do Shareholders Exercise Voting Rights?

Shareholders' Voting Rights

Shareholders' Voting Rights

Christopher Nicholls, "Corporate Law" (2005)

- Shareholders are often described as "owners" of business corporations, while this is not absolutely correct, it is true that shareholders have important financial interests in the corporations in which they hold shares and hold a unique position in the corporate governance structure.
- Shareholders have the power to elect and remove the corporation's directors, and they hold a residual economic interest in the corporation, a "claim" to whatever value might remain in the corporation after the corporation's fixed claimants have been paid

Shareholder Residual Powers

- Shareholders have the right to approve certain fundamental actions that directors can't do alone, but practically speaking, their only day-to-day power is to vote directors:
  a) **Part X – Directors and Officers**
  102(1) Duty to manage or supervise management
  - "Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation"
    - Thus even if the majority of shareholders think corporate action is a bad idea, they can't force directors to act
- The Power to Manage
  - Although shareholders have the power to elect the directors, they do not normally have the power to manage the corporation.
  - It is the directors of the corporation who "manage the business and affairs of the corporation" (*CBA s102(1))*

Automatic Self-Cleansing Filter Syndicate Co v Cunninghame (1906)
F: Articles stated directors manage shareholders subject to unanimous shareholder agreement. P, McDiarmid, and fellow shareholders who agreed with him, brought a resolution to sell off the corporation's assets and liquidate, and a majority of shareholders agreed…they now sue to enforce it. Directors said such action wasn't in the best interests of the company
I: Are the directors forced to sell the assets?
L: Directors manage company

- Within its realm of authority, as established by the corporation's articles or unanimous shareholder agreement, directors may act in a manner opposed by a majority of shareholders

A: It is possible to amend the articles to pass certain powers from the directors to the shareholders. However, it didn't happen here, so directors still had the powers of the corporation. Duty of directors to take care of not only the majority of the shareholders, but also the minority
H: No, for company

Unanimous Shareholder Agreements

- Specialization economies are less likely to arise in small, closely held corporations, and for this reason, *CBCA* s102 states that it is subject to unanimous shareholder agreement.
- The shareholders can agree to remove authority from the board of directors and give primary managerial responsibility to shareholders, pursuant to *CBCA* s146.
- The directors are then absolved from managerial duties. The requirement that the shareholder agreement be unanimous effectively restricts its scope to small issuers.
- Apart from *CBCA* s146, it is not clear to what extent, if any, a corporation's articles, may alter the statutory allocation of authority between directors and shareholders.

Shareholder Proposals

- Shareholders are permitted, in prescribed circumstances, to bring shareholder proposals to meetings of shareholders.
- The scope of what can be brought is highly regulated
- The proposals, event if accepted by the majority of shareholders, are not binding on directors, they may however, be normatively persuasive, given that directors failing to act on a proposal that receives majority support of shareholders may leave themselves vulnerable to not being re-elected by shareholders

Election of Directors

- While shareholder voting rights do not normally extend to a residual power to manage the corporation, shareholders do have other significant voting rights.
- Most important, shareholders have the right to elect directors of the corporation
- The shareholders also have a right to vote in other situations discussed below.

Amendment of Bylaws

- Default rule under the *CBCA* is that directors have the power to initiate changes in the bylaws, this is subject to the articles, the bylaws, or a unanimous shareholder agreement
- It is possible under the *CBCA* to put the power to change the bylaws in the hands of shareholders
- Even where the power to initiate changes in the bylaws is left in the hands of the directors, the shareholders can make proposals for changes in the bylaws and changes initiated by the directors must be approved by shareholders
- Under *BCBCA* s1(1), a "special majority" is required to pass a special resolution if the articles specify "at least 2/3 no more than ¾ of the votes cast on the resolution"

Fundamental Changes

- Shareholders are given the right to vote in respect of certain changes concerning the corporation that are considered "fundamental"
- *CBCA* s173(1) provides that a "special resolution," two-thirds of the votes case at a meeting of shareholders (*CBCA* s2(1)), is required to amend the articles.
- Other fundamental changes also require shareholder approval, for instance a special resolution of shareholders is required to approve:
  - An amalgamation of the corporation with another corporation
  - The sale or lease of all or substantially all of the corporation's assets;
  - A continuance of the corporation under the laws of another jurisdiction; or

  - A liquidation and dissolution of the corporation
- On these particular fundamental changes, shareholders are generally entitled to vote whether or not the share of the class they hold otherwise carry the right to vote
- Shareholders who dissent from a resolution to amalgamate, sell, lease, or exchange all or substantially all of the corporation's assets, have the corporation continued under the laws of another jurisdiction, or change any restriction on the business that the corporation may carry on are entitled to have their share purchased by the corporation at an appraised value.

Class Voting Rights
- Some changes in the corporation require approval from individual classes of shares or, in some instances, a particular series of shares.
- These class voting rights generally apply where the proposed change is a change in the rights or restrictions attached to a particular class of shares or series of shares, or where the change can have a significant impact on the particular class of shares.
- *CBCS* s176 sets out several situations in which a class of shares is entitled to vote separately as a class.
- *BCBCA* s61 specifies that there must be a "special resolution" of the shareholders of a class or series of shares whose special rights will be "prejudiced or interfered with."
- A separate vote of a series of shares is required where the series of shares is affected differently from other shares of the same class.
- Where there is a right of a class or series of shares to vote separately, the right applies whether or not the shares otherwise carry the right to vote.
- Where separate class or series voting rights apply, a proposed amendment to the articles is not adopted unless each class or series of shares entitled to vote separately has approved the amendment by a special resolution.
- Class voting rights also apply to certain other fundamental changes.
- Shareholders entitled to vote separately as a class or series may also be entitled to a right to have the corporation purchase their shares at an appraised value where they dissent to the resolution.

The Distribution of Voting Rights
- There is no requirement that equity interests must always bear voting rights.
- Preferred shares are frequently non-voting shares and even common shareholders may be disenfranchised.
- There must be at least one class of shares with the right to vote.
- There are some corporate decisions on which all shareholders are permitted to vote.
- Although corporate statutes permit a firm to restrict the voting rights of a class of common shares, in recent years the use of dual class shares, with one class of voting and one of non-voting common shares, has been viewed with suspicion.
- Non-voting common shares are not preferred, and hence have no priority claim to earnings or assets, but they also no not carry voting rights or, at best, have limited voting rights.
- Non-voting shares must be clearly described on selling documents as "restricted" and not as common shares
- The creation of restricted shares must be approved by a majority of the votes of minority shareholders
- Securities regulators have also issued rules regarding restricted shares for issuing corporations, particularly in respect of disclosure of restrictions on voting rights of share and the rights of restricted shares on occurrence of a takeover bid.
- Coattail rights allow restricted shares to be converted into voting shares on terms identical to the offer for the voting common shares is that the restricted shares cannot participate in a takeover bid and share in the premium price offered for the shares, this comes close to a prohibition of non-voting common shares for listed firms that were not "grand-parented."

Voting Restrictions
- One person, one vote policies are also violated when special voting rights are attached to one group within a special class of shares
- Such provisions might either limit the voting rights of large shareholders or endow a class of shares held by firm insiders with more than one vote per share.
- These provisions are often even more clearly directed at preventing a successful takeover bid than are non-voting shares

Jacobsen v United Canso Oil & Gas Ltd (1980)
F: Family controlled management of the company although holding only 0.33% of the shares, so the other shareholders wanted to get rid of them. By-laws had capped voting rights provisions, which held that there was one vote per share, but only up to a maximum of 1000 shares. Therefore, holders with 1000 shares and 100,000 held the same voting rights

I: Did this "shark repellant" provision, which provides that no person shall be entitled to vote more than 1000 shares notwithstanding the number of shares actually held, contravene the *CBCA*?
L: Presumption of equality among shares

- There is a presumption of equality among shares, and in order for different voting rights to be attached to votes, separate classes of shares must be established

A: Rights between the same classes of shares are equal, and you can't restrict voting rights on shares unless a corporation does it through issuing separate classes of shares. Where's there's only one class of shares, the shareholders must be treated equally in all respects, thus contravening s.24(3) of the *CBCA*
H: Yes, provision invalid, for shareholders

Cumulative Voting

- The system of cumulative voting for director elections is designed to guarantee that the minority will be able to elect some members of the board of directors
- In a cumulative voting regime, a shareholder may allocate all of the votes that he or she would be entitled to cast for the election of al directors (the number of shares owned times the number of directors to be elected, assuming one vote per share) among different candidates in any manner he or she wishes
- Since reducing the number of directors to be elected at one time dilutes the benefit that cumulative voting can confer on the minority, it follows that if a board of any given size is classified by staggered terms, that will tend to dilute the effect of cumulative voting
- *CBCA* corporations that permit cumulative voting are not permitted to stagger their board (*CBCA* s107(f))

Mechanics of Shareholders' Meetings

Annual Meetings

- Canadian corporate law requires that annual general meeting (AGM) of shareholders be convened, at which time shareholders
  - Elect directors;
  - Appoint auditors; and
  - Receive the financial statements of the corporation
- The meeting must be called not later than 18 months after the corporation comes into existence and subsequently not later than 15 months after the last annual meetings.
- Although the timing of annual meetings seems straightforward in the legislation, there has been some issue as to timing of such meetings after two corporations amalgamate.

Special Meetings

- Special meetings are shareholders' meetings called at other times, usually to approve some transaction not in the ordinary course of business and for which the incorporating statute or the corporation's constitutive documents requires shareholder approval
- Shareholders have the right to participate in special general meetings where issues such as changing the capital structure of the corporation or other "fundamental" changes are addressed

Ordinary and Special Resolutions

- The terms "ordinary resolution" and "special resolution" are used to describe the quantum of majority approval required for different shareholder votes.
- An ordinary resolution is for which the requisite approval is a simple majority
- A special resolution requires the affirmative vote of more than a simple majority of the votes cast-usually two-thirds in Canada
- Under *BCBCA* s1(1), the amount required must be between two-thirds and three-quarters, depending on what the corporate articles specify and if silent, the statute specifies two-thirds or three-quarters depending on when the corporation was registered
- Generally, matters dealt with at the annual meeting call for an ordinary resolution and matters customarily the subject of a special meetings of shareholders require special resolutions for passage.
- One proposal that is almost always the subject of a special rather than an annual meeting of shareholders – removal of directors before their terms are up –can be approved by ordinary resolution. *BCBCA* s128(3) requires a special resolution or the method provided by the articles

Place of Meeting

- The *CBCA* provides that the meeting is to be held at a place within Canada designate in the bylaws, or, in the absence of such a provision, in the place determined by the directors.
- Under *BCBCA* s166, the meeting may take place either in BC or outside the province if (i) the articles provide so; (ii) if the articles do not restrict the company from approving a location outside BC and approved by the resolution required by the articles for that purpose, or if no resolution is required by the articles, ordinary resolution; or (iii) the location is approved in writing by the registrar.

Quorum

- Typically, the bylaws of a *CBCA* corporation will provide a quorum requirement for a shareholders' meeting
- Otherwise, the *CBCA* provides that, subject to the bylaws, a quorum is present at a meeting of shareholders if holders of a majority of the shares entitled to vote at the meeting are present or are represented by proxy
- Unless the bylaws otherwise provide, it is not necessary that the quorum continue to be present throughout the meeting in order for business to be transacted at the meetings
- In BC, the quorum requirement is as set out in the articles, or is two persons where the articles do not provide however if there is only one eligible voter, then that person is the quorum

The Principle of Notice

- When the directors call a meeting of shareholders, they will generally first fix a "record date" not more than 50 nor less than 21 days before the meeting is to be held, for determining who is entitled to receive notice of the meeting.
- The actual notice of the meeting must be sent to shareholders between 50 and 21 days before the meeting is to be held.
- The notice must specify "the nature of that business in sufficient detail to permit the shareholder to form a reasoned judgment thereon."
- "Special business" includes all business to be transacted at a special meeting and all business to be transacted at an annual meeting except consideration of the financial statements and the auditors' report, reappointment of the incumbent auditor and election of directors.
- If the notice is defective, then the action taken at the meeting may be set aside at the instance of a dissenting shareholder.
- Under *BCBCA* notice of general meeting provisions, s169 requires notice of "at least the prescribed number of days but not more than 2 months before the meeting"

Conduct of Meetings

- The chair of the meeting of shareholders, who is often the president or CEO of the corporation is under a general duty to assist the meeting in achieving its objective.
- To this end, the chair's duties are: (1) to preserve order; (2) to see that the proceedings are regularly conducted; (3) to take care that the sense of the meeting is properly ascertained with regard to any question properly before it; and (4) to decide incidental questions arising for decision during the meeting.
- In exercising his or her duties, the chair is to act in good faith and in an impartial manner

Since control at shareholders' meetings in a public corporation will vest in the party that has secured the most proxies, the chair's conduct has most often be challenged where they reject proxies and thus a proxy battle erupts

- This case deals with the role of the chair in conducting a meeting who is entitled to vote the shares, and what responsibility the chair has to look behind the registrar of shareholders to determine who really has the right to vote.

Re Marshall (1981)

F: In Marshall Boston Iron Mines Limited, registered owners held shares in trust for beneficial owners. William Marshall was director, shareholder and beneficial owners, and he and other beneficial owners gave instruction that shares had to be voted in a particular way. I.e. should vote for their nominee. However, one registered owner ignored this in favour of existing Board of Directors. Marshall now seeks order directing the chair to tabulate votes according to will of beneficial owners.

I: Is it the duty of the chair to go behind the registered owners to assess the dispute between the registered owners and the beneficial owners?

L: Chair entitled to rely on votes as cast by registered owners of those shares

- The Chair of the meeting of shareholders is under a general duty to assist the meeting in achieving its objectives, but does not have a duty to look behind the registrar and ensure that those who were registered voted correctly.

A: Court held that the Chair was not required to go behind the share register. Instead, he could take votes as given by the registered owners as the people entitled to vote the shares. Otherwise, it would require the Chair to investigate the legal relationships between

shareholders. This would have the effect of forcing the Chair to resolve a dispute they didn't have training for, which would delay the meeting and creates chaos as no one would know who was entitled to vote. Thus, chairman at an annual general meeting is not to be placed in the position of determining the legal rights of beneficial owners of shares registered in the name of others.
H: No.

Blair v Consolidated Enfield Corp (1993)

- Deals with the question of whether the chair can avoid being found to have breached the duty of good faith and impartiality if the chair relies on legal advice in making a ruling.
- Also looks at the role and responsibilities of parties chairing a meeting in determining validity of proxies
- Getting legal advice not determinative but good idea

F: Plaintiff was president and chair of meeting of Defendant, and at the annual genera meeting he made a ruling on the validity of proxy votes…declared himself not excluded and that shares should be voted in favour of management on the basis of advice of solicitors. Defendant was a corporate shareholder and disagreed with how votes were counted…declared they voted in favour of the new management board. Trial judge found that plaintiff did not act in good faith with a view to the best interests of the corporation…rather, plaintiff acted in his own best interests, plaintiff now wants compensation
I: Is plaintiff entitled to compensation or did he act in bad faith?
R: Echoes *Marshall,* where the Chair need only look at the registrar and ensure that those voting are permitted to do so, that votes are counted properly, and that proxies are executed properly.
A: Court of appeal used test: "whether the ruling was made with the *bona fide* intent that the company have a lawfully elected board of directors." Here, plaintiff sought legal advice, and court notes that it does not automatically sanctify conduct based upon it as honest and in good faith for the purposes of claiming indemnity…however, legal advice is given weighty consideration, and this legal advice was totally professional. Court finds that some decision had to be made regarding the proxies, and no matter what debate ensued or who the chairperson was, there was "no obvious error nor oversight which would enable the chairperson to turn away from the advice of the company's solicitors." There was no obvious alternative for plaintiff, and any other chairperson would "treat the opinion as ostensibly credible"
H: Yes, judgment for chair.

In the shareholders' meeting process itself, corporate management has several advantages. It controls the meeting agenda. It can solicit votes in the proxy solicitation process from apathetic shareholders who simply sign and return the proxy in form in favour of the management nominee without considering the issues involved. Management nominees also decide on the acceptance or non-acceptance of proxies and tabulate the votes at shareholders' meetings.

Shareholder Voice

- Shareholders are entitled to speak to any matter before the meeting of shareholders
- However, if the right to speak at the meeting were unconstrained, it could frustrate the completion of the business of the meeting.
- Thus, the chair of the meeting acting in good faith and in an impartial manner, must allow shareholder to speak to the matter properly before the meeting, but need not allow moer than a reasonable time for reasonable arguments.

Meetings Requisitioned by Shareholders

- Meetings of shareholders are generally called on by the directors, however corporate statutes permit the holders of a certain proposition of voting shares to requisition the board to call a shareholders' meeting.
- Under the *CBCA* s 143, the holders of not less than 5 percent of the shares that carry the right to vote may requisition a meeting of the shareholders for the purposes stated in the requisition.
- *CBCA* s102 sets out a fundamental principle of corporate constitutionality, with management of the business and affairs of the corporation removed from the purview of shareholders' meetings.

Meetings by Order of the Court

- On an application by shareholders under the *CBCA* s144, a court may order a shareholders' meeting to be called. Such order may be made either if it is "impracticable" to call or conduct a meeting in another way or "for any other reason a court thinks fit."
- When ordering the calling of a meeting or directing the conduct of a meeting, the court is very careful to disrupt as little as possible, and hence will order that any meeting should be called and conducted in conformity with such articles or regulations as far as practicable.
- A court in exercising its discretion to call a shareholders meeting will do so in a manner consistent with the corporation's rules so far as possible. However, the court has jurisdiction to alter quorum and notice requirements.

Intervention on the Basis of Fault

- One issue is whether a court should be more ready to intervene in circumstances where one of the parties seems more at fault than the other.

Widely Held Corporations

- Courts have been able to order shareholders' meetings in publicly held corporations

Re Canadian Javelin Ltd (1976)

- Court intervenes in a battle for control to protect company

F: Publically held company, where the Board is split into opposing camps, each claiming that they were legitimate while the others were not…effectively two boards operating at the same time. One insurgent Board doesn't want to call the annual meeting, and it is difficult to get financing in the USA or meet US securities law requirements without having an annual general meeting. Therefore, competing board seeks a court ordered meeting.
I: Even though the petitioning shareholders own a sufficient number of shares to entitle them to requisition a meeting, should the court order the meeting with the requisition process?
L: Courts will intervene and hold court orders shareholder meetings with an impartial Chair in cases of competing boards of directors to protect public shareholders.
A: Court held that while "impracticable" doesn't mean "technically impossible," here it is impracticable because neither board would recognize the other as legitimate. Boards were in breach of their fiduciary duties to look after the best interests of the corporation. Shareholders and directors could not hope to be fairly treated by either board. Therefore, the only way out of this mess is to hold a court-ordered shareholders meeting with an impartial Chair to ensure that the general meeting goes forth fairly. Thus, important to have meeting because of the detriment to company in not having one. Intervention needed here because the dispute among factions is the source of the problem. Damage was being done to the company, shareholders otherwise. Minimum AGM requirements include electing directors, approving financial statements and appointing auditors.
H: No, "impracticable" to conduct a meeting fairly except under court order

Constitutionality Requirements

Charlebois v Bienvenu (1968)

- Where the meetings were impracticable, and discusses the limits of the court's constitutional powers regarding shareholder requisition meetings under *CBCA* s143
- Court can only award shareholders power they ordinarily have

F: Again, 2 competing boards, and the board that did not get re-elected brought an action claiming that the previous meeting was invalid…thus requested an interim injunction restraining newly elected directors and requesting a new meeting. TJ granted the injunction preventing the new directors from acting as such until trial was to be hold to determine if the last meeting and vote were invalid…effectively suspended directors and corporation
I: Could the court order a new meeting?
L: Courts cannot give shareholders power that they don't normally hold
A: Court had to interpret s.310 of the old Ontario *Corporations Act.*

- It was "aimed at and limited to the removal of difficulties militating against the calling of a shareholder's meeting or militating against the conducting of business which lawfully might come before the meeting"
- This does not entitle the court to go beyond what shareholders could do in an ordinary fashion
- Court can order a meeting of the shareholders, but cannot do anything that the shareholders themselves could not do in the course of an ordinary shareholder meeting
- Therefore, shareholders could only elect directors at an annual meeting, so the court couldn't give shareholders the power to elect directors

H: No, for elected board

Access to the List of Shareholders

- Modern corporation statutes require corporations to keep extensive records and generally to make those records available for inspection by directors and shareholders and sometimes by creditors, and in the case of publically held companies, by "any other person."
- The most important of these records is the list of shareholders. Access to it will be critical for any shareholder who wishes to communicate with fellow shareholders concerning the management of the corporation or his or her desire to change management.

- Under *CBCA* s21(3), a corporation must furnish a current list of shareholders, together with addresses and numbers of shares owned, to "shareholders and creditors… their personal representatives, the Director and, if the corporation is a distributing corporation, any other person upon payment of a reasonable fee."
- The only limitation on this right is that the request must be accompanies by the requestor's affidavit stating that the list will not be used "except with connection with…[a] matter relating to the affairs of the corporation."
- Mechanics of Access
  - The *CBCA* provides two devices whereby a shareholder or other party might gain access to the list of shareholders.
  - First, the shareholder might assert a right to examine the list and to take extracts from it
  - Second, he or she might require the corporation, on 10 days; notice, to provide a copy of the list to shareholders, saving him or her from troubling or making extracts

Shareholder Passivity and The Growth of Institutional Investment

- Shareholder passivity becomes progressively less rational as the shareholder's stake in the corporation increases
- In recent years, changes in capital markets in North America have created the potential for shareholders to acquire large stakes in the corporation.
- Institutional investors such as banks, trust companies, pension funds, insurance companies, mutual funds, and private equity funds have grown significantly in size and importance in both Canada and the US
- These institutional investors have had an increasing influence on corporate decision making
- Such investors are subject to a variety of legal constraints that limit their ability to exert influence over corporate decision making

Institutional Investor Monitoring

- The Canadian investment fund industry is a significant force in the marketplace with over $630 billion worth of assets under management, including mutual funds, commodity pools, labour-sponsored funds, venture capital funds, and closed-end funds. Most of these investment funds engage in some monitoring of corporations, depending on the nature of the investment and size of holdings
- Institutions are constrained in the acquisition of substantial stakes in corporations by laws that impose ownership limits on banks, trust companies, and insurance companies
- Mutual funds are also subject to laws that limit the size of the stakes they can take in any individual corporation. Trust companies and insurance funds are subject to rules either constraining the kinds of corporate shareholdings they can have, or subjecting them to a prudence standard that militates against taking a substantial position in the shares of any given corporation
- Securities laws also put significant constraints on the extent of share ownership an institution takes. A person is deemed to be an insider on the acquisition of 10 percent or more of the voting in securities of a corporation, creating both new disclosure requirements and triggering insider reporting obligations and the restrictions on insider trading
- The restrictions on insider trading put constraints on the institutions ability to sell the shares of corporations which it is an insider, because an insider cannot trade when the insider is in possession of undisclosed material information concerning the corporation.
- If the institution acquires 20 percent or more of a class of shares of a corporation, it is then subject to takeover bid requirements
- Although institutional investors with substantial stakes in the corporation have an incentive to exert influence over corporate governance, there are some constraints. Communications between shareholders are limited because of the risk that those communications will subject them to very costly proxy solicitation requirements
- The constraints on the sale of shares by a "control person" also raise concerns because the person is "acting in concert" with other persons and together they hold a sufficient number of shares to affect materially the control of a corporation
- Although a person is deemed to be a control person if he or she owns 20 percent or more of the voting shares of a corporation, a person can be control person with a smaller portion of the voting shares if the person is in a position to affect materially the control of the corporation. Thus an institutional investor may need to exercise caution in having one or more directors on the board of directors of the corporation since this could result in finding that the institutional investor is in a position to affect materially the employee of the institution on the board of directors of a corporation since it can make the institution subject to insider trading restrictions, thereby constraining its ability to sell the shares
- Institutional investors with significant economic interests in a corporation may have access to information that would allow them to better assess the long term benefits of investments in human capital, perhaps through training programs or other human capital development projects. This could reduce the short-term focus that capital markets with dispersed investors are said to have because of their inability to assess long-term investments.

Voting Arrangements and Governance in Closely Held Corporation

Closely Held Corporations

- The majority of corporations in Canada are closely held corporations, ranging from very small family businesses to large enterprises control by a few shareholders.
- A closely held corporation is normally considered to have the following characteristics:
  - There are relatively few shareholders;
  - Most of all of the shareholders participate actively in the management of the corporation;
  - There is no established market for the shares of the corporation;
  - Frequently there is a restriction on the transfer of the shares of the corporation
- This form of corporation is very popular in Canada because sole proprietors or partnerships that begin to expand their businesses often seek the protection offered by the limited liability provisions of corporate statutes, while being able to continue the management and control of the business
- Closely held corporations can take advantage of the enabling provision of corporate statutes because they do not have the transaction costs of bargaining basic division of powers, shareholders rights, and remedies.
- This corporate form allows for administrative efficiencies through the use of provisions such as waiver of notice to shareholder meetings and resolution by unanimous consent in lieu of meetings
- It can also assist in controlling agency costs, because shareholders of closely held corporations are able to control the actions of directors through unanimous shareholder agreements where they determine that such decisions should be made by the shareholders themselves.
- Closely held corporations also frequently have restrictions on share transfers and issuing of capital in order to protect the interests of existing shareholders, given that there is often not a market for their shares.

Corporate Governance Modifications for Closely Held Corporation

- Governance structures for closely held corporations differ from widely held corporations
- With fewer shareholders, there may be less need for monitoring devices imposed in the context of widely held corporations such as mandatory proxy solicitation.
- A small group of shareholders may more readily assemble to deal with an array of matters of a management nature
- With few shareholders in a closely held corporation, individual shareholders usually have a significant stake in the corporation and have an incentive to protect their investments though more active participation in day-to-day affairs of the corporation
- There are four characteristics of closely-held corporations:
  1. There are **relatively few shareholders**, but need at least one
  2. Most or all of the shareholders are **active in the management of the business**
     - Often they're really partnerships, but they've chosen to carry on business in the corporate form
  3. Tends to be **no established market for corporations shares**
     - When you go to sell your shares, you can't go through a broker, you must find your own partner
  4. Usually there is a **restriction on the transfer of shares**
- Generally speaking, courts are less likely and often reluctant to interfere in governance decisions in management decisions in closely-held corporations, such as in the following case..

Re Barsh and Feidman (1986)

- Where courts are reluctant to interfere in management decisions of small corporations

F: Feldman, Barsh, and Barsh's son had a corporation and each had one share. Last shareholder meeting was on April 1966…now it's 1986…Quorum was 3…all had to be present. Barsh dies and in his will he transfers his shares to his son in trust. Feldman initially refuses to attend the meeting so the son applies to the court for an ordered meeting

I: Should the court interfere with the closely held corporation here, ordering a meeting or reducing the quorum to 2 shares holding 51% of the shares?

A: Court is reluctant to intervene because it would only be favouring Barsh's son in battle for control

- If opposite held, court would violate purpose of setting quorum at 3
- Therefore facts here don't support the exercise of discretion to change the quorum requirements, as it would effectively lock one of the three equal SHs into a company in which he has no control

L: When ordering a calling of a meeting or directing the conduct of a meeting, the court should do as little violence as possible to corporate articles or regulations

- In addition to the lax common law approach, the following statutory modifications are available to closely held

corporations:

a) Waiver of Notice to Shareholder Meetings
- Shareholder can waive notice to a shareholder meeting

b) Resolutions by Unanimous Consent in Lieu of Meeting
- Shareholders resolutions can be passed by having the resolution in writing signed by all the shareholders entitled to vote on the resolution

c) **Avoiding Proxy Solicitation Requirements**
- Expense of proxy solicitation often outweighs any possible gains for shareholders

d) **Dispensing with an Auditor**
- Shares aren't being made public, so corporations with small gross revenues don't need an audit

e) **Financial Disclosure**
- No public filing of financial statements because no public shares

H: No, for Feldman

Different Treatment Under Modern Canadian Statutes
- Modifications available to closely held corporations
  1. Waiver of Notice to Shareholder Meetings
     - A shareholder can waive notice to a shareholder meeting.
  2. Resolutions by Unanimous Consent in Lieu of Meeting
     - In lieu of having shareholder resolutions passed at a meeting of shareholders, shareholders' resolutions can be passed by having the resolution in writing signed by all shareholders entitled to vote on the resolution.
  3. Avoiding Proxy Solicitation Requirements
     - The expense of proxy solicitation and the preparation of a proxy circular is likely to outweigh substantially any possible gains for shareholders in closely held corporations when the shareholders have a sufficient stake in the corporation to keep themselves well informed and to exercise their voting rights.
  4. Dispensing with an Auditor
     - The shareholders of a corporation that has not made a distribution of its shares to the public can also dispense with the requirement of having an auditor.
  5. Financial Disclosure
     - A corporation that has not made a distribution of its shares to the public can also avoid having to publically file its financial statements

Shareholders' Agreements
- The most significant modifications for closely held corporations are the statutory provisions that allow a closely held corporation to modify the default allocation of the power to manage the business and affairs of the corporation to the directors.
- Shareholders can enter into agreements whereby they agree as to how they will cote their shares
- Shareholders can unanimously agree to remove management powers from directors and allocate them to the shareholders. Unanimous agreement among the shareholders is not an agreement that is likely to be achieved in the context of a widely held corporation

Ringuet v Bergeron (1960)
- Can't have an agreement that binds directors' discretion on how to vote

F: Corporation had 4 shareholders with a shareholder agreement to make themselves directors. All 4 were supposed to vote at meetings to do this, and if they didn't, the agreement stated that they had to transfer shares to other parties. As a result, Bergeron was voted out by the others as President, and he wanted a remedy

I: Was this shareholder agreement valid?

L: Shareholders can agree on a variety of matters, but can only agree on their rights, powers, and privileges as shareholders, not on their powers as directors

A: Court held that these kind of shareholder agreements were valid. However, you can't constrain the powers of the directors or fetter their discretion. Can't have an agreement to constrain directors to vote as directors at the meeting. Court rejects argument that the *Act* overruns the shareholder agreement. It's perfectly normal for shareholders to agree on who to elect. They have the right to structure their agreements, and it's not contrary to public policy with respect to shareholder agreements

H: Yes, remedy specified by parties to the contract is enforceable

- Thus shareholders can unanimously agree to remove management powers from directors and allocate them to the

shareholders
  - s.102 of *CBCA* allocates power to manage to directors, but subject to unanimous shareholder ag't
  - s.137 of *BCBCA* provides that directors duties may be transferred by modification of the by-laws
- Unanimous agreement among the shareholders is not an agreement that is likely to be achieved in the context of a widely-held corporation…thus significant for closely-held corporations
  - s.146(2) of *CBCA* gives power to the use of a shareholder agreement to reallocate the powers assigned to directors
- While shareholders are generally free to agree on how they would vote to elect directors, an agreement that fettered the discretion of the directors might be impeached
- Can't hear her voice…"shotgun" clause?
  - It provides that one shareholder can make an offer to purchase the shares of the other shareholders
  - Parties to whom offer is made can accept or decline, but can't vary the price
  - Allows parties in disagreement to end in "divorce", where one party is bought out and the other party has all the shares…really only effective in closely held corporations (ie: 2-4 shareholders)
  - Thus this gives a way in advance to provide a dispute resolution mechanism in the case that the closely held corporation will be wound up in the event of a disagreement amongst the shareholders

Binding the Directors' Discretion
- While shareholders are generally free to agree on how they would vote to elect directors, an agreement that fettered the discretion of directors might be impeached
- The underlying notion is that the directors' fiduciary duty to advance the best interests of the firm requires that the directors be free to assess that interests and to act upon their assessment

Share Transfer Restrictions
- Where shareholders are not passive investors, but are expected to take part in management, the identity of the shareholders will affect firm value.
- Even where active management duties are not contemplated, shareholders in closely held corporations will be greatly interested in the identities of the other members of the group because od the heightened possibility of hold-out strategies when decisions are made in small groups
- Closely held corporations' charter will frequently provide for share transfer restrictions.
- Transfer restrictions make it possible for the owners to maintain their relative share ownership, and therefore relative power, within the entity – in this way they are analogous to pre-emptive rights upon a new share issuance
- Transfer restrictions are also required if a firm is to take advantage of securities law private issuer exemptions
- Types of transfer restrictions:
  1. Absolute Restrictions
     - Under these restrictions, the shareholder simply cannot sell.
  2. Consent Restrictions
     - With these restrictions, a transfer of share may be made only on approval of the corporation's board
  3. First Option Restrictions
     - The shareholder may not sell her or his shares or may not sell them to any person not already a shareholder of the corporation without first offering them to the corporation or to the remaining shareholders.
  4. Buy-Sell Agreements
     - This is like a first option restriction except that, as the name implies, the corporation or the other shareholders must buy the shares of the selling shareholder when the triggering event occurs
  5. Buyback Rights
     - The corporation is given the right to repurchase shares on the occurrence of certain events, even if the shareholder does not want to sell
- In general, a share transfer restriction may not be adopted by a firm that has made a public distribution of its shares
  1. Validity
     - US courts, when confronted with share transfer restrictions, tend to emphasize shares as property and therefore to view transfer restrictions as falling into the suspect legal category of restraints on the alienation of property.
     - English courts tend to view shares as predominantly contractual in nature

The Choice Between a Closely Held and a Widely Held Corporation
- Whether a firm will become closely or widely held will depend on a variety of economic considerations
- A firm will go public only when doing so increases the value of the shares that were issued prior to the public distribution

- If, instead, the firm is worth more as a closely held corporation, it will refrain from a public issue of its shares, or if it has already made a public issue of shares, it will seek to repurchase them from outside shareholders in a buyout transaction
- One principle advantage of a public market arises through efficiencies in information production. Competitive markets may exist only if some consumers bear the screening costs associated with comparing the price and quality product against that of similar products
- The availability of a resale market in securities of widely held firms is of course an advantage to investors
- Another advantage of widely held corporations is easier access to capital markets, given the substantial costs of a public issue. As a firm grows in value, it becomes harder to obtain financing solely through injections of equity from present shareholders
- One primary reason to remain or to become a closely held corporation is to economize on agency costs
- Management opportunism is a risk as a consequence of the greater valuation uncertainties surrounding closely held corporations
- Closely held corporations may also wish to adopt different liability rules than those for widely held firms
- Closely held corporations also face lower costs of disclosure given the reduced proxy solicitation and disclosure obligations
- There are also tax advantages to closely held corporations

Conclusion

- There is a continuing debate over the conception of the corporation, and the appropriate balance between public and private interests
- There is also the issue of whether the statute has moved from being largely enabling to becoming much more directive
- While directors have a fiduciary obligation to the corporation, it is the shareholders that, at least technically, have the ability to replace directors if they are not satisfied with the performance of the board
- In reality, it is difficult for shareholders to exercise such rights unless corporate law is sufficiently responsive to shareholders, as well as to other interested stakeholders

Facebook Case Study

- Prior to the IPO, would the entrepreneurs or the investors (or both) make the following decisions:
    - Expanding Facebook's product offerings
    - Merging with Microsoft
    - Selling shares by the venture capitalist
    - Converting preferred stock into common stock
    - Paying dividends
    - Expanding the size of the board of directors
    - Replacing Mark Zuckerberg as a director
    - Replacing Mark Zuckerberg as an officer
    - Increasing Mark Zuckerberg's salary
- If the entrepreneurs want to get rid of the venture capitalists, how can they accomplish that?
- Under what circumstances would the venture capitalist want to redeem their shares?
- Under what circumstances would venture capitalists exercise their right of first refusal when a company issues additional shares? When wouldn't they?

Proxy Solicitation

Proxy Solicitation and Corporate Governance

- Both securities law and corporate law include requirements for corporate officers to solicit proxies from shareholders who may be unable to attend annual and special general meetings
- The term proxy is commonly used to refer to a person appointed to represent a shareholder at a meeting.
- However, statutory provisions in Canada use the term "proxy" is the manner or form or instrument by which such person is appointed.
- The proxy process is the manner in which proxies for meetings are solicited from shareholders and information is provided to them in connection with the solicitation
- Management solicitation must occur for every annual general meeting and special meeting that the issuer calls, and the proxy must be explicit with regard to the scope of authority sought
- Mandatory disclosure in the form of an information circular must accompany this solicitation of proxies

- The information circular provides the background information that allows investors to make informed decisions in respect of the control rights they possess: approval of directors, auditor approval, acceptance of financial statements, and special business to be considered at the meeting.
- The process by which proxies are solicited and exercised is important, as shareholders proposed governance or capital structure changes
- Proxy solicitation requirements are particularly significant in the takeover context

Mary Condon, Anita Anand and Janis Sarra, "Securities Law in Canada" (2005)

- The information circular and proxy process allows security holders to make informed decisions as to whether to purchase, sell or continue to hold their securities; it can also allow investors to exercise their rights to participate through voting and shareholder proposal mechanisms, granted to them by both corporate and securities law statutes. T
- The sale of shares by investors if they are dissatisfied with the overall governance and direction of the issue is called "exit" whereas the exercise of security holder rights through the proxy process is often referred to as "voice"
    - Both have a governance role in that they may signal to directors and officers that there is a lack of confidence in the oversight or management of the issuer's business or operations
    - However, exit as a governance tool is imprecise and can send mixed messages to managed regarding their governance activities
- In contrast, the exercise of participation rights by security holders can serve as a direct communication device to directors regarding investors' confidence in the current management of strategic planning of the issuer.
- Where institutional investors are actively exercising their participation rights, it can also serve as a signaling device for retail investors that do not have the time or resources to fully review the activities of the issuer

Canada, Senate, "Report of the Senate Standing Committee on Banking, Trade and Commerce on Corporate Governance" (1996)

- Effective corporate governance is an ongoing process build on the foundation of continuing involvement by shareholders in the affairs of the corporation and with one another.
- Shareholders must be informed. They must conduct continual research on the company. They must review policies, prospects and decisions. When questionable decisions are made, they must indicate their concern. When good ideas surface that the company should review, shareholders must prod the company to consider them.
- The company, for its part, must assess the preference of shareholders and the views of the market, which is its best critic, on whether value is being realized
- The Canadian proxy rules … create substantial barriers to this kind of continued, informal communication among shareholders
- Information circulars and proxy solicitation requirements engage both securities law and corporate law. While corporate law is aimed at enabling the corporation to operate, setting out the respective rights and obligations of directors, officers and shareholders, securities law is implicated because of the need to protect the integrity of capital markets by ensuring that investors' rights to information and exercise of voting are not compromised.
- The security holder, by signing a proxy, authorizes someone to vote on the shareholder's behalf at the meeting, thus allowing the shareholder a "voice" at the meeting.
- The proxy solicitation provisions are also designed to provide an alternative to "exit" that is, selling shares if security holders are dissatisfied with the governance of the company

The Proxy Process Prior to Regulation by Statute

- Only been extensively regulated since the 1960s
- Even before that time, the courts had held that there where information circular sent by management did not give shareholders sufficient relevant particulars to enable the shareholders to form a reasoned judgment on matters to be dealt with at the meeting, the results of the meeting would be set aside
- Courts might not approve of management's form of proxy if it did not enable the shareholder to exercise a real choice, although this did not necessarily invalidate the meeting

L Getz, "The Alberta Proxy Legislation: Borrowed Variations on an Eighteenth Century Theme" (1970)

- At common law, shareholders in a business corporation had no right to vote by proxy. The common law rule was apparently derived from an earlier rule concerning the rights of members in the quasi-public medieval corporation in which membership was couple with no pecuniary interest. The voting privileged was in the nature of a personal trust, committed to the discretion of the member as an individual, and hence not susceptible of exercise through delegation.
- If there was a right to vote by proxy, special authority had to be found for it in the corporate constitution; as, in the

memorandum jurisdictions at least, the rights created by the corporate constitution are contractual in character, there seemed no limits to the extent to which the right, if granted, could be contractually circumscribed.

- There was no general requirement that a two-way proxy form be used – that is, one worded in such a way as to permit the shareholder, through his nominee to vote either for or against any proposal or group of related proposals.
- The only obligation imposed upon those responsible for summoning company meetings was to give adequate notice, and with one exception, the contents of the notice were left to be regulated by the articles of the company and by the rule of equity and the common law
- It has been held to be a part of the duty of directors to explain and defend to the membership, and where appropriate to solicit its support for, their conduct of the company's business, and also that it is proper to use company funds for the purpose; and it has also been held that the management is under no obligation, moral or legal, to circulate a contrary case or to include in the notice of meeting any reference to proposals other than those emanating from the management itself.

Legislative Developments in Proxies

- The impetus for modern Canadian proxy legislation was the 1965 Kimber Report
- Under Canadian legislation, a "proxy" is defined as a form signed by a shareholder that appoints a proxy holder
- A "proxy holder" is defined as a person appoint to act on behalf of a shareholder. A proxy-holder can be appointed by a shareholder entitled to vote at a meeting of shareholders. The proxy-holder has the same rights as a shareholder. However, the shareholder can limit the rights of the proxy-holder in the grant of authority given by the shareholder.
- At a meeting, the proxy-holder cannot vote by a show of hands where the proxy-holder holds proxies for more than one shareholder and has conflicting instructions from different shareholders
- However, a proxy-holder may register votes on conflicting instructions where a ballot is taken. This would allow the proxy-holder to record votes for the resolution on the basis of a proxy given by another shareholder while recording votes against the resolution on the basis of a proxy given by another shareholder
- A ballot may be demanded by a shareholder in person or by a proxy-holder. Otherwise, the vote can be conducted by a show of hands unless there are proxies representing more than 5 percent of all the voting rights of securities entitled to be represented and voted at the meeting that require that the securities represented by the proxies be voted against what would otherwise be the decision of the meeting

Requirements for the Form of Proxy

- Regulation 54 under the CBCA requires that any form of proxy, whether used by management or by others, must state that the shareholder may appoint as proxy a person other than the one pre-designated on the form and must provide a space to do so.
- The form must either state clearly how the pre-designated individual intends to vote on the business to be brought before the meeting or provide a means for the shareholder to specify how his or her shares shall be voted
- With regard to the appointment of the auditor and the election of directors, for which the voting is not for or against but rather granted or withheld, the proxy form must provide a means for the shareholder to instruct whether or not his or her shares shall be voted for the nominees

Who Must Solicit Proxies

- Management of publicly held corporation must, concurrently with giving notice of a shareholders' meeting
- Mandatory solicitation by management is the linchpin of the modern proxy rules because even the most complete disclosure of regulations would not work if management were free to ignore them by not soliciting proxies or by soliciting them only from sufficient friendly shareholders to constitute a quorum
- Dissenting shareholders that are seeking support for their position may also solicit proxies
- Whether it is management or a dissident shareholder that solicits the proxies, an information circular must be sent.
- The information circular provides information such as the interest of the person making the solicitation in the matters to be voted on, which, in the case of a management solicitation, must not the interests of directors and senior officers, information concerning persons proposed as directors, information on executive compensation, the interest of insiders in material transactions, the indebtedness of directors and senior officers to the corporation or its subsidiaries, and details of management contracts under which a large share of management functions is performed by persons other than the directors and senior officers
- With respect to any special matters to be voted on, such as fundamental changes, the information circular must provide information in sufficient detail to permit security holders to form a reasoned judgment concerning the matter.

Compliance with More Than One Set of Proxy Solicitation Rules

- Currently, all securities legislation includes mandatory proxy solicitation provisions. Canadian securities law requires that management must solicit proxies in order that investors are advised of their ability to participate and are given the opportunity to exercise their proxy rights.
- Given the nature of proxy rights, the provisions in securities and corporate law statutes overlap in their requirements

The Meaning of Solicitation

- Proxy solicitation provisions in corporation statutes and securities legislation in Canada contain very broad definitions of "solicitation," which can have significant implications for the potential for the expression of dissident shareholder views.
- Solicitation can evoke very extensive costs for shareholders
- Amendments to corporate law statutes in the late 1990s, however, reduced constrained on shareholder communication and open up the ability of shareholders to communicate without being in violation of solicitation rules. See s.147

Restriction on Soliciting Proxies and Exceptions to Allow for Shareholder Communication

- In addition to management's obligation under corporate and securities statutes to issue and disseminate proxy circulars, security holders may wish to communicate with one another in order to influence the governance of the issuer or to influence the outcome of a particular issue or proposed vote
- The definition of what constitute a proxy solicitation has been highly contested over the years because some shareholder communication was found to be a proxy solicitation within the meaning of corporate or securities legislation, triggering costly dissident proxy solicitation within the meaning corporate or securities legislation, triggering costly dissident proxy solicitation requirements
- However, recent legislative amendments have opened up the process by allowing increased communication among security holders without activating the proxy solicitation requirements. The CBCA amendments in 2001 were aimed at increasing the ability of shareholders to participate in shareholders meetings' and exercise their voice through more active engagement in voting
- S.150 of the CBCA is illustrative of the changes to corporate law statutes that facilitate communication among shareholders

Janis Sarra, "The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?" (2003)

- The most recent amendments to the CBCA were aimed at removing impediments to shareholder communication and thus promoting shareholder activism and accountability
- Solicitation has now been redefined to allow broader communication without triggering dissident proxy requirements under the CBCA, including a public announcement by a shareholder of how the shareholder intends to vote and the reasons for that decision, or a communication for the purposes of obtaining the number of shares required for a shareholder proposal
- A person may now solicit proxies without sending a dissident's proxy circular, if the total number of shareholders whose proxies are solicited is fifteen or fewer

OBOs and NOBOs

- Most securities holders today are beneficial, as opposed to registered, security holders.
- Only registered shareholders or the persons they appoint as their proxies are permitted to vote at a shareholders' meeting
- Regulators distinguish between those beneficial owners who wish to remain anonymous, called "Objecting Beneficial Owners (OBOs)", and those who have no objection to having their names disclosed and are interested in receiving information and exercising some rights to participate, called "Non-Objecting Beneficial Owners (NOBOs)."

Adequacy of Disclosure

- When a corporation solicits proxies for a shareholders' meeting, it must comply with three separate statutory disclosure standards

    1. It must give shareholders sufficient information of "special business" to permit a reasoned judgment to be formed thereon. All business transacted at a special meeting of shareholders and all business transacted at an annual meeting, except consideration of the financial statements, auditor's report, election of directors, and reappointment of the auditor, is deemed to be "special business"
    2. A similar materiality requirement is imposed on management when it solicits proxies, with the general requirement in CBCA Reg. 57 (z6) that "the substance of each such matter or group of related matters" be disclosed "in sufficient detail to permit shareholders to form a reasoned judgment concerning the matter." Finally, the regulations prescribe detailed disclosure of certain items. For issuing corporations, regard must be had to both corporate law and securities law requirements.

Wotherspoon v Canadian Pacific Ltd (1982)

Materiality Standards in Proxy Solicitation

- Even prior to statutory disclosure requirements, courts sought to ensure that adequate disclosure was provided to shareholders by nullifying the effects of a shareholders' meeting where inadequate disclosure had been made to them. The judicial principle of notice has not been codified, but the pre-statute decisions are still of interest with respect to the definition to the definition of materiality

Harris v Universal Explorations Ltd (1982)

F: A meeting of the shareholders of a corporation (Petrol) was held to approve amalgamation with another company, Universal. A management information circular in support of the amalgamation indicated that a consultant, Colt, had done an "evaluation" of one of Universal's key assets. The circular was structured to imply that Colt was an independent expert that had determined the asset's market value. However, Colt had merely done an operational analysis of the asset. Shareholders who dissented from the decision to amalgamate sued to have the amalgamation set aside due to inadequate disclosure.

I: Did the circular provide "sufficient detail to permit shareholders to form a reasoned judgment" as required by the applicable regulations under the Alberta Companies Act?

L:

1. The test for "sufficient detail" is whether no material facts were omitted. A material fact is one for which there is a substantial likelihood that a shareholder would consider it important in deciding how to vote.
2. If a circular implies that a report is an independent and expert valuation of a property, then the fact that it is not is a material fact the omission of which is a failure to provide sufficient detail.

A: The test is not whether a shareholder was in fact misled by the circular, but whether there is a substantial likelihood that someone was misled.

H: Dissident shareholders win despite not being able to prove that anyone was misled: amalgamation denied.

Express Statutory Remedy

- An express statutory remedy for non-disclosure in a proxy circular is provided by CBCA s.154, which permits an interested person to apply to court for a restraining order where a form of proxy or management or dissident proxy circular "contains an untrue statement of a material fact or omits to state a material fact required therein not misleading."
- Under s.154, the court my make any order it thinks fit
- CBCA s.154 provides and express cause of action for non-disclosure in a proxy circular. However, the remedy exists only for misstatements and omissions that are material

Access to Management's Proxy Circular and Shareholder Proposal

Access to Management's Proxy Soliciting Materials: Shareholder Proposals

- Shareholders are entitled to submit proposals for consideration at shareholders' meetings
- Management is obliged to give notice of such a proposal in its proxy soliciting materials and to include a brief statement in support of the proposal if a shareholder supplies such a statement.
- The main class of proposals that a corporation is not required to include under CBCA s 137(5) are those that are primarily for the purpose of enforcing a personal claim or redressing a personal grievance against the corporation or its directors, officers, or security holders.
- The corporation is also not required to include a proposal where it clearly appears that the proposal does not relate in a significant way to the business or affairs of the corporation; or where the proposal rights are being abused to secure publicity

Scope of Proposals Has Been Broadened

- Under the previous language of corporations statutes, shareholders were prohibited from bringing proposals if they related to or were primarily for the purpose of promoting general economic, political, racial, religious, social, or similar causes

Varsity Corp v Jesuit Fathers of Upper Canada (1987)

- Exception to shareholders proposals under the BCA
- While the proposal had a specific purpose, and the purpose is directly related to the corporation, the language of the proposal and the supporting statement indicates that the primary purpose of the proposal is the abolition of apartheid in

South Africa, and the corporation is therefore not obliged to put the proposition forward

- Another example of a company being exempt from the requirement to circulate a proposal b/c it promotes a general economic/political/social cause

Information Rights and Financial Disclosure

Access to Records and Financial Disclosure

- Access to Records
    - Access to corporate records can provide information for the purpose of monitoring the performance of the corporation's management. Thus, in addition to maintain and providing access to shareholder lists, corporations are typically required to maintain and provide access to corporate records.
    - In addition to a shareholder list, a CBCA corporation must maintain adequate accounting records and records containing (1) the articles and bylaws of the corporation and amendments thereto; (2) any unanimous shareholder agreement; (3) minutes of shareholders' meetings and shareholder resolutions; (4) minutes of meetings of the directors and resolutions of the directors; (5) copies of notices of who the directors of the corporation are and of any changes in the members of the board of directors; and (6) a securities registry.
    - Access to the minutes of directors' meetings, resolutions of directors, and accounting records must be open to inspection by directors at reasonable times.
    - Where the corporation has made a distribution of shares to the public, the general public has access to the same records that shareholders and creditors do. Members of the general public can examine records and may take extracts from the records for a reasonable fee.
- Financial Reports
    - Financial statements for the preceding year must be placed before the shareholders and every annual meetings and they must also be sent to shareholders in advance of the meetings
- Auditing of Financial Statements
    - The use of auditors antedates statutes mandating their use.
    - The auditor's report serves as a signal of the accuracy of the financial statements.
    - *CBCA s.161* now requires the financials to be reported on by an auditor that is "independent" of the corporation.
    - There is an exception for small firms that permits corporations that are not publicly held to dispenses with the requirement of an auditor with the unanimous consent of its shareholders
    - It is important to note that while the financial statements are reported on by the auditor, they are the corporation's statements, and are not issued by it until they have been approved by its directors.

Kripps v Touche Ross and Co (1997)

I: What constitutes fair representation?

A: The statement that "financial statements present fairly the financial position of the company in accordance with generally accepted accounting principles" is ambiguous. It is neither a clear statement of opinion by the professional auditor that the financial statements present fairly the financial position of the company, no that the financial statements are in accordance with generally accepted accounting principles.

Certification of Disclosure

- There has been considerable debate regarding how best to make corporations accountable for the fairness and accuracy of annual filings, including financial statements of the issuing corporation.
- The CEO and CFO are required to certify that the financial statements fairly present the financial condition of the issuer, that there are internal controls to ensure that material information is conveyed to decision makers, and that they have disclosed to the auditor and audit committee any significant deficiencies in internal control and any fraud, material or not, that involved managers or other employees who have a significant role in the company's internal controls.

Certification Requirements

- In both the annual and interim certificates, the CEO and CFO must each certify that their issuer's financial statements, including prior period comparative financial information and other financial information, "fairly present" in all material respects the issuer's financial condition, results of operation, and cash flow for the relevant time period.
- The certification statement must address the financial disclosures in their entirety.
- This certification is aimed at meeting a standard of overall accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles.

- The officer must confirm that he or she, along with the issuer's other certifying officers is responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and that he or she has designed or supervised the design of disclosure controls and procedures to provide reasonable assurance that material information related to the issuer, including its consolidated subsidiaries, is made known to the officers.
- The officer must also certify that he or she has designed or supervised the design of internal control over financial reporting, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP.

Proposed Reform

- Proposed enhancements will require issuers to include some internal control reporting requirements; specifically, the CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that the have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year.
- They will also be required to certify, based on their evaluation, that they have cause the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year.
- Issuers will be required to disclose a description of the process for evaluating the effectiveness of the issuer's internal control over financial reporting and the conclusions about the effectiveness of internal control over financial reporting.
- The board of directors and its audit committee, in consultation with management, can choose to engage the issuer's auditor to assist in the discharging their respective responsibilities

Certification and Fair Presentation

Mary Condon, Anita Anand and Janis Sarra "Securities Law in Canada" (2005)

- The certification that the financial information fairly presents the issuer's financial condition is an important aspect of the assurances given by the issuer's officers, because it is broad than affirming that documents comply with GAAP.
- "Fairly present" means a materially accurate and complete picture of the issuer's financial condition.
- Fair presentation includes but is not necessarily limited to selection of appropriate accounting policies; proper application of appropriate accounting policies; disclosure of financial information that is informative and reasonably reflects the underlying transactions; and inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations and cash flows.
- Where an issuer is of the view that there are limitations to the issuer's GAAP-based financial statements as an indicator of its financial condition, the issuer should provide additional disclosure in its MD&A necessary to provide a materially accurate and complete picture of the issuer's financial condition, results of operations, and cash flows.
- The CEO and CFO must each certify that their issuer's financial statements fairly present the financial condition of the issuer for the relevant period.
- Issuers must report on a consolidated basis, and this reporting requires the certification of disclosure controls and procedures to provide reasonable assurance that material information relating to their consolidated subsidiaries is being disclosed.
- Regardless of the level of control that an issuer has over a consolidated subsidiary, management of the issuer has an obligation to present consolidated disclosure that includes a fair presentation of the financial condition of the subsidiary.

The Role of Audit Committees

- The external auditor provides an opinion that the financial statements present fairly the financial position of the company and the results of its operations for the period in accordance with generally accepted accounting principles.
- External auditors are retained by, and are ultimately accountable to, the shareholders.
- Hence, auditors have a right and duty to provide their views directly to the shareholders if they disagree with an approach being taken by the audit committee
- The recent regulatory requirements aimed at independence of an audit committee are designed as an investor protection device.
- An audit committee is a committee of the board of directors that has responsibility for oversight of the financial reporting process, which includes accountability checks on managers' financial decisions and the solvency of the corporation; helping directors meet their responsibilities; providing better communication between the directors and the external auditors; enhancing the independence of the external auditor; increasing the credibility and objectivity of financial reports; and strengthening the role of the directors by facilitating in-depth discussions among directors, management and the external auditor.

- Shareholders face collective action problems in that they are dispersed and frequently hold too small a stake in the corporation.
- An audit committee must be directly responsible for overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review, or attest services for the issuer, including the resolution of disagreements between management and the external auditors regarding financial reporting.
- The audit committee must also be satisfied that adequate procedures are in pace for the review of the issuer's public disclosure of financial information, including periodic assessment of the adequacy of those procedures.
- The audit committee must establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters (whistle-blowing protection)

Independence of Audit Committees

- Every member of an audit committee is required to be independent
- Independence means the absence of any direct or indirect material relationship between the director and the issuer that could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgment
- A person or company is considered to be an affiliated entity of another person or company if one of them controls or is controlled by the other or if both persons or companies are controlled by the same person or company, or the person or company is both a director and an employee of an affiliated entity, or an executive officer, general partner, or managing member of an affiliated entity
- "Control" in the context of this instrument means the direct or indirect power to direct or cause the direction of the management and policies of a company, whether through ownership of voting securities or otherwise.
- A person is not considered to be an affiliated entity of an issuer if the person owns 10 percent or less of any class of voting equity securities of the issuer and is not an executive officer to the issuer

Temporary Exceptions to Independence Requirements

- Temporary exceptions to the independence requirements are available if the member is able to exercise the impartial judgment necessary for the member to fulfill his or her responsibilities a an audit committee member.
- The individual granted the exemption cannot be the chair of the committee and the exemption is not available unless the majority of the audit committee members are still independent.

Financial Literacy

- Canadian regulators have also now imposed financial literacy requirements for audit committee members.
- An individual is financially literate if he or she has 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 issuer's financial statements
- The issuer must also disclose any experience that the audit committee member has in actively supervising person engaged in preparing, auditing, analyzing, and evaluating financial statements

Non-Audit Service to Be Approved

- Audit committees must adopt policies and procedures for the engagement of non-audit services, which include monetary limits and other factors relating to the independence of the auditor that allow the audit committee to make an informed decision regarding the impact of the service on the auditor's independence.
- The integrity of audit committee requirements in respect of audit services is also augmented by professional codes of conduct for auditors, promulgated by the Canadian Institute of Chartered Accountants, aimed at ensuring responsibility to clients for the integrity and quality of professional services delivered, including the objectives of competence, ethical conduct and impartiality.

Exemptions

- Venture issuers are exempt from some of the audit committee composition and reporting obligations but must complete a separate form of disclosure.

The Role of Corporate Counsel

- The entry by securities regulators into the corporate governance field raises the question of who, if anyone, should regulate the role of corporate counsel in corporate governance.

- Canadian regulators leave the activities of corporate counsel to self-regulatory law societies

Paul Patton, "Corporate Counsel as Corporate Conscience: Ethics and Integrity in the Post-Enron Era," (2006)

- Corporate counsel are effectively left in the uncomfortable position of taking best efforts to ensure compliance, and potentially being left in the position both of no being able to report fraudulent activity, and of losing the client and their livelihood
- "The denial of a duty to go outside in cases of egregiously harmful illegality is hard to square with plausible notions of professional duty. If the organizational client is being harmed, and disclosure would mitigate the harm, it arguably follows that disclosure is appropriate. The bar resists this conclusion on the grounds of confidentiality. It argues that, as a general matter, clients will not consult lawyers without confidentiality safeguards, and that, since legal advice promotes compliance with the law, this will be socially costly."
- Corporate agents have incentives for consulting lawyers that do not depend on confidentiality, and that there are instances where the corporate lawyer must insist on disclosure of information from corporate managers that the organization is legally required to disclose even when it is harmful for the manager personally.
- He concludes "it has always been irrational for a corporate manager to make a disclosure to the organization's counsel that he would not have been willing to make in the absence of any confidentiality guarantee."
- Corporate counsel must also confront the fact that they and their corporate clients are "morally independent"
- Often lawyers and their clients accomplish objectives together, not separately. Lawyers therefore cannot always deny moral responsibility for their clients' conduct.

Conclusion

- Many key aspects of corporate governance are now regulated by corporate law, securities law, or national instruments
- Yet there continues to be considerable debate regarding the scope of regulation that is necessary to ensure that corporations are responsible to the stakeholders that have an investment in them.

What are Directors' Duties and How to Enforce Them?

Duty of Care and the Business Judgment Rule

Introduction

- The current corporate governance structure results from the combined statutory and regulatory effort that is designed to maintain and reinforce the structure
- Question of when directors can be sued for failing to fulfill their obligations to the corporation
- Most direct remedy for shareholders to punish directors is to vote them out, but courts will also step in for failure to carry out their duties

Liability and Management Misbehaviour

- There are four different kinds of management misbehaviour:
  - **Breaches of the Duty of Care**
    - **Shirking**
      - Management decides to shirk, or underinvest, in managerial competence and care
      - How does the law respond to directors who are inactive or insufficiently vigilant?
      - At common law, the standard of care required of directors was remarkably low
    - **Excessive Risk Aversion**
      - As a consequence of a conflict of interest between themselves and other claimholders who are less concerned about the risk of firm failure than managers are
  - **Conflicts of Interest and corporate opportunities**
    - **Looting**
      - Garden variety fraud…manager takes advantage of benefits
    - **Conflicts of Interest**
      - Basic conflict where transaction tainted
    - **Taking advantage of corporate opportunities**
      - Management takes business for themselves and keeps all of the profits even though the opportunity came to them in the context of the management of the corporation

- **Breaches of Fiduciary Duty**
  - **Control Transactions**
    - Happens during a takeover, where an insurgent seeks to get corporate power from incumbent management
  - **Proper Purpose Doctrine**
    - When management develops techniques to defend a takeover, court uses best interest test to determine if management was adopting strategy for the best interests of the corporation

Richard A Booth, "Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)," (1998)

- Whatever the reason for stockholder dislike of company-level risk management, it appears that diversified stockholders, who are supposedly risk-neutral, prefer management to behave as if they were not risk-neutral.
- Diversified investors are likely to invest in all of a corporations securities, including corporate bonds. If returns to shareholders are increased at the expense of bondholders and other fixed claimants, then the investors' gain on one investment if offset by losses in the other.
- Thus, a claimant's bargain would align managerial duty with a duty to all investors.
- Thus, merely concluding that managers ought to carry out their duties with a view to promoting the interests of shareholders does not necessarily solve the issue as to whether the managers ought to be risk-neutral or risk-averse in promoting those interests

Liability for Failing to Exercise Appropriate Skill and Care

- There are 2 general areas of directors liability: Shirking and Looting

Shirking

- Directors failing to do that which they are obliged to do
- Example: not showing up at meetings, ignorance to company's bad financial position, etc
- While directors need not meet a standard of perfection, they must be reasonably informed, attend meetings, not rely blindly on advice, etc
- Must meet standard in *CBCA* to do what a reasonable person would do in the circumstances
- Not required to do day-to-day activities…just only do a general oversight of the company
- **Business judgment rule**:
  - Directors are entitled to choose within a range of reasonable alternatives, and courts will not step in to second guess reasonably-made business decisions
  - Thus directors will not breach their duty of care
  - Courts will not interfere in the management of a corporation in the absence of an allegation that the directors' actions have been tainted with fraud, illegality, or conflict of interest of the company if they keep themselves properly informed and choose from a range of reasonable options
- Additionally, court will defer to relying on advice of advisors, as long as they belong to a professional body and have some kind of professional insurance
- *Wise*: not allowed to rely on anybody with expertise…there, VP-Finance had a lot of experience with the company but no professional certifications
- **Looting**
  - Directors breach fiduciary duty to company by taking business opportunities or assets of the company and using them for their own interests
  - Arises when directors enter into contracts or approve contracts, either between themselves and the firm or where they have an interest in the other party
  - Aka **Conflict of interest** situations

Re City Equitable Fire Insurance Co Ltd (1925)

1) "A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."
2) "A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed."
3) "In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

Barnes v Andrews (1924)

F: Andrews became director of the corporation because he was a friend of the president. He missed one meeting for a valid reason but attended the only other meeting there was during the time he was the director. Corporation sold about 500,000 shares but it wasn't enough to get the corporation going. The receiver now makes a claim against Andrews for negligence

I: Was the director negligent?

L: Before director held liable, plaintiff must show breach was proximate cause of loss

- Directors have an active responsibility to keep themselves informed of the affairs of the corporation, but are only negligent in fulfilling their duties if the loss flowed from the director's negligence

A: Andrews' failure wasn't in his failure to attend the meetings, but rather in his more general failure to supervise the corporation's general affairs

- He had an individual duty to keep himself informed
- All Andrews did was communicate with his friend, the president…he should have pressed for more detailed information, so he was in breach of his duties
- However, even though the director breached his duty, P would have to show that:
  a) Proper performance by the director would have prevented the loss
  b) Amount of loss that would've been avoided
- Here**, P was unable to establish causation**, as there were many factors causing the failure of the corporation…therefore on this standard, it would be very difficult to prove causation

H: No, D was negligent but P couldn't prove causation, so director gets off

Peoples Department Stores Inc (Trustee of) v Wise (2004)

F: Wise brothers acquire People's from Marks & Spencer in early 90s, and ran it as a subsidiary of Wise. Board of Wise elected to put in place a system to manage both company's inventory together, but problems occurred right way…P ended up owing money to Marks and went bankrupt. Marks made claim against Wise for electing to implement a system that was not in its best interest, as it was better from Wise but not for People's

I: Do directors owe a duty to creditors of a corporation?

L: Business Judgment Rule

- Courts will not second guess unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*

A: Court discussed responsibilities of a board of directors…best to have clear corporate governance rules, a sufficient number of outside directors, etc.

- However, just because a system doesn't work **doesn't mean** it makes it an unreasonable decision

Therefore, "because of the risk of hindsight bias", Canadian courts adopted American "business judgment rule"

- Courts look to see that a director made a reasonable decision, not a perfect one
- Not on the court to cast its own judgment on what should have been done
- Here, even though decision screwed creditors, it was made to try to save the corporation, and thus was done in its best interests

H: Yes, but not a fiduciary at common law between directors and creditors

Important:

- "Indeed, unlike the statement of the fiduciary duty in s.122(1)(1) of the *CBCA,* which specifies that directors and officers must act with a view to the best interests of the corporation, the statement of the duty of care in s.122(1)(b) of the *CBCA* does not specifically refer to an identifiable party as the beneficiary of the duty. Instead, it provides that "every director and officer of a corporation in exercising their powers and discharging their duties shall… exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."
- Thus, the identity of a beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors.

Peoples Department Stores Inc (Trustee of) v Wise (2004)

L: Objective duty, business judgment rule

- Unless the plaintiff can point to director's negligence as the sole cause of the loss, it will be very difficult to sue directors when things fall apart due to bad business decisions

A: Standard recommended by the Dickerson Report was objective, requiring directors and officers to meet the standard of a "reasonably prudent person"

- Not a subjective standard…**objective only**
- However, there is not a contextual vacuum, as must **look at surrounding circumstances** that might have influenced the

course of action

Also, in investigating whether director's met the statutory standard of care, the courts will apply the **business judgment rule**

- Rule holds that a reasonable, not perfect decision will suffice
- Provided that the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination
- Thus not result, but care that's taken in setting policy and making decisions that's important

In order for P to succeed in challenging a business decision, they must establish:

a) In breach of the duty of care

b) In a way that caused injury to the plaintiff

Here, since P couldn't point to loss being attributable to the directors, couldn't succeed

C: Can't avoid responsibility by failing to attend meetings…can you avoid responsibility by taking advice from a range of advisors?

- Generally speaking, courts are fairly receptive to arguments stating that directors shouldn't be found negligent where they have reasonably relied on outside advice

Duty of Loyalty → Corporation → Enforced by Derivative Action
Duty of Care → Corporation & Constituents, including Creditors

Joint Stock Discount Co v Brown (1869)

Where the trustee is itself a company the requirements of care and caution are in no way diminished. And here, unlike with companies in general, these requirements have a flow-on effect into the duties and liabilities of the directors of such a company. It was early established – largely it would seem from case law on charitable and municipal corporations – that at least when, and to the extent that, directors of a trustee company are themselves "*concerned in*" the breaches of trust of their company, they are liable to the company according to the same standard of care and caution as is expected of the company itself

UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc (2002)

F: Berg took over Repap, and directors can't agree on compensation. First Board meeting on Feb 22, an independent executive compensation consultant Ms. Engel was hired by compensation committee to give a report. She gave "high level observations" that were limited in scope that had key info missing. Shareholders upset at this proposal and two major shareholders start a proxy fight to replace board. Berg resigned shortly after, and now claims US $27 million in benefits and payments

I: Did Berg breach his fiduciary duty to Repap? More importantly, did the rest of their directors and the compensation committee breach their fiduciary duty to the corporation?

L: Courts don't apply business judgment rule

- The business judgment rule will not protect director's decisions where no informed or reasonable judgment was exercised

A: Court holds that directors are entitled, indeed encouraged, to retain advisors. However, this does not relieve directors of the obligation to exercise reasonable diligence

- Where duty of care requires decision to make decisions likely to affect shareholders, their decision must be made on an informed and reasoned basis
- Here, committee effectively misled (but not in bad faith) the whole board of directors that they had exhausted all investigative opportunities
- Board relies on business judgment rule to prevent court from second-guessing their judgment
- However, **business judgment rule cannot apply when it relies on uninformed judgment of the subcommittee**
- Board relied on this lack of information and didn't do any independent review of agreement
- In a 30 minute oral presentation, advisor gave info without questions or discussion, and approved an agreement with someone they didn't know, didn't recruit, and was generous in circumstances

H: Yes and yes, committee failed in their own obligations to establish a prudent or reasonable process that led to a contract that is not fair and reasonable

C: This case is a good example of what not to do as a Board of Directors

- They can't just rubber-stamp subcommittee reports…must ask Q's and do independent review

This case is relatively uncommon…most directors are not successfully sued for their failure to exercise their judgment…if they had read the agreement and had a length debate, but still approved the contract, it's unclear if the court would have intervened

Exculpation

- Delaware General Corporation Law s. 102(b)(7)
  - A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its

stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

No Exculpation

- CBCA s.122(3) Subject to subsection 146(5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves them from liability for a breach thereof

Smith v Van Gorkom (1985)

F: Trans Union had losses and could take advantage of them for tax purposes if they could merge with another profitable company. Van Gorgom was CEO and Chairman of the Board and arranged a deal with someone to purchase shares of the company for $55 per share. Board met a couple of times to discuss, and ultimately approved the transactions. Shareholders take action to have the merger to be rescinded and sought damages against directors

I: Could directors rely on BJR?

L: Directors can't rely on business judgment rule if they are grossly negligent

- Even where directors think they know the company well, courts will examine whether the directors have acted reasonably and thoroughly, and they will override the business judgment rule where directors have been grossly negligent

A: D made defence that using spread between selling price of $55/share and current market price of $38/share was an adequate basis upon which to assess the fairness of an offering price

- Court disagrees, as it represents only part of the value
- Didn't consider cash flow, investment tax credits, didn't ask the Chief Financial Officer why the price was $55/share, and never reviewed agreement themselves
- None of directors were investment bankers or financial analysts, and weren't required in law of getting outside information if they had adequate info from inside management…but didn't do it
- Again, **issue was whether the directors informed themselves as to all information that was reasonably available to them**…had they have done so, they would have learned of the source and derivation of the $55/share price, and could not reasonably have relied thereupon in good faith

H: No, for shareholders, court holds that the directors were:

a) Uninformed as to the intrinsic value of the company
b) Didn't adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price
c) Therefore given circumstances, they were grossly negligent

Dissent claims that board's decision wasn't unreasonable

- Claims majority only focuses on what the directors didn't do, and doesn't mention experience
- They were qualified to make an "on-the-spot" informed judgment about the sale of the corporation without any additional information because they already knew the company like the "back of their hands"

Shiftable Liability: Indemnity and Insurance

- Incentive goals of management liability strategies may seem frustrated if a manger may pass liability on to the firm or to an insurance company
  - Firms can set up clauses in the company's articles to indemnify themselves against negligent acts
  - However, they can't lawfully indemnify themselves against unlawful activity
- This is not a concern in closely-held corporations
  - More likely where there are outside directors who aren't intimately tied with the company, or with publically traded corporations, where shareholders and directors don't have the same interests

Globus v Law Research Service Inc (1969)

F: Company entered into indemnification K with underwriter. Issuer promised to indemnify the underwriter for any loss arising out of defects of prospectus

I: Could underwriter get insurance?

L: Can't indemnify underwriters against their own reckless, willful, or criminal misconduct

A: Underwriter not entitled to indemnification because they had knowledge of misstatements

- Thus if you have knowledge of misstatements, you can't get insurance

H: No

C: *CBCA* on indemnification:

a) **Part X – Directors and Officers**

124(1) Indemnification

- "A corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation or another individual who acts or acted at the corporation's request as a director or officer, or an individual acting in a similar capacity, of another entity, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the individual in respect of any civil, criminal, administrative, investigative or other proceeding in which the individual is involved because of that association with the corporation or other entity"

Thus, in *CBCA* s.124, you can indemnify against negligence and protect yourself if wrongfully sued

- However, in no case may liability be shifted if the manager has not acted honestly and in good faith with a view to the best interests of the corporation
- Presumption with indemnification is that the directors acted in good faith
- Onus is on the company who refused to indemnify to establish bad faith, which is not easy

Conflict of Interest Transactions

Liability for Misappropriation of Corporate Assets

Looting: Interested Directors' Contracts

- While conflict of interest contracts aren't wholly impermissible, directors must:
  a) Declare interest to the board
  b) Not participate in voting for the proposal
  c) Contract must be voted upon by the shareholders

Aberdeen Ry Co v Blaikie Brothers (1854)

F: Aberdeen contracts to buy metal plates from Blaikie Bros., and Blaikie was a director of Aberdeen. After receiving about half of the plates, they refuse to receive the rest, and claim it is a voidable contract because there's a conflict of interest. Blaikie Bros. sues for specific performance

I: Is Blaikie precluded from dealing with himself on his own behalf or through his company?

L: All contracts are void where directors and officers have an interest

A: Fiduciary duty: director must act in the best interests of the corporation

- **General rule** is that an agent of corporation cannot enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interest of those whom he is bound to protect
- Court doesn't look at whether the contract was done in good faith
- Court holds since there was obvious conflict of interest, the **transaction is automatically voidable.** As Chairman, his duty to corporation was to obtain steel plates at highest possible price
- Personal interest would lead him in the exact opposite direction, as it would induce him to fix the price as high as possible
- Doesn't matter whether he was the sole director, or only one of many…there's still a conflict

H: Yes, for Aberdeen, transaction unacceptable

C: *Aberdeen* presents the strict common law position on conflicts of interest

- However, in business where there may be overlapping relationships, and expertise from different fields are needed, it doesn't allow for corporate K's that may potentially be beneficial to the company
- Compromise position developed that contracts made where there is a conflict of interest are not automatically void, but the contract must be approved by the shareholders

North-West Transportation Co v Beatty (1887)

F: Company had fleet of steamships, and needed a replacement for the *Asia* ship. The company needed another steamer, and purchased the *United Empire*, provided by J.H. Beatty, which was a good steamer, the only one available, and the price wasn't unreasonable. While a majority of shareholders ratified the contract, John Beatty claims that the resolution was passed by unfair and improper means. J.H Beatty had a majority of shares, sold 2 to create other directors and get just under a majority of shares to vote under the articles, and got vote through with new directors assistance

I: Is the shareholder ratification resolution valid?

L: Director may vote as shareholder in ratification

- The fact that a director is also a shareholder does not entitle the director to exercise their ordinary rights as a shareholder to ratify any contract involving a breach of a duty, even if it was his breach of duty

A: Vote of majority must prevail unless the adoption was brought about by unfair or improper means

- Here, every shareholder, including the vendor, had a right to vote on this question, **notwithstanding that he might have a personal interest** in the subject-matter in conflict with the interest of the company itself
- Beatty got the shares in accordance with the articles
- If court disregards vendor's votes, it would disregard opinion of the majority
- Also, PC wants rule to have **process as simple as possible**
- If only disinterested shareholders were entitled to vote, great confusion would be introduced into the affairs of big companies if the circumstances of shareholders, voting in that character at general meetings, were to be examined, and their votes practically nullified, if they also stood in some fiduciary relation to the company

H: Yes, PC overturns SCC

UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc (2002)

- In the context of a director-corporation transaction, there are also duties of disclosure.
- The *CBCA* codifies the manner and extent to which disclosure must be made. It provides that a director shall disclose to the corporation the nature and extent of any interest he has in a material contract with the corporation (s.120)
- What is the level of disclosure that is required to meet the statutory requirement?
    - "There is no precise formula that will determine the extent of detail that is called for when a director declares his interest or the nature of his interest. Rightly understood, the two things mean the same. The amount of detail required must depend in each case upon the nature of the contract or arrangement proposed and the context in which it arises. It can rarely be enough for a director to say "I must remind you that I am interested" and leave it at that. His declaration must make his colleagues "fully informed of the real state of things." If it is material to their judgment that they should know not merely that he has an interest but what it is and how far it goes, then he must see to it that they are informed.
- You must ask whether the directors were **fully informed of the real state of things**

Looting: Corporate Opportunities

- *Foss*: common law limits scope for derivative actions, where shareholder tries to seek a remedy to a wrong done to a corporation
- Question: How "interested" does a director have to be? See *CBCA*, s.120…
    a) **Part X – Directors and Officers: 120(1) Disclosure of interest**
- "A director or an officer of a corporation shall disclose to the corporation, in writing or by requesting to have it entered in the minutes of meetings of directors or of meetings of committees of directors, the nature and extent of any interest that he or she has in a material contract or material transaction, whether made or proposed, with the corporation, if the director or officer
    (a) is a party to the contract or transaction;
    (b) is a director or an officer, or an individual acting in a similar capacity, of a party to the contract or transaction; or
    (c) has a material interest in a party to the contract or transaction"
- Thus s.120(1) doesn't require a contract between a corporation and a director
- Courts take **expansive approach to determining interest**, as it doesn't have to be pecuniary
- If director holds shares in other corporation as trustee rather than as beneficial owner, that interest is sufficient to attract conflict of interest prohibition
- Problem of **looting** is that the director/officer gets a business opportunity and instead of letting the corporation take it, they take it for themselves
    - The director takes the full return even though it may be better to give it to the corporation
    - As a fiduciary, they have a duty to put the company's interests above their own personal interest
    - It's a **simple prohibition, but not easy to determine** when opportunity belongs to the corporation
- ie: what if corporation can't take opportunity itself? What if corporation chooses not to take it? Are directors completely barred from taking opportunity even though corporation couldn't benefit from it?

Regal (Hastings) Ltd v Gulliver (1942)

F: Regal owned cinemas and got an offer to lease two others but landlord he wouldn't lease to them unless the subsidiary had over $5000 in take up capital. Since they could only come up with $2000, all 6 directors had arranged to come up with $500 each to come up with the remaining $3000 to get the leases. After this, the directors sold leases and shares of Regal for $15,000, a 3-time increase in value. New owners of Regal claim that the leases were a corporate opportunity and the directors were obligated to account for the increased value…D's claims Regal wasn't in a position to take on leases.

I: Was this a corporate opportunity that the directors took for themselves?
L: If a director uses position to make personal profit there is a conflict of interest

- **Directors must not take advantage of a corporate opportunity, regardless of whether or not it is to the benefit of the corporation to do so or if the opportunity would be available to the corporation otherwise**

A: Court holds that the rule of **equity**, which insists on those, who by use of a fiduciary position make a profit, being liable to account for that profit, in **no way depends on fraud, or absence of good faith**

- Instead, strict two-part test to determine breach of fiduciary duty
  a) **Fiduciary Relationship**
   - Directors acting in course of their execution of their office
  b) **Profit Made**
   - Liability arises from the mere fact of a profit having been made
   - Profiteer, however honest and well-intentioned, can't escape risk of being called to account
- Equitable principle is a **rule of general application**
  - Court would find it difficult to determine good faith after-the-fact
- Here, this was a corporate opportunity because they acquired shares in the subsidiary by reason, and only by reason, of the fact they were directors of Regal and in the course of their execution of office
- **Remedy** is that the directors had to pay the profits back
  - Thus the new owners of Regal got a windfall of profits

H: Yes, for Regal

Zwicker v Stanbury (1953)

- The majority of shareholders of a company on the verge of liquidation surrendered their shares to the company's directors, who also purchased second mortgage bonds from the shareholders at one-half their face value.
- The directors' interest in these transactions arose from their belief that they could persuade the company's first mortgage bondholders to accept a scheme of refinancing.
- The directors could not be said to have been under a duty to acquire the shares for their company since the company could not hold its own shares.
- Speaking for the majority of the Court, Kellock J stated that the directors "both in their acquisition of the shares and the second mortgage were arrogating to themselves a secret profit." And held that the plaintiff shareholder had standing to bring a derivative action against the directors under the rule in the *Menier's* case.
- The actual basis of the decision is left somewhat in doubt by Kellock J's statement that "they did not obtain the consent of the shareholders and both transactions, therefore, for the reasons stated, cannot stand."

Peso Silver Mines Ltd v Cooper (1966)

F: Cropper and 2 others were 3 of the 6 directors of Peso, a public corporation. Offer made to Peso, but Board of Directors turned it down. 6 weeks later, Dickson approaches Cropper and 2 other members of board about offer, and takes it
I: Did Cropper breach his fiduciary duty to the corporation?
A: In *Regal*, directors had the opportunity solely from being directors on Regal

- Here, on the facts Cropper and others were approached 6 weeks after the Board had rejected the offer and after it had passed out of the director's mind
- Also, directors were **approached not in their capacity as directors of Peso, but as individual members of the public** whom another was seeking to interest as co-adventurer

L: If corporation has no interest, director need not account

- **If a corporation ceases to have an interest, the law can't prohibit a director from taking an opportunity merely because he learned of it in his capacity as a director**

H: No, for Cropper (at trial, BCCA, and SCC)
C: *Regal* states a very strict principle, while *Peso* takes a contextual, factual approach

Irving Trust v Deutsch (1934)

- The view of the profit principle advanced here is further supported by the courts' refusal to relieve a fiduciary from liability to account when it is argued that the profit could not have been obtained for the principal, and particularly by the justification given for the refusal, perhaps the clearest instance of which is found here:
  - The defendants' argument…that the equitable rule that fiduciaries should not be permitted to assume a position in which their individual interests might be in conflict with those of the corporation can have no application where the corporation is unable to undertake the venture, is not convincing. If directors are permitted to justify their conduct on such a theory, there will be a temptation to refrain from exerting their strongest efforts on behalf of

the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally.

- In other words, notwithstanding that the principal might not have been able to acquire the profit for itself, the fiducatiry cannot be permitted to take it himself (absent proper authorization) because to allow that would undermine the objectives of the conflict principle: it would foster in the fiduciary a temptation to underperform his non-fiduciary dities in the hope of being able to take a profit personally.

Abbey Glen Property v Stumborg (1978)

- A director may breach his or her fiduciary obligation to the corporation merely by acting as a director of the second corporation
- No actual conflict is necessary but that the potential for conflict is enough to create a breach of fiduciary duty.

Canadian Aero Service Ltd v O'Malley (1974)

F: Canaero was preparing a bid for topographical mapping of Guyana and O'Malley and Zarzycki were senior officers (not directors) working/negotiating on a contract on behalf of Canaero. Since they felt they couldn't win the bid and therefore lose their jobs, O and Z resigned, formed their own corporation Terra, put in a bid, and won the bid over Canaero from the Canadian government

I: Was this a corporate opportunity?

L: Directors under fiduciary duty after resignation

- The SCC gives a list of non-exhaustive factors that should be addressed in each corporate opportunity case to decide if a breach has occurred

A: Laskin J. gives 2 clarifications of the fiduciary duty:

a) **Not limited to directors of the company**
  - Also applies to "top management" that aren't mere employees, but rather agents

b) **Doesn't end after resignation**
  - Can be liable for breach after termination of D's relationship with the corporation

- Summarizes duty: a director or senior officer are "precluded from obtaining for himself…any property or business advantage either belonging to the company or for which it has been negotiating; and especially is this so where the director or officer is a participant in the negotiations on behalf of the company"
- D tries to rely on *Peso*, but in *Peso* there was a finding of good faith in the rejection of the directors of the mining claims because of the strained finances of the corporation
  - Here, there was a willingness on the part of Canaero to enter into the deal, unlike in *Peso*
  - Also here, D's started company and submitted bid while Canaeor in heat of negotiations
- Thus Laskin J. determines that a strict rule of *Peso* or *Regal* should not be applied…instead, each individual case should be determined based on **individual facts and circumstances**…list of non exhaustive factors to be considered when determining whether conflict of interest arisen:

a) **Position or office held**

b) **Nature or Strength of the corporation's interest**…includes:
  i) **Maturity** – how far had the corporation gone to develop the opportunity?
  ii) **Specificity** – generally or specifically identified by the corporation?
  iii) **Special/Private** – was the opportunity private or significant to the corporation?
  iv) **Rejected** – had the opportunity been rejected in good faith?

c) **Defendant's relationship to the opportunity**…includes:
  i) **Knowledge** – how much possessed by D?
  ii) **Circumstances** – how was knowledge obtained?

d) **If alleged breach occurs after termination of D's relationship with the company**…includes:
  i) **Time frame** – how long after termination did the action occur?
  ii) **Circumstances** – how was the relationship terminated…retirement, resignation, discharge?

- Here, this was a specific business opportunity that Canaero had been pursuing
  - Wasn't just in the same business area…was substantially the same opportunity
  - Also, it was a mature opportunity…extensive prep work done by D's while with corporation

H: Yes, for Canaeor

Enforcement Using Derivative Actions

Foss v Harbottle (1843)
F: The plaintiffs were two minority shareholders in a company 'The Victoria Park Company', which was formed to buy land for use as a pleasure park. The company's articles of incorporation gave the shareholders the power in a general meeting to commence legal proceedings. The plaintiffs alleged that the defendant directors had engineered a fraudulent scheme: the defendants had caused the company to buy land from themselves at an inflated price. This act of the directors resulted in a loss of the company.
L: A suit to redress a wrong done to the corporation may not be brought by a shareholder thereto, and can be brought only by the corporation itself, in any case where the wrong may be ratified by an ordinary majority of the shareholders in general meeting
Exceptions:
- *Edwards v. Halliwell*
  - Ultra vires transactions
  - Actions that could validly be taken only with the approval of a special majority of shareholders
  - Actions in contravention of the personal rights of shareholders
  - Fraud on the minority; D's have done something so awful it can't be ratified.

The Rule
- The company is the only proper plaintiff to bring an action for a breach of a duty owed to the company.
- (premised on the separate legal personality of the corporation and on majority rule in internal corporate affairs)
- If SH sue in the corporation's name, the initiative could be foiled by the other SHs voting to ratify the breach (ie- the company could forgive the directors' negligence). Therefore, had to be corporation suing, not a SH.

General
- Leading English Case followed in Canada until 1970s.
- Now replaced by statute. Has made the process much more formulaic and change the nature of corporate litigation
- Still good law in other commonwealth jurisdictions that don't have stat provisions

Issues in Enforcing Managers' Duties

Shareholder and Corporate Remedies
- Derivative actions are an action allowed by common and statutory law in which shareholders bring an action on behalf of the corporation
- Occurs when a wrong is committed against the corporation (usually by a director within the corporation), and thus harm is arguably caused to the shareholder
- Not surprisingly, directors aren't eager to sue themselves for breach of their duties
- At common law, *Foss v. Harbottle* stated that directors would decide whether or not to bring an action and if they decide not to, shareholders can but only if they have majority support
- Statutory modification occurs *CBCA* to overcome *Foss* limitation that even if shareholders tried to bring the action, they need shareholder majority…see:

  a) **<u>Part XX – Remedies, Offences, and Punishment</u>**

  238 Definitions
  - ""**complainant**" means
    (a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,
    (b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
    (c) the Director, or
    (d) **any other person who, in the discretion of a court**, is a proper person to make an application under this Part"

  239(1) Commencing derivative action
  - "Subject to subsection (2), a **complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation** or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate"

  239(2) Conditions precedent
  - "No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that
    (a) the **complainant has given notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court** under subsection (1) not less than fourteen days before bringing the

application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;

(b) the **complainant is acting in good faith**; and

(c) it **appears to be in the interests of the corporation or its subsidiary** that the action be brought, prosecuted, defended or discontinued"

Primex Investments Ltd v Northwest Sports Enterprises Ltd (1995)

F: Northwest, a company owning the Canucks, starts building new area and then makes pitch for NBA. Arthur Griffiths, who runs NW, pitches idea to John McCaw, who agrees to partnership on condition that they can get control of the arena owning company. After approval, shareholders argue that Griffitsh didn't let the other shareholders know that McCaw's interest was based on owning GM Place. Thus, they expected profits from rent of the Grizzlies when they waived pursuit of NBA franchise

I: Was the action done under good faith? Was it brought in the interests of the company?

L: Question of whether shareholders are acting in good faith and in the best interests of the corporation turns on whether the action has a reasonable prospect of succeeding

A: Two holdings on the issues:

a) **Shareholders acted in good faith**

- Primex argued that shareholders had a personal vendetta against Griffiths, and they are acting in self interest which implies bad faith
- Court rejects this, as it's **ridiculous to assert that acting in self-interest implies bad faith**
- Anything that benefits a company will indirectly benefit its shareholders by increasing the share value and it is hard to imagine a situation where a shareholder will not have a self-interest in wanting the company to prosecute an action which is in its interests to prosecute

b) **Action brought in best interests of the corporation**

- Court applies **"reasonable prospect" test**: does the proposed action have a reasonable prospect of success?
- An **argument which is not dismissed out of hand** is one which has a reasonable prospect of succeeding…done to prevent claims harassing directors
- If this test is passed, it's likely to find that shareholders acted in good faith and best interests
- Court applies the "reasonable prospect" test and finds that there are enough claims where a trial judge may reasonable find that Griffiths didn't make full disclosure to other directors
- Shows that the court has considerable control over derivative actions at this preliminary stage

H: Yes, for Northwest

C: The *CBCA* expands *Foss* but adds check that derivative action must obtain leave of the court (s.239(1))

- Q: what will be the judicial application of the derivative action provisions?
- A: the following case is a typical example of the hospitable attitude that Canadian courts have shown to applications for leave

Re Northwest Forest Products Ltd (1975)

F: Northwest had 51% of subsidiary Fraser Valley, and sold FV assets for $200,000 which appeared to be a great undervaluation (maybe 50% below). Northwest shareholders petitioned directors to vote on bringing a derivative action, but they declined, claiming that the shareholders ratified the sale

I: Did shareholder ratification automatically disentitle shareholders to get leave to bring the action? Is it *prima facie* in the best interests of the company that action be brought?

L: Shareholder ratification not a bar to brining a derivative action

- Shareholder ratification won't be overly persuasive to the court where the alleged misdeed is taken out at the bequest of the majority shareholders

A: Here, reasons for granting leave:

a) **Statute not a bar**

- Statute only stated that shareholder ratification was a factor to take into account to granting leave, not a bar to bringing a derivative action

b) **Best interests**

- Interests of the company and the interests of the shareholders are not synonymous
- ie: differences between majority and minority shareholders
- Thus ratification not a true reflection of what were the best interests of the company

c) ***Foss v. Harbottle* exception**

- *Foss* was a general rule with one exception: fraud upon the minority by the majority
- Statute was designed to overcome this rule

H: No, for shareholders…enough evidence to show it was in the best interests of the company to bring the action

The Role of the Board in Derivative Litigation

- *CBCA* s.239(2)(a) requires P to give "reasonable notice to the directors of the corporation" when bringing a derivative action
  - What happens when the directors consider the matter and decline to cause the corporation to sue?
- The following two cases deal with the American approach in **discontinuing derivative actions that have already started**
  - In Canada, not much emphasis on directors decision not to sue, as it's obvious they wouldn't anyways
- Also in Canada, granting leave placed much more emphasis on the reasonable prospect of success rather than the company's process and arguments in discontinuing the action
- Thus they analyze the role of the courts in deferring to directors…more policy than substantive law
- For Canada, in *Re Bellman*, it was confirmed that **in order to satisfy the *CBCA* requirement that a derivative action "appears to be in the best interests of the corporation", an *arguable* case must be shown to subsist**

Auerbach v Bennett (1979)

F: After a news scandal regarding multinational US firms giving kickbacks and bribes to foreigners, they hire an independent auditor, who produced a report confirming their firm did the same thing. Auerbach brings DA against auditor and corporation, stating they should pay back $11 million bribes. Directors created a special litigation committee to act on behalf of the Board to consider DA. After refusing to proceed with the derivative action, Auerbach sues.

I: Does the business judgment rule apply to the decision of a specifically appointed committee of disinterest directors acting on behalf of the board to terminate a shareholders' derivative action?

L: Substantive decision protected by business judgment rule; procedures open to review

- While courts can review the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment

A: Action of the special committee comprised of two components, each of which the court was attempting to determine if they fell within the scope of the business judgment rule:

a) **Procedures and methodologies to conduct investigation – no**

- Here, procedures were insufficient

b) **Substantive decision based on investigation – yes**

- Conclusion reached by committee is outside the scope of judicial review, and falls squarely within the embrace of the business judgment rule
- Courts can't inquire as to which factors were considered by the committee or the relative weight accorded them in reaching that substantive decision

H: Here, yes, for Bennett

Zapata Corp v Maldonado (1981)

F: P alleged Zapata's directors were optionees and caused the date on which options could be exercised to be advanced in order to save themselves tax liability. To do this, directors decided corporation to make a tender offer for its own shares. The effect of the tender offer would be to raise the market price of Zapata shares. Directors moved up option exercise date by month in order to exercise the options before tender date. P alleges that tax saving to directors represented an increased tax burden to corporation and lessened the burden on the directors, so brought derivative action, which an "Indepdendent Investigation Committee" declined to pursue

I: Does business judgment rule apply here?

L: Courts exercise business judgment rule in Delaware

- Even if a group of directors and its committee convince the court that it acted in good faith and followed a proper process in reaching its decision, it will not necessarily be determinative that the courts will deny granting leave to pursuing the derivative action

A: Court must do a **balancing act in applying business judgment rule**

- Must protect well-meaning derivative plaintiffs through the use of the committee mechanism
- Also must protect corporations unable to rid themselves of meritless or harmful litigation

Once application is before the court to dismiss, court must apply a 2-step test:

a) **Independence and Good Faith**

- Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions
- Court won't presume…onus on the committee to establish they acted in good faith
- If directors don't persuade the court, that's the end…if they do, go to step two

b) **Independent Business Judgment**

- Court determine, applying own independent business judgment, whether motion is granted

- Intended to thwart instances where corporate actions meet criteria of step one, but result doesn't satisfy spirit, or would prematurely terminate stockholder's grievance

H: Yes, for P

Oppression Remedy

Christopher Nicholls, "Corporate Law," (2005)

- Modern Canadian corporate statutes typically contain "relief from oppression" provisions that invite courts to engage in creative, activist solutions to intracorporate disputes
- The **oppression remedy is a unique creation of Canadian legislatures** that provides "the broadest, most comprehensive and most open-ended shareholder remedy in the common law world"
  - Stands in contrast to court's deferential attitude towards decision making managers and directors
  - Damages go to the individual, so where it's available it's more attractive than a derivative action
- Basically, it is a remedy **available if a corporation does something that screws a shareholder, director, officer or creditor**
  - Since it's so far reaching and limitless, the remedy should be **treated with extreme caution**

Comparison with the Derivative Action

- When you compare the oppression remedy with the statutory derivative action, which also allows complainants to bring legal actions concerning the manner in which the corporation is being managed, three crucial procedural differences become apparent
  1. In order to bring a derivative action, a complainant must seek leave of the court
  2. The court exercises a statutory supervisory jurisdiction over the derivative action that enables it to issue orders concerning issues such as the manner in which the action is conducted, which party will have conduct of the action, and who will receive any damages awarded in the action
  3. The damages awarded in a derivative action will ordinarily go to the corporation in whose name the action was begun unless the court orders otherwise
- An oppression remedy has no leave requirement and the court has no statutory power to intervene in the conduct of the application, with one exception. This exception, applicable to both the oppression remedy and the derivative action, in s.242(2) of the *CBCA* requires court approval of any settlement, discontinuance, or abandonment of an oppression remedy application or a derivative action.
- An oppression remedy claimant can pursue a claim for personal compensation for harm to the complainant's interests from the oppressive actions

Relationship with Directors' Obligations

- Directors of corporations are subject to myriad legal obligations arising from corporate statutes as well as other statutes such as securities laws
- Among the most central are the duties of loyalty and care in *CBCA* s.122(1).
- If directors act in compliance with these duties, can their actions be the object of a successful claim for relief under the oppression remedy?
- With respect to the duty of loyalty under *CBCA* s.122(1)(a)-to act honestly and in good faith with a view to the best interests of the corporation – it appears that actions that comply with this duty can give rise to oppression remedy claims
- The courts focus on the effects of corporate actions under the oppression remedy; for example, whether the acts are oppressive or unfairly prejudice or disregard the protected interests.
- Under the duty of loyalty, the courts are assessing the motivation of the director. Thus, in a number of cases where the courts have found that directors were acting in good faith in the corporation's best interests, they have also found that the effects of their actions on the complainant's interests have rise to a successful oppression claim.
- However, it should be noted that in those cases, the remedies being sought were against the corporation, such as redemption of shares or unwinding certain corporate transactions, and not against the directors personally.
- When it comes to the duty of care in *CBCA* s.122(1)(b), the courts are measuring the conduct of directors against an objective standard of diligence. The courts in assessing this conduct, apply the business judgment rule, which provides that the courts will not intervene where the directors have made their decisions "honestly, prudently, in good faith and on reasonable grounds." Thus, conducts that meets this standard may not give rise to a successful oppression remedy application.

Clitheroe v Hydro One Inc (2002)

F: P, director of Ontario Hydro, worked there for 6 years when it was divided into 5 companies in 1999. After employment K signed, Ontario gov't passed legislation directing board of Hydro to negotiate new K's with officers with express purpose of reducing remuneration and benefits received by officers. P was fired by the corporation, but didn't believe it was for a valid reason (wrongful dismissal action)

I: Did P qualify as a complainant to be brought under the oppression remedy?

L: Can't bring every claim under oppression remedy

- The mere fact that an individual is a security holder, director, or shareholder doesn't mean that every claim they have with a corporation is subject to the oppression remedy, but rather that the claim must be connected with their position with the corporation

A: The oppression **remedy is not intended as a backdoor wrongful dismissal motion**

- Defence can only be used to rectify oppression, deal with unfairness, and protect particular interests for reasonable expectations of fair treatment, ie: interest holders, creditors, directors, and officers…not employees
- It's a broad remedy, but not intended to deal with every disagreement one has with the company
- The **expectations must be linked to one's status to the company**
- Here, P was both an employee and a director, and argued she had standing
  - However, **court concerned with opening up remedy to a wide variety of claims**
  - Here, her claim was connected with her position as an employee, not as a director
- Many employees are both officers and employers of corporations, and a larger number are both shareholders and employees, and to allow them in wrongful dismissal context to have recourse to the oppression remedy would be a misuse of the remedy

H: No, for Hydro One

First Edmonton Place Ltd v 315888 Alberta Ltd (1988)

F: Landlord provided package of inducements to a numbered company controlled by 3 lawyers to sign a 10-year lease…after making use of rent-free period and taking the money, they vacated the premises, never signed the lease, and no further rent was paid. Landlord seeks to bring an oppression action, alleging their actions as directors of the numbered company were unfairly prejudicial to or unfairly disregarded the landlord's interests

I: Is the applicant a "proper person" to bring an oppression remedy?

L: A creditor must have an interest as a creditor at the time of the wrongful acts, and the fact that a creditor has a future expectation of becoming a creditor of a corporation doesn't allow them access to the oppression remedy

A: Most actions using oppression remedy are made by minority shareholders, but this decision hinged on the availability of a remedy to a creditor. Here, a "complainant" must be a "**proper person**" to bring an action

- Court holds that determination of "proper person" should be left to the discretion of the court
- There are 2 circumstances where justice and equity would entitle a creditor to be a "proper person":

a) **<u>Fraud upon the applicant</u>**

- Act or conduct of the directors or management of the corporation which is complained of constituted using the corporation as a **vehicle for committing a fraud** upon the applicant
- No evidence of inequality of bargaining power

b) **<u>Breach of underlying expectation</u>**

- Act or conduct of the directors or management of the corporation which is complained of constituted a **breach of the underlying expectation of the applicant arising from the circumstances in which the applicant's relationship with the corporation arose**

Court focuses was on whether there was some kind of expectation on the part of the landlord to become a creditor of the corporation, not in the future but initially

- Thus **applicant must have interest as creditor at the time the acts complained of occurred**
- Here, "creditor" didn't include lessor because no rent was owing at the time of the wrongful acts and the lawyers hadn't signed the lease
- There was no evidence of expectation that lessee corporation would grant a lease of 10 years for any other set term to any other persons
- Thus falls short of evidence of expectation that there would be a lease for the entire 10-year period or for any set term longer than the rent-free period and less than 10 years
- Here, if the lawyers had signed the lease and were late with the rent payments, he would have had standing as a creditor to sue

H: No, for lawyers, applicant was not a creditor at time of the act or conduct complained of

Downtown Eatery (1993) Ltd v Ontario (2001)

F: Manager of nightclub dismissed for cause, then commenced successful wrongful dismissal action. However, nightclub owners reorganized their corporate entities twice before wrongful dismissal judgment, and thus company ceased to exist at the time P became entitled to receive damage award from the corporation…lost at trial, now P appeals
I: Was conduct of the owners "oppressive" or "unfairly prejudicial"?
L: Successful oppression application

- The court will be willing to find an individual as a proper person before they actually become a creditor if the effects of the wrongful acts are unfairly prejudicial and there was no opportunity for the individual to protect himself

A: TJ makes finding that there couldn't be an oppression remedy because he wasn't persuaded that the corporate restructuring was done with fraudulent intent

- However, the **test for unfairness doesn't require malice** under the statute
- The focus of the court's analysis is on the **effects of the wrongful acts**
- Thus, even though the restructuring was done with no wrongful purpose, the effect was oppressive or unfairly prejudicial, and there was nothing P could do to avoid that effect

P is the proper person to bring the claim and is entitled to protection

- Court holds this even though P wasn't a creditor at the time of the corporate reorganization
- Difference is that in *First Edmonton*, the landlord gave all gifts voluntarily and could have taken steps to protect himself, while here, P had no chance to protect himself

Additionally, in terms of reasonable foreseeability, here there is no reasonable expectation that an individual will be dismissed by their employer

- In *Edmonton*, a landlord that gives lawyers gifts accepts risks that they might not be refunded

H: Yes, for P

BCE Inc v 1976 Debentureholders (2008)

Two Step Oppression Test (BCE Inc; court re-packages statutory language)
Step 1: Establish standing
Step 2: Does the evidence support the *reasonable expectation* asserted by the claimant?

- Where *reasonable expectations* are objective and contextual
  - Not frozen at ACC; court will examine the current state of the company and how those expectations have changed
  - Must have regard to the expectations of the stakeholders in relation to the facts of the specific case, the relationships at issue and the entire context
  - RE: Directors owe their duty to the CO, not to SHs – the reasonable expectation of SHs is simply that the DOs act in the best interests of the company (BCE)
- Meant to contextualize the analysis – must consider all of the circumstances of the CO and the intentions of the parties
  - Expectations likely to vary in CHCs vs. WHCs
  - The smaller the CO, the more important it is to understand the circumstances around incorporation
  - Shareholder agreements – need to examine carefully; identify restrictions and mgmt of the CO
  - Past practices – was it a partnership prior to incorporation?
  - Relationship b/w the parties – were they family members? Strangers? How did they meet?

As ____________________ is a [SH/creditor] of a closely held corporation, the expectation tends to be founded on personal relationships of trust and confidence. In this case … [talk about breach].
As ____________________ is a [SH/creditor] of a widely held corporation, the sources of reasonable expectations do not depend on intimate relationships (like CHCs) but rather legal rights to dividend income and capital gains (upon sale of shares, at preferably as high a share price as possible). In this case… [talk about breach].
For the reasons above, I am of the opinion that_____________ [did/did not] have a reasonable expectation that was breached by the corporation.

Step 3: Does the evidence establish that the *reasonable expectation* was violated by the act of oppression, unfair prejudice or unfair disregard?

- First, must find actions that constitute oppression or unfair prejudice – BCE makes it clear that not all conduct that violates reasonable expectations will be unfair
  - "fair treatment" is fundamentally what stakeholders are entitled to expect
- Then, must determine if those actions violate the reasonable expectation
  - Actions that significantly undermine the value of the CO

- Material breaches of the expectations of the complainant

Indicia of Oppression (per Arthur v Signum)

- Lack of valid purpose of corporate transaction, such as excessive salaries
- Lack of good faith of part of Directors
- Discrimination among SHs, which gives benefit to majority over minority
- Lack of adequate financial disclosure of material info to minority SH
- Plan or design to eliminate minority SH
- Refusing dividends to SHs

In my opinion, __________'s application [DOES/DOES NOT] pass the BCE test for oppression. Assuming this is true, the court will now have many remedies available to grant ____________, as listed in section 227(3).

Defining Zone of Protection: Oppression, Unfair Prejudice and Disregard

Scottish Co-Operative Wholesale Society Ltd v Meyer (1959)

F: Scottish anxious to enter the rayon trade in 1946. Felt aid of Meyer and Lucas and their technical experts was desirable to make the venture successful. Scottish created subsidiary with 4000 shares, 3900 of which were owned by M and L. After Scottish learned the secrets, M and L were expendable, and offered to buy the subsidiary but the offer was rejected…subsequently, Scottish entered rayon trade with great diminution to the subsidiary's profits

I: Could M and L make an oppression complaint as they held shares in the subsidiary, not the parent?

L: Omission of directors was prejudicial

- Omissions as much as acts can constitute oppressive or unfairly prejudicial conduct

A: Rather than actively winding-up the subsidiary, the directors on the Board of the subsidiary (who were also directors of Scottish) sat by mutely and let it die a long, slow death

- Duty of the directors of the subsidiary was to complain at Scottish meetings about what they were doing to the subsidiary, but never did
- Thus while there were no active steps, the **omission/neglect of the directors by not using their position to protect the value of the company constituted oppression**

Remedy is that M and L are to be bought-out at the pre-oppression price

- Thus appropriate remedy where value of the company has been destroyed

H: Lord Denning of course says yes

Ferguson v Imax (1983)

F: Several couples set up Imax corporation, which works well until Mr. and Mrs. Ferguson separated. Husband used dominant position in the company by suspending the payment dividends on her class of shares, and further put a resolution to the other shareholders promising many things, mostly permitting the retirement of non-participating shares. These "possible" benefits had the intended effect to convert all of his wife's shares, buy them out, and then issue more shares with the effect of diluting her shareholding

I: Was Mr. Ferguson's conduct oppressive?

L: Successful oppression remedy application out of domestic dispute

- In assessing an application for an oppression remedy in a closely-held corporation, the court may consider the relationship between the shareholders and the *bona fides* of the corporate transaction in question

A: Even if other Class B shareholders agreed to modification of share rights, it was oppressive to Mrs. Ferguson because the other Class B shareholders had continuing investments by virtue of continuing, happy marriages and ownership of common shares

- Court also holds that the **whole point of the actions was to get rid of Mrs. Ferguson**

Thus court must **consider the *bona fides* of the corporate transaction** in question to determine whether the act of the corporation or directors effects a result which is oppressive or unfairly prejudicial to the minority shareholder

- Here, all the founders were colluding to get rid of her, who was also a founder
- Thus company wasn't acting *bona fide* in trying to amend the share rights
- Resolution was a "final solution" to get rid of her

H: Obviously yes, for wife

Naneff v Con-Crete Holdings Ltd (1993)

F: Mr. Naneff founds company, grows to be a multi-millionaire, and shares equitable ownership with his two sons, but maintains control through redeemable voting preference shares. After a family feud, one son, Alex, was removed as an officer and excluded

from participation in management and cut off his income from the business. At trial (in casebook), the court found the family's conduct was oppressive to Alex and the TJ ordered that the family business be sold publicly with Alex, Mr. Naneff and the other son or any combination of them being entitled to purchase it.

I: What was the reasonable expectation of the shareholders? Is an order to sell shares on the public market an appropriate remedy in oppression cases involving family businesses?

L: Court looks at equitable considerations in remedy

- When fashioning a remedy which the court "sees fit" the court can look at equitable considerations such as those of the relationships arising between the parties, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way

A: Here, son's reasonable expectations as a shareholder conflicted with the business expectations

- Expectation of eventually getting part control of the company obviously depended on the continued favour with his father, and knew from the outset that he'd never be a shareholder independent of his father's control, especially since it was a business his father founded
- Appropriate remedy is not one that gives the son more than what was reasonably expected
- Correct is to order father and other son to buy the bad son's shares at a fair market price and pay back company debt to the son

H: CA reverses TJ…the remedy of public sale of the business was an error in principle and is unjust to Mr. Naneff

- Proper remedy should be that Mr. Naneff and the other son acquire Alex's shares at fair market value as of the date of the ouster
- Since Mr. Naneff acted oppressively towards Alex he should NOT be able to take away Alex's right to control the business or his share in the corporation

Naneff v Con-Crete Holdings Ltd (1995)

- When considering which order to grant, courts are cognizant that intervention into corporate affairs should not be taken "lightly" and should "be done with a scalpel, and not a battle axe."Orders must also be fair and balanced as a whole, i.e. it is inappropriate to work injustice to the oppressor.
- Leading case on the subject of oppression and estate freezes. In Naneff, the father founded a thriving concrete business. In order to fulfill his "passionate desire" of having his sons continue the business, he effected an estate freeze. As a result, his two sons became equal owners of all the common shares and he received preferred voting shares. Through the voting shares, the father would retain "full, final and ultimate control…until he died."
- Decades after the freeze, and while the father was still alive, a family crisis arose over "lifestyle" choices of the eldest son. Eventually, the eldest son was "thrown out of the family" and removed from the company, including from its income.39 The Court of Appeal for Ontario had little difficulty finding this conduct oppressive:
    - In circumstances such as these, the strictures of the OBCA and of corporate law override the family desires. In their corporate capacity as directors [the family members] are required to act in good faith and in the best interests of the company, and not for some extraneous purpose.
- The Court of Appeal then considered the appropriate remedy. The Court explained that a remedy in these cases must be guided by the following:
    - At the outset I think it is important to keep in mind that this is not a normal commercial operation where partners make contributions and share the equity according to their contributions or where persons invest in a business by the purchase of shares. This is a family business where the dynamics of the relationship between the principals are very different from those between the principals in a normal commercial business. As the courts below have correctly held, the fact that this is a family business cannot oust the provisions of s. 248 of the OBCA. Nevertheless, I am convinced that the fact that this is a family matter must be kept very much in mind when fashioning a remedy under s. 248(3) as it bears directly upon the reasonable expectations of the principals.41 [emphasis added]
- Applying this principle, the Court concluded a public sale of the company (the remedy awarded at trial) was inappropriate. The Court explained that a public sale worked injustice against the father who had devoted himself to the company. It was also contrary to the reasonable of expectations of the son—i.e. potentially giving him control of the company before the father's death. In the end, the Court ordered that the son's interest be bought by the father at fair market value.
- Thus, Naneff, like Ballard and Van Stone, affirms that directors in family business contexts are subject to corporate duties and potential court supervision. Perhaps most surprisingly, in Naneff the father was limited in how he could treat his son's equity that the father had gifted to him, even while the father remained in voting control. Naneff also indicates that while a court-ordered sale may be inappropriate when the parent effecting an estate freeze is still alive, where the founder is already deceased oppression may result in the public sale and loss of the family business (once again this is a fact-specific and discretionary issue).
- In sum, each of these three cases indicates potential risks posed by the oppression remedy to estate planning. The next

section explains strategies to reduce these risks.

What are Directors' Duties and Shareholders' Rights in Mergers and Acquisitions?

Mergers and Acquisitions: Friendly

Formal Aspects of Mergers and Acquisitions

- "Merger" and "acquisition" are not terms of art in Canada. Indeed, the terms are often used indiscriminately to describe virtually any form of business combination, whether achieved through:
  - (i) a purchase or sale of shares,
  - (ii) a purchase or sale of assets,
  - (iii) (iii) an amalgamation, or
  - (iv) an acquisition effected by way of a court-approved plan of arrangement
- The terms may even on occasion be extended to other forms of combinations, as where one corporation transfers its business to another under a long-term lease.

Sale of Shares

- A sale of a controlling block of shares in one corporation to another corporation or to the latter shareholders will vest control of the two enterprises in common hands.
- Selling shareholders may receive purely monetary consideration for their shares, in which case they will have no interest in the merged corporation. However, they will continue to participate in the combined corporation for their shares is shares of the purchaser
- The kind of consideration received may give rise to different tax consequences, because capital gains tax liability might be triggered on a merger where selling shareholders receive cash only, while tax liability can instead be deferred through a share-for-share exchange until one disposes of the new shares received. As a result, shareholders may in some instances be prepared to accept a lower price on a share exchange than a sale for cash
- Since shares are personal property, a transaction pursuant to which shareholders propose to sell their shares to a purchaser does no require shareholder approval by all shareholders by way of special resolution. The sale may, however, trigger duties of compliance with legislative provisions governing takeover bids.
- A further concern arises when a controlling block of shares is sold at a premium above market price. Since the premium paid for the control block is not offered to non-controlling shareholders, the two classes of shareholders are not accorded equal treatment.
- Mergers accomplished through the sale of shares do not normally have a direct effect on the value of debt claims.

Sale of Assets

- Two corporations may combine if one sells to the other all or substantially all of its assets
- The same transaction may be structured as a lease of assets if the term of the lease is so long that the lessor obtains substantially al of the economic value of the leased business.
- As a sale of shares, the selling or leasing corporation may receive either shares of the purchasing corporation or cash. If the sale is paid for with a share consideration and the selling corporation distributes all of the shares it receives to its shareholders, the transaction is equivalent to a share-for-share amalgamation. Even if no distribution of shares is made by the selling corporation, a sale of assets for shares is financially identical to an amalgamation, for the selling firm will become a holding corporation whose only asset is shares in the purchasing corporation
- A sale or lease of al or substantially all of the corporation's assets requires approval by two-thirds of the votes cast by shareholders under *CBCA* s.189(3), with even non-voting shares endowed with voting rights in certain circumstances under s.189(6). This is because the corporation is disposing of the very business shareholders invested in.
- Many corporate statutes therefore provide shareholders with a say in this decision.
- In a widely held corporation, this will require compliance with proxy regulation requirements, including the mailing of an information circular to all shareholders.
- If a shareholder dissents from the special resolution, he or she may subsequently require the corporation to repurchase his or her shares by asserting appraisal rights under *CBCA* s.190(1)(e)

M Gannage, "Sale of Substantially All the Assets of a Corporation" (2000)

- Does it strike "at the heart of the corporate existence and purpose of" the Company?

- Would it remove the Company's "ability to accomplish the purposes or objects for which it was incorporated" and "have the effect of destroying the corporation's business"?
- Would its effect "fundamentally alter the nature of the company from an operating company to a holding company" and destroy "the company's main business"?
- Would its consequence "be the effective destruction of the company's business"?
- Would it "radically and fundamentally alter" the Company?
- Does it constitute "a fundamental change which strikes at the very heart of the company and… would substantially affect the corporate existence and purpose"?
- Will it "have the effect of fundamentally changing or destroying the nature of the corporation's business" and is it "tantamount to the winding-up of the corporation's business"?
- Will it destroy or alter the company so that it no longer does "what it was originally created for"?

Amalgamation

- A third way in which one business may be combined with another is by filing articles of amalgamation under *CBCA* s.181…two ways:
  a) **"Short-form" Amalgamation - Simple**
    - If one corporation is wholly owned by another, or if both are wholly owned by the same person, they **may be amalgamated without formal shareholder consent** under *CBCA* s.184
  b) **Two Separate Companies - Difficult**
    - In other cases, the amalgamation agreement under s.182 **must be approved by special resolutions of the shareholders of both corporations**
- If it's a widely held corporation, this will require full disclosure of the details of the amalgamation and regulations under securities law regarding info distributed to shareholders
- As of the date set out in the certificate of amalgamation, the two corporations continue as one corporation that possesses all the rights and property and is subject to all the liabilities of the two amalgamating corporations under *CBCA* s.186
- *Black and Decker*: result of amalgamation is a new company, and this new company continues to have both the assets and liabilities of both companies
- Dickson J: "The end result is to create a homogeneous whole…the analogies of a river formed by the confluence of two streams, or the creation of a single rope through the intertwining of strands"

R v Black and Decker Mfg Co (1975)

F: Accused corporation charged with offences under *Combines Investigation Act*

I: Was the amalgamated corporation liable for the criminal charges?

L: Amalgamation does not give absolution to criminal acts

- "The effect of amalgamation is to have the amalgamating companies continue without subtraction in the amalgamated company, with all their strengths and their weaknesses, their perfections and imperfections, and their sins, if sinners they be"

A: Shows amalgamation more complicated than other mergers, as when there are 2 separate companies merging, they must have a new articles of amalgamation that replaces the old articles and respects share voting rights

H: Yes, criminal liability for offences committed prior to 1971 survived the amalgamation

Other Merger Techniques

- *CBCA* proves for a court-approved plan of arrangement (s.192) that can be used to implement a merger and acquisition transaction
  - These involve complex structuring designed to achieve a desirable tax outcome
  - Courts typically require shareholder approval of transactions effected in this manner

Christopher Nicholls, "Corporate Law," (2005)

- The statutory arrangement procedure in s.192 of the *CBCA* has become a very important part of Canadian corporate law practice; but its significance will not become immediately apparent from a simple reading of the statutory language.
- The word "arrangement" itself may lead some to confuse this procedure (which is regularly used by healthy corporations to effect sophisticated transactions) with statutory measure to which only distressed corporations typically have recourse
- Statutory arrangements can be used as a means of structuring business acquisitions and complex reorganizations such as spin offs
- Arrangements may involve the same sort of fundamental change to a business or to a shareholders' *CBCA* does not

automatically accord dissent rights to a shareholder in the case of changed effected by arrangement
- The court has discretion under s.192(4)(d) to grant (or indeed not to grant) such rights to dissenting shareholders.

The Appraisal Remedy

- Under s.190 of the *CBCA*, shareholders who wish to dissent in respect of certain kinds of fundamental transactions have the right to require the corporation to repurchase their shares at fair value
  - This is preferable for them as an exit strategy as opposed to having to hold shares in a new entity in which they do not wish to hold an interest
  - **Appraisal rights are triggered by "fundamental" corporate transactions**, such as amalgamations, sales of substantially all of the firm's assets, transactions that affect shares of a class, ect…see s.190
- They are a trade-off for the loss of individual veto rights, which shareholders had when corporate laws required that these transactions receive unanimous approval
- However, given costs associated with process, the shareholder may simply prefer to sell his or her shares on the market, rather than assert appraisal right
- In *CBCA*, s.190 (subsections other that (1) demonstrate process of executing right):

  a) **<u>Section 190 – Right to Dissent</u>**

  (1) - "Subject to sections 191 and 241, a holder of shares of any class of a corporation may dissent if the corporation is subject to an order under paragraph 192(4)(d) that affects the holder or if the corporation resolves to
  - (a) amend its articles under section 173 or 174 to add, change or remove any provisions restricting or constraining the issue, transfer or ownership of shares of that class;
  - (b) amend its articles under section 173 to add, change or remove any restriction on the business or businesses that the corporation may carry on;
  - (c) amalgamate otherwise than under section 184;
  - (d) be continued under section 188;
  - (e) sell, lease or exchange all or substantially all its property under subsection 189(3); or
  - (f) carry out a going-private transaction or a squeeze-out transaction"
- Big issue is **valuation of the dissenter's shares**
  - Particularly challenging if the shares are not traded widely or actively
- Courts generally don't apply a minority discount…instead in Canada, courts place a heavy **emphasis on asset and earning value**, in effect awarding the dissenter a premium over market value
- Under Canadian statutes, the valuation of dissenters' stock is generally made as of the **date of the resolution**, and not as of a time prior to the announcement of the transaction (*CBCA* s.190(3))

Smith v Van Gorkom (1985)

F: Plaintiffs, Alden Smith and John Gosselin, brought a class action suit against Defendant corporation, Trans Union, and its directors, after the Board approved a merger proposal submitted by the CEO of Trans Union, fellow Defendant Jerome Van Gorkom.

I: The issue is whether the business judgment by the Board to approve the merger was an informed decision.

L: Under the business judgment rule, a business judgment is presumed to be an informed judgment, but the judgment will not be shielded under the rule if the decision was unadvised.

H: The Delaware Supreme Court held the business judgment to be gross negligence, which is the standard for determining whether the judgment was informed. The Board has a duty to give an informed decision on an important decision such as the merger and cannot escape the responsibility by claiming that the shareholders also approved the merger. The directors are protected if they relied in good faith on reports submitted by officers, but there was no report that would qualify as a report under the statute. The directors can not rely upon the share price as it contrasted with the market value. And because the Board did not disclose a lack of valuation information to the shareholders, the Board breached their fiduciary duty to disclose all germane facts.

Dissent: The dissent believed that the majority mischaracterized the ability of the directors to act soundly on the information provided at the meeting wherein the merger took place. The credentials of the directors demonstrated that they gave an intelligent business judgment that should be shielded by the business judgment rule.

C: The court noted that a director's duty to exercise an informed business judgment is a duty of care rather than a duty of loyalty. Therefore, the motive of the director can be irrelevant, so there is no need to prove fraud, conflict of interests or dishonesty.

Mergers and Acquisitions: Hostile

Takeover Bids

Control Transactions

- Control transaction refer to the techniques pursuant to which incumbent management is displaced by a new set of managers…can take two forms:
  - a) **Proxy Battle**
    - Less popular
  - b) **Takeover Bid**
    - Launched through a public offer for the shares of all of the shareholders
- This is heavily regulated by securities regulation, which applies where one shareholder acquires over 20% of the shares in a corporation as a result of the transaction
- 20% seen to give an entity "effective control" over the corporation, and triggers securities laws
- Usually started by issuing a circular or posting a newspaper ad, it stays open for a set period of time, and then shareholders can choose to accept or reject
- While securities regulations affect how a bid is made, corporations law is more concerned about the proper response the directors can take when responding to the bid:
- Takeover bids may be classified in two ways:
  - a) **Friendly**
    - Uncontested by the target corporation, which will issue a directors' circular indicating its support for the offer
  - b) **Hostile**
    - Target management attempts to defeat the takeover bid through defensive maneuvers

Defensive Tactics

- Examples of defensive tactics:
  - a) **Shark Repellant**
    - Clauses in articles that make a takeover difficult
  - b) **Poison Pill**
    - Shareholder rights plans that grants them certain rights when a takeover occurs
    - May be put in place pre-bid or during the 35-day window when the bid must stay open
    - This makes the target corporation seem very unattractive
  - c) **Golden Parachute**
    - Manager contracts give them huge payouts when dismissed, making a takeover bid unattractive
  - d) **White Knight**
    - Target embarks on a series of **share transactions** designed to make acquisition difficult, such as issuing new securities/block of shares to an inside group or allies ("white knights") better disposed to incumbent management, or convince the white knight to make a bid
  - e) **Make Target Seem Attractive**
    - If successful, the firm will not appear to be a suitable candidate for a takeover bid motivated by an offeror's belief that he or she can manage the firm more efficiently
    - ie: dividend payout, share repurchase that eliminates cash flow, propaganda campaign stating shares are worth more than the offer price
  - f) **Offensive Tactics**
    - Includes propaganda campaign and bringing lawsuits for misrepresenation apparent in the takeover bid circular

Teck Corp v Millar (1972)

F: Afton, a mining company, lacked sufficient capital, so directors sought to interest wealthier companies to participate in mining development…Teck wanted an "ultimate deal" with Afton. However, when Teck learned that D would rather sell to Canex with a lower offer , they doubled Canex's offer and bought ½ of Afton's shares on the open market. If Canex's bid was successful, they'd become the majority shareholder, so Teck brings action that directors had an improper purpose in signing K with Canex to defeat. Teck as majority shareholder, even if they acted in the best interest of the company

I: Were the director's defensive tactics valid?

L: Directors acting in the best interest of company must have reasonable belief

- If directors take defensive maneuvers in response to a takeover bid based on a belief that there will be substantial damage

to the company's interest, then there must be reasonable grounds for that belief, otherwise court will find that the directors were motivated by an improper purpose

A: Teck relies on *Hogg,* which stated that directors have no right to exercise their power to issue shares, in order to defeat an attempt to secure control in the company, even if they consider that in doing so they are acting in the company's best interests

- However, Berger J., while admitting there is conflicting authority in Canada on the issue, states that *Hogg* goes too far in restricting director's powers to do what's in best interests of corporation
- Court holds that directors **ought to be allowed to consider who is seeking control and why**
- If directors believe that there will be substantial damage to the company's interest if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorized as improper
- Therefore, Afton's directors could consider the reputation and policy of Teck and consider whether it was desirable that Teck or Canex have control
- There is a **potential for conflict of interest**
    - Directors may claim action is in best interests of company, but really acting to preserve their jobs
    - Therefore, something **more than a mere assertion of good faith is required**
    - Directors **must also show that here are reasonable grounds for their belief**
- Here, directors motivation was not to defeat Teck getting control as majority shareholder, but to defeat them getting the ultimate deal over the mining operations
- Evidence directors held out for better K with Canex while Teck gained control by buying shares
- Also, it's in Teck's best interest, as majority shareholder, to get the best deal possible
- In the alternative, if *Hogg* was correct law, it was inapplicable here, as directors primary purpose was getting the best deal, not retaining control

H: Yes, for D

Poison Pills and Other Defensive Tactics

- Purpose of a shareholder rights plan is to make it extremely unattractive for a bidder to proceed with a bid without having convinced the target company's board of directors to do away with the rights plan
- Also known as a "**shareholder rights plan**", which is usually **triggered upon the bidder's acquiring a certain percentage of the target company's shares** (usually 20%)
- After this "flip-in event", the Rights suddenly entitle the share's holders to purchase voting shares at what is effectively half price
- In addition, the bidder is not entitle to exercise the right
- Effect is to dilute bidder's share from over 20% threshold down to a much lower percentage
- Some rights plan contain **permitted bid provisions**
    - ie: bid will succeed despite existence of the poison pill as long as the bid meets certain conditions
    - Institutional investors have successfully placed pressure on Canadian companies to shorten the list of conditions
- Other defensive tactics include:

    a) **Staggered Boards**
    - Board where directors are placed into different classes and serve overlapping terms
    - Makes it more difficult to gain control of the board, thus making the corporation unattractive
    - Outsider would have to wait a few years before being able to gain control of the board

    b) **Shark Repellants**
    - Provisions in the corporate articles that make the corporation less attractive as takeover target
    - ie: merger would require 95% shareholder approval rather than typical 2/3 special resolution
    - Both 'a' and 'b' are more common in the USA
- Delaware approach is to analyze all of these defensive measures with the ***Unocal*** **proportionality test**
    - **Q**: was the defensive measure reasonable in relation to the threat that was being posed?

Hogg v Cramphorn Ltd (1967)

- Issuing shares to defeat a takeover is always an improper purpose.