BUSINESS ORGANIZATIONS SUMMARY

Table of Contents

1. MANAGEMENT AND CONTROL OF THE CORPORATION ... 8

(i) Corporate Governance: The Role of Legal and Market Instruments ... 8

(a) Introduction ... 8

(b) Iacobucci: Agency Problem in the Separation of Ownership and Control ... 9

(c) The Challenge of Berle and Means ... 9

(d) Enter the Contractarians ... 9

(e) Iacobucci: Framework of Mechanisms of Control of Agency Costs ... 11

(f) The Role of Corporate Law in the Contractarian Model of the Corporation ... 12

(g) Critique of the Contractarian Model of the Corporation ... 13

Mace, Directors: Myth and Reality ... 13

Eisenberg, The Structure of the Corporation ... 13

(h) Iacobucci: Two Viewpoints of the Role of Corporate Law ... 13

2. INTRODUCTION TO THE LEGAL MODEL OF THE CORPORATION ... 15

(i) Introduction ... 15

(ii) Mandatory Versus Enabling Interpretations of Corporate Statutes ... 15

Bushell v. Faith (HL, 1970) ... 15

(iii) Directorial Power and Interpreting the Corporate "Contract" ... 17

Kelly v. Electrical Construction Co. (OLR, 1907) ... 17

Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cuninghame (1906) ... 18

Scott v. Scott (ER, 1943) ... 19

Macson Dev. Co. Ltd. v. Gordon [SH pass resolution preventing lawsuit] ... 20

Gower, Modern Company Law ... 20

(a) Internal Delegation ... 21

CBCA s.115 ... 21

Hayes v. Canada-Atlantic & Plant S.S. Co. (US, 1910) ... 21

(b) External Delegation (delegation to third parties) ... 22

CBCA s.102 ... 22

Sherman & Ellis v. Indian Mutual Casualty (US, 1930) ... 22

Kennerson v. Burbank Amusement Co. (Calif, 1953) ... 23

Cullen v. Governor Clinton Co. (US, 1952) ... 24

(c) Employment Contracts and Director/Officer Tenure ... 24

Realty Acceptance Corp. v. Montgomery (3rd Cir, 1930) ... 24

Southern Foundries Ltd. v. Shirlaw (HL, 1926) ... 26

Shindler v. Northern Raincoat Co. (ER, 1960) ... 27

3. THE EVOLUTION OF BUSINESS CORPORATIONS LAW AND THE NATURE OF CORPORATE PERSONALITY **29**

(i) History of Canadian Business Corporations Law ***29***

(ii) Separate Legal Personality ***29***

Salomon v. Salomon & Co. (A.C. 1897) 29

(a) Employment and Separate Legal Personality 31

Lee v. Lee's Air Farming Ltd. (NZ) 31

(b) Insurable Interest and Separate Legal Personality 32

Iacobucci: Insurable Interest Doctrine 32

Macaura v. Northern Assurance Co. (1925) 32

Kosmopoulos v. Constitution (1983) 33

(c) Conceptions of Legal Personality 35

(d) Protections to Third-Parties 35

(ii) Exceptions to the Rule of Limited Liability ***35***

Wolfe v. Moir (1969) 35

Mesheau v. Campbell (OCA, 1983) 36

Said v. Butt 37

ADGA Systems International Ltd. v. Valcom Ltd. (OCA, 1999) 38

Williams v. Natural Life Health Foods Ltd. (HL, 1998) 40

Hapern, Trebilcock: An Economic Analysis of Limited Liability in Corporate Law 40

(iii) Lifting the Corporate Veil ***41***

Iacobucci: On Piercing the Corporate Veil 41

Clarkson Co. Ltd. v. Zhelka (ON, 1967) 42

Big Bend Hotel Ltd. v. Security Mutual Casualty Co. 43

Gilford Motor Company v. Holmes (1933) 44

Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd. (ON, 1972) 44

642947 Ontario Ltd. v. Fleischer (CA, 2001) 46

Iron City Sand & Gravel Div. v. West Fork Towing Corporation (US, 1969) 46

De Salaberry Realties Ltd. v. Minister of National Revenue (1974) 48

Jodery Estate v. Nova Scotia (Minister of Finance) (SCC, 1980) 48

(a) Debt Priority for Shareholders (Equitable Subordination) 50

Taylor v. Standard Gas & Electric Co. (US, 1939) 50

Stone v. Eacho (US, 1942) 50

(b) Tortious Liability 51

Adams v. Cape Industries (UK, 1990) 51

Walkovsky v. Carlton (US, 1966) 52

Posner – Rationales for Piercing the Corporate Veil 54

4. THE PROCESS OF INCORPORATION ... 55
The Competition for State and Provincial Charters: Delaware Phenomenon ... 55
Incorporation Techniques ... 56

5. THE SCOPE OF THE CORPORATE CONTRACT ... 57
Ultra Vires Doctrine ... 57
Response of CBCA ... 57
(i) Corporate Social Responsibility ... 57
Introduction ... 57
Dodge v. Ford Motor Company (US, 1919) ... 58
Miles v. Sydney Meat-Preserving Co. Ltd. (1913) ... 60
Parke v. Daily News Ltd. (1962) ... 61
Teck Corporation Limited v. Millar (BC, 1973) ... 63
Theodora Holding Corp. v. Henderson (US, 1969) ... 63
Evans v. Brunner, Mond & Co. Ltd. (1972) ... 64
CNR "Run-Throughs" Report ... 65
Report of the Royal Commission on Corporate Concentration (1978) ... 65
E.M. Dodd, "For Whom are Corporate Managers Trustees?" (1932) ... 65
ALI: Principles of Corporate Governance: Analysis and Recommendations (1994) ... 66
Posner, An Economic Analysis of Law (1986) ... 66
Hansmann and Kraakman, "The End of History for Corporate Law (2001) ... 66
(ii) Creditors and Corporate Obligations ... 67
S.122 CBCA: To Which Stakeholders do D/Os Owe a Duty? ... 67
Canbook Distribution Corp. v. Borins (ON, 1999) ... 67
Peoples Department Stores Inc. (Trustee of) v. Wise (SCC, 2004) ... 68
BCE Inc. v. 1976 Debenturesholders (SCC, 2008) ... 70

6. SHAREHOLDERS' REMEDIES ... 72
Introduction ... 72
(i) The Derivative Action ... 72
(a) Introduction ... 72
(b) Common Law Rules ... 72
Foss v. Harbottle ... 72
Mozley v. Alson ... 72
Northwest Transportation v. Beatty ... 73
Exceptions to Foss v. Harbottle ... 73
(c) The Statutory Derivative Action ... 73

The Federal Acts 73
(d) Judicial Interpretation of the Derivative Action 74
Re Northwest Forest Products Ltd. (BCSC, 1975) 74
Re Marc-Jay Investments Inc. and Levy (ON, 1974) 75
Re Bellman and Western Approaches Ltd. (BCCA, 1981) 77
Discovery Enterprises Inc. v. Ebco Industries Ltd. (BC, 1997) 78
Richardson Greenshields of Canada Ltd. v. Kalmacoff (ONCA, 1995) 78
(e) Costs in Derivative Actions 79
Introduction 79
Turner et al. v. Mailhot et al. (ON, 1985) 79
(f) The Relationship between the Complainant and the Corporation 80
(ii) The Personal Action 80
Hercules Management Ltd. v. Ernst & Young (SCC, 1997) 80
Kraus v. J.G. Lloyd Pty. Ltd. (1965) 81
Jones v. H.F Ahmanson & Co. (Cal, 1969) 82
Thomas v. Dickson (US, 1983) 82

7. THE DUTY OF CARE OWED BY DIRECTORS AND MANAGERS TO THE CORPORATION 83
(i) Common Law 83
City Equitable Fire Insurance Co. Ltd. (1925) 83
Re Brazilian Rubber Plantations and Estates, Ltd. (CA, 1911) 84
Selangor United Rubber Estates Ltd. v. Craddock (1968) 85
(ii) Principles Underlying Duty of Care 86
(iii) Due Diligence in the Income Tax Context 87
Canadian Income Tax Act 227.1 87
Soper v. R. (FCA, 1998) 87
Peoples Department Stores Inc. (Trustee of) v. Wise (SCC, 2004) 88
(iv) Statutory Reform: Environmental Obligations 90
R. v. Bata Industries Ltd. (ON, 1992) 90
(v) The Securities Regulators' Public Interest Duty of Care 91
Ontario Securities Act: S.127 – Securities Regulators' DoC 91
Standard Trustco Ltd., Re (Sec. Commission, 1992) 91
(vi) Expansion of Statutory Duties for Directors 92
Directors Face Grab-Bag of Liabilities, Daniels and Morgan (1992) 92
(vii) Other Statutory Director Liabilities in Corporate Law 93
CBCA 118. (1) Directors' liability 93
CBCA 118. (2) Further directors' liabilities 93

CBCA 118. (6) No liability 93
CBCA 119. (1) Liability of directors for wages 93
CBCA 123(4) for Due diligence defence to all 118/119 duties. 93
Policy Concerns regarding Proliferation of Directorial Liability 93
(viii) Business Judgment Rule 94
Overview: Biz Judgment Rule 94
Smith v. Van Gorkom (Del., 1985) 94
Brant Investments Ltd. v. Keeprite Inc. (ONCA, 1991) 96
Pente Investment Management Ltd. v. Schneider Corp. (1998) (OCA) 97
(ix) Indemnification and Insurance 98
CBCA Section 124 98
The Implications of D/O Insurance Liability Crisis on CDN Corporate Governance 99

8. FIDUCIARY DUTIES OWED BY DIRECTORS AND MANAGERS TO THE CORPORATION ... 100
(i) Introduction to Fiduciary Duties 100
CBCA 122. (1) Duty of care of directors and officers 100
(ii) Basic Self-Dealing Transactions (SDTs) 100
(a) Introduction 100
Costs of Self-Dealing 100
Benefits of Self-Dealing 100
(b) The Common Law 100
Aberdeen Railway Co. v. Blaikie Bros. (HoL, 1860) 100
Transvaal Lands Co. v. New Belgium Land and Development Co. (UK, 1914) 101
Imperial Mercantile Credit Association v. Coleman and Knight (HoL, 1873) 103
Gray v. New Augarita Porcupine Mines Ltd. (P.C., 1952) 104
(c) Legislative Response 105
The Common Law Rule 105
CBCA S.120(1) 105
CBCA S.120(5-8) 106
Differences between Statute and CL 107
Insurance 107
Duty of Loyalty vs. Duty of Care 107
(iii) Corporate Opportunities 108
Cook v. Deeks (Ontario P.C., 1916) 108
Regal (Hastings) Ltd. v. Gulliver (HoL, 1942) 110
Phipps v. Boardman (HoL, 1965) 112
Bendix Home Systems Ltd. v. Clayton (BCSC, 1977) 113

Peso Silver Mines Ltd. v. Cropper (SCC, 1966) 114
Irving Trust Co. v. Deutsch (US 2nd Cir., 1934) 115
Canadian Aero Services Ltd. v. O'Malley (SCC, 1973) 117
(iv) Competition 118
London and Mashonaland Explor Co v. New Mashonaland Explor Co (1891) 118
In Re Thomson (1930) 119
(v) Hostile Takeovers and Defensive Tactics by Target Management 120
(a) Introduction and Background 120
Jargon 120
How Hostile Takeovers Happen (Widely-Held) 120
Why Hostile Takeovers Happen 120
Why Fiduciary Duties are Implicated during Hostile Takeovers 121
Statutory Provisions (CBCA) 121
(b) Older Canadian Common Law 121
Bonisteel v. Collis Leather (ON, 1919) 121
Teck Corp. Ltd. v. Millar (BCSC, 1973) 122
(c) US Common Law 124
Unocal Corp. v. Mesa Petroleum Co. (Del. S.C. 1985) 124
Revlon Inc. v. MacAndrews & Forbes Holdings Inc. (Del. S.C., 1985) 126
Paramount Communications Inc. v. QVC Network Inc. (Del., 1994) 128
Pente Investment Management Ltd. v. Schneider Corp. (OCA, 1998) 128
BCE Inc. v. 1976 Debentureholders (SCC, 2008) 131
Chapters Inc., Re (2001) (Securities Comm.) 132

9. Shareholders' Remedies 136
(i) The Oppression Remedy 136
(a) Introduction 136
Interaction with Fiduciary Duties 136
Two Characterizations of the Oppression Remedy 136
(b) Standing to Bring an Oppression Remedy 136
CBCA s.238: Who can bring an oppression remedy application? 136
First Edmonton Place Ltd. v. 315888 Alberta Ltd. (1988) (Q.B.) 137
(c) Does the Majority Owe a Duty to the Minority? 138
Brant Investments Ltd. v. KeepRite Inc. (OCA, 1991) 138
(d) What Duties Does the Majority Owe the Minority Under the OR? 139
Ebrahimi v. Westbourne Galleries Ltd. (1972) (H.L.) 139
Ferguson v. Imax Systems Corp. (1983) (O.C.A.) 140

Diligenti v. RWMD Operations Kelowna Ltd. (1976) (B.C.S.C.) 142
Westfair Foods Ltd. v. Watt (1991) (Alberta C.A.) 142
BCE Inc. v. 1976 Debentureholders (SCC, 2008) 144
(e) Can a complainant launch OR application for a complaint that is in essence derivative? 146
Sparling v. Javelin International Ltd. [1986] (Quebec Court) 146
(f) Application of OR to Shareholder Conduct 147
CBCA S.2: 147
Scottish Co-operative Wholesale Society Ltd. v. Meyer [1959] (HL) 148
(g) Application of OR for Past Wrongs 149
Ford Motor Co. of Canada v. OMERS (OCA, 2006) 149
(ii) Shareholders' Rights: Voting 150
Background and Rationale: Agency Problems to be Avoided 150
Voting as a Remedy for Agency Problems 151
(a) Permissible Limitations & Flexibility on Voting in Articles of Incorporation 152
Jacobsen v. United Canso Oil & Gas Ltd. [1990] (Alta. Q.B.) 152
Bowater Canadian Limited v. R.L. Crain and Craisec Ltd. (1987)(O.C.A.) – p. 708 154
(iii) Shareholders' Rights: Proposals 155
Residual Rule 155
Exceptions (Direct Shareholder Democracy) – 4 types: 155
Enforceability of Shareholder Proposals 156
Medical Committee for Human Rights v. SEC (D.C., 1970) – p. 770 156
Varity Corp. v. Jesuit Fathers of Upper Canada (1987)(O.C.A.) – p. 772 157

1. MANAGEMENT AND CONTROL OF THE CORPORATION

- Background
  - A **positive** statement is a statement about **what is** and that contains no indication of approval or disapproval. Notice that a positive statement can be wrong. "The moon is made of green cheese" is incorrect, but it is a positive statement because it is a statement about what exists.
  - A **normative** statement expresses a judgment about whether a situation is desirable or undesirable. "The world would be a better place if the moon were made of green cheese" is a normative statement because it expresses a judgment about **what ought to be**. Notice that there is no way of disproving this statement. If you disagree with it, you have no sure way of convincing someone who believes the statement that he is wrong.

(i) Corporate Governance: The Role of Legal and Market Instruments

(a) Introduction

- Problem: ensuring the accountability of managers to the goals of the corporation – incentive for corporate actors to deviate from these goals in order to maximize their own welfare, but Corporate law limits the scope for such opportunism
- Iacobucci – Who's Affected by Corporations
  - Directors
    - Manage or supervise management of the corporation
    - Officers
  - Shareholders (typical descriptions – there are exceptions)
    - Common – have the right to vote (ex. vote for directors), the right to receive a proportion of dividends if they are declared by the board of directors, paid out on a pro rata basis; get a right to receive the leftovers in the event the company is liquidated (the residual claimants)
    - Preferred – typically do not have the right to vote; have an understanding that dividends of a certain amount will be paid to them; boards can refuse to pay preferred shareholders dividends – but preferred shareholders may have rights if dividends are not paid (ex. obligations to pay are carried over years); have a right to a fixed amount on the liquidation of the company
    - If liquidate/bankrupt – creditors get paid first, then preferred, then common
  - Creditors
      - In general – less risky than being a shareholder since creditor get paid first; creditors upside is capped – the payoffs are truncated
    - Bondholders (bond is the same as debenture)
    - Bank debt
    - Trade creditors
    - Securities – catchall for debts
    - Bond – trade money for a bundle of rights – rights include interest payments and repayment of principle – these are contractual rights that bondholders would have → if there is a missed payment on the interest, then it's like a breach of contract – so there is an enforceable obligation
  - Employees
  - Community
    - Mining town
    - Environment
    - Customers
    - Government
- Why focus on directors and shareholders, and not creditors?

- Incentive SH have to grow the firm (creditors have a fixed upside) due to residual claim
- SH contract is incomplete; whereas creditors and others have more complete contracts
- Other types of law governs other stakeholder relationships (employment law, etc)
- Potential tension between interests of SH and management, due to separation of ownership and control

(b) Iacobucci: Agency Problem in the Separation of Ownership and Control

- Circumstances: a family business wants to purchase a car for the business that will cost $10,000, and will only benefit the family (not the corporation or any third parties) by a value of $8,000
- Situations
  - (1) Family wholly owns a company and also wholly control it
    - The family is better off not purchasing the car since the cost to them is $2000 more than the benefit
  - (2) Family only owns 60% of the company since they have sold a 40% stake to the public in the form of stock
    - The cost to the family is now only 60% of the total cost of the car, amounting to $6000, since they only own 60% of the company
    - The family will purchase the car since they get $8000 total benefit for a $6000 total cost
- Implication: the family (managers are better off), while the corporation (shareholders) is worse off, all of which occurred due to the separation of ownership and control
- Iac: Agency problem → the efficient decision is made in situation (1) and the inefficient decision is made in situation (2) since there is a social welfare loss in (2)
  - In formal terms: those in charge will not allocate resources such that value is maximized, but will allocate resources such that they benefit the managers
- Other Agency Costs from the Separation of Ownership and Control
  - Shirking (less motivated to work hard after sell shares)
  - Risk aversion (managers may avoid high risk decisions since comes with risk of being fired, even if decision is in best interests of ownership)
- Benefits to separation of control and ownership
  - Capital: facilitate s investment and the pursuit of ventures
  - Specialization: have specialized decision-makers instead of having everyone involved in every decision (reduced costs of information)
  - Spreading ownership: facilitates diversification; allowing outside investors to invest in a variety of things can aid in the diversification of their risk

(c) The Challenge of Berle and Means

- Due to the fact that large corporations often do not have a single shareholder, a separation of **ownership and control** results
- Dispersion of share ownership transformed shareholders into passive principals of the corporations they owned
- Control laid with managerial elite who only had a minor stake in the capital of the corporation, so management was not motivated to advance the welfare of the corporation and its owners – **Iac: this means managerially elite will run the corporation under their own discretion, and not necessarily consistent with the owners' (shareholders) wishes**

(d) Enter the Contractarians

(i) Introduction to the Corporate Contract

- Law and econ view is the corporation as a nexus of contractual relationships among its shareholders, creditors, managers, EEs and suppliers → delegation from principal to agent of functional authority, so situation where the principal and agent's incentives might not align
- **Purpose of corporate law, from L&E perspective, is to achieve the cost-effective reduction of agency costs**
- The greater the ownership stake sold by the original owners to outside investors, the greater the incentive facing the original owners to engage in opportunistic behavior
- Notion: fact that outsiders would enter into a corporate contract suggests there is some assurance of fidelity – logical extreme → agency conflicts are controlled to the point where an additional dollar spent in inducing a certain kind of managerial behavior is exactly equivalent to the benefit generated
- **Two reasons for why corporations are structured to minimize agency costs:**
    - (1) there important incentives for private actors to choose a corporate framework that provides investors with assurance that managerial agency problems will be cost-effectively minimized
        - Depending on the terms of the corporate agreement, investors will adjust their willingness to pay based on the extent agency problems will arise under the agreement
        - The costs and benefits of these rules must be weighed against alternative market mechanisms (see 2 below) that may create a better combination of strictness on certain dimensions
    - (2) there are several legal and market mechanisms that corporate actors can rely on to discipline managers
        - Legal instruments restrain managerial opportunism by imposing *ex post* costs on managers engaging in agency conflicts
        - Market instruments (a) impose significant costs on self-serving management and (b) market signals furnish owners with information of managerial shirking or diversion, so owners can discipline managers

(ii) Voting – Independent and Instrumental Value

- A. Overview
    - Managerial self-interest controlled by share-holder voting
    - Majority rule is the dominant decision rule for board elections – the boards appoint the management – if management fails, then they are responsible for adjusting the management -- if shareholders are dissatisfied with Board's supervision of management, then they can alter the composition of the board
    - Voting on fundamental corporate changes is typically subject to supra-majority (greater than 50%) voting rules
- B. Information Provision and Collective Action Problems
    - Independent capacity of shareholder voting to constrain agency costs is a function of the magnitude and quality of information that is available to shareholders → the more information available to shareholders, the more rational and effective their voting
    - Acting rationally, shareholders should invest in information activities to the point where the benefits that are received are equal to the costs
    - Generating an optimal level of information is unlikely since information is a public good creating a free-rider problem among shareholders → if this is a rational strategy for one shareholder, then it would be for all shareholders, so information investment will be sub-optimal
    - Prisoner's dilemma → created when there are strong incentives for self-interested actors to pursue non-cooperative solutions, even though a mutually advantageous solution exists via cooperating
        - Less of a problem when have large (controlling) shareholders that believe their votes will matter – more likely to invest in information
        - Markets can address the problem by providing information to shareholders

- C. Markets and Information Provision
  - Capital Markets
    - Capital markets, if perfectly efficient, will ensure that the price paid for securities of a corporation fully reflects the magnitude of expected costs generated by agency conflicts → i.e. shareholders will not suffer reductions in their wealth by managerial shirking or diversion because these costs were anticipated at the time of initial investment (and included in the price paid per share)
    - Efficient pricing requires (i) that some subset of fully-informed investors (marginal investors) be able to accurately price the magnitude of expected agency costs, and (ii) that the price paid by marginal investors not diverge significantly from the price paid by less informed investors for shares purchased within the same time frame on the market
  - Product Markets
    - Gauge performance in product market – company performance, relative to entire product market performance, sends a signal to shareholders/investors about managerial performance
- D. Direct Control of Agency Costs Through Markets
  - Managerial Market
    - The market where services of corporate managers are traded
    - Competition encourages managers to act in principals' best interests – if all costs of shirking are included in the adjustment of a particular manager's pay, then no benefit for manager to do so – this assumes that market is able to value the performance of a manager in isolation from her team
    - Whistle-blowing on upper management is incented by promotions of lower management – so there is an incentive to search for managerial opportunism in upper managers by lower managers
  - Product Market
    - Directly sanction managers for inferior performance via bankruptcy – managers likely replaced after such an event
  - Market for Corporate Control
    - Most powerful safeguard against agency costs
    - Operates by transferring control of mismanaged corporations to owners more willing to discipline managers
    - Transfer of control is effected by the use of hostile takeover bid – which operates independently of management
    - So long as acquirer gains 51% of voting stock, she can oust management by electing new directors
    - Profits for acquirer since share price will be reduced to reflect the agency problems
    - So fear of takeover and likely job loss serves as a disincentive to shirk

(e) Iacobucci: Framework of Mechanisms of Control of Agency Costs

- **Law**
  - Direct
    - <u>*Fiduciary duties*</u>
      - Directors and officers owe a fiduciary duty to shareholders to act in their best interests
    - <u>*Duty of care*</u>
      - Directors and officers owe a duty of care (negligence) to shareholders
  - Indirect
    - <u>*Voting*</u>

        - *Control directors:* directors only hold office if voted in by shareholders; so shareholders can vote out directors if they are not acting in the shareholders' best interest
        - *Control changes:* shareholders may also vote on fundamental corporate changes themselves, giving rise to the disadvantage of acquiring information and the advantage of capital pooling
            - Disadvantage of acquiring information: shareholders often will not have sufficient information to make an intelligent decision, and the costs of acquiring adequate information may be high
            - Advantage of capital pooling: having collective holding of shares (ex. by pension funds), so that fund will acquire the information for all those shareholders and make an educated decision (these capital pooling institutions will often have fiduciary duties that require them to vote intelligently
        - *Capital markets*
            - Provide information in a low cost way for shareholders to vote – i.e. shareholders get dividends/residual earnings, so the value of the share price considers the expected future profits of a decision
            - Essence: changes in share price provide information to voters about managerial performance at a low cost [assuming capital markets are efficient]
        - *Product markets*
            - Information about products and their potential success, as assessed by the market and the shareholder, can be used to determine the health of the company
    - *Problems with voting:*
        - *Costs:* It is costly to acquire the information to vote intelligently
        - *Collective Action Problem*: each individual shareholder likely has great costs of gathering information but receives trivial benefits since they only have one vote
        - *Free-Rider Problem*: even if the costs are slightly below the benefits, there still is a free rider problem since the individual can benefit from letting others acquire the information and vote intelligently, while not acquiring (and not paying) for any information himself
        - *Coalition to acquire info* (i.e. all agree to help acquire nfo) → free-rider problem since there is an incentive not to join the coalition and reap the benefits it generates
- **Market**
    - *Market for corporate control*
        - Acquirers may believe that by replacing a company's management the company would be worth even more, so there is an incentive for takeover when management is shitty
        - As a result, this market serves as a source of discipline for managers contemplating self-interested behavior; a threat of takeover incents a manager to do a good job, since a takeover would likely lead to the loss of his or her job
    - *Market for managerial services*
        - Managers may increase the demand for their services if they have a good reputation, which is rewarded in the managerial labour market in the form of higher compensation

(f) The Role of Corporate Law in the Contractarian Model of the Corporation

- Why is corporate law necessary?

- (1) Market mechanism described above only work because of the law (ex. rules related to voting on directors, rules relating to ownership in capital markets)
- (2) Reduces transaction costs of entering into agreements by providing for standard form contracts (ex. incorporation gives rise to complex fiduciary duties that have been refined over many years)
- Overall →corporate law plays an enabling role that facilitates contracting by offering a set of default rules; seeks to give parties what they want and allow them to something different if they so choose

(g) Critique of the Contractarian Model of the Corporation

- (1) Market failures do happen so they may not be able to always effectively control agency costs – product and managerial markets often suffer from various structural imperfections, capital markets are not efficient in relation to certain sets of information and the corporate control market only operates above certain thresholds of agency costs
- (2) Dysfunction of institutions on which the contractual model of corporations appears to place considerable reliance (See MACE and EISENBERG cases below)

Mace, Directors: Myth and Reality

- Argues that the role of boards is to (1) establish basic objectives, strategies and policies; (2) ask discerning questions; (3) select the president → finds that in companies where the president and board members hold only a small proportion of the stock that these roles are not fulfilled adequately

Eisenberg, The Structure of the Corporation

- Drastic skew exists between legal and business models of a board – managers running the company and making decisions, while rules hold the board accountable—leading to the problem that belief in the validity of the legal model prevents regulation by shareholders, legislators and the public since they believe the board is supervising the corporations affairs

- Overall → benefits arise from the separation of management and ownership (since owners are free from selecting managers on factors unrelated to managerial skill); even though there are recognized costs in the system, cannot justify rejecting the current system and its benefits without proposing a better system
- Normative Arguments against contractual theory of the corporation
  - Brudney → concerned with the hostility of the model to regulatory intervention (if parties have created mutually acceptable bargains, then the scope for state intervention is greatly confined)
  - Clark → contractual metaphor fails to accurately depict reality, engenders simplistic optimism about the optimality of existing rules and institutions and deflects attention from underlying value judgments
    - Comparing shareholders to principals is not completely correct since shareholder lack many of the rights afforded to legal principals
  - Chapman → contractual theory is insufficient since does not account for values unrelated to contract (duty of loyalty and trust)

(h) Iacobucci: Two Viewpoints of the Role of Corporate Law

- (1) Enabling [parties themselves are better placed to determine their actions]
  - Corporate law provides the default rules, which apply if the parties do not specify they apply, but can be contracted around if the parties so choose [descriptive and normative approach]
  - Normative aspect: corporate law should generally not have rules that parties cannot opt out of
  - Facilitates contracting among parties by:
    - (1) reducing transaction costs – by way of default rules and standard forms

    - (2) standardize complex rules – standard rules apply upon incorporation and need not be formulated each time one wishes to incorporate
    - (3) standardized procedures
    - (4) creation of separate legal personality – separation of corporate assets from those of the directors, officers and shareholders (very difficult to replicate this rule through contract)
- (2) Regulatory [government in best position to tell corporations how to structure their affairs]
  - Parliament should just create the rules that the corporations adhere to
  - Advantages of this approach:
    - Difficult for investors to acquire information about corporation's contracts and governing rules if they are not strictly provided for in statute – so in order to facilitate continued investment, require regulatory approach
  - Other arguments in favour of the regulatory approach:
    - ***Berle and Means:*** B&M – managerial elite making decisions and contracts
    - ***Mace:*** certain roles are understood to be within the domain of the board; boards do not ask prying questions, instead they accept the objectives and are very passive; management seem to be in charge, and the board doesn't do much to check on them
    - ***Eisenberg:*** empirically, it does not appear that shareholders have much of a say – this is a problem normatively, since accepting this approach leads one to be more open to leaving it up to the parties to decide Ks (shareholders have less influence)
  - Iacobucci's rebuttals to these arguments:
    - ***B&M:*** even though directors are not heavy-handed in managerial supervision, this does not mean there are not other influences on managerial behavior – instead, one of the other control mechanisms (ex. see above -- markets) are controlling managers
      - Do not need a perfect regime; there may be some agency problems, but that does not mean that the regulatory approach is the solution – need to make these determinations relatively
    - ***Mace:*** dated empirical evidence; boards are much more active now

2. INTRODUCTION TO THE LEGAL MODEL OF THE CORPORATION

(i) Introduction

- CSR – is there a duty or capacity of corporate actors to account for constituencies outside the corporate contract?

(ii) Mandatory Versus Enabling Interpretations of Corporate Statutes

- Shareholders' power to remove directors derived from s. 109 of the CBCA and s. 122 of the OBCA

Bushell v. Faith (HL, 1970)

- **Synopsis**: D gets 3x voting rights if about to be removed on all his shares (effectively allows him to prevent his removal), as provided in the corporations articles of incorporation. Majority held that voting rights were OK. Upjohn states that the company has the unfettered right to draft articles that are inconsistent w/ the by-laws, and the articles trump. Donovan holds that the articles of incorporation override the statute, unless Parliament explicitly states otherwise. In dissent, Morris holds that statute trumps articles.
- **Note**: these facts have not arisen in Canada. Could argue both enabling and regulatory views, with a note on the CBCA provision 109.
- Facts
  - Article 9 of association for the company say that upon voting for removal of director, shares held by that director held 3 votes per share
  - Company has 300 shares
  - 100 held by appellant Bushell and 100 each by respondents Faith and Bayne
  - Bushell and Bayne proposed to remove Faith as director and resolution was passed on a show of hands (2:1)
  - Faith demanded a poll and the resolution was defeated 300 -200
  - *Companies Act* (s.2 and 62) says that shares can be issued with special rights, including rights related to voting
  - *Companies Act* (s. 184) also says that "a company may remove a director before the expiration of his period of office, notwithstanding anything in its articles or in any agreement between it and him"
- Issue
  - Is the vote sufficient to remove Faith from office?
    - How should votes be counted, considering article 9 of the company's article association?
    - Is article 9 valid, or is it overridden by s.184?
- Decision
  - Upjohn: dismiss appeal (article 9 is valid)
- Reasons
  - TJ:
    - Appellant argues that allowing article 9 to prevail would frustrate the purpose of s.184 of the legislation ("notwithstanding anything in its articles") →TJ agrees with this argument, stating that allowing article 9 to stand would make a mockery of the law
  - **Majority: Lord Upjohn (Enabling View) (unfettered)**
    - "that was the mischief which the section set out to remedy; to make a director removable by virtue of an ordinary resolution instead of an extraordinary resolution, or making it necessary to alter the articles"

        - Definition of ordinary resolution: passed by a bare majority on a show of hands by members entitled to vote – each member has one vote regardless of his shareholding
      - When poll demanded, then bare majority required, but voting power depends on the voting rights attached to each share
        - ***Unfettered right*** of the company, under article 2 of its incorporation, to attach any share or class of shares special voting rights on a poll
      - Parliament has never sought to fetter the right of the company to issue a share with special rights or restrictions; instead, s.184 was seeking to make an ordinary resolution sufficient to remove a director; if Parliament wanted to fetter these rights, they would have done so explicitly
      - Argues that there is nothing different in this case from the case where the director being removed would always get 3 votes per share
    - **Majority: Lord Donovan (Enabling View) (with limits)**
      - Purpose of legislation (by plain reading of its words)
        - (1) director can be removed by ordinary resolution
        - (2) may be achieved notwithstanding anything in the company's articles, or in any agreement between the company and the director
      - So – any case requiring an extraordinary resolution (such as this case) to remove a director, is overridden by s. 184
      - Ordinary resolution to remove director means that each shareholder has one vote per share and no more – weighted votes are nullified by s.184
      - BUT – since no provision was set out in the legislation that provided that s.184 could not be rendered inoperable; thus, Parliament followed its practice of leaving to companies and their shareholders liberty to allocate voting rights as they pleased
        - Parliament did not intend to block every loophole of removing a director, and rightly so since it is sometimes necessary, particularly with small family companies, to safeguard against family quarrels having repercussions on the board
    - **Dissent: Lord Morris (Regulatory View)**
      - There are special voting rights in some circumstances – but in this case, the special rights only exist for the purpose of circumventing s.184, which would make a mockery of the law if upheld
  - Ratio
    - Majority: private choice will prevail unless parliament is specific about it
  - Iacobucci
    - Majority (Upjohn) has bad argument: to equate the two cases like the majority does seems to be a stretch – since you cannot equate the circumstances where the option to always have special voting rights and where they only do in certain circumstances (in this case)
    - Majority (Donovan) has bad argument: since it seems odd that Parliament would take a formalistic approach to the mischief – but if they want to create space for private choice, the outcome of this case will make sense
    - How does the perspective to corporate law relate to this case?
      - Dissent – regulatory – Parliament gets to decide the rule and it is s.184
      - Majority – enabling – unless Parliament really spells out the derogation of the freedom of the parties themselves, they are going to defer to the freedom of the parties
    - Lynchpin: this case turns on the approach to contractual freedom that the judges take

            - Canada: Have not had the Bushell fact pattern yet – so could argue both ways
                - CBCA: S.109 – can remove director by ordinary resolution
                - CBCA: S.109(4) – says that ordinary resolution is mandatory to remove a director; but it does not speak to special voting rights, so the same type of Bushell issue could arise in Canada
            - Thinking Point:
                - How can we have confidence in the rules (articles of incorporation) when it is the directors who are choosing the rules
                    - Response → shareholders will only pay for the share if they think it is worth it to pay for the share; so there will be incentives to directors drafting the articles, since they want to attract shareholders – generally, share price will take into account the articles of incorporation of the company
                - Back to Car family biz example → the entrepreneur chooses the rule, but doesn't always choose the rule in such a way that will only benefit them, this is because the shareholders drop willingness to pay to make up for the cost of the bad decision
                - Point here: the costs and benefits of the tradeoffs between rules are borne by the company since the price that shareholders are willing to pay will be adjusted

(iii) Directorial Power and Interpreting the Corporate "Contract"

Kelly v. Electrical Construction Co. (OLR, 1907)

P.230

- **Synopsis**: a proxy bylaw was not confirmed by SH when proposed by BoD; later, SH want to pass same bylaw, but it has expired. Ds do not want to pass the bylaw at the later time. Held that the bylaw cannot be in force, since SHs do not have power to propose and enact bylaw, Ds have to propose the bylaw.
- **Policy**: policy makes sense since (i) SHs consented to the arrangement prior to K, (ii) avoids potential for inconsistent bylaws, which would arise if both SH and Ds could propose.

- Facts
    - Action to set aside the election of the board of directors of the D company, an Ontario corporation
    - 4 absent shareholders who were represented by proxy, were not allowed to vote
    - By-law stated that all instruments appointing proxies shall be deposited at the head office of the company at least 1 day before the date at which they are to be used
    - S.47 of the *Companies Act* declares that the directors may make by-laws to regulate proxies, but every such law, unless confirmed at a general meeting, shall only have force until the next annual meeting of the company
    - The bylaw in question (May 1897) was not confirmed at the next annual meeting
    - Since May 1897 by-law not confirmed, it ceased to have force
    - The only kind of bylaw capable of confirmation under s.47 is one in force at the time of such annual meeting – so the bylaw in question was not in force at the May 1905 annual meeting, so it was not capable of confirmation
    - Shareholders contended that if the bylaw couldn't be confirmed at the May 1905 meeting, then it could be supported as a by-law originating in the first instance at a shareholders' meeting
- Issue
    - Whether the by-law respecting proxies passed by the board of directors (in May 1897) was in force at the election of directors (in Feb 1907)

- o Decision
  - ▪ By-law not in force; SH don't have power to enact previously proposed by-law
- o Reasons
  - ▪ S.63 of the *Companies Act* enacts that "at all general meetings of the company every shareholder shall be entitled to as many votes as he holds shares in the company, and may vote by proxy" and s.47 declares that the board of directors may pass by-laws regulating the requirements as to proxies → read together, each shareholder is entitled to the right to vote by proxy, SUBJECT to compliance with the requirements of a directors' by-law, which if not confirmed in the specified time, ceases to exist
  - ▪ S.47 confers express power upon the board of directors to pass by-laws respecting proxies, and deprives the shareholders any inherent power to deal with the subject – so the by-law of 1905, if regarded as originating with shareholders, is null and void; in addition, the directors by-law of 1897 was also null and void, since it was not confirmed by the shareholders
  - ▪ Essence: the 1897 by-law does not exist since it was not confirmed and the 1905 by-law is not in effect since shareholders cannot create and confirm a by-law (directors need to put forth the by-law for the shareholders to confirm)
- o Iacobucci
  - ▪ Principle-agent implications?
    - • → nothing odd with this approach, since could get inconsistent by-laws if both shareholders and directors could enact by-laws
    - • ←shareholders are supposed to be the principals here, so it's odd that the agents have to do the act that the shareholders want for it to be in effect (i.e. a P-A model where the P is constrained from acting)
    - • →while shareholders are constrained from acting, directors cannot act alone, they still need the shareholders to confirm the by-laws (i.e. shareholders have final say)
    - • Contractarian: argue that shareholders consented to this arrangement of delegation of authority to the directors (notion: gains from specialization)
  - ▪ Canadian law:
    - • CBCA s.103 – directors must pass a bylaw, but shareholders must ratify or it ceases to have affect
      - o Preamble to s.103 – this is a default rule, unless articles say otherwise (this makes it clear that this was a contractual choice b/t the parties themselves)
    - • CBCA s.137 – contemplates the idea of shareholders proposing particular bylaws

Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cuninghame (1906)

P.232

- o **<u>Synopsis</u>**: resolution approving sale of company passed by majority of SHs, but Ds refuse sale. Held that Ds were permitted to refuse the resolution since the articles of incorporation stated that in order for BoD to be changed, extraordinary resolution was required; it is not fair to say that the majority is the principal to the director's agent and that the agent could then remove the principal, since the BoD is the agent for the minority SHs as well.
- o **<u>Policy</u>**: rule that require extraordinary resolution makes sense since (i) SHs knew that at the time of contract, since was provided in the articles, and (ii) protects minority SH from majority oppression

- o Facts
  - ▪ Articles of association of the Automatic Self-Cleansing Co. provided that management of the business and control of the company shall be vested in the directors, subject to regulations as from time to time be made by extraordinary resolution (vote of 3/4 of shareholders)

- P major shareholder arranged for the sale of the company's assets – a resolution approving the sale was passed by a simple majority, but the D directors were of the opinion that the sale on the terms was not for the benefit of the company so refused to do so (despite the existence of the majority)
- Issue
  - Were directors permitted to refuse majority of shareholders?
- Decision
  - Yes, the directors are not required to carry out the resolution
- Reasons
  - Based on the wording of the articles of association, if the desire is to alter the power of the directors, then it can't be done by ordinary resolution – extraordinary resolution is required
  - Dismissed the following argument about principal-agent: it would be absurd if a principal in appointing an agent should in effect appoint a director who is to manage him instead of his managing the agent → dismissed since it is the consensus of all the individuals in the company for which the directors are agents
    - Not fair to say that a majority of shareholders is the principal in order to alter the mandate of the agent; the minority must also be considered
- Iacobucci
  - Is this case consistent with directors acting in shareholders' interests?
    - Argue – yes since they signed onto the K that said directors manage the firm
    - Court says that shareholders on the whole agreed to these terms – directors are agents for the collective of shareholders, not just the majority
  - Why might this rule (extraordinary resolution) be in place?
    - Protect minority shareholders from the controlling shareholder – who might have personal reasons influencing his/her preferences with respect to management of the firm
    - Attract minority shareholders, who may not invest otherwise
  - Likewise – could argue the converse → that minority might have an interest in preventing sale or doing things – since minority have veto power when extraordinary resolution required

Scott v. Scott (ER, 1943)

P.234

- **Synopsis**: resolution authorizing pmt of dividend passed at general meeting; company articles provided that the Ds may pay dividends, so Ds bring action challenging the validity of the resolution. Held that SH resolutions are mere recommendation to the BoD, who has the authorization but not obligation to act on those resolutions
- **Policy**: rule of not requiring BoD to do anything based on SH resolution makes sense since they are the agents and should be free from influence. Also, they are subject to control by the SHs through voting.
- Facts
  - Resolution authorizing a dividend to be paid to each preference shareholder was passed at the general meeting
  - The company's articles provided that "the directors may from time to time pay to the members such interim dividends as appear to the directors to be justified by the profits of the company
  - Action brought by Ds challenging the validity of the resolution
- Issue
  - Can the Ds challenge the validity of the SH resolution?

- Decision
- Reasons
  - Directors would not be able to manage the business if they are interfered with (by way of paying a dividend)
  - Even if the resolution not aimed at paying an interim dividend, it is aimed at interfering with the management of the business by the directors, and thus is inoperative
- Ratio
  - Shareholders are merely making recommendations to the board, which the board is authorized to act on; as such, boards are influenced but not bound by resolutions (influenced since shareholders can remove the board)

Macson Dev. Co. Ltd. v. Gordon [SH pass resolution preventing lawsuit]

P.234

- **Synopsis**: president appoints another D, only after he obtained resignation of original Ds, which he said told them was to facilitate the liquidation of the company; w/ new D, the president sues original Ds, but at SH meeting the former Ds (who were SHs) passed a resolution disproving the action. Held that Ds had ultimate power, pursuant to articles of incorporation of the company, so they could refuse SH resolution.
- **Note**: CBCA provides the option for SHs to remove Ds by ordinary resolution.
- Facts
  - President of the P company held a meeting at which he appointed a second director; he did this only after he obtained the resignation of the first directors, in order to, as he told them, to facilitate liquidation of the company
  - With new director, directors held meeting and authorized a law suit against former directors
  - Then, at a general meeting of the shareholders, who were composed of the former directors, a resolution was passed disapproving the action
- Issue
  - Can the SH resolution stop the lawsuit?
- Decision
  - No
- Reasons
  - Judge finds that President had power to appoint the new director
  - By virtue of another article, all management was delegated to directors, not to shareholders, so the shareholders resolution was invalid and could not overrule the decision of the directors
- Iacobucci
  - Concern here is that shareholders are voting a certain way on the resolution out of self interest (protection); however, they consented to the delegation of authority to directors
  - There is nothing wrong with delegating authority to directors; it does not undermine shareholder authority → according to CBCA, shareholders always have the ability to remove directors by ordinary resolution

Gower, Modern Company Law

P.235

- Case law seems to indicate that directors have ceased to be mere agents of the company → both they and the members in general meeting are primary organs of the company between whom the company's owners are divided
- The general meeting only seems to be able to control directors by amending articles or removing directors; outside of these controls, it seems directors are free to do what they so please

(a) Internal Delegation

CBCA s.115

- Sets out the powers of directors to delegate their authority to a subset of directors
  - May appoint executive committee of directors, or managing directors
- Subsection (3)
  - Limitations on the capacity of the board to delegate to an executive committee or a managing director
    - Ex. routine matters can be delegated but questions of fundamental importance cannot

Hayes v. Canada-Atlantic & Plant S.S. Co. (US, 1910)

P.235

- **Synopsis**: Ds H&G put all power in their hands by making an executive committee (which was permitted in the articles of incorporation), divesting the rest of the board of any power. They used their power to effect changes unfavourable to the other board members. Held that this delegation of power to the executive committee was not permitted since it is absurd that the created would have more power than the creator.
- **Rule**: powers can be delegated, but not full control of the board
- **Note**: this is US case, and it is consistent w/ the CBCA in Canada

- Facts
  - The letters patent (Articles) provided for an executive committee of 2 directors, plus the president, who taken together shall have the "full powers" of the board
  - The directors, Hayes and Gale, constituted themselves an executive committee and put all the powers of the board into their own hands. They practically divested the board of directors of any function.
  - They used those powers to remove others from positions, fix salaries, and entrench control to their benefit

- Issue
  - Can Hayes and Gale internally delegate to exec committee (i.e. is their action permitted)?
- Decision
  - Delegation to the executive committee was unlawful
- Reasons
  - It is not acceptable to maintain that the words "full powers", in the provision for the appointment of an executive committee, as it practically divested the directors of their functions and built up a new foundation for it in lieu of that formally established
  - Absurd that the created would have more power than the creator
  - Given the existence of a full board, it does not make sense for a subset of this board to have identical powers
- Ratio
  - Powers can be delegated but they must relate to ordinary business matters and not full control of the board. Executive committee cannot replace the board, cannot take all authority. (*US case and irrelevant b/c of statute)*
- Iacobucci
  - → holding of this case (not full internal delegation)
  - ← Could argue that this is limiting freedom on K (i.e. what if everyone wanted the subset of the board to have full powers)
- Note
  - CBCA is consistent with this case

- CBCA Section 115- Directors of a corporation may appoint from their members a managing director or committee and delegate to that MD or committee any of the powers of directors
  - CBCA Section 115(3) lists a number of issues that are so important to the governing of the corporation that all directors must turn their minds to it (i.e. issue securities, pay dividends, approve a take-over bid, etc)
- CBCA Section 121(a)- the directors may designate the offices of the corporation, appoint as officers persons of full capacity, specify their duties and delegate to them powers to manage the business and affairs of the corporation, except powers to do anything referred to in subsection 115(3)

(b) External Delegation (delegation to third parties)

CBCA s.102

- Provision sets out that the directors are manage or supervise the management of the corporation

Sherman & Ellis v. Indian Mutual Casualty (US, 1930)

P.238

- **Synopsis**: Articles of incorporation delegate full powers of management of company to third party insurance company for 20 years. Held that wholesale delegate to 3rd parties undermines spirit and theory of corporation, which is based on the notion that decisions will be made by D/O elected by SHs. Note *Jones* holds that limited delegation for 5 years was acceptable. Test: look to (i) powers retained, (ii) duration of delegation and (iii) powers granted.
- Facts
  - The statue of the company delegated the power to manage the business and affairs of the corporation to the directors
  - The company granted full powers of management to another insurance company for 20 years – nothing was left to the board except administrative duties
  - In effect the other company was given the power to run the company for 20 years
- Issue
  - To what extent can management be vested in a third party?
- Decision
  - Management can be vested in a third party to a limited extent; not for 20 years and as broad a power as was granted here
- Reasons
  - Wholesale delegation' of powers to manage the business undermines the spirit and theory upon which the corporation is based
  - The grant of corporate power by a state is upon the assumption that these powers will be exercised by the corporation's officers, annually elected by the stockholders and not by the officers of another corporation
  - Directors must either (a) manage a business, or (b) supervise the management – it cannot delegate the right to manage away wholesale
- Ratio
  - Some delegation is possible (ex. 5 years with limited scope), but this is too much (20 years, wide scope)
  - Violates the spirit which the state grants corporate charters (privilege of corp, and some obligations)
  - Corporate power is granted on the notion that powers shall be exercised by the D/O elected by stockholders and not by D/O of another corp. (*look at powers retained, duration of delegation, powers granted*).

- Note
  - *Jones v. Williams* – Delegation was limited and only for 5 years, and was approved. In *Sherman*, powers are delegated for 20 years. The 2 situations are qualitatively different.
- Iacobucci
  - External delegation depends on the circumstances (compare *Jones* with *Sherman*)
  - *Contractarian View* of this case: shareholders contract w/ company imposes certain constraints and duties on the directors, but if all managerial decision-making authority rests with a third-party, then that contract might not be upheld
  - *Regulatory View* of this case: CBCA provides for this quasi-contract between shareholders and directors, so it would be disrespectful to the state to allow wholesale delegation

Kennerson v. Burbank Amusement Co. (Calif, 1953)

P.239

- **Synopsis**: Wholesale managerial delegation of theatre subject to the condition that periodic reports made. Held that requirement of reports is insufficient to retain control over management. In Canada, result would likely be the same due to s.102(1) of CBCA (stating that directors shall manage or supervise management). Delegation to 3rd parties is problematic since 3rd party is not subject to fiduciary duty or oppression remedy
- Facts
  - A third party was given control over the sole corporate asset (the Manor Theater building) in respect of all forms of its operation, such as to book all entertainment into the theater
  - There was a requirement to make *periodic* reports to the board of directors
  - This essentially amounted to wholesale delegation subject only to the proviso that the delegation make periodic reports to the board of director
- Issue
  - Was the requirement that the third party make *periodic* reports enough to allow what is otherwise a wholesale delegation of powers?
- Decision
  - No. The board needs to make policy, select directors, etc; it cannot delegate authority over corporate affairs
  - Periodic reports does not constitute sufficient retention of control over discretionary corporate policy to comply with the rule
- Reasons
  - **What would the outcome be in Canada?**
    - Section 102(1) of CBCA states that subject to any Unanimous Shareholder Agreement (USA), th*e directors shall manage or supervise the management of the business and affairs* of the corporation
    - So if this situation arose in Canada the outcome would probably be the same, with the caveat that, in all likelihood, public companies do not have a unanimous shareholder agreement
  - **Why is it a problem if the directors delegate management to external party?**
    - The external delegate is not subject to the fiduciary duty and probably not subject to the oppression remedy, so it loosens the control of shareholders on the board
    - Oppression remedy: empowers the shareholders to bring an action against the corporation in which they own shares when the conduct of the company has an effect that is oppressive, unfairly prejudicial, or unfairly disregards the interests of a shareholder
- Ratio

- Note
  - *Long Park v. Trenton-New Brunswick Theatres Co*
    - Court held a contract to manage a theatre business invalid
    - Similar to *Kennerson* – delegated full authority over books, policies, admission prices, personnel
      - "the problem is one of degree...if substantially all corporate powers are delegated, the contract will be held void"

Cullen v. Governor Clinton Co. (US, 1952)

P.240

- **Synopsis**: Management company used to manage hotel, with somewhat limited scope and duration shorter than 20 years. Held delegation was OK since it is a question of business judgment to externally delegate.
- **Rule**: directors may delegate to 3rd parties so long as BoD still have ultimate control of biz
- **Test**: to what extent do the terms of delegation sterilize the BoD? Look to: (i) powers retained, (ii) duration of delegation and (iii) powers granted.
- Facts
  - Used management company to manage hotel, with narrower scope and less duration than 20 years in *Hayes*
- Holding:
  - It is a question of business judgment whether to use management company (ie. Benefits of specialization) – so ok
- Result of all of these cases on external delegation:
  - Notion: directors may make a valid decision to enter into a management contract to have the business operated by a third party as long as in so doing they still continue to function as a board of directors with ultimate control over the business
- Iacobucci
  - External delegation issue may turn on: to what extent does the contract with the manager (third party) sterilize the board of directors?
  - Note: CBCA requires directors to be individuals; Canadian company law does not allow a board member to be a corporation; bankrupt people also cannot be directors
    - Interpretation: motivation behind the requirements in the statute might be for accountability; this would be consistent with the holdings in these cases, where wholesale delegation to a third party for a long time might rid the board of accountability
  - Implications on freedom of contract
    - → limitation on freedom of contract, since cannot have wholesale delegation, even if all parties desire it
    - ← freedom of inhibition argument unfounded since this model was chosen at the outset by the parties, where they knew such restrictions would exist; if wanted to get around it, could have set up business to do so

(c) Employment Contracts and Director/Officer Tenure

Realty Acceptance Corp. v. Montgomery (3rd Cir, 1930)

P.241

- **Synopsis**: EE K sets out 5 year term, but corporation's by-laws indicate ability to terminate via vote without cause. Held that the K overrode the by-laws, so EE entitled to damages as a result of being fired.

- **Rationale**: distinguish rights vs. powers → the board has the power to remove EE president, and did so, but since the K overrode the by-laws, they did not have the legal right to do it, so they are liable for damages. Based on incentives, companies would not be able to attract top managers, if they could just amend the by-laws and freely get rid of them
- Facts
  - Montgomery (M) was employed under a 5 year contract for employment as President
  - The By-Laws provided that the Board could, by majority vote, terminate the president's term without cause; M knew of these by-laws when he entered into the contract
  - He served 2 years and then the Board terminated his employment without cause
- Arguments
  - Montgomery argues that the by-laws were amended by the directors when M entered into his contract
  - Board argues that the by-laws allow them to fire the President at any time without breaching the contract
- Issue
  - Which takes precedence – the contract or the by-laws?
  - Do the by-laws constitute a condition on the employment contract?
- Decision
  - Montgomery wins; there was a breach of contract – contract overrides bylaws
- Ratio
  - The court says the by-laws did not form a condition of the contract
  - Employment contract overrides/implicitly modifies the by-laws. Look to reasonable expectations of the parties to the K
- Reasons
  - Justice Morris, "The contract made by the defendant pursuant to the express authority of its board of directors, which had express power to amend at will the by-laws of the defendant (corporation), modified, in its legal effect, all inconsistent by law and prevails over them."
  - Justice Cardoza in *Wood v. Lucy* – says that you should try to attribute some reasonable business purpose to a contract
    - Why bother saying to Montgomery that he has a 5 year tenure if you can just remove him at will → The contract must have trumped the by laws
  - Another way to look at it is as a distinction between "rights" and "powers"
    - The by-law gives the Board the *power* to fire the President without cause, but not necessarily the *right* under the contract
    - The Board has the *power* to fire him – no one is questioning this – the question is whether or not they have the *right* to fire him, and therefore whether or not they have to pay damages
- Iacobucci
  - → this decision makes sense because otherwise the Board could simply amend the contract after signing by amending by-laws (no good people would be attracted to this – good reasons for giving a 5 year term)
  - ← this could be seen as excessive delegation – sterilizes authority of board to exercise important power to remove president
    - The court acknowledges this risk, but says this is reasonable delegation (implies life-term might not trump by-laws)
  - → this does not really sterilize power – just means have to pay damages
- Note
  - This case is probably a more accurate description of how a Canadian court would apply the law than the Southern Foundries v. *Shirlaw* case (below)

- Canadian courts would probably follow: this is NOT improper delegation b/c contract is only for 5 years & delegation does not sterilize the powers of the board
- You could enter into a contract that stated it was subject to change via the by-laws, but it is unlikely manager would agree to this
- This decision is consistent with contractual approach

Southern Foundries Ltd. v. Shirlaw (HL, 1926)

P.244

- **Synopsis**: New board amends articles in order to remove director w/o paying damages. Held that director's owed damages since his EE K prevailed over the original articles. Although removal was by new board, it was held that the old board enabled the new board to change articles, so damages owed.
- **Rule**: A corporation cannot be prevented from altering its AI (injunction is NOT permitted), but changing AI may cause a breach of K dependent on the AI for which the corporation is liable for damages
- Facts
  - Shirlaw was named managing director for 10 years
  - The Articles said he could be removed like any other *director "subject to any provisions in a contract between him and the company"*
  - A third party, Federated Foundries, buys the majority of the shares of Southern and they want to get rid of Shirlaw but they don't want to pay damages
  - Federated gets the shareholders together and try to make a change in the Articles – they want to take out the words *"subject to any provisions in a contract between him and the company"*
  - They added a new clause which allowed the company to remove any director if two other directors agreed to remove him
  - Two of Federated's elected directors sign an agreement to terminate Shirlaw
  - Federated further argues that he is not entitled to damages b/c they took out the words *"subject to any provisions in a contract between him and the company"* and also that this termination was not the result of Southern Foundries but of Federated Foundries
- Decision
  - Shirlaw is owed damages
- Reasons
  - HOL- The contract between Shirlaw and Southern had the intention of prevailing over the Articles b/c of the initial clause *"subject to any provisions in a contract between him and the company"*
  - The HOL agrees that the removal was effected by a third party, the nominated directors (Federated) and therefore was not effected by Southern
  - HOL says that the company cannot be stopped from altering its Articles
  - **So why does Shirlaws win (if removal was by Federated)?** The third party (Federated) could not have been successful without the help of Southern, b/c Southern voted to change the Articles which is what actually allowed Federated to terminate the contract
- Ratio
  - Corporation cannot be prevented from altering its AI (injunction is NOT permitted), but changing AI may cause a breach of K dependent on the AI for which the corporation is liable for damages
  - You cannot facilitate a breach of contract by a third party b/c this has the same effect as if you breached the contract yourself
- Iacobucci

- Example of how the law is sensitive, not allowing corporations to have greater powers than an individual in contract
- Technicality:
  - The contract with Shirlaw was for MD for 10 years; the corporation removed him as director, and as such, he was no longer able to fulfill the role of MD; the court argued that ***there is an implied term that does not allow the deliberately changing the circumstances such that the other party cannot perform the contract*** → this is as good as you breaching the K
- Corporations should be free to enter into Ks w/ third parties, as Southern did here, AND they should be free to amend their articles, as Southern did here, BUT they should be liable for the breach that results from these amendments

Shindler v. Northern Raincoat Co. (ER, 1960)

P.247

- **Synopsis**: S sells company to L, in exchange, L makes S MD. L the sells to 3rd party, who removes S as MD by vote. Held that company liable for damages since change of control does not provide grounds for breach of K.
- **Rule**: there is an implied term in the company's Ks that it shall do nothing to put an end to the state of the world enabling the K to be performed; if it does, liable for damages.
- **Distinguish *Southern***: in this case, the court finds that the corporation itself effected the removal of the MD, but in *Southern* it was determined that the corporation enabled a 3rd party to effect the removal of a director – in either case, the result is that corporation is liable for damages
- Facts
  - Schindler sold the defendant company to Loyds Ltd in return for which, pursuant to a power in Northern Raincoat's articles, Loyds appointed him managing director for ten years
  - Loyds then sold the company to Maudlebery Ltd who removed Schindler from as MD by a vote at a general meeting
- Issue
  - Is Northern liable for damages for breach of K to Shindler?
- Decision
  - The removal was invalid – cites *Stirling v. Maitland*: "If a party enters into an arrangement which can only take effect by the continuance of a certain existing state of circumstances, there is an implied engagement on his part that he shall do nothing of his own motion to put an end to that state of circumstances, under which alone the arrangement can be operative"
- Reasons
  - Justice Diplock- in a similar set of facts as *Southern Foundaries v. Shirlaw*, decides that the removal was effected by the company and not a third party
- Ratio
  - Change of control does not provide grounds to breach K. There is an implied term in K that employer shall do nothing to put an end to the state of circumstances supporting K so that it is impossible to perform the K. (also an issue in Southern)
- CBCA
  - **S. 106(3)**- Shareholders of the corporation shall elect directors to a term of 3 years
    - There is nothing w/in the statute which limits how long an officer can be given tenure for

- **S.247-** Restraining or Compliance- if a corporation or any director, officer, employee, etc does not comply with this Act, regulations, Articles, by-laws, USA, a complainant may apply for an order requiring that person to comply
- **S.241(3)-** Court has the power to order that a contract is null and void

3. THE EVOLUTION OF BUSINESS CORPORATIONS LAW AND THE NATURE OF CORPORATE PERSONALITY

(i) History of Canadian Business Corporations Law

- British methods of incorporation
  - (1) By royal prerogative (by letters patent)
  - (2) Act of a legislature
- Methods to ease incorporation
  - Incorporation by registration → right to register company to be incorporated – was a right, after complied w/ certain rules
- Canada (b/t memo and patent)
    - Memorandum jurisdiction – K b/t each other – authority for corporation to act came from memorandum and articles of association
    - Letters patent – terms of the grant from the state would dictate the authority and rules
  - Hybrid (Canada)
    - Incorporate by registering with registrar of incorporation, but many of the rules governing are found in the corporate statute
    - When incorporate, you continue to file documents (articles of incorporation) – like your constitution, don't need to file you by-laws (which are distinct from articles of incorporation)
    - Statue provides lots of default rules (letters patent feel here, but memorandum feel since authority (statute) will defer to the wishes/desires of the parties)

(ii) Separate Legal Personality

Salomon v. Salomon & Co. (A.C. 1897)

P.68

- **Synopsis**: Salomon structures his business such that he was the principal SH and principal creditor simultaneously. The company goes bankrupt and the unsecured creditors bring a claim against Salomon personally. Held that Salomon is not liable personally since (1) the corporation has a legal existence separate from the personalities of its SH; (2) it does not matter that ownership is consolidated in one person (creditors knew they were dealing with corporation and should have adjusted their behaviour accordingly); (3) SH can take out secured interests in the corporation; (4) Salomon complied with the legal formalities, so is entitled to the protection of separate legal personality
- **Rationale**: consistent with the enabling view since SH know about limited liability before they buy shares, and can K around it by (ex. obtaining (i) a personal guarantee, (ii) security interests, (iii) collateral or (iv) raising interest rates)
- Facts
  - Salomon carried on a business as a shoemaker and incorporated the business b/c he wanted other members of his family to be able to participate in the business
  - Salomon sold his business to a third party with an authorized capital of 40,000 shares with a par value of 1 pound each
  - At that time, the relevant English statute required there to be 7 shareholders in a corporation – so Salomon had 21,001 shares and his wife, four sons and one daughter each had one share – there were a total of 21,007 shares
  - Salomon was the beneficial owner of all the shares

        - Although the business was only worth about $10,000, the purchaser paid $38,800 for it by issuing $20,000 worth of shares, $6,000 in cash and a debenture for $10,000 secured by a floating charge on the company's assets
            - Note: the total value might actually be less than this, since (a) the par value is meaningless, (b) Salomon arbitrarily chose the debenture value and (c) unsecured creditors will not be paid until secured creditors are paid off
        - Mr. Salomon sold his business to the new corporation for almost £39,000, of which £10,000 was a debt to him. He was thus simultaneously the company's principal shareholder and its principal creditor
        - A debenture is essentially the same thing as a bond – it doesn't need to be secured – but in this case it was secured through a floating charge
            - A floating charge is a particular kind of security interest in which the security attaches to whatever assets the business has at any given time – it's not attached to any particular asset, but to any and all assets of the business
            - The reason why you'd use a floating charge is if the business has a lot assets in inventory – since inventory is always changing its hard to constantly change the security to reflect the new inventory in stock
        - The company soon went bankrupt
        - The unsecured creditors went in and seized all of the assets of the company
    - Arguments
        - <u>Unsecured Creditor Arguments</u>
            - They deserve to get something out of the assets of the company b/c the incorporation was a "sham" and therefore they should get something back from Salomon personally (i.e. Salomon and the corporation were one and the same
            - The incorporation did not satisfy the statutory requirement of 7 shareholders- the statute says that you need 7 shareholders with a 'material interest' and 1 share out of 20,007 is not a material interest
            - Creditors argue that to comply with the Statute you need to have 7 shareholders who actually own the shares and the shares are *unencumbered*
                - Salomon's family members owned 6 shares, but Salomon was the beneficial owner of the shares – essentially Salomon's family members were trustees who held the shares for the benefit of Salomon
        - <u>Salomon</u>
            - Salomon argued that the corporation was a *separate legal entity* and that, as a secured creditor, he should be paid first
    - Issue
        - Should Salomon receive payment on the debenture before the ordinary creditors are paid?
    - Decision
        - Yes, he can act as secured creditor to the corporation
    - Reasoning
        - Although you need 7 shareholders to form a Corporation, there is nothing in the *Companies Act 1862* that requires the shareholders to be independent, that the need to take a substantial interest, etc
        - Having 7 shareholders even if 6 are beneficial owners does satisfy the requirement under the statute for incorporation
        - HoL acknowledges that one of the purposes of the Act is to lower bankruptcy costs for people in business, which is what it is achieving here (this extends to sole proprietorships)
    - Ratio
        - (1) Corporation has a legal existence separate from the personalities of its SH

- (2) Does not matter that ownership is consolidated in one person – creditors knew were dealing with corporation and should have adjusted their behaviour accordingly
- (3) SH can take out secured interest in the corporation
- (4) Salomon complied with the legal formalities, so is entitled to the protection of separate legal personality

- Iacobucci
  - Is this fair?
    - Yes → **enabling view**: limited liability can be contracted out of (banks asking for personal guarantees); shareholders know they are the last to be paid at the time they buy the shares (enter into contract)
  - Limited liability companies must contract with their full names (incl. Ltd. or Inc.) and there is a full registry for secured debt
  - CBCA s. 24 eliminates par value of shares

(a) Employment and Separate Legal Personality

Lee v. Lee's Air Farming Ltd. (NZ)

P.75

- **Synopsis**: Owner of incorporated business K's as biz EE and wants worker's compensation. Held that EE is entitled to worker's compensation since is a separate legal personality from the corporation. Potential counter is that this is an abuse of the default rule of limited liability, which is in place but may be contracted around since in this case there was no opportunity for the worker's compensation board to K around it. Note also that there would be no entitlements to compensation had the corporation been set up as a partnership or sole proprietorship.
- Facts
  - Lee incorporated a crop dusting business, gave himself all the shares, was the only officer, and hired himself as the chief employee
  - He paid the assessments to the workers compensation board
  - Lee dies and his wife applies to the New Zealand workers compensation board
- Issue
  - Can Lee be an employee and an owner/manager of a business?
- Decision
  - Yes – New Zealand workers compensation is forced to pay his wife
- Reasons
  - New Zealand Workers Compensation argues that you cannot contract with yourself, but the Court disagrees and says that the *business was incorporated and therefore it was a separate legal entity*
- Ratio
  - Corporation was a legal personality separate from Lee, and therefore Lee could enter into contractual relationships with it
- Note
  - This is different than the decision in *Thorn v. New Brunswick* since in this case the business was incorporated, it was not a partnership
- Iacobucci
  - This would not work if Lee was a sole proprietor, since he needs the corporation to be a separate legal entity
  - Did it make sense for this case to turn on the structure of the business?

- In *Salomon*, limited liability was the default rule that could be contracted around, which arguably is distinct from this case where you the workers compensation program relying of definitions which can be manipulated by setting up the corporation

(b) Insurable Interest and Separate Legal Personality

Iacobucci: Insurable Interest Doctrine

- **Proposition**: in order to acquire insurance on an asset, the insured must have an interest in the asset
- **Problems it Addresses**: (i) moral hazard: otherwise insured would not bear full consequences of his actions, he would have a tendency to take less precautions; (ii) gambling: discourage betting on outcomes that one may influence to get payout [IAC: gambling is the one true problem in this case, since moral hazard can be addressed by insurance companies increasing rates]
- Insurable interest doctrine says that in order to enter into insurance for an asset, the insured must have an interest in that asset
- Problem it fixes:
  - **Moral hazard**: arises because an individual or institution does not bear the full consequences of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to bear some responsibility for the consequences of those actions
  - **Gambling**: encourages gambling → because contracts of insurance have many features in common with wagers, insurance contracts are often distinguished under law as agreements in which either party has an interest in the "bet-upon" outcome *beyond* the specific financial terms. *E.g.*: a "bet" with an insurer on whether one's house will burn down is not gambling, but rather *insurance*
- Practical Result
  - The only interest that really matters is the gambling rationale – and this is public policy
  - Moral hazard problem is not meaningful – insurance companies will be the ones who suffer from recognizing shareholders' insurable interests in corporate assets, and they can protect themselves through extremely high rates
  - There can be moral hazard problem with sole SH too – company could be worth more dead than alive (ex. If has lots of debt, may want to default and collect insurance)
  - So the sole SH/multiple SH distinction does not hold on this basis
- Other solutions
  - In looking at Macaura and Kosmopolous, MacIntosh thinks that the courts have missed out on something big – there is a simpler way to solve these cases
  - Macaura writes the assets in his own name, Kosmopolous does the same – how can we resolve these cases in 5 seconds and completely avoid all the previous discussion?
    - Pay the policy to the company and not to the person – this avoids the moral hazard problem and now the company has money that it can pay to the creditor if necessary

Macaura v. Northern Assurance Co. (1925)

- **Synopsis**: M owns most shares of company and takes out insurance policy on company's assets in his own name. Held that assets were owned by corporation, so M did not have an insurable interest
- **Rationale**: it is impossible to determine how much the loss of an asset will diminish the SH's residual claim, which is what he is insuring against

- Facts
  - M owner of most but not all shares of firm (3 SH, each with 1/3)
  - M took out insurance policy on assets (timber) of the company, in his own name
- Holding
  - Timber owned by firm, not M, so he does not have an insurable interest in it
- Ratio
  - SH do not have an insurable interest in the assets of the corporation, since the corporation, which is a separate legal personality, owns the asset
  - SH have right to dividends and residual claim, not the property of the firm since firm has separate legal personality
- Iacobucci
  - Court says it is impossible to determine how much loss of asset has diminished value of residual claim
    - This is not good reasoning – if shares trade on open market, share price should reflect it. Plus just because it's hard to value does not mean should not do so

Kosmopoulos v. Constitution (1983)

- **Synopsis**: sole SH of biz takes out insurance on corporate assets in own name and insurance company refuses to pay after fire.
- **Majority**: SHs have an insurable interest since they benefit from an asset's existence and lose from its destruction
- **Dissent**: SHs only have insurable interest when single SH; in cases of multiple SHs, no SH has an insurable interest since it would open concept to indefinable limits
- **Iacobucci**: if main concern of recognizing that SHs have insurable interests in corporate assets is moral hazard, then the majority's view makes sense since the insurer has an interest in not providing insurance if there are large risks
- **3 States of the Rule**:
- *Macaura*- Shareholders have no insurable interest – this is now dead in Canada
- *McIntyre (dissent this case)/OCA*- Only a sole shareholder can have an insurable interest in assets – this is almost a completely arbitrary distinction
- *SCC majority (this case)*- Any shareholder can have an insurable interest
- Facts
  - The plaintiff operated a business called Kosmopoulos Leather Goods Ltd. – he was the sole shareholder of the business
  - He took out insurance under his name, just like in Macaura
  - The insurance policy read, "Mr. Kosmopolis O/A Supreme Leather Goods"
  - The leather good store/factory burns down and the insurance company refuses to pay
- Issue
  - Does a shareholder have an insurable interest in the corporation's assets?
- Arguments
  - Insurance company argued that shareholders have no insurable interest in the assets of a corporation – they cite *Macaura*
  - K argued that sole shareholders have an insurable interest in their corporation's assets
  - K also argued for disregarding the corporation's separate legal personality (this would allow him to get insurance since he would own the asset directly)
- Decision
  - Ontario Court of Appeal says that a sole shareholder can have an insurable interest in the corporation's assets
  - SCC- Held that a shareholder has an insurable interest in the assets of the corporation
- Reasons

- OCA
  - K does not have a property right in the assets owned by his corporation (*Macaura*)
  - BUT – Macaura holding also based on the fact that it was difficult to calculate value of insurable interest when have multiple shareholders; in this case, there is a sole shareholder, so valuation is simple
  - As a result, find that K has an insurable interest
- SCC
  - Majority
    - Court of Appeal erred in saying the decision in *Macaura* applies only to cases where there is more than one shareholder
    - This rule proposed by the CA is an arbitrary one, and should not be followed since it would create a legal distinction between a wholly-owned company and one where all but one share is controlled
    - The Court takes a broad definition of insurable interest "benefit from its existence, prejudice from its destruction" and conclude that *a shareholder has an insurable interest in a corporation*
  - McIntyre (dissent)
    - This would open the concept of insurable interest to indefinable limits – *Macaura* still applies, but a shareholder in a one-person corporation has a sufficient interest in the corporation's property to take him/her out of the *Macaura* rule
    - Focus is on the close identity between SH and corporation for determining insurable interest (Iacobucci doesn't really like this distinction)

- Ratio
  - Shareholders have an insurable interest as defined by *Lucena v. Crawford*, as being someone who gets a benefit from an asset or suffers a detriment from its destruction, and can take out and collect on insurance policies related to corporate assets
- Other
  - → *Lucena v. Crawford* (and this case) held that an insurable interest arises when a person benefits from the continued existence of the asset and is prejudiced from its destruction
  - ← *Macaura* held that an insurable interest requires a property right to the asset in question – a shareholder does not have a property right in the assets owned by a corporation
- Iacobucci
  - Why does the SCC majority's approach make sense?
    - If the main concern about recognizing shareholders as having an insurable interest in a corporation is moral hazard, then the finding here makes sense since the insurer has an interest in not providing insurance if there are large risks
- Current State
  - Three Approaches to "Insurable Interest"
    - Macaura- Shareholders have no insurable interest – this is now dead in Canada
    - *McIntyre/OCA*- Only a sole shareholder can have an insurable interest in assets – this is almost a completely arbitrary distinction
    - SCC- Any shareholder can have an insurable interest

(c) Conceptions of Legal Personality

P.85

- **Fiction theory:**
  - Corporation is an artificial legal creation. It is a concession of the state, conferring privileges (ltd. Liability) and burdens
  - CBCA law seems fairly consistent with this – since even a one person corporation has a separate legal personality
  - This approach is likely to facilitate the contractarian approach since it affords great flexibility
- **Realist theory:**
  - When a group of persons reaches a certain level of organization, makes decisions and has continuity of experience, a new personality has come into existence
  - Fact of sole SH corporation seems inconsistent with this
- **Contractarian:**
  - Corporation is a nexus of contracts, explicit and implicit, between all stakeholders. Role of corporate law is to provide default rules to reduce transaction costs. Corporate personality results from individuals contracting around the corporate nexus

(d) Protections to Third-Parties

P.88

- Creditors are not helpless in the face of separate legal personality: Can protect themselves through personal guarantees, security interests, etc.
- *Wolfe*: Need cautionary suffix (Ltd, inc) – s. 10 CBCA
- Does not make D&O immune to tort claims or liability

(ii) Exceptions to the Rule of Limited Liability

Wolfe v. Moir (1969)

P.89

- **Synopsis**: person sues Moir personally for injury at skating rink called Moir's Sportland, which was owned by the corporation Sport Shop Ltd., which had SHs Moir and Wife. Held that Moir was personally liable for damages since in order to rely on limited liability you need to comply with the associated formalities. Moir did not register Moir's Sportland to the business, which was required by statute, so he was liable.
- **Fiction Theory Rule**: in order to gain the benefits of separate legal personality (limited liability), the corporation must bear the burdens (compliance w/ formalities)
- **Iacobucci***:* limited liability should not be viewed as a benefit, but rather as a default rule that the parties can contract around
- Facts
  - Moir and his wife were the company's shareholders and officers; the company owned a rink
  - The skating rink was advertised as: Moir's Sportland (Fort Whoop Up) when the company was named Sport Shop Ltd
  - There was a personal liability claim after a person suffered injuries while skating, made against Moir personally. Moir says there should not be personal liability.
- Issue
  - Is the owner of the corporation personally liable to the customer of the rink?
- Decision
  - Yes, in order to rely on limited liability, must comply with formalities of the statute including s. 82

- In *Salomon*, big focus on fact that formalities had been complied with. Moir did not comply, so liable.
- Reasoning
  - The names the business went by were not registered business names. S. 82 of the corporate statute required that the company name be on all official company publications, including advertising
- Ratio
  - Can breach the corporate veil where non-compliance affects 3rd parties and the formalities for incorporation were not met
- Iacobucci
  - Why does complying with Act matter?
    - **Fiction theory:** must bear burdens (complying with formalities) in order to get benefits of separate legal personality (limited liability)
      - IAC does not like this since does not view incorporation as a benefit
    - **Contractual:** Limited liability is a term of the contract, and it is priced into the contract; it can be contracted around and is merely the default rule
      - That said, parties to the contract must know the terms (i.e., that is limited liability), and as such need to be on notice (correct company name) so can adjust behavior
      - There should be proportionality between the extent of limited liability and the extent formalities are complied with
  - Do patrons really pay attention to the company name (or formalities in general)?
    - Probably not; definitely creditors would though
- Note
  - *CBCA* S. 10 – requires limited liability corporation to use "Ltd." in their name in every contract

Mesheau v. Campbell (OCA, 1983)

P. 96

- **Synopsis**: P sues director personally for wrongful dismissal damages under s.119 CBCA, which states that directors can be liable to EEs for unpaid wages. Held that since damages for wrongful dismissal are not compensation for performance for past services, so director not liable (would have been had the damages been characterized for EE's performance of past services)
- **Policy**: see Why should directors be or not be liable box below.
- Facts
  - P got judgment for wrongful dismissal, but it was never paid
  - He sues for wrongful dismissal damages, based on s. 114 of the CBCA, which provides as follows:
    - S. **114 (now 119.(1)) Liability of directors for wages -** Directors are jointly and severally liable (i) to employees of the corporation, (ii) for all debts not exceeding six months wages payable, (iii) for services performed for the corporation, (iv) while they are such directors (only if the employee successfully sues the corporation but corporation has insufficient assets)
- Issue
  - Does s. 114 cause directors to be liable for an unsatisfied judgment debt following wrongful dismissal?
    - Can damages from wrongful dismissal be characterized as payment for past services?

        - If they are payment for past services, then the directors are personally and jointly liable to the P – since he would have satisfied all requirements under s.119
        - If they are not compensation for services, then P cannot succeed – since directors are only liable for wages of services performed
- Decision
    - P's claim dismissed; Wrongful dismissal damages are not payment for past services
- Reasons
    - "all debts" is modified by the phrase "for services performed for the corporation" – as such, a claim for wrongful dismissal is a claim for services that have not actually been performed
    - P's argument that damages were payment in lieu of salary for services that would have been performed had proper notice been given was rejected
- Ratio
    - Director's liability for debts to EEs is interpreted strictly – does not include wrongful dismissal damages
- Iacobucci
    - **<u>Why should directors be or not be liable?</u>**
    - → moral hazard: directors should be liable since if they are not, there is no incentive for them to take care when dismissing EEs
    - → importance of debt: directors should be liable since EEs rely on payments such as wrongful dismissal damages for sustenance
    - ← EEs engage in a variety of opportunistic behavior, so there is no justification for only protecting this type
    - ← induce directors to leave: directors may leave boards if they believe they will be personally liable for wrongful dismissal damages
    - ← incentive to shut down corporation early: if in situation where many wrongful dismissals have to be made (i.e. corporation struggling), the directors might be enticed to wind up the corporation early to avoid personal damages claims that might follow
- Why have rule in s.119 at all?
    - There must be some mistrust in the contracting process and the ability for corporations and employees to devise a better scheme in this situation

Said v. Butt

P.99

- **<u>Synopsis</u>**: D of theatre sued personally by patron tort of inducing a breach of contract since D disallowing patron to enter theatre, even when had ticket. The thrust of the patron's argument was that when a corporation breaches, Ds are liable since they are the real cause behind the breach. Held that D was not personally liable since was acting in the best interests of the corporation when induced breach.
- **<u>Two Readings (Iacobucci)</u>**: (i) narrow → D not liable for the specific tort of inducing breach of K, as long as acting in best interest of corporation when do so; (ii) broad: D not liable for nay tort, as long as acting in best interest of corporation when tort committed (endorsed by *Scotia McCloud*)
- Facts
    - The director of a theater had banned a patron from coming to the theater, so the patron had his friend buy him a ticket and then he tried to go to the opera, but the theater owner did not let him in
    - This was a breach of contract b/c he had bought a ticket and that should allow him entrance to the theater

        - The patron sued both the director of the theater and the theater itself for the tort called 'inducing breach of contract'; since a corporation is not a living thing, whenever it breaches a contract there must be individuals who actually cause the breach
        - Therefore, in any situation where a contract is breached you could theoretically sue the directors or officers for inducing the breach
        - This is what the plaintiff is arguing in *Said v. Butt* – that the owner of the theater induced the theater to breach the contract
    - Issue
        - Is the director of the corporation liable for damages under the tort of inducing breach of contract?
    - Decision
        - No, director is not liable
    - Ratio
        - An EE cannot be liable for damages for the tort of inducing her corporation to breach a K w/ a third party, as long as she's acting in the best interests of the corporation when inducing this breach
    - Iacobucci
        - Two potential readings of this case:
        - Narrow: you are not liable for the tort of inducing your own corporation to breach a contract, and only this tort, as long as acting in best interest of the corporation
        - Broad: you are not liable for any tort, as long as acting in the best interest of the corporation when tort committed
    - *Scotia McCloud*: CA argues for the more broad interpretation – only liable if make the tort your own, which can only be done if not acting in the best interests of the corporation

ADGA Systems International Ltd. v. Valcom Ltd. (OCA, 1999)

P.99

- **Synopsis**: Valcom raids ADGA's EEs, so ADGA sues Ds of Valcom personally for the tort of inducing breach of K. Held that the directors of Valcom are liable since Ds made the tort their own. Court notes that personal liability is not inconsistent w/ separate legal personality since the personal liability derives from an independent cause of action (i.e. decision of Ds personally).
- **Rule**: Ds can be personally liable for own torts, even when acting in best interests of the corporation, so long as the tort is made D's own (Note: *Said* exception is seen as narrow here – only applying to the tort of inducing breach of K)
- **Iacobucci**: does not think you can justify only making D's liable for tort of inducing breach of K if arguing over-deterrence is the reason, since over-deterrence applies to *Said* and *ADGA* situations (third-party inducing breach and own corporation inducing breach)
- Facts
    - Valcom raided some of ADGA's employees – induced them to breach their contracts with ADGA to come work with Valcom. ADGA sues director and management of Valcom in personal capacity, alleging the tort of inducing breach of contract
- Issue
    - Are the Valcom directors liable for the tort of inducing breach of contract between ADGA and ADGA employees?
- Decision
    - Yes – the directors of Valcom are liable
- Reasons
    - **Policy:** Disadvantages of personal liability for directors:

- [***Inability to attract best Ds***] If personal liability on directors, there are additional costs to becoming a director, which may deter otherwise capable individuals from pursuing the position
- [***Over-deterrence***] Current directors may act very cautiously, and in a manner that may not be in the best interests of the corporation, if they are liable for all torts (ex. directors may not breach, even when efficient)
- **Rationale:**
- Personal liability has nothing to do with the rule in Salomon [i.e. holding a director personally responsible, like in *Said*, is NOT inconsistent with the idea of separate legal personality of a corporation], since any personal liability derives from independent cause of action against the managers of the corporation
- Court cites LaForest's dissent in *London Drugs*:
  - Policy reason for exception from general rule that are responsible for own conduct: Exception ensures that individuals who are dealing with limited liability companies and accept that fact should not be able to sue employees as well
  - IAC: Problem is this rationale muddies the distinction above, that this case is not about separate legal personality – it is about an individual tortfeasor
    - So the fact that are dealing with limited liability company shouldn't matter – nothing about dealing with LLC should be considered a waiver on torts from individual tortfeasors

- Ratio
  - Can be personally liable for own torts, even when acting in best interests of the corporation – *Said* exception is narrow – as long as make the tort your own (take part in decision)
- Iacobucci
  - Does personal liability cause over-deterrence?
    - → Yes; may not permit what would otherwise be an efficient breach (i.e. the director's cost benefit analysis includes costs of personal torts, whereas the corporation's cost-benefit analysis does not)
    - ← No; employees can get insurance, or be indemnified through contract (i.e. contract around) such a default rule
      - → counters to No; (a) insurance markets are imperfect, (b) these claims might come at a time when the corporation has no money to fulfill the claims
  - → Could argue that you get shield of limited liability ONLY when acting in the best interests of the corporation; but IAC does not see reason for limit to *Said* exception – since it may be just as true for EEs to want third-parties to breach (socially, V's directors' actions of luring ADGA's EEs might be welfare creating)
  - ← Could argue that there is under-deterrence when there is blanket limited liability
  - IAC: does not think you can justify singling out this one type of tort and argue that over-deterrence is the reason since over-deterrence applies to all these cases (third-parties and own corporation) so why draw this distinction?
- Note
  - This case does NOT fall under the *Said* exception since it was not inducing breach with your own company, but rather inducing breach with a third party

Williams v. Natural Life Health Foods Ltd. (HL, 1998)

P.107

- **Synopsis**: director sued personally for negligent misrepresentation in financial statements after sold company to Williams and then biz failed. Held that director is not liable since plaintiff could not show that there was an assumption of personal responsibility on the part of the director.
- **Rule**: for directors or EEs to be liable, they must not only be personally involved, but also must have assumed personal liability (by making acts their own). Note that the extent of personal involvement is unclear.

- Facts
  - P acquires franchise from D company for the operation of health food shop
  - Prior to K, defendant assists in financial projects
  - After K, business failed, Williams sues person involved in projections, as well as another defendant (who the P did not know was not involved in the projections)
  - P sues for negligent representation
- Issue
  - Is the action against the second defendant warranted?
- Decision
  - Action against second defendant fails
- Reasons
  - To establish liability of director or EE for negligent misrepresentation, P had to show an assumption of personal responsibility by the director or employee
  - P did not show that on these facts
- Ratio
  - For directors or employees to be liable, they must not only be personally involved, but must have assumed personal liability (make acts "their own")
- Iacobucci
  - The extent of involvement required to be liable is unclear

Hapern, Trebilcock: An Economic Analysis of Limited Liability in Corporate Law

P.107

- **Synopsis**:
- ***(1) limited liability regime is most effective in the case of large, widely held companies*** since (i) unlimited liability unevenly distributes the risk among SHs (since those who got sued would be those w/ the most assets), (ii) company value would be difficult to determine since private assets of all SHs would influence company value and (iii) diversifying becomes costly under unlimited liability since single SH becomes joint and severally liable for all debts. There should be a limited number of exceptions to limited liability in this case: (a) misrepresentation; (b) involuntary creditors; (c) EEs.
- ***(2) unlimited liability regime most effective in case of small, tightly held companies*** since (i) there are fewer valuation problems (can find out SHs assets easily), (ii) can easily K around default rules (few parties) and (iii) limited liability would create incentives for owners to transfer risk from SHs to creditors, creating costs to creditors (incurred by attempting to K around risks)

- ← If shareholders have unlimited liability then there is an argument that all you are doing is shifting the risk away from creditors but you are not reducing the overall risk of corporate liability
- →With limited liability creditors take on additional risk b/c if there are claims against the corporation, the claimants can only go after the company's assets

- (1) Large Corporations
  - In the case of large, widely held companies, a limited liability regime, as a general rule, is the most efficient regime. Unlimited liability would distribute risk unevenly (rich people would be at more risk) and would create costs for owners and creditors in attempting to contract around the risk. However, there should be a limited number of exceptions:
    - (a) Misrepresentation to creditors as to the legal status of a firm or its financial affairs
    - (b) The involuntary creditor – where a firm unilaterally imposes costs on another party; in a large corporation personal liability of directors in this situation would minimize the information costs that owners would face in monitoring each other's wealth, would reduce creditor TCs in enforcing claims and would focus incentives to adopt cost-justified avoidance precautions on that body of persons (directors)
    - (c) The employee --
  - Shares under unlimited liability are also more difficult to value for large companies since (a) the assets of all the other shareholders are influential on the value of the company, since now shareholders are liable; (b) diversifying becomes costly since as soon as you own a single share in any company, you are joint and severally liable for all the corporations debts
- (2) Small Corporations
  - In the case of small, tightly held companies, a limited liability regime will, in many cases, create incentives for owners to exploit a moral hazard and transfer uncompensated business risk away from shareholders (themselves) to creditors, thus inducing costly attempts by creditors to reduce these risks (i.e. contract around the limited liability).
  - An unlimited liability regime for this class of enterprise seems to be the most efficient regime since (a) there are fewer valuation problems (since easier to know the value of the others holding shares) and (b) it's easier to contract around default rules

(iii) Lifting the Corporate Veil

Iacobucci: On Piercing the Corporate Veil

- What is the concern with the idea of holding shareholders to unlimited liability for failing to comply with formalities?
  - Contractarian view
    - May not be able to comply with all formalities since may be too costly
    - Disporportionality: not meant in terms of burden and benefit; but from a functional perspective – do not want people spending too much time ensuring formalities are complied with

Clarkson Co. Ltd. v. Zhelka (ON, 1967)

P.111

- **Synopsis**: Selkirk goes personally bankrupt, but has corporations that are solvent that have many assets. One asset is land, which was conveyed by one of Selkirk's corporations to his sister. P sues for lifting the corporate veil (reverse pierce) arguing land really belonged to Selkirk personally. Held that corporate veil cannot be pierced since the legal persona created by incorporation is an entity distinct from its SHs and Ds, even in case of one man companies. Note. If faced with this case, P should sue for Selkirk's shares in the corporation that owns the land.
- **Rule**: pierce veil if (making individuals liable):
- (i) a company is formed for the express purpose of doing a wrongful or unlawful act; or
- (ii) if those in control expressly direct a wrongful thing to be done
- **Reconcile w/ *Wolfe*** (skating rink injury): in *Wolfe* D was personally liable since did not comply w/ necessary formalities for incorporation (benefit/burden view), but in this case formalities were complied w/ (i.e. creditors were likely not misled into thinking assets were being transferred from corporation to Selkirk)
- Facts
  - Selkirk owns Industrial and other corporations, which are set up so as to facilitate his own purposes and from which exclusively he will benefit
  - Industrial purports to convey land to Zhelka, Selkirk's sister, in exchange for a promissory note of $120,000 – it is clear that this promissory note will never be paid
  - Selkirk runs into financial difficulties and goes personally bankrupt – bankruptcy trustee claims that the land in question really belongs to Selkirk and it was part of his estate
  - The Trustee claims that the land is still owned by Industrial
  - The two elements the creditors need to be found in their favour to be successful are: (a) that there was no land transfer by Industrial to Zhelka, and (b) the land actually belongs to Selkirk the person
- Issue
  - Can the corporate veil be lifted? (in this case, reverse veil piercing)
- Decision
  - No – only pierce corporate veil in exceptional circumstances, which are not met in this case
- Reasons
  - The court states that (a) is satisfied since the sister never intended to pay on the note, so there was no transfer; but does not find (b) that the land belongs to Selkirk
  - This is an example of "reverse veil piercing" since Selkirk the person goes bankrupt and the creditors want the assets of his corporation (unusual, since usually would just seize his personal shares in the corporation)
  - The court sticks to the principle of separate legal entities:
    - "*The legal persona created by incorporation is an entity distinct from its shareholders and directors and that even in the case of a one man company, the company is not an alias for the owner*."
  - The judge lays out two cases where it may be said that the company is a mere sham or alter ego of the controlling person:
  - (1) If the corporation is formed for the express purpose of doing a wrongful act
  - (2) If, after the formation of the corporation, those under control expressly direct a wrongful thing to be done (wrongful does not have to be illegal – so there is a large degree if discretion)
  - In this case there was evidence of wrongdoing, but not enough to *pierce corporate veil* – Selkrik did abuse the corporate form and treated it as an extension of himself

- Ratio
  - ***The corporate veil will be pierced, "if a company is formed for the express purpose of doing a wrongful or unlawful act, or if when formed those in control expressly direct a wrongful thing to be done, the individuals as well as the company are responsible to those whom liability is owed."***
  - Clearly "wrongful" is wider than "illegal" here, so the courts have a great deal of discretion to determine what is 'wrongful" conduct
- Iacobucci
  - This case may turn on information (like *Wolfe*); ask: would someone be genuinely misled by the informalities?
    - Application:
      - Selkirk was loose with corporate boundaries (money transfers, withdrawals for personal use, comingling of assets of all corps, and documentation, etc)
      - But, no evidence of assets being diverted into Industrial from Selkirk, so personal creditors were not really hurt. Industrial's creditors may have had a claim, but not these ones
  - Note: an implication of this case, and others, is that when one disregards legal form, they are at the risk of unlimited liability, since courts have generally taken the *benefits-burden* approach to limited liability
  - Analogize to *Wolfe*: could argue that in this case, the line between Selkirk's personal and business assets was not clear; assets that the creditors could have thought were his personally were actually the business's assets; however, in this case, the argument is not strong enough

Big Bend Hotel Ltd. v. Security Mutual Casualty Co.

P.116

- **Synopsis**: company suffers fire damage and tries to collect insurance. Insurance company refuses to pay since principal SH of company had history w/ fire but did not disclose information when procured policy. Held that the veil should be lifted since it cannot be used to conceal information (i.e. cannot use as shield for improper conduct)
- **Rule**: the corporation cannot be used to shield improper conduct or conceal information
- **Policy**: motive or intent to use corporation for wrongful conduct may be relevant: here, intent was to conceal information about fire history, so liable; in *Clarkson*, corporation not formed for purpose of separating Selkirk's personal assets from the corporate assets.
- Facts
  - Hotel company failed to disclose that principal shareholder (Kumar) had previously suffered a fire loss and his previous policy was cancelled
  - Insurers would not have accepted the risk if they had known that he was principal behind the hotel.
  - Insurer refused to pay. Kumar said he wasn't under duty to disclose
- Issue
  - Can the corporate veil be pierced?
- Decision
  - Lift the veil, due to improper conduct or fraud (misrepresentations)
- Reasons
  - SH used the corporation to conceal a fact which he knew was material to insurers (misrepresentation)
  - Gilford motor company – where D purposely contracts not to solicit the P companies clients → individual who entered into the K incorporates a company

    - Gilford: Corporation was a mere cloak or sham, designed to get around the K commitment that the individual entered into
- Ratio
    - Cannot use corporate form to conceal information (cannot use for shield for improper conduct of fraud)
- Iacobucci
    - Like *Clarkson*, where was possible misrepresentation about assets of corporation
    - ← Corporation was not established for sole purpose of concealing that fact, and the insurance company could have investigated further (have competency in that regard)
    - Issue is how much info must be provided, and how much is reasonable to investigate (*Wolfe* says need to put name). This is close to the line
- Other
    - **Motive / Intent is relevant:** In *Big Bend*, Kumar deliberately concealed his insurance history. In *Clarkson*, Selkirk did not form the corporation with the intent of defrauding his personal creditors. Should motive matter? Who should bear the onus of providing / discovering relevant information?]

Gilford Motor Company v. Holmes (1933)

P.117

- **Synopsis**: company has non-compete w/ individual, but individual forms company that competes. Held that veil can be lifted since the corporation was established for the very purpose of getting around the non-compete.
- **Rule**: circumventing a contract is a wrongful purpose, so veil can be pierced.
- Facts
    - Company entered a K with individual and the individual pledged to not compete with clients
    - Individual then forms company, and company solicits plaintiff clients
- Issue
    - Pierce the corporate veil?
- Decision
    - Yes – this constitutes infringement of initial K since corporation established for purpose of getting around commitment to non-compete
- Ratio
    - Circumventing a contract is a wrongful purpose
- Note
    - *Jones v. Lipman* was a similar case. Both cases are examples where the D is trying to do something indirectly, that which they knew they could not do directly

Rockwell Developments Ltd. v. Newtonbrook Plaza Ltd. (ON, 1972)

P.117

- **Synopsis**: Kel sole SH of PDC, which owns Rockwell. Newtonbrook breaches K w/ Rockwell and Rockwell sues. Rockwell loses on its claim and is ordered to pay costs, but cannot; Newtonbrook argues that Kel should be personally liable for costs. Held that Kel is not personally liable veil not pierced since Rockwell has separate legal personality from K and there is no evidence of wrongful purpose.
- **Iacobucci**: today, RCP 56.01 would require security for court costs before suit, so Newtonbrook's claim against Kel personally would not happen. Newtonbrook essentially became an involuntary creditor for court costs when Rockwell sued for breach of K.

- **Involuntary Creditor Analogy to Big Bend**: argue that veil should be lifted here, since Newtonbrook became involuntary creditor for court costs; this is just like *Big Bend*, where insurer became involuntary creditor since did not have the fire history information on the sole SH to react to.
- Facts
  - Kelner set up Planet, which had beneficial trust in which it managed the assets of Rockwell. Newtonbrook tried to raise the sale price for land due to a zoning issue, and Rockwell (Kelner's company) sued for specific performance. Newtonbrook cross-sued, saying original K was null and void. Rockwell launched suit and lost, and it was required to pay Newtonbrook's costs of $4800, but Rockwell didn't have the money, so Newtonbrook sought the money from Kelner.
  - It was alleged that Kelner departed from corporate form: (i) deposit was paid by Kelner and Cooper; (ii) no board resolution to launch lawsuit; (iii) advance money came from Kelner/Cooper personally. Kelner said that lending was just "shareholder's loan" – it was understood that money would come back. The Trial Judge found that Kelner was the true contracting party and that he is personally liable for costs.
- Issue
  - Was Kelner personally responsible for costs assessed against Rockwell?
- Decision
  - Do not pierce → Court upheld *Salomon* – b/c of this Kelner was not personally responsible for the costs assessed against Rockwell
- Arguments
  - Newtonbrook argued that Kelner was the "real contracting party" and thus the real litigant
  - Kelner argued that Rockwell was the true purchaser, even though he had paid the deposit for the purchase personally and there was no resolution by the board of Rockwell to buy the property
- Reasons
  - Even though Kelner paid the deposit, the contract was made with the company and at all times litigation was conducted on behalf of the company; so there is no basis to conclude that Kelner was the actual contracting party
  - Had the deal gone through, Kelner would not have taken title to the land
  - There are no allegations of fraud – it is contrary to all established principles of company law to suggest that a corporation is a trustee for its shareholders, or even for a single shareholder
- Iacobucci
  - (56.01)Note now that rules of civil procedure provide a means for a count to make an order for security of costs where it appears that corporation may be under-capitalized
  - Newtonbrook got sued, and essentially became an **involuntary creditor** for court costs (i.e., not given chance to adjust for fact that was limited liability); however, it is not clear that even if Kelner had complied with all formalities, that Newtonbrook would have behaved differently
    - A voluntary creditor can react to information (ex. *Wolfe*)
    - An involuntary creditor cannot react to information since it is either not provided, or is false (ex. *Big Bend*)
  - On other hand, know that sometimes litigation results when have real estate deals
  - Should be able to recover costs if win – this is protected in rules of civil procedure, where can get security from SH for costs, if concerned corporation will not be able to pay
  - Slightly diminishes role of separate legal personality
  - Summary:

- Cases for piercing corporate veil:
  - (1) Deception → cannot take precautions since information not good
  - (2) Involuntary → cannot take precautions against status

642947 Ontario Ltd. v. Fleischer (CA, 2001)

P.122

- **Synopsis**: Directors of Sweet Dreams know corporation is undercapitalized but guarantee that the corporation will pay court costs in the event it loses. Sweet dreams loses and cannot pay court costs, so it is argued that directors shall be personally liable. Held that directors are personally liable since they misrepresented the company's capitalization
- **Rule**: pierce corporate veil when corporation is used as a shield for illegal, fraudulent or improper purposes
- **Distinguish *Rockwell***: here, the court finds Sweet Dreams' representation deceitful, but in Rockwell, the representation of paying court costs was not
- **Policy**: pierce veil more readily when have payment of court costs since courts not in as good a position to determine corporation's ability to pay costs relative to private contracting parties (i.e. due diligence standard for private parties is higher than it is for courts)
- Facts
  - Sweet Dreams corporation was involved in litigation with the other party to the appeal
  - Halasi and Krauss controlled Sweet Dreams
  - Sweet Dreams gave an undertaking with respect to costs if the injunction was discharged and its case was unsuccessful
  - Sweet Dreams loses, and TJ holds H&K personally liable on Sweet Dreams' undertaking
  - CA reverses decision; but makes it clear that had Sweet Dreams been liable on its undertaking the TJ would have been justified in holding H&K personally liable
- Decision
  - Court finds SH personally liable for undertaking that corporation will pay court costs, when SH knew that corporation was under-capitalized (misrepresentation)
- Ratio
  - Disregard separate legal personality when used as a shield for an illegal, fraudulent or improper purpose
  - "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"
- Iacobucci
  - Difference between this case and *Rockwell* → court finds something about the undertaking in this case deceptive
  - ***Why treat this case differently from situations where corporations incur legal obligations?***
  - Expect commercial parties to do their due diligence, but we may not expect the same from courts (this distinguishes this case from *Rockwell*)

Iron City Sand & Gravel Div. v. West Fork Towing Corporation (US, 1969)

P. 120

- **Synopsis**: D sued for negligence after barge sunk on the basis that he made all decisions of corporation, loaned it money, etc…. Court finds no negligence, but held that had there been negligence, veil would have been pierced since D misrepresented the company's capitalization
- **Rule**: when corporation is a mere business conduit for an individual, pierce veil to secure just determination of an action

- **Policy**: Inadequate capitalization should only matter in tort cases: Plaintiffs will seek veil pierce only if company cannot afford to pay. If company is inadequately capitalized, though, contractors can adjust terms of trade. The situation in which we would care about inadequate capitalization is in a case like *Iron City* with tort to 3rd party because 3rd party does not have ability to adjust behavior (involuntary creditor)
- Facts
  - P brings action against D corporation and its principal shareholder
  - P's barges sank due to D's negligence
  - Owner made all decisions of corporation, loaned it all its money, located in same building as other businesses, used resources from other businesses
  - P sues for negligence, claiming that D corporation was merely principal shareholder's alter ego
- Issue
  - Pierce the veil?
- Decision
  - No – since there was no negligence
- Reasoning
  - The fact that there is a sole shareholder is not enough to pierce the veil, however, it is a factor to consider
  - Had there been a finding of negligence, the veil would have been pierced since there was inadequate capitalization (i.e. not enough money in the company to allow it to run)
  - Even though separate accounts maintained for the company, accounts were often prepared by employees of principal shareholder's other company (so fuzzy boundaries between corporations)
- Ratio
  - When the corporate fiction is a mere simulacrum (an alter ego or business conduit of an individual) it may be disregarded in the interest of securing a just determination of an action
- Iacobucci
  - Other fact situations where could have inadequate capitalization:
    - Assets are pledged (used as collateral)
  - Piercing the veil:
    - Formalities: would likely turn on voluntariness of creditors
    - Inadequate capitalization (matters for tort, not for contracts) turn on involuntariness:
      - If under-capitalised, lose incentive to not act negligently
      - In contract, can negotiate for higher rate; in tort world, no opportunity to negotiate (i.e., involuntary creditors)
  - Case for piercing the veil with involuntary creditors is stronger than for voluntary creditors
    - Ex. Kosmopolous – preferred not to pay for limited liability status
  - Does number of shareholders matter?
    - With multiple shareholders: could be that more than one are liable when piercing corporate veil → the more shareholders there are, the further they are from the conduct that is impugned as wrongful → in principle, it is not necessarily clear that number of shareholders should matter
    - Shareholders have some residual claim, they know that there is the possibility of a massive tort – want to know whether shareholders are accounting for the costs of the massive tort when they are selecting directors
    - So – the number of shareholders is not obviously relevant as a principle

De Salaberry Realties Ltd. v. Minister of National Revenue (1974)
P.123

- **Synopsis**: sub-subsidiaries created to buy land with purported purpose of building shopping center; Minister argues that sub-subsidiaries were created for purpose of selling land, not developing it, so wants pierce veil and tax as income. Held that the veil of the subsidiary can be pieced to get at parent, but only in the assessment of tax context.
- **Rule**: pierce veil for specific purpose of tax assessment
- Facts
  - Bronfmans → Cemps Corp. → Cemps Holding Company → Sub-subsidiaries
  - Steinbergs → Steinberg Ltd. → Ivanhoe → Sub-subsidiaries
  - Bronfman family owns Cemps Investments which owns Cemps Holdings which owns a bunch of subsidiaries
  - Steinbergs own Steinberg Ltd., which owns Ivanhoe which owns a bunch of subsidiaries ("sub-subs")
  - Sub-subs created to buy a piece of land, purportedly to build shopping centers, but would not search extensively on zoning and only make preliminary plans
  - Court concludes that Cemps Holdings and Ivanhoe have "slight interest" to develop shopping centre, but really just want to resell land at a profit
    - Whether this profit is regular income or capital gains depends on whether the company is seen as a trader in land or just selling land incidentally to a purpose of building shopping centers; if only look at sub-subs, looks like interest in shopping centers, but viewed as a whole, looks like more interested in buying and selling land
- Issue
  - Can veil of sub-sub be pierced to get at parent company?
  - Tax issue: how to characterize the sale of the land
- Decision
  - The sale of the land is income, not capital gains – so veil of sub-sub pierced
- Reasons
  - The court will not look at the sub-subs separately from the family (parent included)
  - The reality was that the directors and officers of the sub-sub companies were identical and none of the sub-subs had any capital
  - All of the sub-subs only had a very weak interest in developing shopping centers
  - Court concludes that parent company is still a separate entity, but for tax purposes, the court must look at the entire context
- Ratio
  - Tax case specifically: disregard corporate form for specific purpose (may not generalize)
- Iacobucci
  - Thinks the tax context of this case was very important to the court's finding – so may not always get piercing of sub-sub veil to get at parent corporation
  - Since tax law creates a sharp and important distinction between income and capital gains, the court is forced to look at the entire context of the situation

Jodery Estate v. Nova Scotia (Minister of Finance) (SCC, 1980)
P.129

- **Synopsis**: Jodery transfers assets to company owned by grandchildren to get around statute requiring estate tax to be paid. Majority pierced veil, holding that grandchildren were "beneficially entitled" to assets so had to pay tax (finding based on (i) fact that companies in scheme were incorporated on same day, (ii) companies engaged in no biz activities, and (iii)

companies had no D/Os. Dissent does not pierce veil, arguing that corporation is separate legal personality; instead, calls for more rigorous tax rules.
- **Response to this case**: *Stubart* – individual can structure his affairs so as to minimize tax; then *GAAR* (s.245 ITA) catches most of these arrangements

- Facts
  - Jodery set up companies to avoid children having to pay succession duties under eponymous Act
  - Jodery incorporates 3 corporations – JCG, 100% owned by JBH, 100% owned by grandchildren; and conveyed shares of other company to WRI in exchange for note of $3.7 million
  - Jodery makes bequest (upon death) of note to JCG (company, not grandchildren)
  - Therefore, the structure, on its face, does not seem to require estate tax to be paid according to Nova Scotia Succession Duties Act since assets going to corporation not the children
- Issue
  - Do Jodery's heirs have to pay estate tax as if they received the assets personally?
- Reasoning
  - Majority
    - The grandchildren were "beneficially entitled" to deceased's estate and therefore subject to succession duties
    - Court relied on evidence that (i) JBH/JCG were incorporated on same day; (ii) no business activities; (iii) no directors/officers; and concluded that the corporations were mere conduit pipes to the grandchildren
      - SO – disregard separate legal personality of JCG
  - Dissent
    - Owning shares in company does not mean they have property interest in note – *Salomon* -- corporate is distinct from its owners, assets belong to the corporation
    - Argue that the TP is taking advantage of the given rules, and the government should set rules to prevent this (ex. GAAR) (consistent with *Stubart*)
- Counter-case (to majority)
  - ***R. v. Stubart Investments Ltd.* [1984] (SCC):** A corporation (affiliate) was structured for tax purposes. SCC said that individual may structure affairs however she wishes, including to minimize taxes. UK says there must be *bona fide* business interest in order to avoid taxes, but SCC rejects this doctrine, saying it's perfectly legitimate business purpose to seek to minimize tax. Parliament responded by enacting s. 245 of *Income Tax Act,* which sets out GAAR provisions, saying we can ignore arrangements solely designed to minimize tax.
- Reconciliation of *Stubart*, *Jodery* and *De Salaberry*:
  - *Jodery* follows *De Salaberry*. In *De Salaberry*, the Court indicates that the entity should be characterized contextually to determine what is actually going on. In *Stubart*, the Court characterizes the entity and finds it to be legitimate. This characterization can be read consistently with the contextual *De Salaberry* test.
- Iacobucci
  - Recap: How do we expect creditors to deal with LLC status (should have list for this in mini) [reasons to take a form is substance approach]:
    - Secure a personal guarantee
    - Take collateral
    - Raise interest rates
  - Arguments from government perspective:

        - → Government should draft statutes to prevent situations it doesn't want
        - ← From policy perspective, it is difficult for the legislature to foresee all holes

(a) Debt Priority for Shareholders (Equitable Subordination)

- Equitable subordination: when sole or controlling shareholder has a claim as creditor, then debt will be dropped in priority
- Note: this doctrine not fully adopted in Canada, but could be on the right facts

Taylor v. Standard Gas & Electric Co. (US, 1939)

P.132

- **Synopsis**: remove controlling SH's claim as creditor when SH violated fair play and good conscience
- Ratio
    - Creditors, upon bankruptcy, can seek to have court deny controlling shareholder the right to enforce a claim as creditor or secured creditor of the insolvent corporation on various grounds
    - One consideration in granting is the violation of rules of fair play and good conscience by fair claimant; breach of fiduciary standards
        - → argue in favour of fair play consideration: with sole shareholder, who is owed security interest, this interest may change the way they control the corporation in a way that makes it good for them as a senior creditor, but bad for everyone else
        - ← argue against fair play consideration: if the other creditors did not like the structure of debt, they did not have to enter into bond contracts with corporation
- **Other alternatives:** (i) Court could pierce the veil in all cases, contrary to *Salomon*. (ii) Deep Rock doctrine of equitable subordination – Instead of nullifying the debt, the debt could be subordinated to other credit.

Stone v. Eacho (US, 1942)

P. 133

- **Synopsis**: Virginia and Delaware Tip Tops were separate legal entities, but no creditors knew this. When Delaware goes bankrupt, creditor finds out Virginia owed Delaware money so sues Virginia for repayment of Delaware's debt obligation, but Virginia goes bankrupt. Held that separate legal personality of the corporations is pierced since the creditors did not know of its existence. As such, there is a pro rata distribution of combined Del and VA assets to creditors.
- **Rule**: pool assets of multiple subsidiaries when existence of subsidiary separate legal personality is unclear to creditors
- **Policy**: (i) PRO: rule will dissuade companies from shifting corporate assets between subsidiaries to avoid debt obligations; (ii) CON: rule will provide windfall for owing subsidiary when one subsidiary owes money to another (i.e. amount effectively paid by Virginia to Delaware is less than $40k; if the debt was due, this would be a higher priority, and Virginia creditors would split $40k less among themselves)
- **Iacobucci**: creditors need to be put on notice of the corporation they are dealing with to enforce separate legal personality
- Facts
    - Stone is appointed receiver (in bankruptcy) for Delaware Tip Top – they sue the Virginia corporation because Virginia store owes a debt to Delaware store of $40K
    - Virginia store cannot pay it, and itself goes into bankruptcy
    - Trustee in bankruptcy appointed for Virginia carries on business for Virginia store
    - No one was aware that Virginia store was a separate entity

    - There are other creditors to Virginia that were more senior than Delaware
- Issue
    - Should Virginia be separate legal personality (and thus, its senior creditors are paid first), or should it be considered part of Delaware?
- Arguments
    - Stone argues that Delaware corporation is to be paid off first
    - Virginia creditors argue that they did not know of the Delaware claim, and that it should be subordinated since it was held by a majority SH
- Decision
    - Upon bankruptcy, all creditors treated as creditors of the parent since no evidence that creditors of Virginia corporation intended to lend as distinct from parent
    - Court proposes pro rata sharing in pooled assets of both Delaware and Virginia creditors
- Reasons
    - The corporation failed to inform people of different corporate structures of Delaware and Virginia; therefore, debt of subsidiary is not subordinated, but it is also not given full priority over parent
- Policy Implications
    - Pro – This will dissuade companies from shifting assets between corporations, leading to preference of shareholders over creditors
    - Con – Creditors of the Virginia corporation should have known of the intra-enterprise debt; they are receiving a windfall from this ruling, since the amount (effectively) paid by Virginia to Delaware is less than $40k; if the debt was due, this would be a higher priority, and Virginia creditors would split $40k less among themselves
- Iacobucci
    - Creditors need to be put on notice of the corporation they are dealing with to enforce separate legal personality

(b) Tortious Liability

Adams v. Cape Industries (UK, 1990)

P.137

- **Synopsis**: parent mines asbestos and sells it under a subsidiary; sub is successfully sued, and Adams seeks to enforce judgment against parent. Held that parent is not liable since a corporation can structure its affairs to minimize tort liability.
- **Rule**: corporate structure can be used to escape tort liability
- **Canadian Position**: disregard separate legal personality when EE have claims against subs (*Downtown Eatery Ltd.*), so argue that this applies to all tort claims since both EEs and tort victims are 3rd parties that cannot contract around the harm.
- Facts
    - Cape Industries mines asbestos, and that sold it in Tex under separate sub
    - Lawsuit in Tex against sub, not defended
    - Judgment entered against Sub
    - P seeks to enforce judgment against Sub against parent Cape industries
- Issue
    - Can separate legal personality be disregarded?
- Reasoning
    - Reject P's claim since a corporation can structure it's affairs to shield it from tort liability
    - The mere fact that Cape might have only existed to protect its subsidiary is not sufficient to pierce the veil

- Ratio
  - UK court permits corporate structure to be established to escape tort liability as an inherent aspect of corporate law
- Iacobucci
  - → Adams – do not pierce veil for tort liability
  - ← *Downtown Eatery Ltd. v. R.* (2001)(OCA), OCA held that even though purpose of restructuring was not to freeze employee from settlement, company was liable for wrongful dismissal under *Employment Standards Act* and under oppression remedy
    - *Employee Standards Act* – treats all members of a corporate group as ER
    - *CBCA S.119:* directors are personally liable for unpaid back wages
  - Iac's take: law seems backward here, since have a complete disregard for separate legal personality when have EE-ER situation (even though EE's may have had a chance to K around harm), and have no veil piercing in situations where there is no chance to K around (tort liability)
- ***Adams* would likely NOT apply** in Canada since courts would likely be willing to view enterprise as a unit for tort purposes if it already does so for employment purposes (since both employees and tort victims are 3rd parties that cannot contract around the harm)

Walkovsky v. Carlton (US, 1966)

P.138

- **Synopsis**: parent corporation has many subs, each w/ 1-2 taxi cabs and minimum liability insurance. W hit by cab and sues owner of parent (Carlton) personally for tort liability.
- **Majority**:
- Majority held that Carlton was not personally liable, drawing a distinction between (i) piercing the veil when it relates to a parent and its subsidiaries and (ii) piercing when it relates to a corporation and its SHs. Majority holds that even if veil pierced to treat corporations as an enterprise wrt tort liability, it should not be pierced to hold SHs liable (here there was no evidence of fraud or misrepresentation so cannot pierce under *Big Bend* rule).
- **Dissent**:
- Dissent held that veil should be pierced since (1) there was insufficient capitalization (improper conduct) in the corporate setup (IAC does not like this argument since companies complied w/ statutory requirements for insurance) and (2) negligence should have a remedy since it has been the policy of the state to facilitate recovery of those injured – if structure is designed to avert this policy despite (i) reasonable foreseeability and (ii) ability to pay damages, then pierce veil
- Facts
  - P was run down by taxicab and sues
  - D vested ownership of taxi fleet in multiple corporations which own 1-2 cabs apiece
  - D's corporations only kept enough cash on hand to cover basic insurance entitlement
  - P sues all corporations jointly and seeks to pierce veil, alleging that the corporations are just the alter ego of Carlton
  - P sues Carlton to get access to companies' assets, rather than saying that companies are all part of same enterprise
- Issue
  - Can Carlton be personally liable for his corporations?
- Decision
  - Other companies not liable
- Reasoning
  - Majority
    - **Distinction drawn between enterprise liability and exposing individual to liability:** it is one thing to assert that a corporation is a fragment of a larger

corporate combine which actually conducts the business; it is quite another to claim that the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends

- There's no basis to hold Carlton individually liable, even if enterprises should be held liable jointly
  - The law allows incorporation for the purpose of avoiding liability, but courts can pierce the veil in situations to prevent fraud or achieve equity
- **Undercapitalizing in accordance with statute is sufficient:** if it is not fraudulent to only take out minimum insurance, then enterprise is not fraudulent because many such corporations are added together; to change this is up to the Legislature
- **Formalities play a role:** court considers that Carlton complied with all formalities

▪ Dissent (pierce since inequitable conduct)

- **Undercapitalizing is *prima facie* unacceptable:** the corporations were intentionally undercapitalized for purpose of avoiding responsibility
- The corporations could have easily anticipated plaintiffs in the business they were in, and yet they structured corporation to avoid this clear risk.
- If capital is illusory or trifling compared with business to be done and risks of loss, this is ground for denying the separate entity privilege.
- **As a policy, negligence should have a remedy:** the policy of the State has always been to provide and facilitate recovery for those injured through the negligence of others. Per *Anderson*, if structure is designed to avert this policy despite reasonable foreseeability and availability of profits to cover it, then Court should be willing to pierce the veil

▪ Iacobucci's rebuttal to dissent

- The dissent's argument that Carlton's companies were undercapitalized is bad since having the minimum insurance that is provided for in the legislation is likely efficient (having more or less could lead to inefficiencies)

o Iacobucci

▪ Tort victim is like an involuntary creditor, who does not have access to a contractual process, as such it is important to choose the mandatory rule in these cases; the mandatory rule should be more sympathetic to victims than the one we have

- Reason: the rule should make it so corporations internalize the costs of carrying on their business (if the only way to carry on biz is to not internalize all costs, then maybe do not carry on biz)

▪ Hansen & Crackman

- → argue that there should be unlimited liability for involuntary creditors (IAC likes)
- ← IAC potential counter: it becomes costly to diversify
- → IAC: address costs of diversification with pro rata liability

o Notes

▪ **Piercing individual veil is preferable:** As a plaintiff, I would sooner get access to the individual and thus other company interests than just the other company interests (since greater pool of wealth available)

▪ **Formalities should not matter:** Complying with formalities should not have a bearing on whether individual is deemed to observe corporate form, from perspective of claimant

- **Deference to the statute:** On one hand, perhaps we should defer to the $10,000 insurance minimum in the statute. On the other, perhaps we should protect the 3rd party, who can't adjust to circumstances in the way a normal creditor can (involuntary creditor). If Court pierced the veil, they'd be saying that Legislature set the minimum at the wrong amount and mandating suboptimal cash usage to satisfy court-ordered insurance requirements
- **Undercapitalization should not matter:** It would be counterintuitive to suggest that Carlton would not be liable if he had capitalized the firm. This should have no bearing on whether tort victim should be made to accept the losses. It would be an affront to limited liability
- **Company is positioned to bear the risk:** On one hand, drivers are least-cost avoiders of tort costs – they should be given incentives to take care. This would militate toward imposing unlimited liability for shareholders. Though shareholders are ostensibly powerless, they do have control through voting and takeovers. Perhaps, a cost of doing business should be 3rd-party losses
- **Externalization is the problem:** Undercapitalization is but one example of the key problem – the firm externalizing costs. This is the principled distinction that should be drawn when piercing the veil and creating personal liability

Posner – Rationales for Piercing the Corporate Veil

- (1) Separate incorporation may externalize a cost of doing business. If a taxi passenger knew that the taxi he was riding in was separately incorporated and could not satisfy a judgment, he would want to be compensated for this risk. Similarly, creditors would charge a higher interest rate. Firms should not be permitted to shift risk they would otherwise bear onto tort victims. *As a matter of policy, the full cost of torts should be imposed on those who have the ability to take precautions to prevent them.*
- (2) Where separate incorporation misleads creditors. Posner does not favour piercing the corporate veil in the case of privately owned firms, since creditors can contract around limited liability and since separate incorporation is necessary to permit owner-managers to diversify their risk. However, in the case of publicly traded firms, distinguish between separately incorporated firms in related businesses and separately incorporated firms in unrelated businesses. Strong incentives exist that mitigate against abuse of the corporate form with respect to unrelated separately incorporated firms (inter-corporate transfers minimized due to need for information on profitability). However, separately incorporated firms in related businesses can mislead creditors. Costly to have to inquire into corporate status every time. Therefore, pierce corporate veil and pool assets in such cases, where there is misrepresentation about the corporate status (i.e. confusingly similar name, co-location, etc.)

4. THE PROCESS OF INCORPORATION

The Competition for State and Provincial Charters: Delaware Phenomenon

P.164

- **Synopsis**: competition for corporate charters is bad since (i) it leads to indulgence and (ii) creates a race to the bottom (*William Cary*); competition for corporate charters is good since (i) choice of law costs are internalized and priced into share value and (ii) TCs are lowered due to ubiquitous nature of rules of corporate law (common among all corps) (*Ralph Winter*). Competition is a non-issue in Canada since securities law is provincial and not chosen by the parties, and permeates corporate law issues. As such, there is no competitive discipline in securities regulation either.
- **Barriers to Modifying Articles of Incorporation**
- (1) requirement of special resolution (2/3 vote)
- (2) appraisal remedy available (dissenting SH has right to have shares repurchased at value prior to the change)
- ***Rationale for barriers***: (a) prevent majority of SHs decisions that are good for them but bad for minority; (b) prevent ability for one group to unilaterally modify the K

- **Phenomenon:** In US, Delaware has become a market leader in attracting companies for incorporation. It has even attracted international companies.

- (1) Is competition over corporate charters good or bad? (Romano)
  - **Bad (William Cary)**
    - **Leads to indulgence:** Corporate managers choose where to incorporate before the company goes public. They take advantage.
    - **Race to the bottom:** Delaware has financial incentive to attract managers (since 15% of budget comes from incorporation fees and charter taxes). The state will likely induce self-indulgence and give managers too much discretion
      - ← IAC: giving managers discretion can be good since they can exercise it in a way that benefits SHs
      - ← IAC: strict laws might put power to make business decisions in the court
  - **Good (Ralph Winter)**
    - **Assumption:** Markets work very well.
    - **Internalization of costs:** Shareholders will penalize managers for choosing self-satisfying rules of the game by paying less for shares. Companies with good corporate law will have more capital available, *ceteris paribus*, since cost of capital will rise from suboptimality (shareholders pay less for equity, debt providers charge more).
    - **Network externalities:** When all companies have the same corporate law, investors and business partners will be familiar with rules of the game and transaction costs will be lower.
    - **Empirical evidence supports "race to the top":** When corporations move to Delaware (which requires 2/3 vote), share price rises. Delaware law adds value to corporation. The assumption holds reasonably well, but evidence is not conclusive (no evidence of negative).
- (2) Why do we not see competition for corporate charters in Canada? (Daniels)
  - **Securities law trumps charter choice:** Securities regulators in Ontario and Canada are intrusive re corporate law questions – e.g. duties of directors. Since governing securities law is where shareholders are located, corporate law is not as conclusive of rules of the

game. (This also holds for SOX.) This is why Romano advocates for choice of securities law as well. (Macintosh)

    - **No need for specialized judiciary:** In the US, state Supreme Courts are the highest corporate courts. However, in Canada, the SCC is the highest court, thus mitigating jurisdictional differences.

- <u>**Interaction with the Contractual Model**</u>
  - **Ability to choose (corp law):** The ability to choose a corporate law model suggests that the contractual approach is more suitable than the mandatory one, since corporations can opt out of entire systems.
  - **Inability to choose (securities law):** regulator chooses you, so there is no competition in the sense that they are chosen over another, thus there is no <u>competitive discipline</u> in securities regulation
  - **Articles of Incorporation**: choosing is restricted → the AI can't be changed easily due to reliance of shareholders on legal foundation. Therefore, 2 barriers exist to protect minority shareholders:
    - **Requires 2/3 vote (special resolution)**
    - **Appraisal remedy:** if shareholder dissents, (s)he has right to have shares purchased by corporation at the value prior to the change. This remedy exists because corporate constitution is so fundamental that one cannot be said to consent to shareholder position if AI are altered against one's will (ie. don't consent to altering the contract)
      - Rationale:
      - (1) controlling SH may want to make a change in the articles that is good for them in the capacity as something other than that of a shareholder
      - (2) do not want a situation where it is easy to unilaterally modify the K; but at the same time, want to have the ability to modify articles if necessary

Incorporation Techniques

5. THE SCOPE OF THE CORPORATE CONTRACT

Ultra Vires Doctrine

P.249

- **Rule:** outside the scope of a corporation's business (AA), the corporation cannot act unless shareholders consent to the action (from memorandum jurisdictions where incorporate via registration)
  - This rule is problematic since corporation cannot enter deals with third parties that might be outside the scope of the AA
- **Indoor management rule:** 3rd parties cannot be prejudiced by *ultra vires* act (see also *Eisenberg*).

Response of CBCA

- **15. (1) Capacity of a corporation** – A corporation has the capacity and, subject to this Act, the **rights, powers and privileges of a natural person**.
  - The presumption has shifted toward presumption of validity.
- **16. (1) Powers of a corporation** – It is not necessary for a by-law to be passed in order to confer any particular power on the corporation or its directors
- **16. (2) Restricted business or powers** – A corporation shall not carry on any business or exercise any power that it is restricted by its articles from carrying on or exercising, nor shall the corporation exercise any of its powers in a manner contrary to its articles
- **S.16(3)** → no act of corporation is invalid simply because it is ultra vires (on the modern understanding of the word → nothing is ultra vires unless explicitly excluded
  - IAC SUMMARY OF NEW LAW OF ULTRA VIRES: a company can restrict itself, but the default rule is that company can act flexibly. This is opposite of the old common law regime
- **S.17 & 18** → where the corporation enters into K that is contrary to its articles, the third party is protected and can enforce the K, unless it knew or ought to have known that the K contravened the articles
- **247. Restraining or compliance order –** If a corporation or any director, officer, employee, agent, auditor, trustee, receiver, receiver-manager or liquidator of a corporation **does not comply with this Act, the regulations, articles, by-laws or a unanimous shareholder agreement**, a complainant or a creditor of the corporation may, in addition to any other right they have, apply to a court for **an order directing any such person to comply** with, or **restraining any such person from acting in breach** of, any provisions thereof, and on such application the court may so order and make **any further order it thinks fit**.
  - This provision facilitates the indoor management rule.

(i) Corporate Social Responsibility

Introduction

P. 262

- **119. (1) Liability of directors for wages** – Directors of a corporation are jointly and severally, or solidarily, liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.
  - This is an example of a provision requiring directors to care about 3rd-party interests.
- **2 approaches to CSR stem from 2 different philosophies:**
- (1) Goal of corporation is to make profit.

- (2) Modern corporations should and do have duties to stakeholders beyond shareholders.
- **Concerns:** Query whether the corporation and corporate law is the best vehicle for advancing the interests of stakeholders. Do we want to rely on the choices made by corporations with respect to the environment, employment, etc., or whether we would rather rely on elected governments and lawmakers to regulate these aspects of business? A question of who has the expertise on these issues. CEO's are chosen for their ability to maximize profits, not their environmental or social expertise. Last case – *Medical* – is a good example of a case where corp made what most would consider an anti-social decision, but thought they were being socially responsible.

Dodge v. Ford Motor Company (US, 1919)

P. 263

- **Synopsis**: Director Ford wants to use company's surplus money to increase employment and make costs of producing cars lower, but minority SHs Dodge brothers object, arguing that Ford has to pay excess out in dividend. Held that some dividends have to be paid out since (i) business is for the profit of SHs (directors have discretion in how to profit-maximize, but no discretion in changing the goal of profit-maximization), and (ii) excess cash must be paid out. Court notes that there is no preference of short term profit over long term profit, so if it can be justified that investment will maximize long run profit, then it can be undertaken in lieu of dividend payment today (Ford did not make this argument). In addition, the withholding could have been justified by arguing efficiency wages.
- **Policy**:
- Profit-maximization is consistent w/ contractual approach since consistent w/ SH expectation at time shares purchased (facilitates investment)
- ***Appropriateness of Duty to Third Parties (EEs):***
- ***Inappropriate***: non-profit maximizing goal discourages investment, raising the cost of capital, and thus lowering the ability of the firm to pay EEs. As such, EEs may lose with a permissive rule, which runs counter to the efficiency wage rationale justifying the non-payment of dividends in the first place. Note that efficiency wages position can be defended by arguing that if they are too high (inefficient), then ER will go out of business
- ***Appropriate*:** charitable behaviours may serve profitable ends, even if not intentionally (eg. CIBC Run for the Cure). Ford may have paid efficiency wages to workers to improve productivity.
- Facts
  - FMC shares had par value of $2M, but dividends of $1.2M and special dividends of $41M were paid between 1911 and 1915 (60% dividend)
  - Ford decided not to pay special dividends despite having a large surplus in 1916 of $112M
  - He would take cash reserves and put them back into company to increase employment & sell larger number of cars at lower price per car
  - He controlled BOD, who went along with his views and Ford admitted to wanting to spread his industrial model as far as possible
  - Minority shareholders Dodge brothers brought suit to compel declaration of dividend not less than 75% of surplus ($50M)
  - Lower court ordered a dividend, not full amount that Dodge was looking for - $19M
  - Ford appeals the order.
- Issue
  - Can directors be compelled to pay dividends if surpluses are large?
- Arguments
  - Dodge

    - Argues that Ford has adopted this new strategy to benefit EEs and customers at the expense of SHs; Ford does not have authority to run the company as a semi-charitable organization
- Decision
  - Some dividends have to be paid out
- Reasoning
  - **<u>Ability to behave *ultra vires*</u>**
  - **Business is for profit of stockholders:** Profit is primary; a corporation cannot be run for the incidental benefit of shareholders and primary purpose of others. Directors have discretion to choose strategies to achieve profit-maximizing, but there is no discretion to change that objective
  - To the extent that Ford was running semi-charitable organization to benefit employees & customers, he is enjoined.
  - **Long-term profit vs. short-term profit:** There is no necessary preference of dividends over investment. Investment does not lead to profit in the short term. The remedy in this case is narrowed since Ford's proposed expansion will not necessarily harm shareholders.
  - **Excess cash must be paid out:** Though Ford's proposed action was not *ultra vires*, the cash held on hand to pay for the expansion was excessive and the excess must be paid out.
- Iacobucci
  - How could Henry Ford have gotten a different result?
    - (a) argue that withholding was in the interest of long term profit
    - (b) argue that higher payment was for efficiency wages (pay more to make risk of job loss a higher cost for EEs)
  - Contractual Perspective
    - If SH bought shares with the understanding that the board would act in a manner that maximizes SH value, then reneging on this is harmful since violating the K may make it more difficult to attract future investors
    - This perspective does not require SH to be privileged over other stakeholders, it merely stands as a caution to violating expectations
- Note
  - **Decision should be read narrowly:** In this case, Ford admitted that his plan was not to create profit. Court found that end must be profit, but means is discretionary. If Ford had argued that his plan would be profitable, Court may have come to different conclusion. The Court explicitly noted that the decision to pay dividends still rests with the directors.
  - **Ford may have had ulterior motive:** Dodge wanted payout to start rival car facilities. Ford may have hoarded funds to avoid competition. Court may have acted on this undertone (which is arguably a legitimate purpose for Dodge's business).
  - **Appropriateness of benefiting 3rd parties:**
    - **Bad** – if directors are permitted to change ultimate objective, then shareholders will be reluctant to invest. This will raise cost of capital, lowering the ability of the firm to pay employees in the hand. Therefore, employees lose with a permissive rule. [this is a counter to efficiency wage argument; but can defend efficiency wages with the position that ER should be able to pay them, since if inefficient, then will go out of business (i.e. paying EEs too much]
    - **Good** – Charitable behaviours may still serve profitable ends, even if not intentionally (eg. CIBC Run for the Cure). Ford may have paid efficiency wages to workers to improve productivity.
  - **The right rule is set**: Ultimately, apart from how end will be achieved, profit must be ultimate goal. Since some organizations might object, there should be discretion to put

provision in AI for other objectives (even if it's unlikely that either objective will be met).
- **Inappropriate institution for charity generation**: (1) The profit motive is not a positive statement about the appropriateness of charity. Rather, it is a statement that shareholders have the right to use their money how they wish. If money is not used to generate profit, it should be returned. (2) It is inappropriate to impute charitable values to the heads of industry. CEOs are not strategically positioned to allocate funds toward these ends.

Miles v. Sydney Meat-Preserving Co. Ltd. (1913)

P. 267

- **Synopsis**: AI said Ds could pay dividends out of profits, but none were ever paid; instead, it was argued that excess money was used to benefit the pasteurial industry.
- **Majority**: Held that there is no duty to pay dividends since profit duty does not imply duty to pay out as (i) prices would have to be set to skim and not penetrate and (ii) ER would be enjoined from providing housing to EEs. Iacobucci notes that these two reasons are inept and doing them can still be consistent with long run profit maximization.
- **Dissent**: Held that there is a duty to pay out and majority approach leads to perverse results since it permits company to engage is SDTs.
- Facts
  - Meat preserving business said in AI that directors could pay dividends out of profits every half-year and allocated a certain portion of money for payment of dividends.
  - No dividends were ever paid.
  - Majority of company said company was not to be run for purposes of profit, but for benefit of pasteurial industry
  - The plaintiff alleges that there is an implied contractual duty to maximize profits and distribute them when earned. Such an implied duty is not known to law.
- Issue
  - Is the company required to pay dividends?
- Decision
  - No duty to pay dividends
- Reasoning
  - Majority
    - **Duty to pay dividends**
    - **Profit duty does not yield short-term profit and payout duty:** A duty to pay dividends implies a duty of short-term profit maximization and immediate payout. However, this would lead to perverse results – (i) price would have to be set to skim and not penetrate; (ii) employer would be enjoined from providing housing to employees and would be forced to pay dividends.
  - Dissent
    - **Majority leads to perverse results:** The majority would permit the company to engage in SDTs which reduce residual claim but siphon low-interest-rate funds to a controlling shareholder. This cannot be permissible.
    - Social goals and the bottom line (profit-max) are not inconsistent; it's wrong to say that providing benefits to someone other than the SH could not be in SH interest
- Iacobucci
  - **Analogies are inapt:** (1) penetration price may be a long-term profit strategy, and (2) housing reimbursement may be in best interests of the company. The primacy of the profit motive is unharmed by the analogies chosen. (analogies by majority: (1)

telecommunications in remote area would have to be priced to gauge people [IAC: fails to see SR/LR distinction] and (2) you cannot compensate EE w/ house since against interest of corporation)

- **Appropriateness of policy depends on when shareholders bought:** The policy was announced. Anyone who bought after the announcement can be presumed to endorse the policy. However, those who bought beforehand should be reimbursed since they were likely misled by the company being set up as a for profit company
- **Contractual approach doesn't preclude Not For-Profit:** If company really wanted to set up NFP, they could have set it up separately. It's dangerous to blow up corporate rules midstream. (NFP is a corporation that can make profit, but does not have to distribute it to investors)
- **Non-payout of dividends is not evidence of disregard of profit motive:** If IRR of available projects exceeds expected return of company, then money should be invested, not paid out.
- Note that a share that will never pay out a dividend will trade for $0 since it is worthless

Parke v. Daily News Ltd. (1962)

P.269

- **Synopsis**: Daily News selling subs, and planned to use some proceeds to pay off EEs for lost jobs, pensions and holidays. Minority SH in Daily News claims that payment to EEs is *ultra vires* the corporation (today: not in the best interests of the corporation). Held that the payment to EEs is NOT permitted since only payments that are reasonably incidental to the corporate purpose and in good faith are permitted (*Hutton*)
- **Test for Gratuitous Payments to 3rd Parties**:
- Context: if there is no SH dissenting, payments can be made to 3rd parties, so long as they are in the best interests of the company (*Hutton*). If there is a dissenting SH, then the following test from *Lea & Perrins Co.* applies, with the onus on the board/payer:
- (1) is the transaction or payment reasonably incidental to the carrying on of the business?
- (2) is the transaction or payment bona fide (in good faith)?
- (3) is the transaction of payment done for the benefit and to promote prosperity of the company?
- **Policy**:
- ***Arguments against payments to EEs***: (i) allows minority oppression through SDTs; (2) corporate law not the best governing instrument, labour law should make the rules; (3) need to protect the relatively undefined terms of SH's right to residual claim, whereas EE K'ed upfront and for fixed terms.
- ***Arguments for allowing payments to EEs***: (i) provide positive performance incentives to EEs, (ii) quell general mistrust b/t EE and ER, (iii) attract best EEs
- Facts
  - Daily News employed 2800 people
  - They had 2 subsidiaries which they were selling to Associated News, but they were to continue to carry on business
  - There was no legal obligation to pay employees anything following the sale; there was likely the implication that workers would be paid off
  - Still, prior to sale of business, directors (who were continuing) said balance of sale price should be used exclusively for staff and pensioners (for compensation for lost jobs, pensions, holidays).
  - Agreement said that Associated (buyer) would not be responsible for any liabilities associated with former employees

        - Plaintiff (minority shareholder) commenced an action saying disbursement to employees is *ultra vires* the corporation, arguing that even putting the question to shareholders must be enjoined.
  - Issue
    - Is an action not in interests of shareholders (payment of sale price to employees for past services rendered, etc.) *ultra vires* the directors?
      - TODAY: this issue would come up in the context of CBCA s.122: director's duty to act in the best interests of the corporation
  - Decision
    - Yes, the payment to EEs is ultra vires
  - Reasons
    - ***Hutton* case** → says that the company can pay EEs money on windup, but not when there is a dissenting SH; so can be generous to EE when it is good for the company
      - Implication → sacrificing current dividends not to grow future dividends is permissible so long as it is reasonably incidental to the corporate purpose (profit maximization?) and in good faith
    - **Gratuitous Payments to 3rd Parties:**
    - **Balance between objectives:** A company can't treat employees with Draconian severity and expect to be successful. Yet it is not in the business of charity either. Therefore, reasonably incidental costs will not be interpreted too narrowly or flexibly.
    - **Test** (from *Lea & Perrins & Co.*)**:** presumption against allowing gratuitous payments, unless they can be justified by addressing the following (onus on board/payer):
    - (1) Is the transaction/payment **reasonably incidental** to the carrying on of the company's business?
    - (2) Is it a ***bona fide*** transaction (i.e. in good faith)?
    - (3) Is it done for the benefit and to promote the **prosperity of the company**?
    - **Note:** Test only needs to be met if shareholder dissents: In *Hutton*, shareholders resolved to pay executives highly upon windup. Court said that company could do so if no shareholder dissented. However, upon shareholder dissent, test must be met.
    - Ability to behave *ultra vires*
      - No duty to employees: Court explicitly rejects notion that employees are integral as justification for making payments.
  - Note
    - **Consistency w/ Contractarian approach:** the decision in *Park* is consistent since upholds SH expectations and thus encourages investment
    - **Possible ulterior motive in this case:** The Cadbury family were shareholders, and they may have paid off employees to preserve their reputation as being good employers generally.
    - **Arguments against allowing payments to EEs:**
    - **Minority oppression:** permits the use of generous severance packages under the guise of duty. *It opens up ability of majority to oppress minority*. Content of duty to shareholders is lost
    - **Unsuitability of corporate law to protect employee interests:** Corporate law is not the appropriate vehicle through which to address employment concerns. Employment/labour or insolvency law are better suited and more reliable, assuming that the concerns are justified.
    - **Governance of K process/SH primacy:** EE contract terms made explicit upfront whereas SH entitled to residual claim and dividends – EE contracted for fixed upside, SH did not. SH residual claim is somewhat undefined, so there is a need to protect them from directors potentially taking their claim

- **Arguments for allowing payments to EEs:**
- **Increasing duties to stakeholders leads to inefficacy:** *UK Companies Act* has overturned this case, saying some payments are all right, even if not in best interests of company.
- **Rationale for distinguishing employees from other stakeholders:**
- (i) Payments may provide incentive to employees to stay on after transaction (N/A in this case);
- (ii) CBCA s. 119(1) suggests that there's mistrust re employee protection that warrants differential treatment;
- (iii) Permitting generous payouts to employees may attract better workers. Though shareholders will disapprove of payouts ex post, they may want to ex ante commit to make payments to employees. (However, the commitment is admittedly weak.) If there are rumours, etc. of bad times coming up, don't want employees to bail or work only half as hard, thinking they won't get paid.
- **Free-rider problem**: encourage/permit good corporate responsibility when allow
- **Part of implicit contract (facilitates contracting)**: when EEs sign on, there is an understanding that they would be entitled to receive these types of payments on windup

Teck Corporation Limited v. Millar (BC, 1973)

P.277

- **Synopsis**: payouts to EEs using residual earnings are appropriate, even if there is a dissenting SH; *Lea & Perrins Co.* endorsed in *Parke* would be satisfied since (1) the payment is reasonably incidental to carrying on the business, (2) the payment is in good faith and (3) the payment is for the benefit and to promote the prosperity of the company.
- **Potential Readings**: (1) consistent w/ *Parke* since can apply the test and find payments allowed; (2) inconsistent w/ *Parke* since duty is to the company, not the SHs (based on *People's* & *BCE*), although payment still would be allowed, but for different reasons.
- **Changing attitudes toward stakeholder commitments:** The classical theory must yield to modern life. Today, we would pay employees and consider it in *bona fide* interests of the company
- **Iacobucci**
  - → argue *Teck* is consistent w/ *Park*: wording is consistent w/ applying the *Park* test ((1) reasonably incidental; (2) bona fide transaction; (3) prosperity of the company)
  - ← argue *Teck* is inconsistent w/ *Park*: duty is to the company, not just the SHs (based on *People's* and *BCE*, which rely heavily on *Teck*)

Theodora Holding Corp. v. Henderson (US, 1969)

P.278

- **Synopsis**: D makes donation to charity, but the donation is challenged by SHs. Held that donation was permitted since (i) charity is a bona fide acceptable corporate activity (per *Smith v. Barlow*, where donation was made to Princeton to promote the capitalist system), (ii) donation amount was reasonable (impact on corporation reduced via tax benefits) and (iii) there was no personal benefit. Note that promoting capitalism is found to be valid purpose for donation, but Iacobucci notes that these benefits accrue to all corporations, creating a free-rider problem.
- Facts
  - Alexander Dawson had control of Theodora company, which had control of Dawson Co.
  - He used Theodora to make $528K pledge to Dawson Charity for "rehabilitation and education of deprived and deserving young people."
  - Shareholders challenge the donation.

    - In Delaware, the rules permit corporations to make donations in times of war/national emergency or for public welfare, social good, etc.
- Issue
    - Can the directors give such a large sum of money to charity?
- Decision
    - Yes, action is *intra vires*
- Reasons
    - **Charitable Donation**
    - **No clear personal benefit:** There is no showing that the gift was made indiscriminately or in furtherance of personal rather than corporate ends. The charity is a legitimate charity – it fit into the statute's charity legitimacy provision.
    - → **Charity is a *bona fide* acceptable corporate activity:** The Court refers to *Smith v. Barlow*. Here, there was a donation to Princeton without statutory authorization, and the Court upheld validity of the donation, saying that with shift of wealth towards corporations in society, there was role for them to play in making these kinds of donations, and they benefit from these donations by ***promoting the capitalist system*** to the public. As well, the Delaware statute contains no limiting language on corporate giving.
    - → **Reasonable charity will be permissible:** Here, the $528K donation cost the company $80K due to tax benefit due to *Internal Revenue Code* permitting 5% of income to be deducted if donated. The statute is a good indicator of what is "reasonable." Also, social benefit is high.
- Note
    - **Justification for charity is broad:** Benefit of furthering of capitalism seems to fit into the Court's interpretation of benefits.
    - ← **Personal benefit seems more likely than court recognizes:** The charity chosen was the Alexander Dawson Foundation, not arm's length from principal shareholder. He is diverting others' resources to his own organization. We would prefer him using own money.
    - ← **Preservation of capitalist culture is not necessarily a benefit:** Benefits of good perception of capitalism accrue to all corporations. It is in best interests of corporation to free-ride on efforts of others. This demonstrates why institutions (e.g. tax deduction) must be developed to promote corporate donation – otherwise, free-rider problem would never be solved. (Use *Evans* here)
    - **Benefits to company:** (i) Tax deduction; (ii) Public relations (e.g. logo on t-shirt)

Evans v. Brunner, Mond & Co. Ltd. (1972)

P.280

- <u>**Synopsis**</u>: charitable donation for research made to university. Held that donation was allowed since the advantages to the corporation were not too speculative or remote, and it would train the correct people for the technology company. Iacobucci notes a free-rider problem exists, since benefits accrue to all companies relating to the research.
- **Expansive view of corporate donation:** Court found it profitable to give 100K to university because directors said it would end up training the right people for this innovation company.
- Eve J said advantages are not "too speculative or too remote" and he must rely on evidence of those responsible for conduct of company's affairs that the investment was prudent because it would cultivate a scientific attitude of mind.
- **Critique – Free-riding:** All companies benefit from a non-proprietary scientific attitude of mind. However, we also want to promote scientific atmosphere as a public policy.

CNR "Run-Throughs" Report

P.283

- Background: report addressing the legal obligations of CNR when it decides to close a station in a small town it "runs through" and which subsists on the railway
- ***Question: does CN owe these communities a legal obligation?***
- → Yes
- CN was established by the state, and thus has a public obligation that would not arise for private corporations
- ←No
- Creating a legal obligation is paternalistic
- It is not up to the court to guide the legislature on where it should direct resources (which is what it would be doing if found for a legal obligation)

Report of the Royal Commission on Corporate Concentration (1978)

P.285

- **Synopsis**: should corporations of government be primarily responsible for corporate social responsibility? (1) the proposition that D/Os must act in the best interests of SHs is not to say that SHs are the only members of society that matter; other areas of law impose restrictions on directors as well (employment, environmental etc…)
- **Widely Held View (gains from specialization)**: in general, CSR duties will be left for the government to implement, while the corporation can voluntary engage in such activities when they align with profit-maximization (gains from specialization)
- **Alternative View (corporation is social institution)**: corporations are social institutions, and they should internalize costs as much as possible, taking into account stakeholders other than only SHs
- To say directors should act in best interests of SH is not to say that SH are the only members of society that matter: other areas of law (employment, environmental) constrain the choices of directors
- Contractually, seems reasonable to let firms decide for themselves who managers owe duty to; but generally will leave social responsibility to government (presumptive rule) and will only engage in CSR when aligns with profit maximization
- It is a question of respective competency: Who is better at dealing with needs of community? Probably government (although gov is not perfect, is better than corp)
- Alternative view is that corporations are a social institution, and of such importance to society, that there should be mandatory rules forcing firms to internalize costs and take social responsibility
- Distinction between rules (employment, env regulation) and discretion. This is about discretion and whether managers should take into account only SH or society at large when exercising discretion

E.M. Dodd, "For Whom are Corporate Managers Trustees?" (1932)

P.287

- → Directors have ***no obligation to maximize profits***; they have to act in the best interest of the corporation, which is a separate legal entity from the SHs, and which managers control (*Dodd*)
- ← Directors ***obligation is to maximize profits***, since absent this obligation, there are too many other conflicting duties that would make interpreting director duties impractical [accountability to everyone is accountability to no one] (*Berle*)
- **Dodd** begins from the position that the corporate entity is a reality, not merely a legal fiction. The corporation is a person that differs from the individuals who compose it, and like other

persons in society, it must be affected by public norms on what is ethical behavior. Managers, those through whom the corporation acts, may employ the corporation's funds in a manner congruent with this and not be guilty of a breach of trust.

- **Berle's** critique of Dodd's article is that once managers have to take into account considerations broader than profit-making, they have too much unrestrained scope for decision-making. Example – closing an unprofitable plant. If the rule is profit-making, close it. But if the rule is broader, there are rationales in favor and against closing the plant, since you are responsible to too many constituencies. Too much discretion, directors (who are still self-interested) are unconstrained. A duty to all is a duty to none. Cannot abandon profit unless can offer a comprehensive system that can be confident will be enforceable and concrete. Need to have duties to guide directors' behavior and constrain their choices
  - This is the problem with the *BCE/Peoples* fiduciary duty standard – it is too indeterminate.
  - Shareholders elect directors. How can directors have a duty to anyone else but the people who control whether or not they are in office?

ALI: Principles of Corporate Governance: Analysis and Recommendations (1994)

P.288

- ← **No restriction on donations**: corporate donations should not have to be tied to a charity, and should be allowed even if do not comply with *Theodora* principles (promotion of capitalism and reasonableness)
- → **IAC:** allowing any corporate donation creates disincentives for investment

Posner, An Economic Analysis of Law (1986)

P.290

- **Synopsis**: In competitive markets, corporations that make any sort of sustained commitment to goals other than profit maximization will be forced out of business.
- **Problems with the subordination of profit maximization to social responsibility:**
- ***(1) sub-optimization*** – managers who try to accomplish two goals will likely fail at both;
- ***(2) standard*** – how do managers decide what the ethically correct stance is on a given issue?
- ***(3) distributive justice*** – the costs of social responsibility will be borne by consumers in the form of higher product prices, a form of regressive taxation (all consumers pay higher prices, income tax distributed); and
- ***(4) substitution*** – to the extent profits are reduced, this reduces the ability of shareholders to exercise social responsibility themselves, and substitutes corporate choices of responsibility for SH choices.

Hansmann and Kraakman, "The End of History for Corporate Law (2001)

P.291

- **SH primacy is the default rule**: SH primacy does not mean that SH matter more than other stakeholders, but rather giving them primacy provides the most effective method of corporate governance (other stakeholders can be protected by other law)
- **Iac**: note that this appears not to be the case in Canada (*People's* and *BCE*)

(ii) Creditors and Corporate Obligations

S.122 CBCA: To Which Stakeholders do D/Os Owe a Duty?

- **(1) Duty of care of directors and officers** – every director and officer of a corporation in exercising their powers and discharging their duties shall
  - (a) act honestly and in good faith with a view to the ***best interests of the corporation***; and
  - (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances
- **(3) No exculpation** – no provision in a K, 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 of a breach thereof

- **Summary of Interpretation in Case Law**
  - *Park*: duty is owed to the company, but this is always understood to be a duty to the SHs
  - *People's* → duty is owed to the company, which may include many stakeholders, including SHs, creditors, EEs, suppliers, etc…
  - *BCE* →

- **Iacobucci: Why might there be a duty to creditors?**
  - **Rationale:** when have an insolvent corporation (debts>>assets), then the value of shares is close to 0. In this situation, shareholders would only be interested in managerial decisions that would have the potential to bring the corporation out of debt and provide some residual claim to the SHs (ex. high risk decisions); however, in this case, the creditors would have an interest in any corporate action that would increase the value of the company, even marginally since that value will accrue to them.
    - ← **counter**: creditors can protect themselves via K, and have certain specified rights and amounts (principal and interest payments), whereas SHs do not have well-specified rights
    - → **counter the counter**: creditors' specific rights may not ever be realized, so they may get something less than the specific K provides for

Canbook Distribution Corp. v. Borins (ON, 1999)

P.293

- **Synopsis**: creditor Cranbrook brings claim for breach of fiduciary duty against corporation for giving priority to other creditors when corporation goes bankrupt. Held that there is a fiduciary duty owed to creditors when corporation is insolvent.
- **Policy Rationale for Fiduciary Duty to Creditors when Insolvent**: when insolvent, SH residual claim is 0; as such, SH incentives are aligned w/ only risky opportunities that have the potential to increase their residual claim (i.e. must first raise enough money to pay creditors), however, creditors incentives aligned w/ any opportunity that can raise money (i.e. increase their residual claim).
- Facts
  - EBAL, owned by Edsed, was adjudged bankrupt
  - Canbook (creditor) wants to commence action against EBAL for making a decision which negatively affects creditors (improper dealings – prioritizing security for Edsed payout)
  - Defendant says no duty owed to creditors, so summary judgment.
- Issue

- Does s. 122 of CBCA (see legislation in *People's*), setting out duties, encompass a duty to creditors?
- Decision
  - Yes; Court denies motion for summary judgment by defendants
- Reasons
  - **Fiduciary duty to Creditors**
  - **Duty owed to creditors when insolvency an issue:** From commonwealth case law, *Nicholson v. Parmakraft* notes that fiduciary duty is owed to company, which may *inter alia* include shareholders. At insolvency, when interests at risk are borne by creditors, it defies logic to allow shareholders to authorize a breach of the duty. (IAC: Insolvency is a finding of fact at trial.)
- Note
  - **Rationale for duty to creditors:**
  - At insolvency, residual claim (to SH) is worth virtually 0
  - Directors should be taking into account creditors' interest and preserve what value is left in the organization
  - Creditors, in some sense, have become the residual claimants; note that creditors' incentives differ from SH in this case (i.e., if company is worth $5, but has debts of $100, SHs are only interested in decisions that will get the value of the company over $100, whereas creditors are interested in any increase in value)

Peoples Department Stores Inc. (Trustee of) v. Wise (SCC, 2004)

Handout

- **Synopsis**: Wise to merge with Peoples, under special internal transfer pricing policy that fails, leading to both companies bankruptcy. People's creditor sues for breach of fiduciary duty (arguing Wise was favoured over People's in merger transfer pricing policy). Held that there was a constant fiduciary duty owed to the corporation, which includes, inter alia, SHs, EEs, suppliers, creditors, consumers, governments and the environment. On the facts, although duty was owed, there was no breach since there was no finding of bad faith or self-interest.
- **Note**: no allegations of self-interest we made and no derivative actions were brought, although they could have been on these facts.
- **Rule**: a fiduciary duty is owed to the corporation, which includes, inter alia, SHs, EEs, suppliers, creditors, consumers, governments, and the environment. The duty is constant, and does not change under varying circumstances (i.e. bankruptcy).
- Facts
  - Wise brothers owned Wise. Wise acquired Peoples from Marks & Spencer, but the merger did not go smoothly
  - Inventory procurement policy: One of terms was that Wise would pay M/S in installments. Internal transfer pricing engaged by Wise/Peoples prejudiced Peoples – Peoples exchanged North American inventory to Wise in exchange for credit. They had the opposite arrangement for overseas inventory.
  - Both companies went bankrupt.
- Arguments
  - Trustee for Peoples claims that Wise was favoured over Peoples by directors, which was in breach of s. 122(1) of CBCA. [TJ finds duty owed, but CA says no duty owed.]
- Issue
  - Pursuant to s.122 of the CBCA, do directors owe a fiduciary duty to creditors?
- Decision
  - Duty is owed to corporation, which may sometimes include creditors.
- Reasons

- **<u>Duty to Creditors</u>**
- **Fiduciary duty is to "corporation":** S. 122(1) requires observing decent respect for *inter alia* shareholders, employees, suppliers, creditors, consumers, governments and the environment. There is no reason to suggest that best interests of "corporation" includes only one stakeholder (not even shareholders). From *Teck*, it's clear that meeting interests of other constituencies may still be in best interests of corporation.
- **Content of duty is constant:** The various shifts in interests that naturally occur as a corporation's fortunes rise and fall do not, affect the content of the fiduciary duty in s. 122(1).
- Statutory fiduciary duty requires directors/officers to act honestly and in good faith vis-à-vis the company – not "best interests of shareholders" but "best interests of the corporation."
- **<u>Context of the Case</u>**
- **No bad faith:** Court found no breach of FD on finding that there was no bad faith or self-interest.

- IAC:
  - No allegations of self-interest made
  - No derivative action brought
  - **Reconcile w/ *Parke*:** argue that *Parke* stands for the proposition that in order to discharge duty to act in the best interests of the corporation a director has to maximize aggregate interests and that is SH value (in the case where the company is solvent); could also argue that *Peoples* is not inconsistent with this proposition since in it stands for the proposition that when directors maximize aggregate interests, in the case of insolvency, the interests may lie w/ creditors and other stakeholders, as well as SHs
  - **Irreconcilable w/ *Parke*:** could argue that *Peoples* actually stands for the proposition that directors may choose what is in the best interests of the corporation, and thus it is actually director discretion not aggregate interests that govern
- Note
  - **Contractual view of social goals:** When A contracts with B, corporate law should not interfere with terms. However, if A/B harm C/D/E/F by pollution, etc., the private decisions of A/B are suboptimal in their imposition of external social cost. In such a situation, mandatory rules may be more appropriate than enabling.
  - **Contractual view of institutional competence:** We will want directors to account for 3rd parties and social goals in their director duties. However, we should not veer from the profit motive. Directors should be responsible to external sources of regulation as constraints on the profit motive. In cases like *Wolf v. Mohr* and *Walkovsky v. Carlton* with involuntary creditors, we may seek a mandatory rule. Mandatory if cannot contract; enabling if can.
  - **BUT corporations may respond by committing resources to lobbying:** Corporations may lobby for laws that are good for the corporation, rendering the ability of the state to optimize faulty. (You would have to weigh the harm from lobbying against the suboptimality of acceding to corporate social choice.)
  - **Duty to creditors is not made explicit:** The Court rejects a fiduciary duty owed explicitly to creditors. The corporation cannot be reduced to one stakeholder at a time, despite fact that creditors become pseudo-residual claimants (with all the worries attached) during insolvency.
  - ***Peoples* may or may not lead to reversal in *Dodge* and *Daily News*:** If duty is now owed to corporation as a whole, then Ford and Daily News may be justified considering employees since they built company. However, in reconciling *Peoples* with *Dodge* and *Parke*, note that the decisions are not necessarily in tension. In light of *Teck*, *Peoples* may

say that other constituencies may be considered to the extent that they are in accordance with the profit motive – satisfying other constituencies can be good for shareholders. It is unclear how far *Peoples* goes – it may be narrow, resurrecting dissent in *Miles v. Sydney* or broad, permitting loss in shareholder value.

- **Court rejects duty to residual claimant:** The question arises whether a narrow duty to protect the residual claimant, whomever that is, is appropriate. The Court rejects this – the decision is not narrowed to where shareholders make risky decisions at the expense of creditors – they say the duty would not be susceptible to legal definition. Despite the Court's rejection of the model, Delaware does have a shifting legal duty model.
- **Not distinguishing shareholders is problematic:** *Peoples* overrules *Dodge*, saying that the "corporation" is more important than the "shareholders." However, the rest of corporate law does distinguish shareholders from creditors/employees/customers by granting directors the right to vote. Allocating the duty to the voters is coherent and allows directors to be conscious of who their overseers are. Conceptually, this would seem to matter. It is hard to know what real effects of this sort of conceptualization are.

BCE Inc. v. 1976 Debenturesholders (SCC, 2008)

Handout

- **Synopsis**: consortium of buyers propose LBO for BCE, paying a premium of 40%, which is approved by SHs. Creditors claim breach of fiduciary duty since leveraged buyout reduces the value of their stake by 20%. Held that the fiduciary duty to the corporation prevails if there is a conflict b/t the duty to the SHs and the duty to the company. Application was that the board adequately took into account the interests of the creditors, and thus, transaction can go through.
- **Rule**: (i) if duty to the SHs and to the corporation conflicts, then duty to the corporation prevails; (ii) at a minimum, fiduciary duty requires satisfying statutory obligations
- **Application**: (i) unclear the extent to which D/Os must consider non-SH stakeholders; (ii) this seems like an obligation to consider but not to act; (iii) seems like directors are afforded a high degree of discretion in determining what stakeholders to consider and the weight of the potential impact on them
- **Resulting Policy Issues**:
- (i) ***Government as a stakeholder***: is the government a stakeholder? If so, LBO is bad since an increase in leverage causes corporation to pay less tax
- (ii) ***Creditors could protect themselves***: LBOs are common and creditors are sophisticated – can put in provision to protect themselves in this case (contracts are fairly complete)
- (iii) ***Implications of corporate governance***: this gives incredible discretion to directors – will be hard to restrict their decisions and may lead prudent boards to consider all stakeholders disingenuously
- (iv) ***Why SHs have the vote***: SH likely remain the primary concern, since they have the vote; this decision questions the rationale for them having the vote (i.e. best incentives to grow the corporation) since it permits the board to focus on other stakeholders; (note however, that it does not forbid them from giving SH primary consideration)
- **Textbook: Rationale for Fiduciary Duties**
- (1) ***Law and economics approach (agency costs)***: anytime SHs are not managing the corporation themselves, there is an incentive for D/Os to personally benefit at the expense of the corporation. Wide range of potential self-interest behavior D/O (fiduciaries) could engage in makes TCs so high as to be infeasible to K around. As such, the mandatory rule of fiduciary duty is justified in corporate law. KEY: As such, a court trying to figure out what the fiduciary duty requires in any particular case must ask what the SHs would have agreed to if they had been permitted to bargain and there were no costs associated with the bargaining process (…likely profit-max!)

- (2) ***Corporate responsibility and integrity***: promote basic values of responsibility and integrity that are common to all members of society
- (3) ***Risk aversion***: since D/Os can expose company to risk of loss, they need governing duty.
- Facts
  - Consortium of buyers to buy BCE for $50B; 40% premium bid LBO
  - Process: Board thought were about to get acquired, so decided to make it systematic through auction; 3 bids, all used lots of leverage; Vast majority of SH approve; Takes place as arrangement (s. 192)
  - Dispute: BH opposed because value of bonds decreased dramatically with increased leverage (i.e. new debt added to old debt, but holders of old debt do not have priority claim over new debt holders)
  - Losses to BH (20%) less than gains to SH (40%) – pie bigger overall
  - BH challenge under breach of fiduciary duty, duty of care and oppression remedy
- Aside: Oppression Remedy
  - Protects stakeholders, including BHs, from unfair treatment
- Issue
  - To which group(s) of stakeholders is the fiduciary duty under s.122 owed to?
- Reasons
  - Court reinforces *Peoples* – duty is to the corporation:
    - If duty to SH and corporation conflict, duty to corporation prevails
      - IAC: how do you distinguish the interests of the corporation from the interests of the stakeholders (IAC thinks they are one and the same)
    - At a minimum, fiduciary duty requires satisfying statutory obligations
    - It's not mandatory for directors to consider the interests of other stakeholders, but they can (i.e. can consider stakeholders other than SHs)
    - Interpretation: this is not very clear, and categorical quality is perplexing (breaching some statutory provisions may be in best interests, ex. speeding)
  - How much must directors consider non-SH interests? Court not clear
    - Just say generally duty is to corporation and say may consider impact on SH and other stakeholders
    - But, in discussion of oppression remedy and relationship with fiduciary duty, suggest may be obliged to consider other stakeholders as a good corporate citizen (see OR): IAC thinks this means that a board may be obliged to act as good corporate citizen might make the corporation consider a lot of stakeholders – and it seems clear that you don't have to act in the interest of one stakeholder – there may be moments when you have to consider the other stakeholders [***obligation to consider, but not to act***]
- Iacobucci
  - **High Amount of Director Discretion**: IAC thinks that the duty is fulfilled so long as the directors genuinely believe that some move will be good for the corporation. In this case, could they have rejected bid? Probably – creditors adversely affected and duty to corporation required protecting them
  - Is nonsensical: To suggest conflict between stakeholders and corporation makes no sense – the best interests of the corporation can only be seen through lens of the corporation
  - Government as stakeholder? Others?: LBOs bad, because increase leverage so less tax. So should they be considered? If not, are acting as bad corporate citizen?
  - Creditors could protect themselves: LBOs are common and creditors are sophisticated – can put in provision to protect themselves in this case (contracts are fairly complete)
- Implications of corporate governance?
  - This gives incredible discretion to directors – will be hard to restrict their decisions

    - Prudent Boards will consider all stakeholders – perhaps disingenuously
- Take Home
    - SH will remain primary concern, since they have the vote (begs the question why they have the vote – because have best incentives to grow the corporation) and this case does not restrict them from focusing on SH

6. SHAREHOLDERS' REMEDIES

Introduction

P.859

- Important Questions
    - (1) Who has rights?
    - (2) What rights exist?
    - (3) What is the content of the right?

(i) The Derivative Action

(a) Introduction

- **Definition of Derivative Action:** Shareholder sues in the name of the corporation to redress a wrong done to the corporation. (a.k.a. representative action). The right is "derivative" of a harm done to the corporation.

(b) Common Law Rules

Foss v. Harbottle

P.862

- **Synopsis**: land sold by Ds to company at inflated value, so minority of SHs bring an action in the name of the corporation. Held that in order for a derivative action to be brought, it must be endorsed by a majority of SHs. Minority SHs cannot bring an action in their own names since the wrong was done to the corporation, which has separate legal personality from them as individuals.
- Facts
    - 2 shareholders objected to directors selling land to company at inflated value
- Issue
    - Can the 2 SHs sue in the name of the corporation to redress a wrong done to the corporation?
- Decision
    - Court dismissed the case for 2 reasons:
    - (i) **Separate legal personality** (*Salomon*): Wrong is done to the corporation, not shareholders. Shareholders have no standing.
    - (ii) **Principle of majority rule** in the corporation: Majority could ratify self-dealing transaction at common law – majority represents corporation; single shareholder does not
- Ratio
    - Court recognizes that SHs can initiate a lawsuit in the name of a corporation, but requires a majority to do so

Mozley v. Alson

- **Synopsis**: reinforces *Foss* (i.e. require approval by majority of SHs to bring derivative action)
- Facts

    - 2 SHs bring personal action for a declaration that the BoD was holding office illegally and in contravention of the terms of the company's Act of incorporation
- Decision
    - *Foss* rule applies – a usurpation of the office of a director was a wrong done to the company and the company was the only proper complainant
- Note
    - ***S.247 CBCA*** gives SH the right to individual complain that rights not complied with --- so have moved away from the rule in this case

Northwest Transportation v. Beatty

- **Synopsis:** director involved in SDT, but puts transaction to vote of SHs and uses his controlling share to approve; minority SHs challenge the deal. Held that the self-interested director's votes would not be counted.
- **Rule**: self-interested directors' votes do not count when considering approval of a transaction.
- Facts
    - Controlling director had a company purchase his own property (self-dealing transaction)
    - He put purchase to vote of shareholders
    - Interested director used his share to vote in favour of transaction
    - A lawsuit was brought challenging deal
- Reasons
    - SCC ignored interested director's shares for purposes of determining whether vote sanitized self-dealing transaction
    - PC reversed (for stupid reasons)
- Ratio
    - SCC: Interested directors vote does not count when thinking if transaction was approved; argue that the *Foss* rule only applies where there is harm done to a corporation and in these cases only the corporation can bring a lawsuit

Exceptions to Foss v. Harbottle

- *Ultra vires* act
- Fraud in transaction (hard to establish) (ex. *Northwest Transportation*)
- Where action is personal in nature – individual harmed *qua* individual

(c) The Statutory Derivative Action

The Federal Acts

P.865

- **CBCA S.238. Definitions – "complainant"** – "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.

- **CBCA S. 239. (1) Commencing a 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.

- **(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.
- ***Rationale for notice requirement is that directors (as managers) are ones we expect to bring suit. However, in cases where directors are defendants, derivative action may be necessary***

- **CBCA S.240: Powers of court** – In connection with an action brought or intervened in under section 239, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,
  - (a) an order authorizing the complainant or any other person to control the conduct of the action;
  - (b) an order giving directions for the conduct of the action;
  - (c) an order directing that any amount adjudged payable by a defendant in the action shall be **paid, in whole or in part, directly to former and present security holders** of the corporation or its subsidiary instead of to the corporation or its subsidiary; and
  - (d) an order **requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant** in connection with the action

- **CBCA S.242: (1) Evidence of shareholder approval not decisive** – An application made or an action brought or intervened in under this Part **shall not be stayed or dismissed by reason only** that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary **has been or may be approved by the shareholders of such body corporate**, **but evidence of approval by the shareholders may be taken into account** by the court in making an order under section 214, 240 or 241.
- ***Even if majority approves particular course of action (votes against suit), this is not dispositive (strong departure from Foss v. Harbottle).***

(d) Judicial Interpretation of the Derivative Action

Re Northwest Forest Products Ltd. (BCSC, 1975)

P.867

- **Synopsis**: corporation sells land to director at a discount and the transaction was deemed in the interests of the corporation by a majority SH vote. Claimant sought leave to bring derivative action against the corporation. Court held that the derivative action could be brought since a majority SH vote approval of the transaction is not dispositive.
- **Application**: provides glosses on interpreting the derivative action statutory requirements: (i) notice does not have to be of specific cause of action, just of facts supporting the case; (ii) claimant does not have to show prima facie outcome is in interests of the company, but rather that a case is in interest of company (no analysis of probability of winning)

- Facts

- Directors of not-for-profit approved grossly-undervalued sale of Fraser Valley Corporation land to director which had the effect of lowering share price
- There was plenty of evidence that directors fell below standard of care
- Shareholders petitioned directors to vote the company's shares to set aside the sale, but directors did not respond
- Majority vote was taken, and sale deemed in interests of the corporation. Applicant sought leave to bring derivative action in BCBCA (similar wording to CBCA, but slightly different)

- Issue
  - Did the shareholders have standing to launch a derivative action?
- Decision
  - Derivative action is valid since majority vote does not determine final outcome – must merely look at factors in the Act.
- Reasoning
  - **<u>Requirements for Derivative Action</u>**:
  - (1) Make reasonable efforts to cause the directors to commence the action [notice]
  - (2) The action is prima facie in the interests of the corporation [see *Marc-Jay* for gloss on this requirement];
  - (3) The applicant is acting in good faith;
  - (4) The applicant was a member of the company at the time of the wrong (this is removed in *Richardson Greenshields* case below)
  - **<u>Application</u>**
  - **(1) Notice of particular action not required:** The Court says the directors had enough information to have pursued lawsuit. Notice doesn't require specific notice of particular cause of action – must merely have notice of specific facts capable of supporting lawsuit
  - **(2) <u>Burden of Proof</u>**
  - **Need NOT make prima facie case on outcome**: must merely show that action is prima facie in ***interest*** of company, since minority shareholder on the outside is often not in a position to obtain good evidence.
  - **<u>Nature of Proof</u>**
    - **Pricing does not reflect market value:** Assets were sold at certain price, and on very same day they were used as collateral – in collateral deal, asset value was deemed much higher than sale price.
    - **No other bids solicited:** One director was director of both Fraser Valley and Green River, which never solicited any other bids.
    - **Shareholder vote may have been tainted:** There is no evidence from minutes of meeting that significant number of shareholders voted or that 25% shareholders voted.

Re Marc-Jay Investments Inc. and Levy (ON, 1974)

P.871

- **<u>Synopsis</u>**: Levy buys company from Seaway, but conflict of interest arises since directors of the two companies are the same. Claimant argues that transaction was not in best interests of Levy since fraud (overlapping ownership stakes gives rise to conflicting duties). Held that the action could proceed since the action must be in best interests of the corporation, which means it cannot frivolous, vexatious or bound to be unsuccessful (was found not to be in this case).
- **<u>Policy</u>**: rationale for frivolous/vexatious requirement as part of best interests of the corporation: (i) disclosure might hurt company if shareholder operates on behalf of a competitor; or (ii) we might not want competitors to pursue action at this time; or (iii) it could be economically unsound to sue

- Facts
  - Applicant was beneficial holder of 12.9% of shares in Levy when Levy bought Premium Forest Products from Seaway
  - Note that beneficial ownership, despite no legal ownership, is sufficient to bring a derivative action
  - 12 directors of Levy are the same 12 directors as Seaway, so conflict of interest exists.
- Arguments
  - Applicant says that transaction was not in best interests of corporation. Applicant makes the following claims:
    - (i) Overlapping directorships makes transaction constructively fraudulent (since they have duties to act in the best interests of both the buyer and seller simultaneously, but may have more personal interest in one corporation over another)
    - (ii) Even if not, it was just a bad deal
    - (iii) Even if not fraudulent, there was insufficient information to Levy shareholders
- Issue
  - Were procedural requirements for derivative action met? (Is prima facie case that action is in the interests of the corporation made out?)
- Decision
  - Derivative action can proceed
- Reasoning
  - **<u>Standing</u>**
    - **Beneficial holder of shares:** Applicant was not registered holder of shares; but beneficial owner can bring derivative action.
  - **<u>Nature of Proof</u>**
    - **Good faith:** Applicant acted in good faith
    - **Does not appear frivolous or vexatious:** Applicant points to some evidence pointing to fact that Levy paid too much for Premium.
    - **In interests of shareholders:** Levy may have paid too much for PFP.
  - **<u>Class Critique</u>**
    - **"Frivolous/vexatious" seems not to add relevantly to "interests of shareholders":** Factors must be relevant to whether case is prima facie in interests of corporation – whether or not there is grudge should not make a difference. BUT
      - (i) disclosure might hurt company if shareholder **operates on behalf of a competitor**; or
      - (ii) we might not want competitors to pursue action **at this time**; or
      - (iii) it could be **economically unsound to sue** – e.g. $4M fees for $1M in damages. BUT if you don't sue, directors could skim money off the top all the time – need to deter people from doing these things)

- **<u>Gloss on *Northwest Forest* Test for Derivative Action:</u>**
- To make prima facie case for derivative action, the action (1) must NOT be frivolous, vexatious or bound to be unsuccessful; and (2) it must be in the interests of the SHs; [this is a fairly low standard and goes to the requirement of prima facie in the corporations interest (see *Northwest*)]
- ***Application:*** ask whether the there is the potential of winning, and whether it is in the interests of the corporation to win
- ***Consideration***: bringing an action, where it is against the board, will require the board to divert attention to defending the lawsuit, potentially costing the corporation in the LR

Re Bellman and Western Approaches Ltd. (BCCA, 1981)

P.873

- **Synopsis**: Duke wants majority of investor shares, so gets financing from TD bank, but on unfavourable terms to the company (i.e. they have to disclose confidential information and go public). Duke gets control, appoints directors, who then vote against bringing an action against the corporation. Bellman is the claimant seeking to bring derivative action. Held that the derivative action can proceed since (i) notice of complaint was sufficient (only gist required), and (ii) discretion in determining "in interests of the corporation" is broad and is satisfied by the fact that the PWC report could be deemed inconclusive since it was not sufficiently broad.
- Facts
  - Bellman owned 3/8 and Duke owned 5/8 of founders' shares (as distinct from investors' shares, of which Bellman owned majority)
  - Duke wanted to elect the whole board, so it borrowed from TD Bank to buy investors' shares and get a majority
  - There were various terms of financing with TD that created issues (overall, these issues were argued to have caused Duke Group to breach the duties to the corporation):
    - (i) provisions permitted Western to disclose its confidential information to the Bank – not in interests of Bellman as shareholders;
    - (ii) directors agreed to use their powers to cause Western Approaches to go public – and if they did not cause Western to go public, they would have to pay penalty to guarantor of loan at TD, which would be based on revenues of Western.
  - Duke gets control of the board and can nominate all 8 directors
  - Current directors hire special counsel who hired PWC to look into allegations. PWC investigated subset of allegations and concluded that there was no wrongdoing with that subset. Special counsel recommended changing some wording of financing agreement, including "fiduciary out" saying directors must act in best interests with respect to going public.
  - Western directors then voted on whether to bring action. Directors voted not to go ahead with lawsuit.
  - Bellman seeks to bring derivative action in the name of Western against the Duke Group, TD Bank, and Canwest
- Issue
  - Were the requirements for bringing a derivative action met?
- Decision
  - Yes, derivative action can proceed
- Reasoning
  - **Requirements for Derivative Action**:
  - ***(1) Notice***
  - **Generality is sufficient:** Notice must merely give gist of complaint – need not specify every cause of action (like *Northwest Forest Products*)
  - ***(2) In the Interests of the Corporation?***
  - **Discretion re "in interests of corporation" is broad:** Common law factors may be considered in determining what is in interests of corporation. ***Application:*** (a) refusal by directors to bring action carries little significance since Duke Group appointed them. (b) instructions to lawyers were insufficient: PWC report deemed inconclusive since inquiry was not broad enough to conclusively determine that non-action in best interests.
  - **Nature of Proof**
    - **Multiple actions is not evidence of bad faith:** They simultaneously launched personal action & oppression remedy derivative action. Court rejects defendant argument of bad faith, saying relief sought was different in each action – since

fiduciary duty is owed to corporation, damages flowing from breach can only be recovered through derivative action.

- **Burden of Proof**
  - **Conflict of interest meets prima facie burden:** Court stresses the fee payable to guarantor in the event that company didn't go public. (i) Best interests may mean not going public. (ii) Agreement says payment is based on revenues – if not going public, then incentive is to keep revenues low, not high. The financing agreement puts directors in conflict.
- **Case Comment**
  - **Disinterested directors should have greater discretion:** The Court imputes partiality to directors not chosen by Duke shareholders who voted against commencing the lawsuit. However, the very relevance of these shareholders is that they can't be coerced by majority shareholders. Does this mean that a majority shareholder automatically discounts the independence of every director, even the disinterested ones?
  - **Strictly applying *Foss* rule would deny this action**: note that the rule from *Foss* has been weakened, and now a strict majority of SHs is not required in order for a derivative action to be brought

Discovery Enterprises Inc. v. Ebco Industries Ltd. (BC, 1997)

P.877

- **Synopsis**: good faith requirement requires there to be no personal advantage gained by the claimant from bringing the derivative action, which may arise when: personal spite, SH of another company, strike suit (sue for legal fees).
- **Nature of the Proof**
  - **Best interests imply good faith:** Maybe if in best interests of corporation to bring case, there's nothing left for good faith analysis. This is probably the case when there is no personal advantage to be gained by party bringing claim. If there is evidence of special personal advantage or conflict of interest for claimant, suit may be carried out in way that is vexatious.
- **Types of Personal Advantage**
  - Personal spite
  - Shareholdings in another company (e.g. *Dodge*)
  - Suing for sole purpose of extracting a settlement – e.g. a lawyer wanting fees covered, not uncommon in US (known as strike suit)

Richardson Greenshields of Canada Ltd. v. Kalmacoff (ONCA, 1995)

P.878

- Issue
  - If complainant buys shares for the purpose of bringing a derivative action, and complains about past conduct (pre-share ownership), can the derivative action be brought?
- **Standing**
- **Shareholder can buy share in order to sue:** If a shareholder buys share for purpose of bringing lawsuit, this doesn't disqualify him from bringing suit.
- **Case Comment (Does this lax standing requirement create windfalls?)**
- **Stock price fully accounts for legal decision:** We might think loss will be already reflected in stock price, and winnings from suit will represent windfall gain. However, value of legal damages should be reflected in the share as well. The two will cancel out. Windfall gain won't be realized. (Again assume semi-strong form efficient markets, where all publicly-available information is factored into the stock price.)

- **Allowing new shareholder to bring suit has deterrence effect:** If standing was denied, then suit could only be brought by shareholders at time of harm.
- Note
  - In order to get oppression remedy, you have to have been a SH at the time of the harm/transaction

(e) Costs in Derivative Actions

Introduction

P.879

- **Synopsis**:
- **CBCA S.240. Powers of court** – In connection with an action brought or intervened in under section 239, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,
  - (a) an order authorizing the complainant or any other person to control the conduct of the action;
  - (b) an order giving directions for the conduct of the action;
  - (c) an order directing that any amount adjudged payable by a defendant in the action shall be **paid, in whole or in part, directly to former and present security holders** of the corporation or its subsidiary instead of to the corporation or its subsidiary; and
  - (d) an order **requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant** in connection with the action.
- Though former shareholders can theoretically benefit, normally it is current shareholders who get remedy, since it is corporation that formally launches suit. Court may be reluctant to grant leave to former shareholders, despite their listing in ss. 239 & 240.
- **Rewarding only current shareholders makes economic sense:** We want applicant who brings suit to rely on incentives. This only happens if costs and benefits are internalized. Applicant bears legal, research, transaction costs – former shareholder can just realize a windfall by free-riding.

- **CBCA S.242. (4) Interim costs** – In an application made or an action brought or intervened in under this Part, the **court may at any time order the corporation or its subsidiary to pay to the complainant interim cost**, including legal fees and disbursements, but the **complainant may be held accountable for such interim costs on final disposition of the application or action**.

Turner et al. v. Mailhot et al. (ON, 1985)

P.880

- **Synopsis**: minority SH locked out of company after dispute; seeks leave for derivative action and wants court order corporation to pay costs of derivative action (under s.240). Held that ½ the costs will be awarded since claimant had sufficient resources to bring claim himself and claim brought in the name of a privately-held company (less of a free-rider and collective action problem exists in this context relative to public company context).
- **Policy**: rationale for indemnification in widely-held public company setting is to mitigate free-rider and collective action problems.
- Some argue cost indemnification could lead to flood gates of suits, but frivolous suits would not result from right rule since high leave requirement to bring suit addresses this concern (i.e. prevent the overload of cases that are brought by lawyers merely to collect fees)
- Facts
  - Turner and his wife owned 30% of shares
  - After dispute with defendant, Turner was locked out of company premises and employment terminated as director and officer of company
  - Turner wants corporation to pay his costs of bringing lawsuit

        - Order was sought under provision analogous to s. 240 of CBCA, which explicitly gives court discretion to order corporation to pay costs of lawsuit
    - Issue
        - Can plaintiff be awarded costs in derivative action from the corporation?
    - Decision
        - Half of costs awarded.
    - Reasoning
        - **Rationale for Awarding Costs**
        - ***Wallersteiner v. Moir (No. 2)* Indemnification Criteria suggest there is *prima facie* right to indemnification:** In widely-held public company, plaintiff should be indemnified for costs because action was ***(i) reasonable/prudent and (ii) in company's interests and (iii) brought in good faith***. Requirements for indemnification in *Wallersteiner* look a lot like requirements for leave in statute, suggesting there is prima facie right to indemnification. However, below, we see there are other factors to consider.
        - **Distinguishing Wallersteiner:**
        - **Money problems warrant indemnification:** Moir had doggedly pursued wrongdoer and then ran out of resources. Here, Turner was not out of resources and they were also the beneficiaries of the suit
        - **Public companies (where personal interest is small) warrant indemnification:** Moir was dealing with public company of long standing, and this company is privately held. Advantage to Moir himself would have been trivial if he were successful. In present case, it's basically a private, personal struggle between Turner and defendants. Benefits of suit were in the millions. Contrast this with "attack by lone altruist upon devious miscreant."
    - **Case Critique**
        - **The right rule causes applicant to internalize costs and benefits:** The rationale for having corporation pay costs is to overcome ***free-riding*** market failure where individual shareholders do not have incentive to sue (e.g. Moir really couldn't afford to launch action…but he did anyway).
        - **2 elements of collective action problem:** (i) **Externality:** Since full private costs outweigh fractional private benefits, the right social decision is not made. (ii) **Opportunity Cost:** Even if benefits outweigh costs, it is still in interests of shareholder to let another shareholder bring suit.
        - **Externality is not internalized:** Here, since only 2 shareholders, free-riding is not an issue. However, Turner only gets 30% of benefits, yet bears 65% of costs (50% + 30% of corporation's half). Though B>C in this case, he will not bring lawsuit in every case – incentives aren't rationalized.
        - **Frivolous suits would not result from right rule:** Full cost indemnification would seem to lead to nuisance suits. However, high leave requirement to bring suit addresses this concern (i.e. prevent the overload of cases that are brought by lawyers merely to collect fees)

(f) The Relationship between the Complainant and the Corporation

(ii) The Personal Action

Hercules Management Ltd. v. Ernst & Young (SCC, 1997)

P.903

- **Synopsis**: appellant SHs in company bring personal action against 3rd party auditor EY for improper preparation of audit reports. Held that appellants cannot bring personal action, but

could have brought derivative action. Court reasons based on first principles (*Foss*) that the harm was done to the corporation not to the SHs individually, so cannot bring personal action (this avoids the potential for multiplicity of actions). A drop in share price does not constitute personal harm to a SH and thus is insufficient to justify allowing a personal action.

- Facts
  - Appellants claimed that audit reports were negligently prepared by EY
  - They bring a personal action against EY
- Issue
  - Do auditors owe a duty to shareholders as persons and not as derivatives of corporation?
- Decision
  - No – derivative action would have been appropriate
- Reasoning
  - **<u>Nature of Duty</u>**
  - **Duty owed to corporation, not individuals:** Start with rule in *Foss v. Harbottle* – if wrong done to corporation, only corporation can bring suit. Though plaintiff shareholders believe they are reacting as individuals, their reactions as shareholders would be in respect of the corporation as a collective. This is why audit reports are presented to corporation.
  - **Policy rationale – avoids multiplicity of actions:** Permitting only corporation to bring suit avoids hassle of a multiplicity of actions that would otherwise exist if every SH had a personal right to sue
  - **Non-shareholders may have personal right:** If same audit report was given to potential investors and induced their investment, they may have personal right of action apart from corporation's right of action; but in this case, the report was given to the company [this is a fine line, and the court seems to take a very narrow view of an audit (only applies to investment reports), drawing a distinction b/t investment and governance reports]
  - **Distinguish Derivative and Personal Action**: is the harm derivative or direct?
  - **<u>Shareholders: Principals or Agents?</u>**
    - **2 choices available to shareholders – personal or collective (Hirschmann):** What actions can you take if you don't like what you see in F/S?
      - **Voice:** Try to influence management directly. Advantage of voice is that you can realize your benefit.
      - **Exit:** Advantage of exit is that you can avoid the costs of trying to implement change.
    - **Exiting is an inherently personal decision:** Buying and selling can influence how corporation is run. Auditing can influence people to sell their shares, driving down price, and spurring board to action.
      - **BUT effect of personal decision is on corporation:** Even if we recognize buying/selling argument, corporation would still have cause of action because share price dropped. LaForest says that it's not buying/selling losses that matter, it's effect they have on corporation. Hercules as a shareholder can't sue EY directly here.

Kraus v. J.G. Lloyd Pty. Ltd. (1965)

P.906

- **<u>Synopsis</u>**: allow personal action when director fails to comply with a vote since find this is personal harm.
- **<u>Line b/t Personal Harm and Corporate Harm Blurry</u>**: it is not clear how failure to comply with a vote is a personal harm and not corporate harm, but that inaccurate audit report (*Hercules*)

that reduces share price and affects SHs exit opportunity from the company is corporate harm and not personal harm.

- Facts
  - Director fails to retire. Plaintiff sues as individual, seeking injunction preventing director from acting as director of company.
- Decision
  - Personal action succeeds
- Reasons
  - **Nature of Right**
    - **Voting is a personal right:** Whereas an audit does not engage any distinct individual rights of shareholders (contestable), voting is an inherently personal right as an individual shareholder. By not resigning pursuant to shareholder vote, a personal right of action was engaged.
  - **Case Comment**
    - **Line is blurry:** We could say non-recognition of vote outcome is harm to corporation, since he failed to live up to obligations of corporation. It's not clear how the personal effect here is more meaningful than the personal effects associated with the exit option available to individual shareholders in the audit scenario.

Jones v. H.F Ahmanson & Co. (Cal, 1969)

P.906

- **Derivative action must be sought for incidental harm to shareholders:** Injury due to corporation injures shareholders. However, if personal injury is merely incidental, then it is derivative action that must be sought. This explicitly states LaForest's distinction.

Thomas v. Dickson (US, 1983)

P.907

- **In 1-person corporation, rationale for derivative suits doesn't exist:** There is no risk of multiplicity of lawsuits; no share liquidity; no outstanding or dissatisfied creditor. Therefore, direct action permitted.

7. THE DUTY OF CARE OWED BY DIRECTORS AND MANAGERS TO THE CORPORATION

(i) Common Law

City Equitable Fire Insurance Co. Ltd. (1925)

P.301

- **Synopsis**: MD diverts funds of successfully company to bad investment and company goes bankrupt. The corporation attempted to opt out of the DoC in its articles, by imposing a standard of "willful misconduct" in relation to negligence. Held that
- **Rule**:
- ***Deferential and Subjective Standard:*** meet standard if directors (i) act honestly, (ii) exercise some degree of both skill and diligence
- The standard is one of gross negligence, where director is expected to take reasonable care, but not all possible case (and directors are not liable for mere errors in judgment)
- Directors duties cannot be described in general terms, since it will vary with (i) industry, (ii) size of company and (iii) organizational structure (i.e. lower standard for big, decentralized company)
- ***Application notes:*** (i) cannot expect a level of skill greater than actual knowledge and experience; (ii) directors are entitled to rely on their subordinates to act honestly, in the absence of grounds for suspicion.
- **Statutory Context**: duty stems from CBCA S.122(1) and cannot be contracted around (S.122(3). However, D/Os can obtain insurance for losses they may incur as a result of their breach of DoC. Note that in Delaware, directors can K around the DoC.
- Facts
  - A successfully-run company was wound up because it diverted funds to another company (in which MD was interested) and investment in securities went sour.
  - MD was jailed for fraud and could be sued. Liquidator brought action against other directors for negligence.
  - In its articles, the company set a standard of "willful misconduct" to determine whether directors were negligent – this is tantamount to opting out of the duty of care.
- Issue
  - Did the other directors owe a duty of care to investors?
- Decision
  - Directors were not negligent. (They were not willful.)
- Reasoning
  - **Nature of the Duty**
  - **Narrower than trustee:** Directors are only "trustees" in a fiduciary sense. However, duty is narrower than trustee's with respect to negligence – we do not want to discourage directors from taking risks; in addition, SH can take steps to protect themselves from risk (diversification), but trustees likely cannot
  - **Subjective standard:** Director must (i) act honestly and (ii) exercise some degree of both skill and diligence. However, we cannot expect greater degree of skill than actual knowledge and experience.
  - **Gross Negligence:** Deferential attitude to the standard of care itself – adopting previous cases, standard is one of gross negligence (expected to take "reasonable care", not "all possible care"). Directors are not liable for mere errors of judgment.
  - **Context of the Duty**

- **Contextual analysis:** Impossible to describe director's duty in general terms – may vary according to ***industry*** & ***size of company***. Level of detail required will be lower for big, decentralized company.
- **Deference to organizational structure:** Dependent on the allocation of duties that the corporation has adopted. Eg. Some directors will have greater duties than others depending on responsibilities that they've been assigned [acceptable so long as divisions of labour/responsibility are reasonable]
- **<u>Content of the Duty</u>**
- **Level of interaction:** Directors are not bound to give continuous attention to the company. They perform intermittently at meetings, and they don't have obligations to attend every meeting.
- **Reliance on subordinates:** Directors are entitled to rely on their subordinates to act honestly in absence of grounds for suspicion.
- **CBCA 122(3) No exculpation** – 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.
  - Cannot contract around DoC as you could have under CL
  - **BUT Insurance:** While can't opt out of duty of care, large public corporations can insure directors for losses they may incur as a result of liability for duty of care (even though this gives a bad incentive – however, a breach of this insured duty would mean they would not get directorships in the future).

- Iacobucci
  - Delaware permits directors to K around the DoC, but Canada does not

Re Brazilian Rubber Plantations and Estates, Ltd. (CA, 1911)

P.305

- **<u>Synopsis</u>**: 2 directors not experts in rubber business (while one was) rely on report that overstated the attractiveness of a rubber plantation investment for assessing the value of the plant, and as such purchase plant well over market value. Claim brought against directors for negligence. Held that Ds were not liable since they were not grossly negligent. Ds acted honestly and relied on report (appropriate to do so since gains from division of labour)
- **<u>Policy</u>**: (i) subjective standard is an odd choice of a rule, since it will deter Ds with expert knowledge from taking directorial positions since they will be held to a higher standard, and encourage those that are not experts to take the positions; (ii) relying on other parties is appropriate in order to have efficiency gains (from specialization)
- **<u>Why Have a Lax Standard of Care</u>**:
- ***(a) institutional competence***: courts are not biz people, so should not be making decisions on good business judgment
- ***(b) hindsight bias***: wrong has already occurred – assessing biz decision in light of unfavourable result
- ***(c) deterrent effect***: a strict duty would cause over-deterrence in directors, and lead to bad biz decisions
- ***(d) alternative discipline***: voting, product market, managerial labour market etc…
- Facts
  - One director was deaf; another was ignorant; another only gave opinions regarding the rubber business.
  - Authors of a report overstated the attractiveness of a rubber plantation investment.
  - The directors used the report as the basis of their prospectus regarding sale of land which they presented to the company
  - 3 details could have put directors on notice:

        - Land purchased for 150K pounds had been purchased previously for 15K.
        - One author of report was one of the vendors of the land
        - Directors did not get independent report.
- Issue
    - Were the directors negligent?
- Decision
    - Directors were not negligent (court finds that duties were not violated and argues that in business, conflicts often arise
- Reasoning
    - <u>**Nature of the Duty**</u>
    - **Gross negligence:** As long as directors act honestly, cannot be made responsible in damages unless guilty of gross negligence.
    - **Subjective standard:** Does not have to bring any special qualifications to his office – only liable in light of knowledge and experience. [IAC: this seems like an odd screening device, since it would discourage people w/ vast knowledge from becoming directors]
    - <u>**Content of the Duty**</u>
    - **Relying on interested parties:** In business, you often make decisions based on information gained from interested parties [rationale is gains from division of labour]. It was reasonable for directors to make allowance based on report. They did not realize how big a fraud it was.
    - **Grounds for suspicion:** Reliance is appropriate unless there are grounds for suspicion.
    - **Business judgment:** Not liable for errors in judgment (from *City Equitable*)
- Iacobucci
    - **Rationale for DoC:** to overcome agency problem that results from the separation of ownership and control (i.e. incentive for managers to shirk since do not internalize costs of poor performance is offset by the DoC)
    - **Rationale for Lax Standard:**
    - (a) institutional competence: courts are not biz people, so should not be making decisions on good business judgment
    - (b) hindsight bias: wrong has already occurred – assessing biz decision in light of unfavourable result
    - (c) deterrent effect: a strict duty would cause over-deterrence in directors, and lead to bad biz decisions
    - (d) alternative discipline: voting, product market, managerial labour market, market for corporate control
    - **CBCA S.123:** director is deemed to consent to actions she did not attend, unless she files a written dissent (so cannot avoid liability by not going to meetings)

Selangor United Rubber Estates Ltd. v. Craddock (1968)

P.308

- Facts
    - Directors did everything asked of them by controlling shareholder, Craddock
    - They approved transfer from Selangor to another company
    - Craddock used assets of the other company to take control of Selangor
- Decision
    - Directors were negligent
- Reasons
    - <u>**Content of the Duty**</u>

- **Listening to only 1 shareholder:** They basically abdicated responsibilities by doing everything they were told. Once it was clear they were his puppets, their decisions would be scrutinized more carefully.

(ii) Principles Underlying Duty of Care

Separation between ownership and control leads to 2 kinds of concerns:
(i) Duty of loyalty (fiduciary duty)
(ii) Duty of care (to combat shirking)

Why a **gross negligence** standard?
- **Nature of business:** Intrinsic to risk is that it might turn out badly – courts might be influenced by outcome in adjudicating duty of care. Hindsight is 20/20. Ex post v. ex ante concerns and knowledge.
- **Judicial competence:** Courts are not well-placed to evaluate reasonable care in business decisions.
  - **BUT** Courts evaluate technical information in medical and engineering cases all the time. Why should the business context be any difference?
- **Incentive for directors:** A lower standard will attract more directors to the company and lead to better business decisions. The alternative will over-deter.
- **Alternative control mechanisms:**
  - (i) Direct voting can punish directors
  - (ii) Market for corporate control (threat of takeover) disciplines directors
  - (iii) Reputation effects regarding getting multiple posts will motivate directors
  - (iv) Failure to make good decisions will lead to failure of the company in the product market

Is a **subjective standard** (based on knowledge/experience) appropriate?
- Uniform standard will attract more knowledgeable directors since more knowledge = less risk. Conversely, poorly-skilled directors will be encouraged by subjective standard.

CBCA 123(4) Defence – reasonable diligence – A director is not liable under section 118 or 119, and his complied with his or her duties under subsection 122(2), if the director exercised the **care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances**, including **reliance in good faith** on
(a) **financial statements** of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or
(b) a **report of a person whose profession lends credibility** to a statement made by the professional person

CBCA 123(5) Defence – good faith – A director has complied with his or her duties under subsection 122(1) if the director **relied in good faith** on
(a) **financial statements** of the corporation represented to the director by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or
(b) a **report of a person whose profession lends credibility** to a statement made by the professional person

Why do we allow **reliance on 3rd parties**?
- **Time investment would deter directors:** It would consume all of director's time to check up on 3rd parties. Taking more precaution is not what shareholders want in every case.
- **Division of roles:** Idea of board qua board (as opposed to officers) is that they oversee what's going on, but are not involved in day-to-day.
  - Still, hard to justify the principle that directors need not come to meetings. CBCA has implicitly moved away with this in s. 123, saying that "director is deemed to consent to actions taken at directors' meeting even if does not attend unless s/he files a written dissent."

(iii) Due Diligence in the Income Tax Context

Canadian Income Tax Act 227.1

- (1) Where a **corporation has failed to deduct or withhold** an amount as required by subsection 135(3) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the **directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally liable**, together with the corporation, to pay that amount and any interest or penalties relating thereto …
- (2) A director is not liable for a failure under subsection 227.1(1) **where the director exercised the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances**.

Soper v. R. (FCA, 1998)

P.312

- **Synopsis**: D not informed company had stopped remitting to CRA in bad times. Held that D was not negligent since director was an outside director, and thus was held to a less high standard relative to insider directors with specific knowledge and expertise.
- **Rule**: standard of care is assessed on a subjective-objective standard – what a reasonable person in the circumstances with the person's specific knowledge would have done. Distinction between inside and outside directors, where inside directors are held to a higher standard since they are thought to have more knowledge and expertise with the company.
- **Duty to Act**: when a D becomes aware of facts that might lead one to conclude that there could be a potential problem, the standard of care requires that D to react.
- Facts
  - Soper, a competent businessperson, joined the RBI board during financial difficulties.
  - RBI failed to remit source deductions to Department of National Revenue, and directors ensured that Soper was never told that RBI had ceased remitting
  - Soper didn't inquire as to whether RBI was remitting.
  - He should have been put on notice by balance sheet, which showed they were losing money.
- Issue
  - (i) Did Soper meet standard of care indicated in ITA 227.1(2)? Can he utilize the due diligence defense?
  - (ii) Is the statutory standard objective or subjective?
- Decision
  - Soper is not negligent
- Reasoning
  - **Nature of the Duty**
    - **Subjective-objective standard:** Standard is flexible and asks what the reasonable person in the circumstances with the individual's specific knowledge would have done
      - **Legislative intent:** "Person" was not changed to "director" in the Act. When s. 122 was enacted, there was debate re whether it should be "reasonably prudent person" or "reasonably prudent director." "Director" suggests the standard is more professional. However, it was not adopted. Choice not to adopt "director" standard could be further evidence of choice to retain subjective elements.
      - BUT amendment could have read "reasonably prudent director, given knowledge/experience" → subjective element could still be retained if "director" had been adopted.

- **Skilled vs. Prudent:** If they had put "reasonably skilled person", it would have been pure objective test. Since CL rule was subjective, there is no reason to imagine that we've departed from CL rule.
    - BUT how could we say that there's still subjective element to "reasonably skilled person"? If "in comparable circumstances" modifies "reasonably prudent person" to make it subjective, then the same language could go to modify "reasonably skilled person." The result would still be the same.

- **Content of the Duty**
    - **Inside vs. Outside Directors:** Inside directors will have more difficulty in establishing a due diligence defence due to contextuality. Responsibilities will vary with positions (*City Equitable*), and it's not an outside director's job to have same info as day-to-day officers. The wording in the statute, "in comparable circumstances", suggests evaluation from an outside director's viewpoint
    - **Duty to act on information:** A positive duty arises where a director obtains information or becomes aware of facts which might lead one to conclude that there is, or could reasonably be, a potential problem with remittances. Doing nothing in this case was inadequate for discharging the burden.
- **Class Critiques**
    - **Language suggests objective standard:** If they wanted subjective test, they could have said (as in CL), "given her knowledge and experience". They didn't do that – they said "in comparable circumstances." "Knowledge/experience" is unambiguously subjective. "In comparable circumstances" – the level of subjectivity is debatable.
    - **Hindsight is 20/20:** Court expects Soper to anticipate officers' failure to remit based on poor performance of business. It might be unreasonable for Soper, as experienced businessman, to expect officer to hide lack of remittance from him. Perhaps officer should bear the burden. At the very least, hindsight risk exists.

Peoples Department Stores Inc. (Trustee of) v. Wise (SCC, 2004)

Handout

- **Synopsis**: Wise to merge with Peoples, under special internal transfer pricing policy that fails, leading to both companies bankruptcy. People's creditor sues for breach of duty of care (arguing Wise was favoured over People's in merger transfer pricing policy). Held that
- **Duty of Care**: DoC extends to creditors under s.122, inferred from Quebec Civil Code (note that justice major believes that would be owed in other provinces as well)
- **Standard of Care**: objective standard – reasonable person cognizant of context but not capacities. An individual's position and role within the company constitutes context. Business Judgment Rule – deference to biz decisions since they are made w/ a lack of information; decisions need merely be reasonable, and courts will assess whether the decision was made with the appropriate prudence and diligence.
- **Defenses**: s.123 defenses is interpreted narrowly, but is a factor that is considered in assessing negligence
- **Policy**: (i) this duty does not accord w/ limitation in *Foss* (harmed suffered to corporation), and thus could open floodgates for DoC claims brought by many different stakeholders; (ii) specific duty of care to creditors casts net too wide since creditors claims aren't affected by breach of duty of care, instead the amount is taken from the residual profits (SHs affected); (iii) good argument for duty only being owed to creditors during insolvency (same reasoning as why fiduciary should be owed to creditors in insolvency), but duty not explicitly narrowed in such a manner in this case.
- Facts

- Wise bought Peoples. Inventory between Peoples and Wise wasn't integrating well.
- Wise VP Finance changed system so that Peoples would buy North American inventory and transfer to Wise for debt obligation, and vice versa for non-North American purchases.
- When both corporations ended up insolvent, Wise owed Peoples a lot, so it cost Peoples (and their creditors). Peoples' creditors sued Wise brothers for negligence in adopting inventory system.
- **Important:** The creditors launched neither a derivative action, nor did they launch an oppression remedy. They just sued with standing as a trustee in bankruptcy directly for s. 122 negligence

- Issue
  - What is the content of the duty of care to creditors?
- Decision
  - Duty of care owed, but not breached.
- Reasoning
  - **Nature of the Duty**
  - **Duty extends to creditors:**
  - **Statutory construction requires appealing to Civil Code:** In interpreting federal statute in Quebec context, *Interpretation Act* ss. 8.1 and 8.2 says to look to the Civil Code. Article 1457 of Civil Code says that, "every person must abide by rules of conduct so as not to cause injury to another." Similarly, s. 122 doesn't say to whom the duty is owed (unlike fiduciary duty, which is owed "to corporation"). We can use article 1457 to interpret s. 122: "directors are people; creditors are another person." So if directors cause damage to creditors, they can be held liable.
  - **Standard of Care**
  - **Objective standard:** The standard is that of the reasonable person cognizant of context but not capacities. An individual's position and role within the company constitutes context. (This is departure from *Soper*.)
  - **Business Judgment Rule:** Business decisions command deference – they are often made with a lack of information; decisions must merely be reasonable, not perfect. Courts can't second-guess decisions, but they can determine whether an appropriate degree of prudence and diligence was brought to bear. There exist alternative control mechanisms for director behaviour.
  - **Defenses**
  - S. 123(4)(b) – says that directors are not liable for negligence if they rely on financial statements given to them by an officer or if they rely on something that should be seen as credible
  - **Narrow interpretation of defense**: Directors cannot rely on this defence since the word "profession" and not "position" is used. Report from vice-president of finance is not sufficient since he does not fit professions listed. If person did have applicable expertise, then defense can be used.
  - BUT this does not mean that relying on report is irrelevant to duty of care analysis. It is a factor to consider in determining whether initial finding of negligence is appropriate.
- **Class Critiques**
  - **Duty owed to creditors may not accord with rule in *Foss v. Harbottle*:** *Foss v. Harbottle* states that wrong done to corporation requires that duty is owed only to corporation (not to "another person"); creditors (or shareholders) may not sue in personal capacity since they are not harmed directly. In addition, a duty owed to everyone encourages a multiplicity of actions. With this rule, a multiplicity of actions may be

encouraged and managerial behavior may be influenced in a manner unwanted by SHs. Could even argue that the open-endedness of this rule may enable EEs to bring claims

- **Peculiarity of DoC to Creditors since they do not normally bear economic consequences when directors are negligent:** When corporation is healthy, creditors will get paid with or without negligence. Only bearers of the residual claim (shareholders) stand to lose when directors are negligent. Expanding scope of the duty might allow for negligence duty to be owed to customer. Duty to creditors casts net too wide. (Mitigating factor: standing rules require claimant to have sufficient interest in dispute)
- **Narrow decision:**
- If duty owed to creditors, best to confine duty to situations of insolvency (when creditors have a residual-like interest). Directors may behave differently when company is in danger of insolvency. If shares will be insolvent, then there is incentive to make more dangerous decisions. This may justify duty owed to creditors at times of insolvency. However, court doesn't do this explicitly.
- Since interpretation is based on Quebec Civil Code, breadth of duty may only be applicable in Quebec context since no provision analogous to art. 1457 in common law [Major J seems to think that CL can emulate Quebec statute]

(iv) Statutory Reform: Environmental Obligations

R. v. Bata Industries Ltd. (ON, 1992)

P.324

- **<u>Synopsis</u>**: harmful chemicals not removed from plant under directors B, M and W. Directors behaved differently and acted in different capacities: B was not onsite, and when he was notified of chemicals, they were cleaned up; M was onsite occasionally and knew of the problem but did not act; W was onsite often, knew of problem but did not act. Held that B was not liable, but that M and W breached the standard of care.
- **<u>Implications on Standard of Care</u>**: (i) standard of care can vary depending on the role of the director; (ii) when delegating work, directors should ensure delegate is capable of performance, (iii) industry standards may be used in determining the requisite standard of care
- Facts
  - Containers at Bata contained chemicals which were known carcinogens. In 1983, a union safety officer raised concern about the containers.
  - In 1986, containers were not removed at high quote of $56K. In 1988, containers were not moved because $28K quote didn't come through.
  - In 1989, containers were finally moved. "Failing to take all reasonable care to prevent a discharge" violates s. 75(1) of *Ontario Water Resources Act*.
  - D/Os
    - Bata: He was CEO, in charge of global expansion. He attended site, and as soon as he was notified of problem, it was fixed.
    - Marchand: He was on site 1-2 times per month. He knew of problem, but did not act.
    - Weston: He actually worked on site. He had highest probability of being aware of the concerns – and did in fact delay in getting waste removed
- Issue
  - Did any of 3 directors with varying levels of involvement fall below standard of care?
- Decision
  - CEO passes; other directors fail.
- Reasoning

- **Due diligence defense**
  - Directors are responsible for reviewing environmental compliance, but they are justified in placing reasonable reliance on reports by other officers.

- **Content of Duty**
- **Content varies depending on position:** If liability were uniform among all directors, ability to delegate would be severely impaired.
- **Subordinate officers are addressing the problem:** Directors should ensure that officers are addressing concerns. Delay in cleanup by Marchant showed lack of due diligence. He should have exercised degree of supervision and control that "demonstrate that he was exhorting those whom he may be normally expected to influence or control to an accepted standard of behaviour."
- **Subordinate officers have adequate training:** If delegating, Weston should have ensured that the delegate receive training necessary for the job and to receive detailed reports from that delegate.
- **Industry standards:** Directors should be aware of industry standards.
- **Duty to act on information:** Directors should immediately and personally react when they have noticed the system has failed.

(v) The Securities Regulators' Public Interest Duty of Care

Ontario Securities Act: S.127 – Securities Regulators' DoC

P.331

- (1) The Commission may make one or more of the following orders **if in its opinion it is in the public interest** to make the order or orders:…
  - (3) An order that any exemptions contained in Ontario securities law do not apply to a person or company permanently or for such period as is specified in the order.

Standard Trustco Ltd., Re (Sec. Commission, 1992)

P.332

- **Synopsis**: Ds of ST approve press release that misstated company's financial position. Held that Ds breached their duty to act in the public interest.
- **Implications on Standard of Care**: (i) cannot rely on management unquestioningly when have reason to be concerned about management's integrity/ability; (ii) time of peril necessitates a higher standard for Ds in the sense that they should be suspicious of management, and be pro-active in making inquiries into the company's well-being; (iii) outside directors have lower but non-trivial level of liability.
- Facts
  - ST's unaudited financial statements, prepared by officers, showed $5M gain.
  - OSFI expressed extreme concerns about Standard Trust's condition. Still, they approved press release to the public that glossed over difficulties.
  - New press release after audit showed loss of $50M instead of gain of $5M.
  - Option available to OSC was "denial of exemptions" order where directors couldn't trade their shares.
- Issue
  - Did directors breach duty to act in the public interest?
- Decision
  - Directors were negligent.
- Reasoning
  - **Nature of the duty**

- **Subjective standard:** Level of sophistication of directors influences court in ascribing liability.
- <u>**Content of the duty**</u>
- **Reliance on officers:** Directors should not rely on management unquestioningly where they have reason to be concerned about integrity or ability of management or where they have notice of particular problem relating to management's activities.
- **Level of inquiry required is high in times of peril:** They should have made a number of inquiries directly of various people to obtain necessary information. Advice from outside lawyer and auditor given to management was insufficient. Directors are required to be suspicious of management.
- **Outside directors have lower but non-trivial level of liability:** Non-management directors are also to blame, but lack of evidence causes intervention of OSC to be unwarranted.
- <u>**Defense of due diligence**</u>
  - **Reliance on report of management is inadequate:** s. 123(4) does not seem to apply in securities context.
    - BUT it may be that reliance in this case was not in good faith; rather, it was blind reliance at time when directors should have been on notice.

- Class Note
  - **Interaction with Peoples:** Peoples may overrule subjective standard here. However, OSC continually expands public interest power, so subjectivity may still apply in securities context.
- Iacobucci
  - This is important for showing how securities commissions can get involved with respect to enforcing a duty of care and failing to discharge a standard of care (for public interest)
  - Potential concern when securities law requires one behavior but corporate law requires a conflicting behaviour

(vi) Expansion of Statutory Duties for Directors

Directors Face Grab-Bag of Liabilities, Daniels and Morgan (1992)

P.339

- Policy issue:
  - Does it make sense to have directors liable for environmental hazards?
    - → No
      - [***Public Duty***] Argue that is does not since the government is trying to pass the public duty of environmental regulation onto directors – it is unrealistic for the directors to be familiar w/ the statutory environmental standards
      - [***Over-deterrence***] Potential for over-deterrence since directors may be excessively cautious wrt environmental issues (over-deterrence would result since the statute would stipulate the socially optimal amount, but w/ personal liability, there is a great cost to directors if they go over that optimal amount, even slightly; as such, they will take more precautions than necessary to avoid liability)
    - ← Yes
      - Response (*Beta*): have personal liability in place, but have defenses that can exculpate directors from liability (ex. due diligence, contextual analysis, industry standards and division of labour)

(vii) Other Statutory Director Liabilities in Corporate Law

P.341

CBCA 118. (1) Directors' liability

- Directors of a corporation who vote for or consent to a resolution authorizing the issue of a share under section 25 for a consideration other than money are jointly and severally, or solidarily, liable to the corporation to make good any amount by which the consideration received is less than the fair equivalent of the money that the corporation would have received if the share had been issued for money on the date of the resolution.

CBCA 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;
  - (a) a purchase, redemption or other acquisition of shares contrary to section 34, 35, or 36
  - (b) a commission contrary to section 41
  - (c) a payment of a dividend contrary to section 42
  - (d) a payment of an indemnity contrary to section 124; or
  - (e) a payment to a shareholder contrary to section 190 or 241.

CBCA 118. (6) No liability

- A director who proves that the director did not know and could not reasonably have known that the share was issued for a consideration less than the fair equivalent of the money that the corporation would have received if the share had been issued for money is not liable under subsection (1).

CBCA 119. (1) Liability of directors for wages

- Directors of a corporation are jointly and severally, or solidarily, liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively. [With conditions precedent in 119(2)]

CBCA 123(4) for Due diligence defence to all 118/119 duties.

- This amendment may mitigate perverse incentive which would cause directors to fire employees to prevent unpaid wage liability.

Policy Concerns regarding Proliferation of Directorial Liability

- **Empirical evidence:** Daniels & Morgan count 106 statutes imposing directorial liability. At the time, D&O insurance was highly unavailable, but now it's available
- **Overdeterrence of Participation:** Directors may not participate due to high risk associated with being a director.
- **Excessive risk aversion:** Directors may be overly cautious and spend lots of company money to protect themselves from liability (e.g. by purchasing reports)
- **Counterargument:** We may want personal liability for e.g. environmental shirking. However, positive and negative effects must be considered.

(viii) Business Judgment Rule

Overview: Biz Judgment Rule

P.342

- **Rule:** When there is no evidence of fraud, illegality, or conflict of interest in respect of a given corporate action involving business judgment, directors are presumed to have acted in good faith.
- **Adjunct:** Onus is on the plaintiff. In Delaware (and US), onus shifts to director when fraud, illegality, conflict, or gross negligence are plausibly supported. [note there is no onus shift in Canadian law]
- **Standard of care:** Gross negligence (*Van Gorkom*)
- **Implications of the rule:** Courts evaluate duties of care with reference to procedure, not content. They recognize their relative inadequacy in evaluating hindsight business decisions.

Smith v. Van Gorkom (Del., 1985)

P.422

- **Synopsis**: Van Gorkum recommends LBO at valuation of $55/share (mkt price was 37/share) and board approves; lawyer suggested there was no need for an independent valuation and that corporation could be sued if did not accept LBO offer at $55. Held that directors were negligent despite the fact they acted in good faith, since they exhibited gross negligence by not getting a fairness opinion.
- **Business Judgment Rule:** (i) [onus on Ds]: where there is no evidence of fraud, illegality, or conflict of interest wrt a given corporate action involving business judgment, directors are presumed to have acted in good faith; (ii) [onus on P]: presumption rebuttable if P can show gross negligence, where gross negligence can be either substantive (content of decision) or procedural (steps taken to reach decision)
- ***Application***: (i) high premium on sale is not determinative; (ii) procedural standard is whether directors have informed themselves, prior to making the decision, of all material information reasonably available to them (note that this is relatively more strict a standard than when assessing substance of decision, even though both measured according to gross negligence); (iii) reliance on legal (expert) advice is not sufficient to discharge standard; (iv) reliance on directors own expert knowledge is not sufficient to discharge standard
- **Legislative Response**: Delaware has a rule that allows corporation to put in its articles terms that protect D/Os from lawsuit for money damages from breach of DoC (Delaware Charter s.102(b)(7))
- Facts
  - Van Gorkom was Chairman of Trans Union – he was entitled to tax deductions, but didn't make enough money to take advantage of them, so he sought to sell TU.
  - CFO notifies VG that an LBO may be viable at a price between $50-60 (well above $37 share price).
  - VG instigated sale for 50% premium of shares ($55) and made 20-minute presentation to board regarding LBO sale to Pritzker. Lawyers recommended against independent valuation of the company.
  - Board accepted merger, after lawyer said that they could be sued for not accepting and that there was no legal obligation on the company to get a fairness opinion.
  - A clause in the deal permitted rescission contingent on a better offer from another party.
  - TJ said business judgment rule precluded liability on the part of directors.
- Issue
  - Are directors negligent, pursuant to business judgment rule?
- Decision

- Directors are negligent; although directors acted in good faith and the initial presumption of the BJR was met, the directors exhibited gross negligence (the directors should have got a fairness opinion in order to discharge the standard of care)

- Reasoning (Majority)
  - **Content of the Duty**
  - **BJR:** where there is no evidence of fraud, illegality, or conflict of interest with respect to a given corporate action involving business judgment, directors are presumed to have acted in good faith; the plaintiff can overcome this presumption if he can show gross negligence on the part of the directors: **2 elements of gross negligence:** (i) substantive (ii) procedural – evidence with respect to content of decision or information upon which decision is based is admissible.
  - **Application**
  - **A high premium on sale is not determinative:** A 50% premium was not deemed enough to shield directors from due diligence requirements. Stock price is not necessarily accurate reflection of intrinsic value. [IAC does not like this too much since goes against efficient markets argument]
  - **Procedural information requirement is high:** Standard = whether directors have informed themselves "prior to making a business decision, of all material information reasonably available to them." Here, directors were not aware of relevant info – this makes them more vulnerable to suit.
  - **A report must be *inter alia* relevant:** There is no evidence that any report was presented to the Board. A report must be pertinent to the subject matter upon which a board is called to act and otherwise entitled to good faith reliance. Here, the Board did not call for a valuation study.
  - **Reliance on legal advice is not determinative:** Lawyers said valuation not needed nor is fairness opinion. However, some kind of information is necessary. Circumstances of this case required getting a fairness opinion in the business sense, but not legal sense
  - **Directors' expert knowledge insufficient:** simply being an expert is not enough for complete deference to judgment. Even if suit would have resulted for non-acceptance of deal, directors should have gotten information – they would have won on BJR.
- Reasoning (Dissent)
  - **Directors behaved appropriately, in light of expertise:** Directors of this caliber (Dean of business school, 68 years of board experience, and immersed in industry) are not taken in by a "fast shuffle." They had a lot of knowledge already, so there was no point for them to spend more time acquiring reports on what they already knew.
- Case Critiques
  - **Premium on sale:** it's unlikely the buyer would have better information than seller re value of company. Furthermore, independent valuation is imprecise and based on estimates. The market is normally not off by greater than 50% - lots of arbitrage opportunity for such a market imperfection (!!).
  - **Fairness opinions:** Directors now get fairness opinion before transaction. However, it's unlikely that valuation of transaction will provide better information than market.
  - **Substance/procedure:** Court is strict on procedure and lenient on substance (despite same standard of gross negligence for both). IAC thinks that this approach is incorrect, since if the court has to be deferential on the substance because they lack biz knowledge, then they likely lack knowledge about the appropriate biz process as well
    - **Expertise of board:** If dissent's view is accepted, does that imply acceptance of subjective standard? No – achieving the objective standard can be based on gathering information or expertise or both.

        - **Legal reliance:** Court might suggest that lawsuit is easy to file and inexpensive. However, lawsuit is a business decision – avoidance of lawsuits is attractive.
    - Follow-up
        - **Delaware adopts enabling rule (S.102(b)(7)):** *Smith* led to widespread reaction suggesting to leave Delaware. Now, in Delaware, corporation can adopt articles that protect directors from suit for money damages for breaches of duty of care. Note that this enabling rule does not exist in Canada.

Brant Investments Ltd. v. Keeprite Inc. (ONCA, 1991)

P.358

- **Synopsis**: parent mergers 2 subs, one which is wholly owned and one which is 65% owned. Minority SHs of partially owned company bring suit claiming terms are more favourable to wholly owned subsidiary. Held that DoC was not breached since (i) reliance on an independent committee is strong evidence, (ii) robust strategic plan is unnecessary, (iii) consultant repot must merely be based on reasonable assumptions and (iv) valuation of purchasing parent company unnecessary, since value will change post merger of subs.
- **Business Judgment Rule**: Ds bear the tactical onus to produce information that shows the decision was reasonable, prudent and diligent
- Facts
    - Inner City Manufacturing (ICM) had 65% interest in Keeprite (KR), with rest of shares being publicly traded.
    - ICM considered merger of Keeprite with another subsidiary (IC), which was 100% owned by ICM.
    - An independent committee was struck by ICM to review the merger, and the committee indicated that Keeprite price would have to be raised, so it was
    - Full board approved transaction based on recommendation of the committee.
    - Minority shareholders file suit under oppression remedy, finding deal to be unfair
        - Basis of suit: parent company has an incentive to merge w/ terms advantageous to IC since it will get 100% of the upside and only 65% of the downfall (of the unfavourable terms to KR)
- Issue
    - (i) Did directors, who trusted independent committee, breach duty of care?
    - (ii) Who bears the burden of proof? Do we presumptively favour or disfavour directors?
- Decision
    - Duty not breached
- Reasoning (per McKinlay JA)
    - **Content of Duty**
    - **Reliance on independent committee is strong evidence:** Court finds none of alternatives to be presumptively superior and consideration of other alternatives in context of concrete solution is sufficient.
    - **Robust strategic plan is unnecessary:** In the interests of time, decisions are often not made with robust strategic plans. A minutely detailed plan was sufficient.
    - **Consultant report must merely be based on reasonable assumptions:** Fault in consultants' assumptions does not undermine directors in relying on outside report.
    - **Valuation of buying company is unnecessary:** ICM was never valued as a stand-alone going-concern. Court says this valuation was unnecessary since its value as merged entity was more relevant.
    - **Fairness:** The Court found the transaction to be fair.
    - **Business Judgment Rule**

- Deference shall be given to business decisions, so long as they are reasonable and made w/ prudence and due diligence
- **BJR concerns 2 issues:** (i) Standard of review; (ii) Onus of proof.
- **Tactical onus lies with directors:** Court says that since directors are lowest-cost producers of private information, they bear a "tactical" onus to produce this information (so there is no onus shift like in the US rule (see below), but rather there is assumption that the decision-makers will defend the deal)
- **Tension between 2 policies:** (i) Court must protect minority. (ii) Court can't usurp power of the board from the company. As a compromise, the court should canvass a variety of factors, but not substitute its own decision for decision of the board.
  - **Re independent committee:** In situation of conflict of interest, the very striking of independent committee that is not subject to conflict can discharge burden.

- Case Critiques
  - **Valuation of buyer**: By not valuing the buyer in the merger, it would be impossible for Keeprite to negotiate the price in an informed fashion.
  - **OCA should not have relied on TJ's findings of fact:** TJ proceeded on assumption that plaintiffs bear onus and made findings based on that assumption. However, OCA is evaluating whether onus should shift earlier, which would affect findings of fact. So it's peculiar that OCA would accept TJ's findings.
    - **2 valid reasons for reliance:** (i) TJ undertook a very close examination of the facts; and (ii) Defendants assumed that they bore the onus of proof – so nothing would have changed had it formally been decided that onus was shifted.
  - **Tactical onus undermines the purpose of an onus:** The very burden of an onus affects how much information a party will disclose. Imposing a tactical onus is tantamount to shifting the onus.
- Iacobucci
  - **U.S. BJR**: presumption that the decision was made absent a conflict of interest and was informed, unless shown otherwise (*Sinclair*); where there is a conflict of interest, the onus shifts to the majority SHs to prove that the decision was fair

Pente Investment Management Ltd. v. Schneider Corp. (1998) (OCA)

P.367

- **<u>Synopsis</u>**: Maple Leaf makes takeover bid for Schneider, but Schneider finds white knight.
- **<u>Business Judgment Rule Refinement (Onus)</u>**: Onus may not always rest with same party when business decision is challenged:
- No onus on defendant if took steps to minimize potential conflict of interest (ex. independent committee review)
- Onus on defendant if did NOT take steps to minimize conflict of interest

- Facts
  - Maple Leaf made takeover bid for Schneider
  - Schneider found White Knight (saves from a takeover bid)
- Issue
  - On which party does the onus lie?
- Decision (per Weiler)
  - **<u>Business Judgment Rule</u>**
  - **Brant is indeterminative:** *Brant v. Keeprite* did not decide whether onus shifts
  - **Burden does not shift if conflict of interest thwarted:** (obiter) Burden of proof may not always rest on same party when a change of control transaction is challenged. We must ask whether directors of target company took steps to avoid a conflict of interest. If so,

the rationale for shifting the burden of proof to the director may not exist. The independent committee in *Brant* is a nice illustration of this principle.
    - **IAC: Idea may be:** if you take steps to minimize a potential conflict of interest, then there is no onus; if you do not takes steps to ensure there is no conflict, then onus is on you to prove there is no conflict
    - **Purpose of CAN BJR:** Canadian BJR is not about shifting onus, but rather is about examining deferential posture
- Case Comment
    - **Consistent with Delaware:** In Delaware, you overcome BJR by showing no conflict of interest. Here, *Brant* and *Pente* say that if defendants establish independent committee, onus will shift back.

(ix) Indemnification and Insurance

CBCA Section 124

- Overview
    - This section establishes provisions that allow a corporation to indemnify directors and officers against judgments won by 3rd parties against corporation or directors themselves.

- (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. [subject to s.124(3) limitation below]

- (3) **Limitation** – A corporation may not indemnify an individual under subsection (1) unless the individual:
    - (a) **acted honestly and in good faith with a view to the best interests of the corporation**, or, as the case may be, to the best interests of the other entity for which the individual acted as director or officer or in a similar capacity at the corporation's request; and
    - (b) in the case of a **criminal or administrative** action or proceeding that is enforced by a monetary penalty, the individual had **reasonable grounds for believing that the individual's conduct was lawful**.

- (4) **Indemnification in derivative actions** – A corporation may with the approval of a court, indemnify an individual referred to in subsection (1), or advance moneys under subsection (2), **in respect of an action by or on behalf of the corporation or other entity to procure a judgment in its favour, to which the individual is made a party because of the individual's association with the corporation or other entity** as described in subsection (1) **against all costs, charges and expenses reasonably incurred by the individual in connection with such action**, if the individual fulfils the conditions set out in subsection (3).
    - Corporation can choose to indemnify director when corporation is a plaintiff. Indemnification is limited to costs of the suit.

- (5) **Right to indemnity** – Despite subsection (1), an individual referred to in that subsection is **entitled to indemnity** from the corporation in respect of all costs, charges and expenses reasonably incurred by the individual in connection with the defence of any civil, criminal,

administrative, investigative or other proceeding to which the individual is subject because of the individual's association with the corporation or other entity as described in subsection (1), **if the individual seeking indemnity:**

- (a) **was not judged by the court or other competent authority to have committed any fault or omitted to do anything that the individual ought to have done; AND**
- (b) **fulfils the conditions set out in subsection (3).**
  - Director can require indemnification of costs of the action if director is successful on the merits.

- (6) **Insurance** – A corporation **may purchase and maintain insurance for the benefit of an individual referred to in subsection (1) against any liability incurred by the individual:**
  - (a) in the individual's capacity as a director or officer of the corporation; or
  - (b) in the individual's capacity as a director or officer, or similar capacity, of another entity, if the individual acts or acted in that capacity at the corporation's request.
    - **Broader than indemnity provisions:** You can maintain indemnity for derivative action – but policy can protect director for damages (s)he has to pay.

The Implications of D/O Insurance Liability Crisis on CDN Corporate Governance

P.368 (Daniels & Hutton)

- **Rationale for Allowing Insurance of D & O Liability**
  - **(i) Insurers adequately monitor risks:** Insurers don't want to insure bad risks, so we delegate monitoring to the insurer. For example, an insurer won't want to insure director with bad record or company with bad corporate governance.
    - **BUT Misaligned Incentives:** Insurers won't always be able to control directors, who will sometimes be grossly negligent. This could undermine incentive effects that duty of care has.
  - **(ii) Incentive to get good directors:** Even if incentive effects are undermined, companies prioritize the attraction of good directors. Directors might be overdeterred, bearing too much downside and not enough upside. Perverse incentives that exist because of duty care are dampened by insurance. Besides, there are other sources of discipline – market for corporate control, etc.
- **Implications of Insuring Liability**
  - **Effective opt-out from s. 122 is enabling:** You cannot directly opt out of s. 122 (duty of care, below), but you can indirectly opt out through insurance policies. This is another example of an enabling rule which leaves it up to the parties.
  - **Gross negligence is not a primary concern anyway:** There will be self-selection going into picking directors for public companies. Laziness is typically not a real concern, since people are selected for ambition, drive, and energy. Risk of shirking is normally minute, so gains from shirking will be pretty small.

8. FIDUCIARY DUTIES OWED BY DIRECTORS AND MANAGERS TO THE CORPORATION

- **Agency Problem:** While duty of care breach does not inherently benefit director, conflicts of interest arise when director stands to gain pecuniary benefits. Incentive to breach duty is thus far greater for financially-minded officers.
  - **Fairness** principles
  - **Quasi-contractual approach:** Fiduciary duty provision should replicate what parties would choose as default rule.

(i) Introduction to Fiduciary Duties

CBCA 122. (1) Duty of care of directors and officers

- Every director and officer of a corporation in exercising their powers and discharging their duties shall:
  - (a) **act honestly and in good faith with a view to the best interests of the corporation; and**
  - (b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.
- Note
  - This includes (i) good faith (ii) conflict avoidance (iii) no secret profit derived from office.
  - FD complaint can be brought by (i) derivative action (ii) personal action.

(ii) Basic Self-Dealing Transactions (SDTs)

(a) Introduction

- **Phenomenon:** In role as director, party will want lowest transaction price. As beneficiary on opposite side of transaction, individual will want highest transaction price. Note that this phenomenon arises only because majority shareholders do not internalize full costs of self-dealing (so it would not arise for 100% shareholder).

Costs of Self-Dealing

- **Underinvestment:** Investors will be unwilling to invest in company if SDTs are permitted. They will worry that they'll get underpaid for their investment (dominant effect).
- **Deadweight Losses:** Asset may be most valuable in hands of corporation and less valuable in hands of buyer in the self-dealing transaction.

Benefits of Self-Dealing

- **Low transactions costs**: Director may have great information about possible transaction. Consummation might be cheaper due to parties' knowledge of each other.
- **Allocative efficiency:** Transaction may be allocatively efficient (opposite of DWL).

(b) The Common Law

Aberdeen Railway Co. v. Blaikie Bros. (HoL, 1860)

P.377

- **Synopsis**: D on both sides of a transaction for chairs. Held that the transaction was voidable since fiduciary duty requires no conflict of interest.

- **Rule**: prophylactic rule (very strict, without inquiry into fairness) prohibits D/Os from entering an engagement in which they have a personal conflict of interest, or a conflict of interest with those whom they are bound to protect, regardless of whether D is only one of many Ds.
- **Policy**: advantage of strict rule is certainty of no STDs with wrongful motivation, and achievement of full deterrence of these motivations; disadvantage is loss opportunity for low cost transaction (suboptimal resource allocation).

- Facts
  - Company entered into K to purchase chairs from a partnership. Director of company was member of the selling partnership.
- Issue
  - Is transaction voidable due to breach of FD?
- Decision
  - Transaction is voidable.
- Reasoning: (Lord Cranworth L.C.)
  - **Nature of Duty**
    - **Strict rule of universal application:** Director has duty which precludes him/her from entering engagement in which (s)he has personal conflict of interest or interest which conflicts with those whom (s)he is bound to protect. Once we have found this interest, transaction can be set aside – no exceptions. It is a prophylactic rule (very strict, without an inquiry into fairness)
  - **Content of Duty**
    - **SDT:** In this case, Blaikie's personal interest (as principal of the chair manufacturer) would induce him to fix the price as high as possible, contrary to his interest as Aberdeen director.
    - **Multiple directors does not take away from obligation:** Even if only one of many directors, director has duty to give other directors full benefit of his/her knowledge and skill. It's not just about voting – FD extends to obligation to give knowledge/skill. In addition, other directors may be influenced by self-interested director's desire for the transaction
- Case Comment
  - **Advantages of strict rule:**
  - ***Certainty***: If Court were to try to resolve situation, it would not be equipped to contrast with alternative situation. Also, if there were uncertainty, directors would take calculated risks to take advantage of the conflict. Full deterrence may not be achieved without a strict rule
  - **Disadvantages of strict rule:**
  - ***Suboptimal resource allocation*:** It could be that director has information about the chairs which benefit the company. It would be potentially harmful for corporation to say that under no circumstances can corporation deal with partnership.

Transvaal Lands Co. v. New Belgium Land and Development Co. (UK, 1914)

P.379

- **Synopsis**: 2 Ds involved in self-dealing transaction. 1 discloses he was D of selling company and abstained from voting w/o disclosing the extent of his ownership in the selling company, while the other D voted despite his conflict. Held that transaction was voidable since there was a conflict of duties by Ds being on both sides of transaction.
- **Rule**:
- (i) the existence of a conflict of duties is sufficient to breach fiduciary duty, regardless of whether the D receives the benefit of the conflict personally.

- (ii) the existence of an ownership interest, regardless of size of interest, is sufficient to trigger conflict
- **Policy**: strict prophylactic CL rule runs the risk of preventing too many transactions, even where ownership interest is too minute to give rise to legitimate conflict. As such, opting out via articles of incorporation is consistent w/ contractarian approach.
- Facts
  - Plaintiff purchased a block of 3333 shares of Lydenberg on Samuel's recommendation.
  - Samuel did not disclose that he owned ½ the shares of the proposed purchase – he merely abstained from voting, on the ground that he was a director of the selling company.
  - Harvey was 1 of 2 voting directors, and he held 1000 shares in the selling company (as a trustee under his father-in-law's will). As a trustee of the seller, he had an obligation to maximize the value of the estate and as a director of the buying company, he has a duty to buy at the lowest price possible
  - Harvey was the investigating director into the acquisition because he didn't understand Samuel's rationale for the decision.
- Issue
  - Can a director buy shares from a company in which he has a pecuniary interest?
- Decision
  - Transaction is voidable.
- Reasoning: (Swinfen Eady LJ)
  - **Content of the Duty**
  - **Broad characterization:** Where a director has an interest as shareholder in another company or is in a fiduciary position towards and owes a duty to another of which he is a director, he is within the rule.
  - **Conflict of duties is sufficient to create conflict:** It is immaterial whether this conflicting interest belongs to him beneficially or as trustee for others. All that matters is that he is a trustee of an estate which owns shares in the selling company. Here, Harvey would never have personally benefited from purchase of shares – only beneficiaries of trust would benefit. However, there is a conflict of duties, which he owes as director and as trustee.
  - **Ownership interest in contracting party triggers conflict:** Once an ownership interest exists, there is a conflict, regardless of size of ownership interest (so long as there is a material interest) This provides certainty for directors who act pursuant to the rule.
  - **Opting Out of the Common Law Rule permitted (Contractarian)**
  - **Nature of the interest must be disclosed:** Article 98 says that Director shall disclose the nature of his interest, and shall not vote in respect of any contract in which he is concerned.
    - Here, Harvey didn't disclose, and he voted. Without his vote, there would be no quorum.
    - Samuel didn't disclose nature of interest – he just stated he was director, not seller.
- Case Critique
  - **Not all ownership interests create real conflict:** If a person owned 1 share of IBM and was majority controlling shareholder in computer company, the 1 share wouldn't legitimately affect purchase decision. The nature of the interest should also be evaluated.
  - **Overdeterrence of CL rule:** Presumably, parties opted for the exception in their articles to sanitize SDT in order to better balance concerns about self-interest and diversion of corporate assets to oneself with fact that sometimes self-deal is the best deal.

Imperial Mercantile Credit Association v. Coleman and Knight (HoL, 1873)

P.382

- **Synopsis**: member of underwriting firm strikes deal to underwrite a debenture for 5% commission; member is also D for another underwriting company (Imperial) and gets them to do the same work for 1.5%. Articles of Imperial allowed SDTs, so long as conflicts of interest were declared and involved Ds abstained from voting. D w/ conflict disclosed he had a 1.5% interest, but gave no other details. Held that the CL fiduciary duty was breached since D did not sufficiently disclose the nature of his interest (explicit elaboration)
- **Rule**: where corporation opts out of strict prophylactic CL fiduciary duty rule, and its articles state that conflicted Ds must "disclose their interest", Ds must give explicit elaboration of the nature of their interest (details!)
- **Remedy**: disgorgement of profits
- **Policy**: D in SDT is the lowest cost provider of information of his conflict, so logical that duty is on him. Counter argue that failing to disclose is not sufficient to justify disallowing a potentially profitable transaction.
- Facts
  - Coleman is a member of brokerage firm engaged in underwriting – helping corporations sell securities to market.
  - Coleman & Knight underwrote debenture for Peto at 5% commission → Coleman agreed to sell the debentures and take a 5% commission from gross proceeds.
    - Aside: underwriters could have assumed some of risk associated with debentures – underwriter has cost of selling, and they can assume risk.
  - Coleman was also director for Imperial Mercantile and sought to get them to underwrite same debenture for 1.5% commission.
  - This is good for Coleman – they get paid 5% by Peto, they get somebody else to do the work, and they do work for 1.5% → 3.5% is gravy to C&K.
  - Articles of IM allowed self-dealing transactions, so long as the director(s) involved declared their interest in the transaction and abstained from voting
  - Before IM Board approved transaction, Coleman disclosed that he had a 1.5% interest, but it's not entirely clear what that means.
  - He did not disclose that in his capacity as stock brokerage, he would get 5% commission.
- Issue
  - What must Coleman disclose regarding his interest in the underwriting transaction?
- Decision
  - Coleman/Knight are liable.
- Reasoning: (Lord Chelmsford)
  - **Content of the Duty**
  - **Must disclose nature of the interest:** Director must declare not only presence of an interest, but nature of the interest (explicit elaboration). Court infers from "disclose your interest" that nature of the interest is critical. Coleman said: "The other directors knew I was a stockbroker. They knew the kind of interests that were typical in this industry." BUT this is problematic – commission varies a lot case-to-case with level of risk assumed by underwriter. Just to say "I'm in industry" doesn't say what his commission is. This was acknowledged to be a difficult underwriting. It would have been relevant for directors to learn more detail.
  - **Peripheral participants bear duty:** Knight was a party to and implicated in the breach of trust (though he wasn't a director of IM). He was acquainted with the transaction the entire way through. Liability thus extends to Knight – he must disgorge the profits he earned, since he knowingly participated in this breach of trust by Coleman.
  - **Remedy**

- **Disgorgement of profits:** There is no question of what "would have been" – they just owe the profits they earned.

- Case Comment
  - **Burden to provide information:** Perhaps Coleman should not have to disclose nature of interest – as long as he puts them on notice, perhaps IM directors should have questioned him. However, he is <u>lowest-cost provider of information – and he has FD to provide skill and knowledge to provide information which improves IM bargaining power</u>.
  - **Strict rule is suboptimal:** If decision is profitable, perhaps they should have taken the deal and FD shouldn't matter.
  - **Empirical evidence suggests no old boys club:** It may be that the real benefit to Coleman is not in voting, but getting others to vote his way in old-boys club fashion. However, he didn't disclose nature of his interest here – so this isn't that sort of case. Also, shareholders wouldn't opt out of strict rule if it was empirically observed that directors provided quid pro quos like this. Furthermore, these sorts of dealings may also breach duty of care.

Gray v. New Augarita Porcupine Mines Ltd. (P.C., 1952)

P.383

- **<u>Synopsis</u>**: Gray involved in a variety of SDTs in his past dealings with company. New Ds appointed, and Gray brings proposal to extinguish his liabilities for a fixed sum; proposal was approved by the new Ds w/o them knowing the nature and extent of Gray's liability. Held that transaction was voidable for Gray's breach of fiduciary duty since he did not sufficiently disclose the nature of his interest.
- **<u>Rule</u>**: Ds must leave colleagues fully informed, disclosing anything that is material. Merely declaring an interest is insufficient on any standard.
- ***Application Note***: assessment requires contextual analysis w/ no precise formula.
- **<u>Remedy</u>**: K voidable at breached party's discretion
- **<u>Policy</u>**: argue that onus on Ds to ask questions, not Gray's responsibility to disclose; Counter argue that Gray is the lowest cost producer of information, and thus, it is most efficient for him to provide full information.
- Facts
  - NAPM's affairs were conducted in the offices of Gray
  - Gray was VP, Chairman of Board, counsel. 2 other directors were accountant and typist from law office.
  - By-laws precluded director from voting on any contract in which he was interested. Gray engaged in various SDTs.
  - Gray issued shares to himself at a discount of 80%, caused company to purchase mining claims from him for fully-paid shares + cash, and caused company to purchase speculative shares from him.
  - OSC started poking around, and old directors resigned. Gray knew that he had dealt unfairly with the corporation. After new directors were appointed, Gray brought proposal to extinguish his liabilities for fixed sum, and the proposal was approved without board knowing nature of Gray's interest and extent of his real liability and what it would have been.
  - Board also knew that Gray was in position of conflict with respect to this deal. Effect of settlement was that Gray stood to benefit substantially. Board did not investigate extent, and settlement went through.
- Issue
  - Is transaction voidable due to breach of FD on Gray's part?
- Decision

        - Transaction is voidable.
- Reasoning (Lord Radcliffe)
    - **Opting Out of the Common Law Rule**
        - **Some discretion existed for SDTs:** Rule for this company was that director was not precluded absolutely from entering into K, but (i) not permitted to vote upon a resolution dealing with such a K or arrangement and (ii) must disclose the "nature of his interest" in order to be permitted to retain profits arising from the transaction.
    - **Nature of the Duty**
    - **No precise formula for nature of interest:** No precise formula exists to determine extent of detail required when director declares interest or nature of interest. Test is contextual. But merely declaring an interest is insufficient on any standard
    - **Remedy**
        - **Voidable at company's discretion:** Director cannot put himself in position of conflict without giving corporation the opportunity to avoid the contract. Company can set aside the deal.
        - **Accounting of profits:** If impossible to rescind (if already performed), then there is accounting for profits earned (from *Imperial Mercantile*). But it is open to companies to modify this general approach to self-dealing.
    - **Rule**
    - Director must leave colleagues fully informed, disclosing anything that is material
- Case Comment
    - **Burden to inform:**
    - → We could say Gray is not to blame - directors could have asked questions. They were on notice.
    - ←BUT we might not want directors to have to ask questions – Gray already has the information in his mind. Gray is ***lowest-cost producer*** of information. If onus lies on director to show that dealings were fair, disclosure will begin immediately. If onus lies on other parties to question, then information will not be as available.

(c) Legislative Response

The Common Law Rule

- **Not enabling:** Common law rule is strict – parties are contracting around CL rule, so CL rule might not capture generally what parties would want. Default rule should be what parties would want anyway – in order to save TCs.
- **Not mandatory:** What is nice about CL rule is that it is default rule.

CBCA S.120(1)

- **(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.
- **Note**
- Applies to party, director, or shareholder to transaction

- **"Material interest"** overrules *Transvaal*, which said every interest is relevant. We now ask, "Is this the sort of interest that will affect the director's judgment?" Old rule slowed transactions, with directors having to disclose all sorts of information that would be immaterial. And they'd have to abstain from voting.
- **Iacobucci**
- S.120 is a mandatory rule governing self-dealing – there is no contracting around it; this is a derogation of the contractual freedom that the strict contractual approach would provide

CBCA S.120(5-8)

- **(5) Voting –** A director required to make a disclosure under subsection (1) shall **<u>not</u>** vote on any resolution to approve the contract or transaction unless the contract or transaction:
  - (a) relates primarily to his or her remuneration as a director, officer, employee, or agent of the corporation or an affiliate;
  - (b) is for indemnity or insurance under section 124; or
  - (c) is with an affiliate.
- English: D cannot vote on any transaction in which he has an interest

- **(6) Continuing disclosure –** For the purposes of this section, a general notice to the directors declaring that a director or an officer is to be regarded as interested, for any of the following reasons, in a contract or transaction made with a party, is a sufficient declaration of interest in relation to the contract or transaction:
  - (a) the director or officer is a director or officer, or acting in a similar capacity, of a party referred to in paragraph (1)(b) or (c);
  - (b) the director or officer has a material interest in the party; or
  - (c) there has been a material change in the nature of the director's or the officer's interest in the party.
- Note
  - Rather than disclosing every time, director can make disclosure once about various types of transactions
  - This seems to have the effect of negating the "nature of interest" requirement

- **(7) Avoidance standards** – A contract or transaction for which disclosure is required under subsection (1) is not invalid, and the director or officer is not accountable to the corporation or its shareholders for any profit realized from the contract or transaction, because of the director's or officer's interest in the contract or transaction or because the director was present or was counted to determine whether a quorum existed at the meeting of directors or committee of directors that considered the transaction, if:
  - (a) **disclosure of the interest was made in accordance with subsections (1) to (6)**;
  - (b) the **directors approved** the contract or transaction; and
  - (c) the contract or transaction was **reasonable and fair** to the corporation when it was approved
- Note
  - This is a carve out: the deal is okay if there was disclosure, abstention, and deal was fair and reasonable at the time.
  - **"Fair and reasonable"** departs from CL. If transaction is fair and reasonable, we stymie the overdeterrence in the CL. Courts won't be interventionist when there is disinterested Board of Directors in evaluating "fair and reasonable."
- Difference between "fair and reasonable" and "best interests of corporation":
  - **Higher standard:** Courts will review decisions more carefully than they might in duty of care cases. The standard of fairness/reasonableness will be higher.

- **Different onus:** In *Brant*, onus may shift on duty of care where there is self-interest. Here, directors bear the onus right from the start.
- **Remedy:** Duty of care includes damages inquiry – did it cause the damages? What are the extent? With FD, remedy awarded is accounting of profits (disgorgement)

- (7.1) **Confirmation by shareholders** – Even if the conditions of subsection (7) are not met, a director or officer, acting honestly and in good faith, is not accountable to the corporation or to its shareholders for any profit realized from a contract or transaction for which disclosure is required under subsection (1), and the contract or transaction is not invalid by reason only of the interest of the director or officer in the contract or transaction, if:
  - (a) the contract or transaction is **approved or confirmed by special resolution** at a meeting of the shareholders;
  - (b) d**isclosure of the interest was made to the shareholders in a manner sufficient to indicate its nature** before the contract or transaction was approved or confirmed; and
  - (c) the contract or transaction was **reasonable and fair** to the corporation when it was approved or confirmed.
- Note
  - Director is not accountable for profits if there was (i) disclosure to the shareholders (ii) special resolution of shareholders approves the transaction, (iii) fair and reasonable.

- Remedy: (8) **Application to court** – If a director or an officer of a corporation fails to comply with this section, **a court may, on application of the corporation or any of its shareholders, set aside the contract** or transaction on any terms that it thinks fit, or **require the director or officer to account to the corporation for any profit or gain** realized on it, or do both those things.

Differences between Statute and CL

- "Material interest" makes it harder to establish infringement in 120(1)
- "Fairness and reasonableness" in 120(7)
- **Opting out is impossible:** At CL, you could contract out of these rules. You can't contract out of s. 122, and there is nothing in s. 120 that allow for different procedure. By restricting choice, it departs from contractual view. However, it does choose the right rule – the one which parties were choosing when they did have freedom of choice.

Insurance

- **No bad faith:** You can insure directors for anything you want, but insurance policies are typically structured to not include anything resulting from bad faith. Otherwise, there would be moral hazard.
- **No insurance for FDs due to pecuniary gain:** Why isn't insurance available for breach of FD but it is available for duty of care? Directors have pecuniary gain from FD, but not from duty of care. If negligent, director doesn't get anything out of the mistake. If breach of FD, director stands to gain. Company won't want to indemnify this. Also, other mechanisms exist for stemming negligence – e.g. market for corporate control.

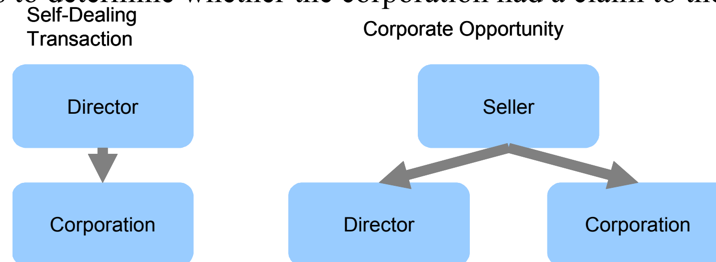
Duty of Loyalty vs. Duty of Care

- Why tougher to K around duty of loyalty for self-dealing than the duty of care?
  - <u>**Different Incentives**</u>
  - Under DoC: a director has no clear motive/interest since the benefit of breaching duty does not accrue directly to him, and there is a reputational risk if negligent → as such, permissive to contract around

- Under Self-dealing (loyalty): there is a direct profit motive for self-dealing and there is minimal reputational risk since will be rich after the self-dealing

(iii) Corporate Opportunities

- **Problem:** Diversion of corporate resources by pursuing opportunity that "belongs" to the corporation (conflict not as clear as in SDT); Director is diverting potential opportunities from the SH to himself, and analysis is to determine whether the corporation had a claim to the opportunity



Cook v. Deeks (Ontario P.C., 1916)

P.387

- **Synopsis**: D&H get K w/ CPR in their position as Ds of TCC, but carry out K themselves (motivation was to freeze out the third director), never allowing TCC the chance at the K. Third director launches suit for breach of fiduciary duty. Held that FD was breached since Ds role in corporate played substantial role in their obtaining of the K, and there is no need to show that corporate would have ultimately won the K. Additionally, SH resolution is insufficient to permit the D/Os taking of the opportunity since it would (i) be unfair to the minority SHs and (ii) is ultra vires the corporation (giving away corporate assets).
- **Rule**: the law has to be careful not to be too onerous on putting burdens on directors, but it also has to be careful that directors are not free to sacrifice the interests they are bound to protect.
- ***Application Notes***: (i) no but-for test for loss (too speculative); (ii) SH resolution insufficient to permit taking since unfair to minority and ultra vires corporation; (iii) D vote may allow taking; (iv) D overdetterence implications should be considered.
- **Policy**: less strict rule for taking of corporate opportunities relative to SDTs makes sense since here there may be instances where no one is harmed and Ds gain by taking an opportunity (i.e. increase in social welfare (or a pareto optimal solution); this is not the case in SDTs, where nature conflict of interest inherently makes one party worse off. In addition, the disgorgement of profits remedy still has an effect, despite Ds being SHs of the corporation, since (i) Ds' reputation is harmed, and (ii) it exposes D to downside risk, since suit only brought if taking of opportunity was successful.
- Facts
  - Deeks and Hinds, directors of Toronto Construction Company (TCC) had relationally negotiated contracts with CPR
  - D&H earned reputations for doing good job in fulfilling contracts all within roles as directors of TCC
  - D&H agree that they want to shut Cook out of the business
  - Rather than dissolving corporation and starting again, or starting own company, they do best to just keep Cook out of the loop
  - H gets contacted by CPR re South Shore. In the South Shore negotiation, D&H negotiated while in their position as directors of Toronto Construction Company. At the end of the contract, D&H announced that they would carry out the contract themselves, not as TCC (they do this at 11th hour). They never allowed the company to have any chance of acquiring the benefit.

    - Cook launches suit against them for breach of fiduciary duty.
- Issue
    - Did D&H breach their fiduciary duty?
        - (i) Apart from subsequent shareholder resolutions, was the corporation entitled to the benefit of the contract?
        - (ii) If it was presumptively entitled to that contract, could the shareholders ratify the release of that contract to D&H?
- Decision
    - Fiduciary duty was breached
- Reasoning (Buckmaster)
    - **<u>Corporate Opportunities</u>**
    - **Strict and Contextual Test:** Especially in the case of COs, the circumstances of the FD are relevant. In this case, the TCC directorship was a lynchpin for dealings in personal capacity, and thus D&H had a FD not to take the opportunity. "The law has to be careful not to be too onerous on putting burdens on directors, but it also has to be careful that directors are not free to sacrifice the interests they are bound to protect"
    - **No But-For Test for Loss:** once presumptive entitlement is shown, Court will not try to determine whether TCC would have ultimately won the contract. This analysis would be too speculative
    - **SH resolution insufficient to permit D/O taking of opportunity:** SH resolution insufficient since (a) unfair to minority, (b) it is ultra vires the corporation since waste of corporate assets (giving away property is a waste of corporate assets)
        - **Veto of opportunity would produce different results**: If the directors had voted as matter of discretion not to pursue contract, then corporation may have no equitable interest in the K.
        - **Awareness of overdeterrence**: If test is too rigid, (i) directors may be reluctant to become directors, or (ii) some positive-NPV opportunities will not be taken due to overdeterrence.
        - **Remedy is Accounting of Profits:** D&H must pay the profits from their own personal venture to the corporation.
- Case Comment
    - **Windup of company is no answer:** Court says if D&H had wound up TCC, corporate opportunity might not have breached FD. However, windup would be oppressive – FDs survive past life of corporation, and presumably, windup would harm shareholders even more than forfeit of single opportunity. This doesn't comport with ***Hooper's Telegraph*** (which stresses the interests of minorities)
    - **Court overestimates distinction between SDT and corporate opportunity:** Court states that SH cannot vote to approve the taking of a corporate opportunity since the corporation has an interest in the opportunity (note that this interest does not exist for SDTs). Though waste doctrine does not apply in SDT, oppression of minority is still possible. The Court made the clear decision to distinguish *Northwest Transport*. However, it would have been better to just say that *Northwest Transport* was wrongly decided.
    - **Logic of distinction b/t CO and SDT**: Iacobucci also does not think that such a strict rule makes sense, since there may be instances where it makes sense for the directors to take an opportunity that the corporation cannot (counter w/ the argument that you do not want director able to feather own nest by taking corporate opportunities)
    - **Accounting of Profits does have deterrence power:** AOP is criticized for not penalizing directors for taking the K. They are shareholders of TCC, so they essentially pay profits to themselves. They do not end up worse off. However, there are 2 deterrent

effects: (i) Reputation is harmed, (ii) They are exposed only to downside risk, since company will only bring suit if contract is profitable, but not all will be profitable.

Regal (Hastings) Ltd. v. Gulliver (HoL, 1942)

P.392

- **Synopsis**: Regal subsidiary gets investment from parent and Ds of parent to give it sufficient capital to make lessor of cinema agree to a lease for 2 cinemas. At the same meeting the shares in the sub were bought by Ds, the Ds voted to sell the parent and sub to another party, resulting in 200% profit for subsidiary. New management of corporation (after sale) sue former Ds for breach of FD based on their profits from the transaction. Held that the FD was breached since acting in good faith is not enough.
- **Rule**:
- ***Profit rule:*** (MacMillan in *Regal Hastings Ltd.*): (i) Was the behaviour related to their positions (done in course of management, in utilization of opportunities, with special knowledge)? (ii) Did they profit?
- ***Conflict rule:*** (Sankey in *Regal Hastings Ltd.*): No fiduciary can enter into K when he has interest which conflicts with interests of those who he is bound to protect.
- Facts
  - Regal owned a cinema. They thought they'd buy 2 more cinemas and sell the company.
  - Regal forms a subsidiary in order to obtain the other cinemas – they would enter long-term lease for cinemas
  - Seller (landlord) of other 2 cinemas was willing to offer lease, but insisted on personal guarantee of directors for lease payments unless the paid-up capital of the subsidiary was 5000 pounds. (Landlord was trying to contract around limited liability - wanted either personal guarantee or evidence of money in bank account.)
  - The parent did not have 5000 pounds – it only had 2000 pounds. Directors did not want to give personal guarantees on the lease, so they had Regal buy 2000 shares of subsidiary for 1 pound each and solicitor of Regal and other directors would also buy shares in the subsidiary. This brought the total up to 5000 pounds in paid-up capital.
  - At same meeting of finding 5000 pounds, directors voted to sell the company to buyer of 3-cinema company. Acquisition of Regal and subsidiary resulted in profit wrt subsidiary of 2 pounds per share (profit of 200%).
  - Company, as a result of shareholder transaction, came under new management.
  - Shareholders seek to recover damages from old directors for their benefits from the stock transaction since they only received a largely reduced proportion of the sale price for the two cinemas.
  - At the Court of Appeal, it was held that the transaction was carried out in good faith.
- Issue
  - Did the personal pursuit of corporate opportunity constitute FD breach?
- Decision
  - FD was breached.
- Reasoning (House of Lords)
  - **<u>Corporate Opportunities (Russell of Killowen)</u>**
    - **Factual finding is conclusive:** FD rule does not depend on fraud or absence of bona fides, or on whether profit would have otherwise gone to company, or whether profiteer was under duty to obtain source of profit for company, or whether damage has been found. ***If you are in fiduciary position and you make money as a result, you are liable to the beneficiary for the profit that you earned***. Distinguish *Keech v. Sanford*, where individual trustee pursued lease that

trust could not have taken (by terms of the trust). Here, it's clear that directors earned their profits by reason of and in course of office.
    - **Alternative course of action seems relevant:** The directors could have sought loan funds or given personal guarantees instead of personally invested. By not doing either, only fraction of proceeds were earned by shareholders. This is brought into reasons of the court.
  - **Who Has a Duty? (Russell of Killowen)**
    - **Personal benefit:** Gulliver was a director who did not personally invest, but found other companies to invest in which he was director. He was not found liable.
    - **FD to start with:** Garten was a solicitor involved in the transaction. He was not held liable since he was not in fiduciary position and was merely asked to invest.
  - **Who Gets the Remedy? (Porter)**
  - **Windfall gain is permissible:** New shareholders can get the AOP reward even though the actual losers were the old shareholders who only received 40% of the stock proceeds. The new SHs essentially get a rebate on sale and windfall gain.
  - **Permissible for deterrence:** Deterring directors and preserving the FD is so important that non-specific shareholders can realize the benefits of suit (this view endorsed in ***Abbey Glen*** by majority).
  - **Corporate Opportunities**
  - **Strict Rule due to institutional incompetence (Wright):** Courts aren't well-equipped to determine whether Regal could have pursued opportunity. Hence, strict prophylactic rule is adopted.
  - **Conflict rule (Sankey):** No fiduciary can enter into K when he has interest which conflicts with interests of those who he is bound to protect.
  - **Profit rule (MacMillan):** 2-part test articulated: (i) Was the behaviour related to their positions (done in course of management, in utilization of opportunities, with special knowledge)? (ii) Did they profit? [Note: in *Keech*, where there is a trust w/ no interest in the opportunity, the conflict rule would not apply, but the profit rule would apply, and deny the director from receiving the benefit]
  - **Shareholder waiver (Wright):** If other shareholders assent to the opportunity (voting), then director may profit personally for otherwise corporate opportunity.
- Case Comment
  - **Windfall gain problem would now be avoided:** The CBCA **(s.240(c))** now allows for payment directly to former shareholders and for derivative actions. Though in *Regal*, old shareholders could not have benefited, today they could.
  - **Effect of shareholder ratification is ambivalent:**
    - → Allowing shareholders to ratify director ability to take corporate opportunities accords with contractual approach – directors should be permitted to profit in situations where shareholders stand to benefit. A strict prophylactic rule precludes this.
    - ← Majority can oppress minority if voting is self-interested
  - **CA's finding of good faith may be flawed:** If the prospect of profit was so certain, the company should have been able to line up a loan – capital should have been easy to get. More contentiously, a personal guarantee may not have been all that risky for directors.
  - **Scope of individuals with duty is too narrow:** (i) Though Gulliver did not invest personally in the subsidiary, he should still be liable. As director of companies that did invest, he still had SDT incentives. D&H would be no less culpable if they formed a company and pursued the South Shore investment under its name. (ii) The lawyer should

be liable as one who knowingly participated in a fiduciary breach. (*Irving Trust v. Deutsch* will discuss this.)
    - **Conflict rule overlaps a lot with Profit rule:** Most often, personal opportunity to profit implies conflict with duty to company. Normally, if there is conflict re opportunity, it is due to ability to profit personally in some way. Though *Keech v. Sanford* is an exception, the 2 rules overlap quite a bit.

Phipps v. Boardman (HoL, 1965)

P.400

- **Synopsis**: B&P are lawyer and accountant for trust; the trust owned 8k shares of a company. B&P try to get trustee appointed director but fail at vote, so instead they use private information gained from their internal position to purchase enough shares to gain control of the company. They turn the company around, generating profits. The trust sues B&P for breach of FD. Majority held that FD was breached since (i) profit rule is triggered when B&P used fiduciary position to gain knowledge and use it to profit and (ii) trust's inability to profit itself (since it could not invest) is no defense since they could have changed the terms of the trust to allow investment. Dissent argues that only knowledge gained/used by the fiduciary that is (i) confidential and (ii) conflicts w/ duty is sufficiently related to his position to trigger profit rule (and thus, breach of FD).
- **Policy**: strict rule (Denning) is arguably better since (i) it makes it easier for courts in assessing whether the opportunity is something the corporation would have pursued on its own and (ii) it deters directors from engaging in any potential takings; BUT – IAC thinks that strict rule is SUBOPTIMAL since (i) it causes over-deterrence, (ii) it causes DWL where corporation would not have taken the opportunity and (iii) it does not facilitate reduced compensation of directors (which may be achieved if Ds know at the time they K w/ company that they may profit from taking corporate opportunities).
- Facts
    - B & P were solicitor for and accountant for trust which owned 8000 shares of company.
    - They concluded company was underperforming and attended company's general meeting with proxies of estate.
    - They tried to get Tom (son of the estate) appointed as director. B&P tried to get control of company.
    - Trustee could not have invested in company, so P&B decide themselves to invest in company. They got information from company about how it was doing business (e.g. private share prices) and used it to take control.
    - After obtaining control, company turned around – trust made money, and B&P made money.
    - One of beneficiaries says B&P's profits were held in trust for the estate. Estate sues for breach of FD. Nobody argued that there was dishonesty, but nobody argued that permission was gained from trust or beneficiaries to pursue opportunity.
- Issue
    - Did B&P breach FD by acting on information obtained through fiduciary positions vis-à-vis trust? (This is not a corporate FD case, but lessons are eminent.)
- Decision
    - FD was breached – order to disgorge profits
- Reasoning (Lord Denning)
    - **Corporate Opportunities**
    - **But-for Information is Property subject to Profit Rule:** By asking for information in role of trustee, B&P are treated as such. Here, knowledge gained was in that role and was

used personally and not professionally to make profit. Unless principal consents, agent must pay AOP to trust, regardless of effect on trust.
    - **Inability to profit corporately is no defense:** Here, trust was barred from investing further in company (so essentially no conflict), but Court says that trustees could have gone to court and changed terms of trust to permit further investment. This point nicely demonstrates why the conflict rule and profit rule may be the same. The conflict causes the directors to not go to change trust terms.
- Reasoning (Lord Upjohn, dissenting)
    - **The Treatment of Information**
    - **Information is not necessarily property:** Not all info is "property of the trust." Otherwise, trustee would be hampered from acting in personal capacity. It is only property if (i) confidential (ii) creates conflict with duty. The consequence of Denning's rule would be to make it difficult for private trustees to administer more than one trust. Rule should be narrowed. Here, no conflict (since no way of injuring trust) and info wasn't confidential.
    - **Conflict must be real, not hypothetical:** Denning (above) made up idea of changing terms of this trust to permit investment. We don't know how remotely possible this is, and it does not qualify as a legitimately possible conflict which would implicate FD.
- Case Comment
    - **Role of property in judgments is unclear:** On one hand, case seems to turn on whether info is property. On other hand, property analysis falls out from judges' predispositions.
- **Arguments in favour of strict rule (Denning):**
- Easier for courts since do not have to determine whether the opportunity is something the corporation would have wanted to pursue on its own
- Deter directors from engaging in taking opportunities that would otherwise accrue to the corporation
- **Arguments in favour of flexible rule (Upjohn – IAC favours this interpretation):**
- Avoid over-deterrence: strict rule may overdeter. In this case, trust was better off since 8000 shares appreciated due to B&P's behaviour. We want to encourage, not deter, this sort of behaviour.
- Sometimes, everyone wins – beneficiaries of trust win from opportunistic behaviour of director. Here, shares would have languished if not for B&P's bold moves.
- If directors can use positions to profit personally, then director participation is induced and directors can be compensated at a discount.

Bendix Home Systems Ltd. v. Clayton (BCSC, 1977)

P.408

- **Synopsis**: D uses non-unique information gained in his position as director to create startup. Held that there was no breach of FD since any D/O in the industry would have had that information.
- Context
    - Involves both breach of confidence and breach of fiduciary duty
- Facts
    - D was president, director and CEO of P company
    - Alleged that he used his position to put into place another company which took managers from the P company
    - Alleged breach of confidence was the improper disclosure of proprietary information which D acquired in position as president of P company
- Held

- No breach of confidence since all matters pleaded were those which any company would be expected to know and to take with him from job to job in the industry

Peso Silver Mines Ltd. v. Cropper (SCC, 1966)

P.410

- **Synopsis**: Peso board turns down opportunity for mining claims; weeks later 4 Ds set up private company and take the claims, arguing that the company was started to hold the claims for Peso. Later Peso is purchased, and new President sues D for breach of fiduciary duty. Held that there was no breach of FD since D acted in good faith, giving the option to take the opportunity to Peso first. In addition, application of the conflict and profit rule lead to the conclusion of no breach since (i) not all personal dealings w/ continuous offers to a company automatically lead to a conflict. Further the BoD's abandonment of the opportunity made information available to Ds to use since company no longer interested in those claims.
- **Policy**: (i) giving evidence of BoD's prior rejection of the opportunity substantial weight is flawed since rejection is not good evidence of no conflict: since at the time of vote Ds may reject for the very reason that they will take it personally in the future. The incentives of the relaxed rule may be optimal since avoids over-deterrence problems.
- Facts
  - In 1962, Peso was offered the Dickson mining claims which were contiguous to Peso land, but the board turned down the offer due to insufficient capital and overextension of projects.
  - 6 weeks later, 4 members of the BoD formed a private company and took on the Dickson claims. Walker stated that reason for purchasing Dickson was to keep it available to Peso eventually. (If ore exists on own land, want to buy contiguous properties in case it extends.)
  - In 1963, Peso was acquired by Charter, whose president asked 3 members (Cropper, Walker, Verity) to turn over their stake in Dickson to Peso.
  - Cropper refused, so the president of Charter (Peso) used his majority control to commence suit against him.
- Issue
  - Do directors breach their FD by pursuing opportunities that the company was not equipped to take on?
- Decision
  - No breach of FD.
- Reasoning
  - **Corporate Opportunities**
  - **Good faith finding helps:** Cropper acted in best of faith in both transactions. The private one was after the Peso one was already out of his mind.
  - **Conflict Rule and Profit Rule can be applied:** First, Court says that not all personal dealings with continuous offers to a company automatically lead to a conflict. Then, test articulated is MacMillan 2-part Profit Rule test: (i) knowledge in execution of office (ii) profit.
  - **BoD Rejection constitutes abandonment of the information:** Here, Court says knowledge not gained in execution of office since once BOD rejected claims, they were no longer directors with respect to those claims. Good faith rejection is best evidence that claim not in company's interests – Peso was not interested.
- Case Comment
  - **SCC and CA assign too much weight to BOD rejection:** The SCC endorsed the CA's reasoning. They cite *Regal* and Lord Russell's support of Green's obiter as

jurisprudential foundation for rejection being good evidence of no conflict. But *Regal* didn't put a lot of stock in rejection. Here, rejection was assigned decisive weight. Norris JA's dissent rearticulated the rule in *Regal* strictly.

- **Rejection is not good evidence of no conflict:** When directors vote on investment, they may turn down the transaction ***precisely because they want to undertake it in personal capacity***. Whether the vote was bona fide becomes the real question. Assuming it was bona fide sidesteps the problem. Here, the Court's reliance on rejection goes against the institutional competence argument laid out by Lord Wright in *Regal*.
- **Incentives of a relaxed rule of some sort may be optimal:** The strict rule is rejected in this case. Though it is rejected on faulty reasoning, there is merit to permitting directors to pursue corporate opportunities. With strict rule, Cropper will have no incentive to buy the Dickson claims for himself and hold them and sell them at low TC to Peso – he only bears downside risk since he has to account for profits if caught. The strict rule may over-deter.
- **Merits of strict rule offset relaxed rule somewhat:** Strict rule doesn't preclude these opportunities. Rather, a mere vote is required. BUT there are TCs associated with voting – information circulation at corporate expense and special meetings of shareholders.
- **Contractual approach is appropriate principle to govern:** What duties would shareholders want to impose? The strict rule works, but some flexibility may be warranted.

Irving Trust Co. v. Deutsch (US 2nd Cir., 1934)

P.416

- **<u>Synopsis</u>**: seller of patents wants buyer company to buy shares in seller company, but buyer company cannot afford to do so. Ds of buyer personally buy shares in seller in exchange for their company's purchase of patents. Ds sell the stock on the market and their company also goes bankrupt. Trustee for the company brings a claim for Ds disgorgement of profits from sale of shares. Held that FD was breached since if allowed Ds would be permitted to not exert strong efforts on behalf of the corporation in its pursuit of the opportunity, knowing they could benefit personally from the taking (in this case, Ds should have tried harder to raise funding – facts lead to questioning of good faith).
- **<u>Rule</u>**: ***duty extends to non-fiduciaries***: one who knowingly participates in a fiduciary breach becomes jointly and severally liable with him for the profits. However, individuals do not have a constructive duty to inquire about potential breaches of FD by their conduct.
- **<u>Policy</u>**: rule endorsed here influenced by the court's skepticism of Ds to act in good faith under a permissive rule.
- Facts
  - Acoustic sought to acquire patent rights from DeForest (owned by Reynolds)
  - Reynolds would not sell patents outright, but would on condition that Acoustic acquired 1/3 of DeForest's stock.
  - Director of acoustic investigated whether company could afford to purchase stock. The company couldn't afford, so BoD approved resolution allowing several directors to purchase the stock, and facilitating a clear benefit to Acoustic by allowing for utilization of patents.
  - Directors then sold the stock in the market for substantial profit. Acoustic became bankrupt, and trustee brought action against defendant directors seeking to recover gains that various directors realized from buying DeForest shares.
  - BOD's defense was that they only bought shares to benefit Acoustic.
  - The trial court found breach of FD.
- Issue

        - Do directors owe FD when their actions are pursuant to intentions which help the company and with respect to an action which was not considered a corporate opportunity?
    - Decision
        - Breach of FD.
    - Reasoning
        - **Corporate Opportunities**:
        - **Strict prophylactic rule endorsed:** If Court accepted the argument that corporation was unable to undertake the venture, then directors would be permitted to refrain from exerting strong efforts on behalf of the corporation in order to benefit personally. A stronger effort should have been made to procure the necessary funds. This is only way we can know that directors did all they could to get benefit for Acoustics since it's too difficult for courts to evaluate whether Acoustic was positioned to take advantage of the opportunity.
        - **Good faith questioned:** Court acknowledges that BOD of Acoustic did not do certain things that they may have pursued to obtain financing: (i) collection of $125K debt obligation from Deutsch; (ii) procurement of line of credit a few weeks earlier to facilitate share purchase
        - **Who Owes the Duty?**
        - **Duty is broadened to include non-fiduciaries:** One who knowingly participates in a fiduciary breach becomes jointly and severally liable with him for the profits. However, individuals do not have a constructive duty to inquire about potential breaches of FD by their conduct.
        - **Examples:**
        - **Negotiator is liable:** Bell negotiated on behalf of Acoustic with DeForest. He invested in shares. Since he was acting as agent of the corporation, he owed fiduciary duties in position as an agent. Court says whether or not he is fiduciary, he is liable because he "knowingly participated in breach of trust." (same as *Coleman & Knight* rule)
        - **Employee not liable:** Chief engineer was employee of Acoustic. Employee does not owe FD, as general proposition. He had nothing to do with negotiations. He invested because he was told it would help get patents. He didn't "knowingly participate in breach of FD."
        - **Seller:** Seller of shares didn't have to investigate carefully what was going on at Acoustic re who was buying shares. No duty imposed on Reynolds.
    - Case Comment
        - **Case conflicts with *Peso Mines*:** It's unclear to what degree skepticism re good faith conflicts with *Peso*. On one hand, court takes a harder line and is more skeptical of incentives for directors to act in self-interest. On other hand, mining industry may warrant deference.
        - **Inability to finance is a poor justification for passing up opportunity:** Though it is difficult for court to know whether financing was available, as a general rule, if directors perceive investment as worth the personal risk, then investment is likely a good deal. (But this assumes that directors are no more risky in their own investments than they are in business investments.) Assuming that capital markets work reasonably well, it is fair to assume that capital would be available for the investment. Of course, markets aren't perfect, and there are exceptions.

Canadian Aero Services Ltd. v. O'Malley (SCC, 1973)

P.419

- **Synopsis**: EEs of company (Can Aero) assigned mapping project, but before they start, they resign and incorporate another company that wins the bid for the project. Can Aero sues former EEs for breach of FD. Held that duty was breached since corporate opportunity was denied generally (even though bid's differed, still took opportunity); (ii) EEs benefited, regardless of dishonesty; (iii) unnecessary to show opportunity would have been corporation's but-for the occurrence of the impugned conduct.
- **Rule**: see 4-part test below
- Facts
  - Can Aero employees were assigned to Guyana to pursue contract for mapping the country
  - They resigned and then incorporated Terra to perform the identical work and compete against Can Aero in bid
  - Terra's bid beat out Can Aero's
  - Can Aero sues, saying that employees breached duty
  - Court of Appeal found that relationship was not fiduciary, that it was employer/employee
- Issue
  - Does an employee of the company owe a fiduciary duty with respect to corporate opportunities?
- Decision
  - Breach of FD owed and breached.
- Reasoning
  - **Corporate Opportunities**
  - **4-part contextual test articulated (different from Profit/Conflict rule):**
  - **(1) Nature of relationship:** Top management has duty akin to directors. Since these 2 acted like VP and President prior to resignation, they were akin to senior officers (s.122 duty catches EEs who act like Os). FDs aren't restricted to directors, and CA erred in finding that they were just employees.
  - **(2) Duty owed:** Duty embraces loyalty, good faith, avoidance of conflict. Duty includes not being allowed to pursue corporate opportunity without approval of company for any property/advantage either belonging to company or for which it has been negotiating. Duty is stronger for the actual negotiators.
  - **(3) Breach of Duty:** Factors include:
  - (i) Position or office held;
  - (ii) Nature of the opportunity – ripeness, specificness to interests of the company, director/manager's relation to the opportunity;
  - (iii) nature of knowledge – amount, circumstances of obtaining info, level of confidentiality
  - (iv) circumstances of termination and time passed since – duties extend beyond resignation, and resignation is more culpable than being fired.
  - **(4) Damages:** Profits must sometimes be disgorged even if not gained at expense of the company, as in this case.
  - **Application:**
  - **Corporate opportunity is defined generally – minor details don't detract:** Though Terra submitted a different bid than Can Aero, the altered details of the opportunity do not change the fact that it was the same opportunity sought.
  - **Dishonesty is irrelevant:** All that matters is that directors benefited.
  - **No but-for test required:** It is unnecessary to show Can Aero would have won but for Terra.

- Case Comment
  - **Contextual approach accords with contractual approach:** Strict profit/conflict rule led to overdeterrence, which parties would not want. Contextual rule balances deterrence with overdeterrence while looking to what parties would want ex ante.
  - **Relevant factors differ from *Peso* – may not overrule it:** (1) In *Peso*, court found that opportunity was rejected in good faith. Here, Can Aero never rejected – it remained interested. (2) Peso's mining claims were continuous, with many rejected. This K was one which Canaero consciously chose to pursue.
  - **Officer defined broadly in CBCA s. 2:** "officer" – means an individual appointed as an officer under section 121, the chairperson of the board of directors, the president, a vice-president, the secretary, the treasurer, the comptroller, the general counsel, the general manager, a managing director, of a corporation, or any other individual who performs functions for a corporation similar to those normally performed by an individual occupying any of those offices
  - **Strict rule is mandatory, not enabling:** FDs are meant to address principal-agent problems arising from separation of ownership and control. Strict rule recognizes degree of control inherent in officer functions and level of autonomy which must be curbed to protect owners.

(iv) Competition

- **Problem:** Directors engage in a competing enterprise directly or indirectly through equity interest.
- **Question:** what scope is there for future employment in same line-of-business?

London and Mashonaland Explor Co v. New Mashonaland Explor Co (1891)

P.434

- **<u>Synopsis</u>**: Mayo is the D and chairman of P company, but articles do not forbid him from becoming a D of another company; Mayo becomes D of competitor as well. Held that FD was NOT breached since (i) corporation's articles did not forbid him from being a D of another company (i.e. lack of exclusivity) and (ii) there was no evidence of divulging of confidential information. Notes that this would be different in the partnership context.
- **<u>Rule</u>**: an individual can be a D on the boards of competing companies, absent its prohibition in company articles or private contract; endorsed in *Bell*
- **<u>Policy</u>**: (i) permissive rule is inconsistent w/ enabling approach since increases TCs by way of requiring parties to explicitly K around no liability; a default rule disallowing membership on competing boards would reduce TCs. (ii) rule in this case is inconsistent w/ jurisprudence of strict rule for SDTs and taking of COs.
- **<u>Note</u>**: see notes on Abbey Glenn, Scottish Co-Op and Bendix
- Facts
  - Lord Mayo accepted appointment as director of P company, and circular included his name as director/chairman. He never carried out activities in that regard.
  - A prospectus (heavily-regulated document sent to prospective investors outlining business) was then circulated for D company saying Lord Mayo would be head of its list of directors. There was no contractual provision or article in P company's AIs saying he could not become director of a similar company.
  - Mayo took a position as a director w/ another competing company
- Issue
  - Does Lord Mayo breach FD to P by accepting directorship with D?
- Decision
  - No breach of FD.
- Reasoning
  - **<u>Non-compete duty</u>**

- **Prohibition on serving in 2 competing posts must be explicit:** Nothing in articles required him to give any part of his time, or his whole time to the business of the company or prohibited him from acting as director of another company. No contract express or implied gave his personal services to P and not to another.
- **Confidential information sharing could be problematic:** In this case, there was no evidence that confidential info would be divulged.
- **Partnership environment is different:** In partnership, duties may be owed to partners. However, that is not the case here.

- Case Comment
  - **Positive treatment of case:** *Bell v. Lever Brothers* adopted same reasoning, saying if nothing in articles restricts acting as director for rival, then no reason to restrict from acting for rival.
  - **Enabling approach favours strict rule with AA opt-out:** *Prima facie*, there is conflict in competing directorship situation since competition is zero-sum game with winner and loser. Therefore, default rule should prohibit competition. Though parties could adopt strict rule in AA, default flexible rule would lead to increase in TCs contracting around the optimal rule and, in some cases, working out convoluted contingencies. On **functional approach**, AA opt-out would inform FD and cause certain opportunities to be pursued.
  - **Case is inconsistent with jurisprudence and enabling model:** The **doctrinal approach** employed in the case is inconsistent with the enabling model and with jurisprudence regarding corporate opportunities, where FDs are enforced strictly.
  - **Possible rationale for doctrinal approach:** (i) SDTs and corporate opportunities are difficult to contract around. However, non-compete clauses can more easily be tailored to individual companies. (ii) Collusion might be facilitated among the 2 companies for the benefit of the companies. Iacobucci thinks these are insufficient reasons, since difficult to craft a non-compete as well.
  - **Negative treatment of case:** We've moved away from these cases.
- Note
  - **Oppression remedy applies in competition cases:**
    - In ***Scottish Cooperative Wholesale Society v. Meyer*** [1959](HL), Denning said that s. 241 (oppression) would likely be brought for director who joined rival corporation and preferred their concerns.
  - **Contextual approach approved:**
    - (1) In ***Abbey Glen Property Corp. v. Stumborg*** [1976], Director may breach FD to A merely by acting as director to B. Duty to B cannot be a shield for breach of duty to A. *Canaero* contextual test will govern this inquiry.
    - (2) In ***Bendix Home Systems Ltd. v. Clayton*** (1978) CPR, Court took *Canaero* approach to defendant employees launching rival to compete with Bendix. Rule is that duty of loyalty and good faith is paramount to self-interest. Contextual analysis showed that recruitment of employees and discussions with same partnering allies breached duty in context of the case.

In Re Thomson (1930)

P.437

- **Synopsis**: executor of yacht business estate acts as yacht agent on his own. Held that FD breached since being in a competing position breaches FD.
- Facts

    - A executor (fiduciary to estate) for a testator who carried on business as a yacht agent opened up his own business as yacht agent.
    - The yacht agency business includes listing yachts-for-sale, and if they sell, agents take commission. Key factor is that multiple agents can list same yacht.
    - Therefore, executor can conceivably act as personal agent trying to sell yacht and act on behalf of agency that estate owned.
- Issue
    - Does this competing business breach his FD as trustee?
- Decision
    - Breach of FD.
- Reasoning
    - **Competition**
        - **Being in competing position breaches duty:** Director cannot enter into conflict of interest with beneficiary of trust. Here, success in personal agency necessarily deprives beneficiaries of commission on the particular yacht sale in question.

(v) Hostile Takeovers and Defensive Tactics by Target Management

(a) Introduction and Background

Jargon

- Raider
    - Makes bid for target w/o the support for the target corporation's board
- Target
    - The company being acquired
- Tender offer
    - First stage of a takeover bid (an offer to buy shares by the raider, which may or may not have conditions)
        - Securities law – puts restrictions on tender offers; have to treat all SHs equally
- If successful takeover, the acquirer takes over control of the company (could be that they purchase all shares, or only get control of 51%)
- Why "hostile"
    - Since incumbent board resists the takeover bid

How Hostile Takeovers Happen (Widely-Held)

- Potential acquirer makes an offer to all shareholders. Current shareholders have the option of tendering into the bid. Bid opens for a period of time, and shareholders deposit shares. Offer closes, and shares are taken up on pro rata basis, depending on amount sought.
- Typically, bidder will make friendly overture to BOD, which is rebuffed. Then, bidder goes straight to shareholders accumulating as many shares as possible to obtain power.

Why Hostile Takeovers Happen

- **Management discipline hypothesis:** Takeovers are motivated by gains that an acquirer can realize by displacing opportunistic management with more dedicated and efficient managers once control is obtained → potential for gain varies with severity of agency problems
- **Romano:** Raiders make bids for target company because target is poorly run – agency cost and synergy gain are most plausible explanation for takeovers.
- **Market for corporate control is socially beneficial:** Constraints on takeover market will exacerbate problems occasioned by separation of ownership and control

Why Fiduciary Duties are Implicated during Hostile Takeovers

- **Defensive tactics:** Management's jobs are on the line, and even if takeover is good for shareholders, managers will reject it, using defensive tactics.
  - **Poison pill** in articles can make it unattractive to acquire control by diluting the acquired interest such that the transaction is irrational. Bids under these conditions are made conditional on the pill being withdrawn.
  - A more appropriate way (if notice is provided) to avoid HTs is with **dual class share structure**, where managers own all voting shares and others own non-voting shares, causing management to be invulnerable to takeover bid.
- **Fiduciary duty may be breached with takeover defences:** Not all takeover defences should be permitted, and not all circumstances should allow them. Restrictions are necessary.

Statutory Provisions (CBCA)

- **25. (1) Issue of shares –** Subject to the articles, the by-laws and any unanimous shareholder agreement and to section 28, **shares may be issued** at such times and to such persons and for such consideration as the directors may determine.

- **34. (1) Acquisition of corporation's own shares** – Subject to subsection (2) and to its articles, a corporation may purchase or otherwise acquire shares issued by it.

- **189. (3) Extraordinary sale, lease or exchange** – A sale, lease or exchange of all or substantially all the property of a corporation other than in the ordinary course of business of the corporation requires the approval of the shareholders in accordance with subsections (4) to (8).
- Note
  - Power to declare dividends, initiate takeover or amalgamation, or sell shareholder assets (sometimes subject to shareholder vote)

- **6. (1) Articles of incorporation** – Articles of incorporation shall follow the form that the Director fixes and shall set out, in respect of the proposed corporation, … (d) if the issue, transfer of 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; …
- Note
  - Power to refuse to register a share transfer if such power is conferred in AA

(b) Older Canadian Common Law

Bonisteel v. Collis Leather (ON, 1919)

P.465

- **<u>Synopsis</u>**: Board issues shares to make takeover more difficult. Held that it was an improper purpose to issue shares to effect control; shares may be issued for raising capital for project.
- Facts
  - Directors confronted w/ potential acquirer
  - Directors believed it not to be interest of company that the deal proceed
  - The directors caused the corporation to issue more shares, to make it more difficult for the acquirer to take over the company (since now more difficult to buy enough shares to have sufficient control)
- Reasoning

- **Cannot issue shares to effect control:** Court found (and *Hogg v. Cramphorn*) share issue to be for improper purpose - directors do not have power to issue shares for purpose of effecting control. Court set aside the share issue.
- **Can issue shares to raise capital for projects**

Teck Corp. Ltd. v. Millar (BCSC, 1973)

P.466

- **Synopsis**: Millar, a major mining company, approached jr. miner Canex to do deal, but cannot agree to terms. Canex then purchases stake in Afton Mines for $3/share, earning the right of first refusal. Teck owned a majority of Aften Mines buy buying shares on market for $13/share. In order to subvert Teck taking control, Millar agreed to deal w/ Canex, issuing more shares to give them a 30% stake in Afton, and in the process, diluting Teck's holdings. Teck sued Millar on the basis that it breached FD.
- **Held**: No breach of FD since (i) there is no reason to distinguish discretion in share issuance from discretion in other matters for Ds; (ii) Ds were acting for a proper purpose under old rule and therefore are given broad discretion so long as they are acting in good faith and upon the reasonable belief that there would be harm to the corporation. The onus is on the plaintiff to prove that defendant corporation was acting in bad faith or on an unreasonable belief. Further, there is no duty to solely protect the majority SH, just that decision must be made with an eye to the best interests of the corporation.
- **Rule**: Ds given broad discretion to defend against takeover in acting in best interests of the corporation, so long as Ds: (note: presumption (i-ii) below are met; burden on P to disprove), (i) act in good faith, and (ii) have reasonable grounds for their belief that there will be a danger to the company if the takeover proceeds
- **Policy**: (i) court is naive to think that Teck is acting in the best interests of the corporation and in good faith in the takeover context, since there is an inherent conflict of interest since likely that Ds will be replaced if takeover goes through.
- Facts
    - Millar led group that started Afton Mines, whose asset was copper claims in BC.
    - In mining industry, junior mining business holds claims, and they enter "ultimate deal" with major mining company to develop those claims. In ultimate deals, junior will give equity to major in exchange for major's commitment to explore/develop the claim.
    - Millar, a major mining company, approached Canex (Placer subsidiary) for possibility of doing ultimate deal, but Millar rejected terms.
    - They subsequently purchased 100,000 shares @ $3 in Afton to receive right of first refusal on future financing (ultimate deal).
    - Earlier, Millar had met with Teck, who offered $4 for same claims, but Millar turned them down. Teck then began purchasing Afton shares in the market, and they obtained majority within a year at approximately $13 per share.
    - When everyone (including Millar) knew that Teck was about to take control, Millar accepted Placer ultimate deal where Placer would get 30% stake in claims (notwithstanding Teck's actions in anticipation of getting control).
    - Deal ratified on June 1. On May 31, Teck insisted that lawsuit would ensue if deal was made involving issuance of shares. Teck sued following deal.
    - Judge found as fact that this was not battle over control – it was about Millar doing what was best for corporation. However, Teck says directors do not have discretion to protect best interests of corporation in battle over control.
    - Note: Issuing 30% shares would lead into realm of "issuing shares for improper purpose."
- Issue
    - Did Millar breach FD by finding white knight to avoid Teck takeover?

- Decision
  - No breach of FD.
- Reasoning
  - <u>**Issuing Shares to Avoid Hostile Takeover**</u>
    - **Skepticism re rule in *Cramphorn* and *Bonisteel***: The *Cramphorn* rule precludes issuing shares to affect control if it is in best interests of corporation. However, there is no reason to distinguish share issuance from other activities.
    - **New era gives way to broader discretion to defend against takeover:** Directors should be given more discretion to determine who is seeking control & why in acting in best interests of company. Limitations on discretion include (i) acting in good faith and (ii) must have <u>reasonable grounds</u> for their belief.
    - **Reasonable grounds includes fundamental change in policy:** Extent of damage that must be anticipated is fundamental change in policy that would have profound consequences to company's whole way of doing business and which would be damaging.
    - **Even if control is inevitable, best interest deal is not improper purpose:** Here, Millar was resigned to Teck getting control. But there's nothing wrong with trying in good faith to get best deal possible while still in control. They negotiated for good deal. Teck's existence does not convert their interest to an improper one.
    - **Onus of proof is on the plaintiff to show unreasonable grounds:** Directors can defend against takeover under guise of best interests, and burden is on P to show bad faith or unreasonable grounds (not shown in this case).
    - **No requirement to protect shareholder interests of acquirer:** Millar had no duty to protect Teck's interests – it could in law ignore best interests of majority shareholder in favour of corporation as a whole.
- Case Comment
  - ***Cramphorn* rule may not be inconsistent with "best interests" duty:** Since director jobs are at stake, court may still be required to investigate director's behaviour to make sure deal is sanitized even if under guise of best interests. By saying we always allow directors to act in best interests and extending the reasoning to hostile takeover circumstance, court is naïve.
  - **Instead of letting directors defend, perhaps shareholders should decide:** Shareholders are the only stakeholders. We might worry that (i) majority may oppress minority through SDT (but safeguards exist) or (ii) competing visions for company are inconsistent. Re (i) SDT may be in best interests of corporation; otherwise, Teck would stay away. Re (ii) poor vision is costly for Teck, who acquires 51% and cheap for directors, who have no money at stake and will lose their jobs if they stand idly by. Directors will always prefer their entrenched policy to a newly-proposed hostile one. We should just let shareholders vote with their shares.
  - **Onus of proof is too deferential:** In Delaware, onus is not always with bidder. Here, it is assumed that Millar pursued deal with Placer out of best interests. Though he knew that Teck would be prejudiced by decision, Millar went with Canex. Millar was permitted his discretion even though thinking was intuitive & unrefined, based on business acumen.
  - **Proving bad faith is challenging with corporation broadly-defined:** Court takes broad view of "best interests of the corporation." As long as directors can point to harmed stakeholders from change in control, good faith can be shown. This gives directors lots of discretion to pursue job entrenchment strategy.
  - **Proper purpose argument was already discarded by older courts:** Court says that even if directors were trying to thwart control, acting in best interests of corporation is for proper purpose. But older courts disregarded this argument.

- **Directors should not be permitted to resist takeover to protect employees:** Concerns: (1) Acquirer may pursue takeover to undermine pay-for-seniority arrangements and redistribute wealth from employees to corporation. By being unable to make implicit promises re pay raises to employees, company may lose benefit of the implicit promise. However, if this logic holds and implicit promises are valuable, then acquirers wouldn't renege. There are reasons to be skeptical of this motivation. Also, takeover isn't necessary to renege on employee contracts – if it was value-added, incumbent managers would do it. (2) We might think we should permit takeover defences to allow directors to avoid the social costs of employee layoffs – though maintaining productivity with fewer employees is Pareto efficient, frictional unemployment may offset gains. On the other hand, corporate law may not be best framework to handle employee concerns.
- **Empirical evidence refutes this takeover theory:** (1) Lower-level employees subject to the implicit promise tend not to get laid off in great numbers during takeover. Normally, it's middle/top management that are laid off. (2) Unions normally undermine the use implicitness in pay raise contracting.

- Notes
  - **Negative treatment of case:** In *Exco Corp. v. Nova Scotia Savings & Loan Co.* (1987) (NSTD), directors distributed stock to friendly parties in order to defeat unwelcome takeover bid. Court articulated requirement that directors defend actions as inconsistent with personal interests. This case is skeptical of *Teck*.
  - **Oppression remedy may be better forum:** Advantages of challenging takeover under oppression remedy include (i) no-frills application procedure (ii) fairness standard is broader (iii) wider remedial jurisdiction.

(c) US Common Law

- **Delaware imposes duty on directors:** In *Cheff v. Mathes* (1964) (Del. Ch.), Court found that directors satisfy their burden by showing good faith and reasonable investigation. They will not be penalized for honest mistake of judgment.

Unocal Corp. v. Mesa Petroleum Co. (Del. S.C. 1985)

P.480

- **Synopsis**: Acquirer Mesa offers 2-teir bid for Unocal: first tier is at a price of $54 cash for 50% of the shares; the second tier is $54 in face value of junk bonds (subordinated debt), which is worth much less than $54 cash. As such, the offer was structured into coercing the SHs to tender their shares, since there is no downside risk if the offer does not go through, but there was downside risk if they did not tender and the offer did go through. However, in response Unocal proposes a share buyback at a price of $72 of senior debt (excluding Mesa from buying), making it very difficult for Mesa to gain control. Mesa claims that the self-tender by Ds of Unocal breached the FD.
- **Held**: No breach of FD since bid was coercive due to low price and 2nd tier junk bonds.
- **Rule**: see test below
- **Policy**: (i) SHs may not be better off from the defense since the money to pay the premium for the shares is coming in the form of debt to the same corporation (paying yourself to wash the dishes). (ii) The company's own offer is coercive as well, since they structure the offer in a similar manner, causing a reduction in value of the back-end shares. As a result, while the first 50% of shares may be repurchased at a premium, the remaining shares will be reduced in value proportionally, since the company has become less valuable (more debt).
- Facts

- Mesa underwent two-tier bid for Unocal, in which it attempted to acquire *de facto* control and then squeeze rest of shareholders out. In order to defend against bid, Unocal management offered to repurchase shares of Unocal at a premium from all shareholders except Mesa.
- Mesa's bid was deemed coercive due to its two-tier nature. Mesa offered $54 cash for 50% of the shares of Unocal. It then was going to buy the rest of the shares after taking control in follow-up transaction.
- For the rest of shares, Mesa offered $54 in face-value of various subordinated debt – debt obligation that company owes to former shareholders of Unocal, but debt obligation is subordinated: they come last after other creditors. Subordinated debt is worth less than $54 cash – due to risk of non-payment. (junk bonds)
- The bid is coercive because investors will rationally tender in to avoid being screwed on back end: if bid succeeds, tender is appropriate; if bid doesn't succeed, not tendering leads to being no better off. Everyone will tender. Only if shareholder has large portion of shares will decision affect probability of success.
- Company offered $72 of senior debt to repurchase shares and thwart Mesa bid. This would make it difficult for Mesa to get the 51% it sought for control. Mesa says directors breached FD to all shareholders including Mesa, with the self-tender.
- Unocal says it was good faith; they took care.

o Issue
- Did directors breach FD with defensive tactic of competing bid?

o Decision
- No breach of FD.

o Reasoning
- **Defensive Tactics in Bid for Control**
- **Selective treatment is permissible:** Efforts to defeat offer would have been thwarted by including Mesa in exchange offer. Therefore, selective treatment is permissible. However, it would be impermissible if done to entrench themselves in office.
- **Burden of proof is on directors due to omnipresent spectre:** In managing the company, potential conflict of interest requires judicial examination of behaviour as threshold inquiry before BJR is conferred.
- **TEST (onus on defensive D to show):**
- **(i)** Must show **reasonable grounds for believing there was danger to corporate policy** and effectiveness due to another person's ownership – easier to prove if outside directors perceive threat - This burden is satisfied by showing "good faith and reasonable investigation" – defensive actions must be proportionate
- **(ii) Proportionality:** Defensive tactic must be reasonable in relation to threat posed. Factors to consider in evaluating nature of bid & effect on enterprise – (i) inadequacy of price, (ii) nature/timing of offer, (iii) illegality, (iv) impact on other constituencies, (v) risk of nonconsummation, (vi) quality of securities being offered. Here, bid deemed coercive because price was low and Mesa's bonds on back end were junk bonds.
- **Note:** If satisfy above test, defensive Ds are protected by the BJR; if do not satisfy above test, onus shifts to plaintiff to show breach of FD

o Case Comment
- **Low price should not be threat factor:** If everyone thinks price is too low, then just don't tender into bid. In and of itself, low price is not threatening.
- **SHs may not be better off:** The shares are being bought back at a significant premium, but it is coming from the company who they own → idea is that they are taking money out of the corporate treasury and paying themselves with it
- **Problem - Coercion begets coercion:** Note that the self-tender itself is coercive – since if have a pot of money and overpay for half the shares, the remaining shares are worth

less – so again, there is this incentive to sell shares at first instance and exchange for debt obligation, since the existing shares will be worth less relatively speaking – since they just funded the extra debt that was issued

- **Standard is not perfect:** Ds are still given a great deal of discretion, and can easily argue that the takeover bid is undervalued.

Revlon Inc. v. MacAndrews & Forbes Holdings Inc. (Del. S.C., 1985)

P.484

- **Synopsis**: Board of Revlon decided, in consultation with advisors, that Pantry Pride's bid was inadequate and initiated defensive measures (issued Rights permitting Revlon to repurchase shares in event of takeover for less than $65; and issued noted containing a several covenants (make LBO less possible)). Revlon entertained rival bids, and accepted Forstmann's for $56 and included clause waiving covenants; caused value of notes to drop in market; PP announced would top any bid by F. F made new offer for 57.25, and requested lock-up clause (purchase sub for less than market value) and no-shop clause (Revlon will not seek another buyer), and break fee (payout to F if another R sold to another company). F would also support the par value of the notes (guaranteeing the debt, making the share price drop). Board accepted bid. PP offered $58 and filed for an injunction.
- **Held**: Ds defense tactics breached fiduciary duty since the board must auction the corporation to the highest bidder once a sale is inevitable. Note that the first prong of the *Unocal* test was easily met since there was an opinion that the price was low. In addition, there is no duty owed to creditors in the context of hostile takeovers, and can only consider other stakeholders' interests to the extent that they benefit the SHs (i.e. in this case, the interests to the creditors could not be used to argue for supporting the defense tactics, since supporting creditor interests came at a cost to the SHs).
- **Rule**: once sale of corporation becomes inevitable, then Ds must auction corporation to highest bidder as even-handed auctioneers.
- **Policy**: (i) duty to auction will increase bid price after first bid received, but likely reduces the probability that a bid will be received, and if it is received, it will likely be received at a lower value than it would have had there been no duty (incentive effects due to increased costs to bidders); this opens the possibility that perhaps the best rule is managerial passivity, where Ds got to SHs w/ first bid.
- Facts
  - Pantry Pride is going to make an offer for Revlon; R board meets and is told by banker that $45 bid would be inadequate and that the company would be worth $60-70 if it was broken up into component businesses and mid-$50s if held together; R's lawyer advises the board to repurchase its shares and adopt a notes purchase rights plan (not as draconian as some poison pills, but the same kind of thing: essentially forces the acquirer to buy for $65). PP is not deterred and makes an offer for $48/share, conditional on obtaining financing and on the rights being redeemed; R board rejects offer and, further, issue notes with covenants that restricted the ability of R to raise more debt, sell assets or pay dividends unless approved by the outside directors on the board. PP keeps sweetening bid and R rejects every time; eventually board authorizes management to look for a white knight.
  - R enters into agreement with Forstmann & Little for $56; R agreed to redeem the rights and waive the debt covenants wrt F&L bid; this waiver causes the value of the notes to fall. PP then makes a new offer for $56; R goes back to F&L, who agrees to sweeten its bid to $57.25 and top up the value on the notes, but in return gets (i) a "lock-up" option to purchase a particular division of R at a steep discount if it loses to another bidder, (ii) a "no shop" provision so R can't look for other bidders and (iii) a $25 mm break fee. PP

then ups its bid to $58 and seeks an injunction to prevent the lock-up and break fee from having effect

- Issue
  - Did directors breach FD through any of takeover defences?
- Decision
  - Breach of FD.
- Reasoning
  - **<u>Hostile Takeover once Sale is Contemplated</u>**
    - **Once sale is contemplated, duty to auction to highest bidder and treat suitors even-handedly:** Duty shifts from canvassing alternatives to facilitating sale at highest price. This case is different from *Unocal*, since that case did not involve alternative bidders.
    - **First prong of *Unocal* is easy to meet:** Here, mere opinion of low price met threat prong.
    - **Duty is not owed to creditors vis-à-vis HT:** Here, directors made support of the notes an integral part of the company's dealings with Forstmann, even though primary responsibility was to equity owners. However, notes rights were fixed by contract, and directors didn't have duty to them. Though BOD can consider others, must be rational benefit to shareholders. Here, directors benefited themselves by avoiding personal liability to creditors to whom no corporate duty was owed.
    - **Lockup fee to preferred bidder is not impermissible in general, but is not permitted in this context:** Lockup is not illegal, per se. Fact that they promised to sell Vision Care to Forstmann at $150 discount was not problematic. Idea is, company will want to attract people to bid. By promising compensation for bid, company may do good things for the shareholders by creating a bidding war. (B>C) However, result of this lock-up was not to foster bidding, but to destroy it.
- Case Comment
  - **No duty to creditors is appropriate ruling:** In *Unocal*, it was alleged that directors could consider wide variety of stakeholders. But duty to all is really duty to none. Here, directors might have avoided liability under guise of duty to noteholders. In any event, creditors don't need same protection as shareholders. Creditors can contract – they didn't need FD to cause Revlon to not incur more debt in the future. Part of this contract was that company could waive covenant in event of sale at fair price.. No reason to protect noteholders beyond that. They already protected themselves.
  - **Duty to auction may be appropriate:** *Prima facie*, high price benefits shareholders, and if shareholders don't like bid, they can choose to not tender. But see below.
  - **Easterbrook/Fischel: Lockup options and breakup fees may be bad for target shareholders:** *Prima facie*, providing incentives to compete for company is good for shareholders since it facilitates auction. Second bidder will not want to invest in i-bankers, lawyers, strategic analysis etc. unless it is compensated for its work. However, generating auction may ignore other effects. Though creating auction after bid will run up bid price, there is danger that no bid will be generated in first place if directors have duty to generate competition. Since 1st bidder has higher costs than 2nd bidder due to pioneer status, 2nd bidder can free-ride on 1st bidder's work. 1st bidder will thus incur much more risk in undertaking pioneer bid. 2 costs accrue to shareholders: (i) 1st bid may never come, which is bad because it comes at premium to existing price, or it may come at a lower price than it would have. With duty to auction, premium will be greater, but probability of receiving bid will be smaller. (ii) Market for corporate control has less

capacity to discipline managerial behaviour. Instead of generating auction, perhaps rule should be – go straight to shareholders with first bid.

- **Discretion for directors is empirically harmful:** Empirical evidence supports the notion that once you put directors in position to have discretion to say No to takeover bid, that lowers value of target company's shares. (That could be because they'll say No to any bid, which is clearly bad for shareholders.)

Paramount Communications Inc. v. QVC Network Inc. (Del., 1994)

P.491

- **Synopsis**: Paramount enters alliance w/ Viacom, prompting QVC to make unsolicited takeover bid. Clarifies US rules: Enhanced scrutiny test applies when Ds are (i) approving transactions resulting in sale of control , or (ii) Ds are adopting defensive mechanisms in response to threat of corporate control.
- Facts
  - QVC offered an unsolicited bid for Paramount after Paramount entered into strategic alliance with Viacom.
- Issue
  - When does Revlon duty to get best offer come into play?
- Reasoning
  - **Fiduciary Duty during Hostile Takeover**
    - **Test for enhanced scrutiny arises in unique circumstances:** (1) approving transaction resulting in sale of control and (2) adoption of defensive measures in response to threat of corporate control. 2 reasons for scrutiny: (i) Omnipresent spectre (ii) Once sale takes place, shareholders lose their once-only opportunity to get premium. Therefore, BJR is waived at these times.
    - **Content of scrutiny:** Scrutiny relates to both decision-making process and reasonableness of directors' action (substance). Decision need merely be reasonable – deference still exists.
  - **Initiation of *Revlon* Duty**
    - **Sale of control initiates duty – breakup unnecessary:** *Revlon* suggested that duty only arises if company will be broken up. However, sale itself creates duty to auction.
- Case Comment
  - **Unclear whether duty to auction should arise on sale:** If company will be broken up, only factor left to consider is price, since intrinsic value is not being protected in any event. If company will be kept together, perhaps other factors should be considered. On the other hand, if acquirer (Viacom) can really fix Paramount, then it will bid higher due to greater synergies. Therefore, maybe duty to auction should be maintained.

Pente Investment Management Ltd. v. Schneider Corp. (OCA, 1998)

P.495

- **Synopsis**: Schneider owns 70% common shares and 17% voting shares. Purpose of coattail provision in articles was to ensure equal treatment of voting shares and non-voting shares in the event of takeover; provision stipulated that
- (a) in order for control to be acquired via the purchase of voting shares, non-voting shares must also be purchased;
- (b) an offer for voting shares alone will create a right for non-voting SHs to convert their shares to voting shares;
- (c) the option to convert would not arise if 50% of non-voting SHs refused the offer; and

- (d) Schneider could ensure coattail not triggered if they filed certificate declaring their intention not to participate in the offer.
- Maple leaf tried to acquire by making non-identical bids for voting and non-voting shares, triggering the coattail provision; Smithfield makes better offer and Schneider likes it. BoD, on recommendation from special committee, removes some barriers to the transaction. Schneider enters lock-up w/ Smithfield, but then receives subsequent offer from Maple Leaf at a premium to Smithfield's offer. Found that Schneider liked Smithfield better due to tax savings, even though Maple Leaf offer was higher.
- **Held**: Ds did not breach fiduciary duty.
- **Rule**: see New Rule (CAN) under Hostile Takeovers in Short Summary
- Facts
  - The Schneider family held 70.5% of voting common shares and 17.2% of non-voting A shares of Schneider. In articles, **coattail** provision was enacted aimed at ensuring equal treatment of voting shares and non-voting shares in event of takeover bid. Basic idea of coattail: 2 classes of shares – if you want to get control by buying voting shares, you also must buy non-voting shares. On offer for voting shares alone, A shareholders have right to convert their shares to voting common shares → takeover would be forced to be extended to A shares. Shares would not be convertible if 50% of common shareholders refused the offer. Then, control can become contestable (without Schneider family having the same control that they had before). Other aspect of coattail was that Schneider family could ensure that coattail was not triggered if they filed certificate saying they didn't intend to participate in takeover offer.
  - Maple Leaf tried to acquire control by making 2 non-identical bids for both classes of shares, triggering the coattail provision at $19 a share on November 5, 1997. They made another offer of $22, which was refused. Schneider attracted other bid from Smithfield. Smithfield made a $25 a share offer, which Schneider family liked, since it was best combination of financial value, commitment to Schneider family values, commitment to all stakeholders in Schneiders. They don't stress that structure of Smithfield bid was such that Schneider family themselves would get tax savings of $4 per share (even though not everyone would be in Schneider family tax bracket).
  - Nesbitt Burns went to special committee and advised that PV of Smithfield proposal was $23.50 – they also said that if nothing materialized, shares would be worth around $18 per share. (With this sort of discrepancy, it is highly likely that there will be change in policy.*) BOD refused to sanction transaction. Schneider family wanted to approve the Smithfield transaction, so they needed BOD to waive standstill provision and remove the rights plan. BOD did this, on recommendation of special committee.
  - On December 18, family entered into lock-up agreement with Smithfield. Company says – Smithfield, if you want to buy, announce a bid for the shares – they made bid to shareholders conditional on getting Smithfield shares. They entered lockup, where Smithfield made commitments to keep Schneider family name and seat on board of Smithfield. Following lockup, Maple Leaf made a subsequent $29 a share offer. BOD reviewed the various proposals and found that even though there was $4 discrepancy, tax savings to Schneider family was decisive. Some institutional investors launched complaint about way that directors behaved.
- Issue
  - Did directors act in breach of FD in helping family accept Smithfield offer?
- Decision
  - No breach of FD
- Reasoning
  - **FD during Hostile Takeover**

- ***Teck* "reasonable ground" test is adopted:** Court adopts *Teck* – management in accordance with best judgment, which must be reasonable. If no reasonable basis, then can't act.
- **Delaware enhanced scrutiny test adopted (*Paramount*):** Court will look for reasonable, but not perfect, decision regarding adequacy of decision-making process reasonableness of the actions in light of circumstances then existing.
- **Onus may not be on directors if self-interest addressed:** In Delaware, onus is on directors to demonstrate reasonableness and good faith (*Unocal*). Here, Court says that if steps taken to avoid conflict of interest, then onus is not on directors to satisfy 2-pronged test. BJR holds.
- **Special committee can satisfy onus:** Such a decision garners respect under BJR, provided that special committee discharged role independently, in good faith, and that in change of control transaction, special committee only agrees to best available alternative.
- **Senior management is allowed to negotiate bid without burden shift:** In *CW Shareholdings*, it was found that participation of management in special committee does not taint approval of a bid. Potential conflict of interest must be weighed against benefits of having informed party negotiate. Here, special committee made final decision, after input of director. Dodds was better equipped to determine bid quality. It would be problematic if inexpert special committee was the ultimate decision-makers.
- **Data room is permissible:** Shareholders complained that company should not have created data room or used company resources to generate bids. However, the data room also benefited shareholders by facilitating bid process.
- **No *Revlon* duty to auction due to other factors:** *Revlon* is not the law in Canada/Ontario. There is a duty to ensure that conflicts of interest are avoided in process, and auction may be 1 way of doing that, but there's no requirement of an auction. The principles in *Paramount* offer guidance. Board is not limited to considering only the amount of cash; standard is more flexible. A canvas of the market to determine if higher bids may be elicited may be appropriate. However, such a market canvas does not yield additional obligations. For example, the time window for the offer may be too short to permit auction. IAC thinks that meeting Revlon would be sufficient to protect oneself in Canada, but it is not necessary (i.e. the test there is more strict, here is more loose) [Argue that no need to address auction point since in this case, family has control of sale]
- **Burden is on bidder to act if directors discharge duties properly:** Maple Leaf was content to let its $22 bid stand despite knowing that competing bids may be accepted and despite fact that Maple Leaf's board authorized $29 bid. That was their risk.

- Case Comment
  - **Hostile bids are very rare in closely-held context:** It's unusual to have a control block of shares & a hostile bid. No matter what the bid, Schneider family doesn't have to tender its shares into the bid. Despite Maple Leaf's claim that Schneiders created expectation of sale, Schneider couldn't possibly have had to sell company if they didn't want to. Maple Leaf must have thought it could leverage coattail provision to get control. Even if there had been *Revlon* duty to auction, Schneiders wouldn't have had to tender into bid.
  - **Social waste theory of takeovers seems wrong on these facts:** 1 theory of takeovers is that takeovers are waste of time because raiders merely seek out undervalued companies, which is socially wasteful. Empirically, this doesn't hold water. Nesbitt's prediction is consistent with the notion that there will be real changes to way company is run ($18

without sale). Situation here is typical. Source of value is normally in the real changes that raider brings.
    - **Independent committee may be accorded too much credit:** Here, key factor was that no managers/officers on the committee. However, (1) managers/officers scared up bids and were key in negotiations – special committee got all their information, which may have been partial, from fiduciaries. (2) Directors may still be impartial. Schneiders vote them in, and it's likely that there is preexisting relationship between directors and Schneiders. On the other hand, keeping management off the committee does minimize the conflicts – outside directorships are less risky than inside directorships, where day-job may be lost.
    - **TSE Response:** TSE requires coattail provision if 2 classes of shares being issued.

BCE Inc. v. 1976 Debentureholders (SCC, 2008)

Handout

- **<u>Synopsis</u>**: LBO good for SHs, bad for creditors.
- **<u>Gloss on Test for Hostile Takeovers</u>**: Adopts 2-prong test from *Unocal* and *Revlon* (US), without the enhanced scrutiny aspect (onus shifting). Instead, it states that the onus is dependent on the circumstances and whether the Ds acted in good faith.
- **<u>Policy</u>**: Attempts to reconcile Canadian law w/ *Revlon*, arguing that *Revlon* was an exceptional case where duties to SH had to be paramount. Iacobucci thinks that the distinguishing factor between the tests is the enhanced scrutiny aspect (onus shifting) and the consideration of other stakeholders. He thinks the enhanced scrutiny aspect likely would have little effect in Canada since corporation can argue that it was considering another stakeholder (i.e. non-SH) based on stakeholders recognized in *Peoples*

- Facts
    - Consortium of buyers to buy BCE for $50B; 40% premium bid LBO
    - Process: Board thought were about to get acquired, so decided to make it systematic through auction; 3 bids, all used lots of leverage; Vast majority of SH approve; Takes place as arrangement (s. 192)
    - Dispute: BH opposed because value of bonds decreased dramatically with increased leverage (i.e. new debt added to old debt, but holders of old debt do not have priority claim over new debt holders)
    - Losses to BH (20%) less than gains to SH (40%) – pie bigger overall
    - BH challenge under breach of fiduciary duty, duty of care and oppression remedy
- Issue
    - Was there a breach of fiduciary duty?
- Decision
    - No; board adequately took into account the interests of the creditors
- Reasons
    - Court adopts broad duty to corporation (discussed in 'duties to creditors') – find no breach
    - This provides very wide scope for the constituencies that may be considered by the Board in making its decisions
    - Court addresses US cases explicitly:
        - *Unocal* – 2 prong test – danger to corp, defences proportionate; and *Revlon*
    - Court takes 2 prong test and uses it, though not explicitly, and slightly modifies it:
        - (1) Danger to the corp?
            - Duty is to corp
        - (2) Defences proportionate?

- Enhanced scrutiny?
  - Not clear in Canada. In *Pente,* say do not shift onus when have taken steps to mitigate the conflict
  - In US – apply enhanced scrutiny
  - Problem is, in Canada would not even make a big difference if shifted the onus, because duty to the corp if so blank anyway (see below)
- Court says Revlon may have been an exception, saying ordinarily duties run to corp, and duty in Revlon to SH was exceptional

- Iacobucci
  - Iac: That is not in fact what was unique – what was unique about the Delaware cases was there emphasis on the omnipresent spectre of self-interest
    - Objective (SH primacy) was the same as in all Del cases; the enhanced scrutiny was the exceptional part
    - So, Court need not adopt SH primacy because that's not what was exceptional, but could have adopted closer scrutiny
    - Although, in fact, due to duty being to "the corporation", it would have been a fairly vacuous standard anyway

Chapters Inc., Re (2001) (Securities Comm.)

P.519

- **<u>Synopsis</u>**: Securities law intervenes for takeovers in ON. Chapters declines friendly bid from Trilogy, and then Ds of Chapters incorporate Rights Plan (poison pill – which allows all SHs but the acquirer to buy shares at a great discount (dilution)) into articles of incorporation. Ds then find alternative bidder, Futureshop, who bids $3 higher than Trilogy, but Futureshop tender comes w/ break-free, no-shop and confidentiality clauses, as well as a lock-up agreement. Pill waived for futureshop (note: Pill was designed so it could be redeemed by the board), but still in place for Trilogy. Pill was maintained until very last minute, so that at the time it was waived, the shares would already be won by Futureshop. Trilogy complains to OSC, alleging Ds breached FD.
- **<u>Held</u>**: Ds breached FD since ultimately the SHs should get to decide and there is a restriction on the life of a pill.
- **<u>Rule</u>**: see Jorex factors below.
- Context
  - Securities law intervenes when it comes to FDs for takeovers in Ontario. This is not true for SEC in US. This is fairly expansive view of role. National takeover policy is that directors may establish defenses, but bids may only be resisted in order to generate better offers.
- Facts
  - Gerry Schwartz of Trilogy made friendly bid for Chapters for $13 (because they wanted to merge Chapters and Indigo). Chapters CEO rebuffs overture, and then Chapters' BOD incorporated Rights Plan into articles, saying permitted bids remained open for 45 days, and no shares could be taken up unless more than 50% of outstanding shares were deposited.
  - **Aside:** Pill had a "waive-for-one, waive-for-all" clause, where pill would be waived for all if waived for one. This is to protect shareholders from bidder preference on the part of management. Pill was approved by shareholders. Trilogy announced bid for 43% of shares for $13 per share.
  - BOD scrambled and initiated a search for alternative acquirers. They found Future Shop. They waived the pill for Future Shop's bid – at $16 or 2 Future Shop shares. 30% of

shares tendered to FS offer. They also gave FS 5% of price in break fee, no-shop clause (wouldn't find other bidders), wouldn't share confidential info with anyone but FS, and lock-up agreement said that tender could only be offered to superior bid of $17.50 or more by Jan. 24, 2001.

    - Agreement contained covenant requiring that Chapters support FS offer, and rights plan was waived for FS but in place for others. On Jan. 10, 2001, Chapters increased price to $15 per share, and said it would increase to $17 if rights plan were ceased – excluding locked-up shares, management shares, and own shares. But they say pill has to be withdrawn.
    - **Aside:** Trilogy committed not to tender own shares into bid so that shareholders who tender will get better yield – only 60% of outstanding shares are eligible for tender.
    - **Aside:** Here, pill was used in discriminatory way – they promised to maintain pill until very last minute. There is waiting period during which shares are tendered, but not purchased. Just before actual purchase of shares, pill would be waived. At time pill was waived, shares would already be won.
- Issue
    - To what extent can director conduct be scrutinized in connection with a poison pill?
- Arguments
    - Trilogy
        - Pill is permissible in principle, but there is a time when it has to go – i.e. cannot adopt a pill and use it indefinitely
        - Purpose of the pill is to drive up the price that the SHs expect to receive – once drive up the price, the purpose of the pill ceases to exist
- Decision
    - Breach of FD
- Reasoning
    - **<u>Fiduciary Duties during Hostile Takeover</u>**
        - **Shareholder choice must be balanced with Management duty:** National Policy reflects value that shareholders should get to decide takeover battle. Case law thus imposes limits on power to retain pills.
        - **Pill must eventually be removed:** In Delaware, there is duty to auction, and failing that, there is duty of proportionality which can be triggered by saying price is too low. In contrast, in Ontario, from *Jorex* case, pill must be withdrawn eventually.
    - **<u>*Jorex* factors to consider re pill removal:</u>**
        - **Whether shareholder approval of pill obtained:** Not required, but relevant factor
        - **When plan was adopted:** if long period, another bid is unlikely.
        - **Broad shareholder support for continuation of pill:** Though pill approved initially, continued support may be lagging, as 2 institutional shareholders want pill removed.
        - **Size and complexity of the target:** Complex company requires more thorough synergy evaluation and financing arrangement than simple company. Pill won't be as necessary for small company, where bids can be made more readily.
        - **Other defensive tactics:** Broader actions are evaluated. Tactic of waiving pill at last second combined with pill to reduce bid competition, not increase it.
        - **Number of potential, viable offerors:** If lots of bidders, pill put in place to control process. If not lots of bidders, pill will likely not induce another bidder. Here, unlikely to find another bidder – Indigo had unique synergies with Chapters.

            - **Whether the bid was coercive or not**
            - **Steps taken by target to find alternative bid or transaction that would be better for shareholders**
            - **Likelihood that, with more time, target could find better bid**
            - **Nature of bid, including coerciveness or unfairness to target shareholders:** If coercive, then can keep pill in place. Here, there was arguably coercive bid - $15 cash for 43% of the shares. Possible coercion – if $15 for first 43%, but $10 for next batch, then everyone will tender into bid that they don't agree with because it will make sense to tender in whether they think it's successful or not. Bid for all shares now would arguably not be coercive since no concern of now-or-later decision.
            - **Length of time since bid announced and made**
            - **Likelihood that bid will not be extended if rights plan is not terminated:** This factor isn't always useful. Bidder will always threaten to leave to induce company to remove pill. However, in current case, Trilogy's threat to leave is credible. Pill should be removed, leaving shareholders to decide, rather than managers through use of pill.
        - **Pill should be removed due to contextual analysis:** (i) Pill must have time constraint; (ii) 2 institutional shareholders support elimination of pill; (iii) company is small; (iv) differential waiver times subverts competition; (v) pill has been in place for 54 days; (vi) Trilogy would credibly not give better offer unless pill was removed due to oppressiveness of pill.
        - **Chapters bid not coercive:** (i) 30% could not tender into bid – they already locked into Future Shop bid. (ii) Chapters was not taking up own shares either – 9.5%. Therefore, 40% of shares were out of play. When they bid for 43%, that was 43% over total of 60%. They were bidding for 75% of the shares that were in play, so bid is not as partial as it first appeared.
    - Case Comment
        - **Balancing interests is inappropriate – shareholders should be dominant:** Managers are shareholders' agents – they owe FD to company. Shareholders should have a dominant view. Commission intends that shareholders may want pills to avoid coercive bids and facilitate competition. However, if balancing is to take place, shareholders' perspective is still the only relevant one.
        - **Commission is more auction-happy than courts, a-la-Revlon:** Both Commission and courts want rule that is best for shareholders. Commission wants rule that reasonably encourages other bids and engenders competition. Courts suggest that takeover defences can only be used to maximize shareholder value. However, this is a controversial approach. Although this may be good ex post, ex ante perspective suggests that before bidder comes along, shareholders may be better off committing to not defend – this will better facilitate market for corporate control.
        - **2 institutional shareholders may not be representative:** 1 factor to consider re appropriateness of pill is shareholder sentiment. Institutional shareholders matter due to (i) large holdings; (ii) ability to assimilate information. However, they may still not be representative of shareholder plebiscite.
        - **Degree of coercion is consistent with *Unocal*:** *Unocal* says that if threat associated with bid, can act reasonably to counteract bid. Testing for coercion to determine appropriateness of pill is consistent with this principle.
        - **Chapters bid may still be coercive, despite Commission's finding, but not alarmingly so:** Even in soliciting 75% of shares, coercion can accrue to 25%. However, we don't worry as much – if everyone tenders, only 25% of an individual's shares are on

back end. Everyone still wins – selling 75% at premium is far better than selling only 43%. Also, coercion seems unlikely since Trilogy said they were willing to raise bid to $17 if pill removed.

- Note
  - **Coercive bids come in all shapes and sizes:** A coercive bid can result even without second tier of bid. E.g. if Conrad Black bid for 50% of company, he could divert company assets to himself at the expense of minority shareholders.
- Iacobucci
  - **Normative questions:**
    - ***(1) Is it appropriate for target board to take steps that drive up the value of the target's shares? [i.e. make sense to have takeover defences]***
    - Allowing targets to drive up prices in takeover bids may not be good, even though the target SHs might be better off by driving up the price, the problem is that in anticipation of driving up the price, bidders are less likely to emerge (so there will be less surplus available for the acquirer). As a result, SHs may lose opportunity to sell at premium; the reason the premium exists is because bidders believe management can be improved. Result: unclear effects on whether there is an advantage
    - When it comes to maximizing SH value, it is not a good idea to have unfettered SH discretion; there could be disagreement whether it is a good idea for them to drive up their price
    - ***(2) Is Chapters consistent w/ BCE [note that Chapters is securities commission]***
    - Iacobucci does not think so – since all factors of when pill has to go concerns SH value
    - BCE allows a reaction on the part of the board – which have duty to act in best interest of corporation, but not any particular stakeholder (i.e. SHs, creditors, EEs, etc…) → IAC thinks this could require D/Os to say that the bid is a bad idea (if bad for one of the stakeholders (may turn into an obligation to resist the takeover bid)
    - Securities regulators have taken the approach that is all about SH value maximization

9. SHAREHOLDERS' REMEDIES

(i) The Oppression Remedy

(a) Introduction

241. (1) Application to court re oppression – A complainant may apply to a court for an order under this section.
(2) **Grounds** – If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates
- (a) any **act or omission of the corporation** or any of its **affiliates** effects a result,
- (b) the **business or affairs of the corporation** or any of **its affiliates** are or have been carried on or conducted in a manner, or
- (c) the **powers of the directors of the corporation** or any of its **affiliates** are or have been exercised in a manner

that is **oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer**, the court may make an order to rectify the matters complained of.
(3) **Powers of court** – In connection with an application under this section, the court may make an interim or final order it thinks fit including, without limiting the generality of the foregoing,
- (a) an order **restraining the conduct** complained of;
- (b) an order appointing a receiver or receiver-manager;
- (c) an order to regulate a corporation's affairs by **amending the articles or by-laws** or creating or amending a unanimous shareholder agreement;
- (d) an order directing an issue or exchange of securities;
- (e) an order appointing directors in place of or in addition to all or any of the directors then in office;
- (f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;
- (g) an order directing a corporation, subject to subsection (6), or any other person, to pay to a security holder any part of the moneys that the security holder paid for the securities;
- (h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;
- (i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 155 or an accounting in such other form as the court may determine;
- (j) an order compensating an aggrieved person;
- (k) an order directing rectification of the registers or other records of a corporation under section 243;
- (l) **an order liquidating and dissolving the corporation**;
- (m) an order directing an investigation under Part XIX to be made; and
- (n) **an order requiring the trial of any issue**.

- Addresses concern re majority harming minority in any permutation
- Set of remedies is powerful and wide-ranging.
- Directors' powers are engaged explicitly. Officers' powers are engaged through the wording in 241.(2)(a) & (b) regarding corporation's act and business. (*Imax v. Ferguson*)
- In contrast, OBCA includes a prospective aspect for future acts.

Interaction with Fiduciary Duties

- o **Broader standard circumscribes FDs:** Fairness standard is broader than "best interests of the corporation" standard.
- o **Remedies are broader:** Court has 14 strong remedies for oppressive behaviour. As well, DAs have been allowed for the OR, despite harm not being to corporation itself. This leads to conclusion that OR may be swallowing up FDs through full subversion of the old paradigm.
- o **(textbook) Application procedure instead of full court proceedings**

Two Characterizations of the Oppression Remedy

- o **Procedural element:** way to bring action to complain about conduct
- o **Substantive element:** fairness

(b) Standing to Bring an Oppression Remedy

CBCA s.238: Who can bring an oppression remedy application?

- **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.

First Edmonton Place Ltd. v. 315888 Alberta Ltd. (1988) (Q.B.)

P.915

- **Synopsis**: Lessor tries to recover lease obligation from lessee and brings an OR. Held that lessor has no standing since (i) a lease is not a registerable security. Creditors do have standing under s.238(a) as a registered security holder, since analogous to a preferred SH who has a financial claim to the corporation and no control over management. Finally, the court holds that a wrong need not be done to the corporation for OR to be brought, so long as the individual was a complainant at the time of the wrong.
- **Rule**: a test for standing under s.238(d) – "any other person … who is a proper person…" is set out below.
- Facts
  - Lessor takes back obligation from lessee to make payment. First Edmonton was a lessor that tried to recover a lease obligation from its lessee. It brought both an OR application and a DA (where definition of "complainant" is identical).
- Issue
  - What routes may a creditor bring to get OR? Is lessor a " registered security holder"?
- Decision
  - Leave is denied – no standing.
- Reasoning (D.C. McDonald J)
  - **Complainant definition**
    - Old s. 231(b)(i) – now s. 238(a)
      - **Lease is not a registrable security:** Based on definitions of "debt obligation" and "security", the lease is a security. However, reference to "registered security" in OR section restricts the definition of "complainant" to those security holders with share certificates. (Even a mortgage is a registrable security.)
      - **Registered creditors are like shareholders intuitively:** Though the registrability requirement excludes leases, it does not exclude registered debt. This is intuitive because bondholders are similar to preferred shareholders – they have a financial claim on the corporation, but no power over management. Therefore, creditors can be complainants.
    - Old s. 231(b)(iii) – now s. 238(d)
      - **Residual provision for (i)/(ii) exclusions:** Test for inclusion in this section is as follows:
        - (i) Person who could reasonably be entrusted with responsibility of advancing the interests of the corporation by seeking a remedy to right the wrong allegedly done to the corporation
        - (ii) In circumstances of case, justice & equity require opportunity to have claim tried
    - **Creditor fits substantive definition:** If creditor has been harmed, then they may be deemed substantively oppressed – this brings s. 238 in accordance with substance of s. 241. Types of harm contemplated include "if corporation is used as vehicle to commit fraud on applicant." This can be expanded to include breach

of underlying reasonable expectations of creditor regarding corporation. Creditor must show, though, that contractual protection was not available at time debt contract was entered into.
- **Must be complainant at time of wrongdoing:** This creditor could not meet this criterion. Since creditor knew of misconduct, could have set terms of contract to internalize it.

- Case Comment
  - **Time of wrongdoing should maybe not matter:** Since remedies can be granted to corporation and not directly to creditor, it may be irrelevant whether complainant could complain at time of wrongdoing. In *Regal Hastings*, acquirer got windfall gain in order to deter breach of FDs. Even if First Edmonton wouldn't gain from remedy, maybe we deter unfair conduct better by permitting suit. In situation where First Edmonton took over lease from predecessor, they may be only ones in position to sue. Decision of court on this matter is contestable.
  - **Creditors should not be included in s. 238(a) unless insolvency is faced (Law Reform suggestion):** 2 problems: (i) Court's logic re bondholders can be extended to all creditors, including lessors; (ii) Preferreds are more vulnerable than any bondholder to misconduct since their claim is "more residual." In normal circumstances, where solvency is assured, only common shareholders are harmed, so creditors should be excluded from the provision. If facing insolvency, shareholders will take excessive risk with what is essentially creditors' money (since creditors are the new residual claimants). The law should be changed to exclude creditors from having standing in normal circumstances. (On the other hand, standing does not guarantee that the creditor will succeed.)
  - **Creditors should only be permitted if contracting was impossible:** Unlike shareholders, creditors can contract for contingencies. Even if creditors become residual claimants, this may have been risk of initial agreement – everything they expected should have been included in covenants, even the expectation that business would not be excessively risky. This concern is why Court states that contractual protection must have been unavailable.

(c) Does the Majority Owe a Duty to the Minority?

Brant Investments Ltd. v. KeepRite Inc. (OCA, 1991)

P.561

- **Synopsis**: parent mergers 2 subs, one which is wholly owned and one which is 65% owned. Minority SHs of partially owned company bring suit claiming terms are more favourable to wholly owned subsidiary. Held that no FD is owed since the minority have the oppression remedy, which protects real expectations.
- Facts
  - ICG owned all shares of ICM, all shares of ICG Energy, and 65% of Keeprite. ICG sought to merge all 3 concerns. Keeprite set up committee of independent directors to investigate fairness of transaction. They recommended a substantial reduction in purchase price, from $24M to $20M. Transaction was then approved. There was risk that majority would take steps to harm the minority, due to 35% non-interest. Minority shareholders commenced oppression action – articles did not permit issuance of additional shares, and the financing of the transaction would require additional issuance. Shareholders were thus permitted to dissent to the transaction, under CBCA **s. 190**. Plaintiff shareholders dissented and sought fair value for their shares, saying that shareholders owe FD to minority.

- o Issue
  - What is the nature of duties that a parent owes a subsidiary? Fiduciary duty?
- o Decision
  - No FD owed.
- o Reasoning (McKinlay JA)
  - <u>**Majority Shareholder Duty**</u>
    - ***Goldex* does not create majority shareholder duty:** *Goldex* (a pre-CBCA case) tells us that the majority governs, subject to behaving fairly and honestly. It also states that the categories of FDs are not closed. However, *Goldex* does not positively create a shareholder FD explicitly. Enactment of the CBCA has rendered FD expansion inappropriate.
- o Case Comment
  - **Oppression remedy curtails need for shareholder FD:** It would be odd for majority to owe minority a duty, since it would be redundant. FDs arise when parties are in positions of vulnerability, and the OR curtails that vulnerability. This reasoning is bolstered by fact that US imposes shareholder FD but does not have supplementary OR.

(d) What Duties Does the Majority Owe the Minority Under the OR?

Ebrahimi v. Westbourne Galleries Ltd. (1972) (H.L.)

P.565

- o <u>**Synopsis**</u>: Nazars voted by ordinary resolution to oust Ebrahimi as D. Ebrahimi seeks order for Nazars to buy out his shares, or, in the alternative, a wind up is sought. Held that windup was just and equitable since Ebrahimi expected participation since business sprung out of old partnership structure, and same obligations of good faith were expected.
- o <u>**Rule**</u>: see contextual analysis approach below.
- o <u>**Policy**</u>: Consistent w/ K approach: (1) implied terms; (2) parties do not want expectations to be perceived (i.e. analogize to pre-nuptial agreement)
- o Facts
  - There were initially 2 equal shareholders in Westbourne, a Persian rug business. Business was carried on as a partnership. Eventually, both shareholders gave 1/5 of their shares to the son of 1 of the shareholders, George Nazar. In 1969, the 2 Nazars voted by ordinary resolution to oust Ebrahimi from his directorship. They conform to all relevant rules in doing so. Ebrahimi seeks relief ordering the Nazars to buy out his shares. In the alternative, a wind-up is sought. TJ found that it would have been just and equitable to order winding up, and CA overturned.
- o Issue
  - When is it just and equitable to order winding up, despite no contractual provision?
- o Decision
  - Relief granted. Wind-up is just and equitable.
- o Reasoning: (Lord Wilberforce)
  - **Purposive and liberal approach if "partnership analogy" applies:** The *Partnership Act* sets out flexible principles of equity, as partnership law is open-ended. In contrast, corporate law is typically confined to MOA, AA and CBCA. However, these rules are not exhaustive. In most settings, technical legal rights may be sufficient to evaluate obligations. However, in some cases, "rights, expectations and obligations are not submerged in the company structure." Courts should then ask whether legal rights were exercised in equitable manner.
  - **2 approaches that can be taken:**

- **(1) Contextual analysis (adopted principle):** Factors to consider include (i) association is formed/continued on basis of personal relationship with mutual confidence; (ii) agreement that all shareholders shall participate in conduct of business; (iii) restriction on transfer of members' interest in the company. **In this context**, participation was expected since business sprung out of old partnership structure, and same obligations of good faith were expected. (**Note:** These requirements were not imported into Canada.)
- **(2) Underlying obligation breached:** If legal rights not infringed, just/equitable provision may still apply if applicant can prove some underlying obligation of fellow members in good faith, or confidence, that so long as business continues he shall be entitled to management participation, an obligation so basic that if broken, the conclusion must be that association must be dissolved. **Here,** this was the case.

- **Equitable remedy must be windup:** It would not be just/equitable to remove him as director, given his expectation. Since all earnings are paid out as director's remuneration, Ebrahimi would heretofore be at mercy of Nazars for dividends, which have never been paid. Nazar's failure to recognize Ebrahimi as a partner, but rather as employee, demonstrates how their personal relationship was repudiated.
- **Good faith may matter, but not in this case:** Nazars alleged that removal was in "best interests of corporation." However, since majority governs, this is a suspect allegation. TJ did not find good faith as a fact. Despite complying with formal obligations, there was no established good faith reason to remove Ebrahimi.
- **Scope of judgment is narrow:** Judgment only applies in case of just/equitable windup.

- Case Comment
  - **Restriction on share transfer is common for closely-held firms:** Parties want control over who will be running the company going forward. Here, share transfer restriction would ensure (i) directors would be entrenched and remuneration stable; and (ii) majority vote would be reliable, with balance of power stable.
  - **Equitable principles suggest a broad view of the corporate contract:** On one hand, the ruling seems inconsistent with the contractual approach since removal from directorship was done according to articles – if Ebrahimi wanted protection, he could have put provision in articles. Using the OR causes court-ordered outcome to be unpredictable. This view interprets the contract narrowly. **On a broad interpretation**, like with any contract, the corporate contract may have implied terms. Though firing directors may not be impermissible in the closely-held environment, we may want to ask whether the parties had reasonable expectations that they would actively carry on the business jointly. The alternative to this inquiry would be to require the company to structure the director removal provision finitely; however, alternatives are limited (remember *Bushell v. Faith*) – either (i) shareholders have veto over their own removal (permitting entrenchment) or (ii) the majority rules (leading to excessive risk to parties). Spelling out exact fairness in the contract is very difficult. The OR may offer a baseline rule that the parties would want.
    - **May still be inconsistent with contractual approach:** Though the rule may save on TCs, it's unclear whether parties can contract out of the rule.
  - ***Ebrahimi* principles have been imported into OR jurisprudence.**

Ferguson v. Imax Systems Corp. (1983) (O.C.A.)

P.922

- **<u>Synopsis</u>**: 3 owners of Imax and their wives hold shares; husbands hold common shares and wives hold class B shares. Ferguson husband and wife separate and Furguson wants to freeze

wife out by diluting class B shares over time. Wife alleges that conduct by Imax was oppressive. Held that OR granted since (i) true motivation (not subjective intention) will govern remedy (in this case IMAX intention was malafide); (ii) s.241 must be broadly interpreted (not simply codification of CL); (iii) conducted via contextual analysis (look to substantive questions of fair treatment in light of all circumstances, not just as a class of SHs). Application: wife expected to be paid out and to participate in the company, but in this case she got neither.

- Facts
  - Imax was started in 1967 by Ferguson, Kroiter, and Kerr. Each husband received 700 common shares, and wives received 700 class B shares. Class B stock could not vote, got 5 cents before anyone else got paid, and equal share in residual claim. Unlike other wives, Mrs. Ferguson worked hard for the company in management and administration in a largely uncompensated fashion. There was an agreement that shares would flow to the husband if wife died and sold to other partners if husband died.
  - In 1972, Fergusons separated. In 1974, company turned around and started to be successful. They issued shares and sold shares to other financiers. Ferguson put pressure on rest of management to freeze his ex-wife out of the growth by redeeming the class Bs.
  - Management agreed, because they wanted their new partners to share in the growth e.g. Jim Chaplin and Bill Shaw, but they didn't want dividends paid to Mrs. Ferguson. She refused to sell her shares, so they voted on a new resolution to pay a fixed dividend to class Bs and phase them out in 5 years. The effect of the reorganization would be limited Class A dividend followed by redemption of her class B non-redeemable shares and would edit her out of the company because she was the only holder of class B shares without any other share interest.
  - Mrs. Ferguson alleges that Imax was oppressive/unfairly prejudicial/unfairly disregarding in attempting to amend its articles to reorganize its capital – she objects to the behaviour of the corporation (even though it all stemmed from 1 individual shareholder).
- Issue
  - Was Imax unfairly prejudicial in freezing Mrs. Ferguson out of the residual claim?
- Decision
  - Oppression remedy is granted.
- Reasoning: (Brooke J.A.)
  - **Oppression Remedy**
    - **True motivation for behaviour will govern remedy:** Imax led evidence re possible benefits that might flow from share reorganization. However, despite possible rationale, court concluded that this was the *mala fide* "solution to the ex-wife shareholder" and arguments about cleaning the balance sheet were false pretense.
    - **Broad interpretation:** S. 234 (now s. 241) must not be regarded as simply a codification of the common law. It should be interpreted broadly, (*Interpretation Act*, s. 11) incorporating shareholder relationships, not just formal rights.
    - **Contextual analysis leads to finding of oppression:** Mrs. Ferguson's investment must be regarded as being in the shares which both she and her husband held. Freeze-out is culminating event in a lengthy course of oppressive and unfairly prejudicial conduct.
  - **Case Comment**
    - **Fact that she worked for company may not be relevant:** It may be that benefit from residual claim was reason she worked for the company. However, if other spouses decided to work, we wouldn't impute additional rights to them in the abstract.

- **Unfairness lies in share price:** If company bought her out at price that reflected true value of company, it wouldn't be unfair. Unfairness turns on value ascribed to the shares.
- **Good faith is not a requirement:** *Brant v. Keeprite* makes clear that OR does not require it.

Diligenti v. RWMD Operations Kelowna Ltd. (1976) (B.C.S.C.)

P.924

- <u>**Synopsis**</u>:4 partners initially had equal relationship in joint venture (all Ds); 3 directors oust a 4th director, and no contract exists explicitly stating that all SHs are to participate in management. The 3 Ds set up management company and charge fee to corporation for their services (funnel profits away from corporation). Diligenti sues under OR. Held that the conduct was unfairly prejudicial and D entitled to OR since (i) unfairly prejudicial is broad and invites a contextual analysis (in this case there was expectation for participation).
- Facts
  - The relationship between 4 partners began on an equal-proportioned JV basis. Each of the partners became a director of restaurant business. No explicit agreement exists for all shareholders to participate in management. However, 3 directors have ousted the 4th. The 3 formed a management company and carried on the business of the restaurant, charging a fee to the corporation for their management as a way to funnel profits out of company to the 3 shareholders. Diligenti sues, saying action was unfairly prejudicial.
- Issue
  - Is "unfairly prejudicial" broader in meaning than "oppressive"?
- Decision
  - Yes – "unfairly prejudicial" must be read expansively.
- Reasoning (Fulton J)
  - **"Unfairly prejudicial" is broader in meaning than "oppressive", inviting a contextual analysis:** The expansion imports the notion of equitable rights into the oppression remedy, since "oppressive" applies only to legal rights. Contextual analysis would lead to conclusion that 3 shareholders were unfairly prejudicial by diverting money. "Rights, expectations and obligations" included right to participate in corporate direction – the JVs were held equally, with all 4 names on the contracts and all 4 acting as directors. These equitable rights were breached.
- Case Comment
  - **General language is necessary to ensure remedy is effective.**
  - **Opt-out of conclusion is possible even if opt-out of OR is impossible:** A shotgun clause in a closely-held contract could avoid the problem caused – a price is set, and either the majority must buy minority's shares or vice versa – to prevent unfairness. Such a clause would not constitute an opt-out from s. 241, but it would shape s. 241's interpretation. Another way to shape interpretation would be to entrench a management participation right in articles (though CCCC is costly).
  - **Consistent with contractual approach:** Purpose of the OR is to give parties what they want. Though rules may not be optimal, veering from this rule costs less than starting from scratch.
    - **BUT predictability is compromised:** Judges can interpret articles narrowly or broadly, leading to a lack of clarity regarding the law. This undermines the optimality of the OR as a residual provision.

Westfair Foods Ltd. v. Watt (1991) (Alberta C.A.)

P.927

- **Synopsis**: Company set up w/ 2 classes of shares: class A got a $2 dividend, and common shares which got a residual dividend as determined by the company. In the event of liquidation, class A shares and common shares would split the proceeds equally. Incentives: common share holders want all excess to be paid out in dividends, since class A will be capped at $2 and the rest will go to common; but Class A share holders want the company to only pay out the $2 dividend, and retain the rest in the corporate coffers, so in the event the corporation is liquidated, there is more there for them relative to if the funds had previously been paid out to dividends (accruing only to common SHs). The company is structured to allow common shares holders to choose the policy – and obviously they choose for dividends to be paid out immediately. Class A SHs bring an action under OR.
- **Held**: the conduct was oppressive on procedural grounds, not substantive grounds. The policy of only paying out $2 to Class A shares was fine, but the procedural mechanism of getting there (namely, the decision by common SHs who had conflicting interests was unfair). Court says that the contextual analysis is appropriate when addressing interclass disputes.
- **Remedy**: order to corporation to purchase all class A shares
- Facts
  - The Appellant company had 2 classes of shares – A shares with a $2 dividend in complete priority to common shares, and common shares (owned by Douglas) which got residual dividends in any amount that company saw fit. In the event of liquidation, class A shares would share proceeds equally with common shares. In 1985, the company adopted a policy of distributing net annual earnings (all R/E) as dividends. Company is structured such that common shareholders get to choose policy on dividends, but preferred class A shareholders don't get to choose policy. TJ found this policy to be oppressive to holders of class A shares, who had an interest in R/E. TJ ordered the corporation to purchase the class A shares.
  - **Rationale for Oppression:**
    - In cases where residual claim is less than $2 per share, commons may liquidate to share in proceeds. More commonly, here, commons pay huge common dividend to minimize the class A interest in R/E. This possibility of oppression is created because, unlike in normal circumstances, preferred shareholders have conditional interest in the residual claim. There is conflict of interest between preferreds and commons re dividend policy. Still, the odd securities were issued to attract shareholders during time of growth; now that growth is slower, commons are trying to exclude class A shareholders, who thought they had upside benefit.
- Issue
  - Is the taking away of residual claim from class A shares oppressive to these shareholders?
- Decision
  - Oppressive on procedural grounds, but not on substantive grounds.
- Reasoning (Kerans J.A.)
  - **Oppression Remedy**
    - **Smell test should be avoided; contextual analysis is appropriate:** The OR is a form of "legislative delegation" with minimal guidance – still, standards should be homogenized. Here, principles governing majority vs. minority are unhelpful – this is an **interclass dispute**, where directors must have regard to all shareholders' reasonable interests.
    - **Circumstances surrounding entrance into relationship must be determined to evaluate Reasonable Expectations:** Not all interests deserve protection – we must check if this interest could be "reasonably expected." In this case, expectation of future success is bounded by promised dividends – everything

beyond was unreasonable. Rights of different classes are different – even if interest is diminished, treatment may not be unfair.

- **Procedural deficiencies can be oppressive:** Forced purchase is an appropriate remedy due to way class As were treated. Directors didn't take them seriously in decision-making e.g. by describing corporation as wholly-owned subsidiary in Annual Report. Directors "unfairly disregarded" class As as nuisance.
- **Remedy is compelled purchase at unfavourable price:** Since no substantive oppression found, sale price does not permit sharing in R/E and will not reflect Class A's expectation.

- Case Comment
  - **Widely-held has less likelihood of oppression than closely-held:** In *Diligenti*, the parties worked closely together, so tacit understandings b/w parties were more likely. In widely-held, we are more ready to assume that what's written down reflects intention of the parties. Here, $2 dividend may have been paid precisely because this behaviour was foreseeable.

BCE Inc. v. 1976 Debentureholders (SCC, 2008)

Handout

- **Synopsis**: LBO good for SHs, bad for creditors.
- Facts
  - Consortium of buyers to buy BCE for $50B; 40% premium bid LBO
  - Process: Board thought were about to get acquired, so decided to make it systematic through auction; 3 bids, all used lots of leverage; Vast majority of SH approve; Takes place as arrangement (s. 192)
  - Dispute: BH opposed because value of bonds decreased dramatically with increased leverage (i.e. new debt added to old debt, but holders of old debt do not have priority claim over new debt holders)
  - Losses to BH (20%) less than gains to SH (40%) – pie bigger overall
  - BH challenge under breach of fiduciary duty, duty of care and oppression remedy
- Issue
  - Are creditors entitled to a remedy under the OR?
- Decision
  - No; conduct toward creditors was not oppressive
- Reasons
  - Court's approach: (consistent with cases)
    - Broad
    - Equitable remedy
    - Contextual, taking account of particulars, including informal relationships
  - **Test - Two-prong: Brand new**
    - (1) Ask whether there was a violation of reasonable expectations
    - (2) Ask whether conduct was oppressive, unfairly prejudicial or unfairly disregards
      - Oppressive – harshest conduct; UP – intermediate; UD – Weakest form that could support OR
      - Query: Can there be a situation when breach of reasonable expectations is fair? Seems unlikely. What about unforeseen circumstances – i.e., was fair because was unforeseen, but still was violation of reasonable expectations (because had reasonable expectation of future state of affairs). But, that could just be categorised as not being a breach of reasonable expectations, because is unreasonable to expect future to be exact same as present

        - So, it is really all about reasonable expectations
    - <u>What are "reasonable expectations"?</u>
        - Cites *Ebrahimi* and builds on idea that there are rights, expectations, obligations that are not necessarily found in the formal structure
        - Considerations:
            - Commercial practice – norms in the industry
            - Nature of the corporation (closely held more latitude to deviate from formalities)
            - Relationships (including informal personal relationships)
            - Past Practice (informative, but not dispositive)
            - Preventative steps (steps could have taken to avoid conduct complained of – ex. Contract for covenants to protect self in LBO)
            - Boards must strive to resolve competing interests (as best interests are to the corp – have some winners and some losers – just need to fairly balance interests)
    - <u>Complainants' arguments:</u>
        - (1) Violation of reasonable expectations that would maintain investment grade rating of bonds? Court says no – any representations in that regard were always qualified
        - (2) <u>Must consider BH interests when making decision</u>? Is it a violation of their reasonable expectations not to be considered?
            - Court says it must be a violation to breach fiduciary duty, and duty is to the corporation, so Directors may sometimes be obliged to consider the impact on other stakeholders (act as a good corporate citizen)
            - Court says on the facts there was a reasonable expectation to be considered, as there were representations that would consider them. But, on the facts, did consider them, so not a violation of reasonable expectations
- Iacobucci
    - Does this mean that always must consider BH? Perhaps when make such representations, or when there is a profound impact on them – but not necessarily always
    - Makes little sense – duty to corp says don't have a duty to any particular stakeholder, but this suggests there is such a duty to BH in some cases
    - Does this apply to all stakeholders? What about government – this transaction had huge tax implications
    - Probably will lead to a lot of disingenuous inquiries by Directors
- Implications on Takeovers
    - This case imposes costs on takeovers (note this is not a hostile takeover – this is a board deciding to sell)
    - Takeovers are more of an issue in practice, since in the takeover setting, there is likely enhanced scrutiny in the context of a takeover (in Delaware there is law for enhanced scrutiny, but not in Canada)
    - Even if did have enhanced scrutiny law in Canada, it would be meaningless, since could get around it by considering other stakeholders
    - ***Social cost***: takeovers enhance value – but if hindering this, this is not good
    - Note: SH still elect the board; executive compensation is highly dependent on equity – so there is a natural bias that they feel responsible to SHs

(e) Can a complainant launch OR application for a complaint that is in essence derivative?

Sparling v. Javelin International Ltd. [1986] (Quebec Court)

P.936

- **Synopsis**: Controlling SH Doyle of Javelin does illegal things, becomes fugitive and flees to Panama. Incorporates sub from Panama, against dissenting SHs wishes, and elects BoD to do his bidding. Sparling (D of CBCA – "the Director" under the statute) brings application for OR. Note that in this case, the harm is done to the corporation, not to the Director, so Doyle argues that a derivative action is required.
- **Held**: OR action permitted since it embraces derivative complaints – there was no intention on behalf of Parliament to restrict it to non-derivative matters.
- Facts
  - Doyle was a controlling shareholder of Javelin until 1976. He did a variety of illegal things then became a fugitive and fled to Panama. There was a revolt among dissenting shareholders – they tried to remove him from position as director, but didn't succeed.
  - From Panama, he incorporated a subsidiary called Pavonia. He then elected sympathetic BOD who did his bidding.
  - Sparling, Director of CBCA, brought application for the OR, which he has authority to do. There was a finding of oppressive actions. Quebec Superior Court suspended the powers of the BOD. Doyle also arranged phony transactions at the expense of Javelin from which he benefited. There was follow-up transaction seeking wind-up of the company. Doyle said that derivative action needed to be launched for complaint on behalf of corporation.
- Issue
  - Were the wrongs alleged by Director of the CBCA derivative in character, rendering them unsuitable for oppression application?
- Decision
  - Oppression remedy granted. It does embrace derivative complaints.
- Reasoning (Gomery J)
  - **Oppression Remedy in Derivative Setting**
    - ***Goldex* suggestion of inapplicability is inconsistent with Parliament intention:** Court discards *Goldex* in favour of views of a variety of authors, who say that OR is available, since it was intention of Parliament to give the remedy in the event of unfairness/oppression, and there is no clear dividing line between derivative action and oppression remedy cases.
    - **Provisions contemplate overlap**: s. 241(3)(h) includes "compensation to the corporation" as a remedy for OR. This suggests that there is overlap. Since splitting of cases into OR/DA is murky, aggrieved person can select most suitable remedy.
    - **Permitting OR in DA setting will lead to efficiencies:** Procedurally, permitting oppression remedy for derivative cases will avoid a multiplicity of proceedings. Doyle's acts may be oppressive to both minority and corporation – by combining acts together under OR, 2 streams of lawsuits are unnecessary.
- Case Comment
  - **OR applicant should be permitted to sidestep DA leave requirement:** Difference between OR and DA is lack of leave requirement for OR – can go directly to court. We might think that we shouldn't allow parties to sidestep the leave requirement – it may lead to frivolous lawsuit problems (nuisance suits for settlement). However, DA contemplates *prima facie* right to indemnification (per *Turner v. Mailhot* and *Wallersteiner*) which is not contemplated for OR. Since OR does not contemplate cost

indemnification, leave requirement unnecessary (s. 242(4) as interpreted in *Alles v. Maurice* (1992) permits financing of lawsuit but no only on an interim basis).

- **242. (4) Interim costs** – In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for such interim costs on financial disposition of the application or action.
- ***Sparling* was rightly decided because nuisance worry is unfounded:** (i) Rationale for barring OR application is that nuisance suits might result. However, it is not as if DA is only way to launch nuisance suit – party could launch tort, OR, or other complaint anyway. Even with the DA leave requirement, possibility of nuisance exists. (ii) Finding that suit is frivolous can lead to cost award for defendant – so risk associated with bringing nuisance suit is high even without DA leave requirement.
- **Rationale for indemnification for DA does not extend to OR:** With DA, there is higher likelihood of free-riding since suit is on behalf of corporation. Indemnity is thus warranted.
  - **Even without indemnification, OR has value:** Because OR offers broader remedies and a simplified procedure, it is still a valuable legal route.
- **OR seems to apply in *de facto* control setting.**

(f) Application of OR to Shareholder Conduct

CBCA S.2:

2. (1) Definitions
"affiliate" – "affiliate" means an **affiliated body corporate** within the meaning of subsection (2);
"body corporate" – "body corporate" includes a **company** or other body corporate wherever or however incorporated

2. (2) Affiliated bodies corporate – For the purposes of this Act,
(a) one body corporate is affiliated with another body corporate if one of them is the **subsidiary of the other** or both are **subsidiaries of the same body corporate** or each of them is **controlled by the same person**; and
(b) if **two bodies corporate are affiliated with the same body corporate at the same time**, they are deemed to be affiliated with each other.

2. (5) Subsidiary body corporate – A body corporate is a subsidiary of another body corporate if
(a) it is controlled by
(i) that other body corporate
(ii) that other body corporate and one or more bodies corporate each of which is controlled by that other body corporate, or
(iii) two or more bodies corporate each of which is controlled by that other body corporate; or
(b) it is a subsidiary of a body corporate that is a subsidiary of that other body corporate.

- S. 2(5) defines "subsidiary" with regard to control. If A controls B, then B is subsidiary of A.

2. (3) Control – For the purposes of this Act, a body corporate is controlled by a person or by two or more bodies corporate if
(a) securities of the body corporate to which are attached **more than fifty percent of the votes** that may be cast to elect directors of the body corporate are held, other than by way of security only, by or for the benefit of that person or by or for the benefit of those bodies corporate; and
(b) the votes attached to those securities are sufficient, if exercised, to elect a majority of the directors of the body corporate.

- **De jure control:** 2(3) defines "control" as *de jure* control – where a person has more than 50% of votes for BOD.

Conclusion: A shareholder is subject to OR proceedings if the corporation is a subsidiary of that shareholder (whether the shareholder is incorporated or not), and the shareholder has *de jure* control of the subsidiary either directly or indirectly.

- **Ways to use OR if control is *de facto*:** It's not clear that *de jure* control should matter, since *de facto* control still permits oppressive conduct. To address this, the applicant can (i) ignore the distinction between shareholder and corporation (as in *Ferguson v. Imax*); or (ii) leverage interlocking directorships as lynchpin for oppressive control through conflicts of interest (*Scottish Co-operative*).

Scottish Co-operative Wholesale Society Ltd. v. Meyer [1959] (HL)

P.942

- **Synopsis**: Sub established to run biz, hiring Myers and Lucas (who were also minority SHs in sub), with parent maintaining control. Parent then wants to get into the biz of the sub itself, so parent diverts work from sub to parent. Myer sues under the OR, arguing the controlling SHs actions were subject to the OR. Held that controlling SH is subject to OR since there is an obligation to act in best interests of the corporation (doing nothing to protect the interests of a subsidiary is unfair).
- Facts
  - SCW hired Meyer as MD of subsidiary rayon company. Meyer was given substantial stock to take the position. However, SCW retained 50% of equity. Recession hit the industry. After 5 years, Meyer was no longer needed for successful operation of the business, and parent established own internal department to perform subsidiary's task and compete against subsidiary. (This action was impermissible previously.) Subsidiary's board (SCW appointed 3 of 5) passively supported the parent by allowing activities to decline – they may have even taken steps to divert business from subsidiary to parent. There was discussion of SCW buying Meyer and Lucas's shares, but they decided not to buy them out.
  - **Context of case does not permit direct use of statutory language:** Above are 2 options for how to get around *de jure* control requirement. Though SCW had *de jure* control, the "complainant" definition did not encompass this arrangement at time of case. Also, the case is unlike *Ferguson*, where the corporation itself proposed recapitalization. Here, parent (not corporation) is directly harming the subsidiary, so it doesn't seem as if traditional ways of targeting shareholder are possible. "Interlocking directorships" is crafted as alternative.
- Issue
  - Can OR be brought against a majority shareholder absent express provision?
- Decision
  - Yes. Remedy can be brought against majority shareholder.
- Reasoning (Lord Denning)
  - <u>**Oppression Remedy in Controlling Shareholder Setting**</u>
    - **Interlocking directorships in competition creates *prima facie* unfairness:** SCW put directors in an impossible position, causing them to prioritize SCW FDs above those of subsidiary. In *Bell v. Lever Brothers*, Denning permitted sitting on 2 boards as long as interest of parent and subsidiary are in harmony, but said directors would then be walking a tightrope (which could lead to OR) once interests diverge.
    - **Positive action by directors demonstrating discharging of subsidiary FD is required:** Directors of subsidiary did not act as if they owed duty to subsidiary - they should have protested against the conduct of the SCW. Their absolute fidelity to parent was oppressive.
    - The Court can order the oppressor to buy the minority's shares at a fair price – value at the date of petition, if there had been no oppression.
- Case Comment

- **Interlocking directors should be unnecessary:** As long as director is a representative of SCW, that should create conflict.
- **Effect of requiring director protest is ambiguous:** It's hard to argue that the directors "caused" the harm – SCW may have competed in any event. Still, Denning says that the directors should have protested. Arguably, protesting may have deterred wrongful behaviour by keeping the parent honest. The procedural requirement may work because (i) it imposes an additional procedural constraint to oppressive behaviour absent court's ability to evaluate the parent's business decisions; and (ii) whistleblowing can have positive effect on behaviour, as evidenced by the public outcry about Frank Stronach's excessive personal spending.
- **Windup would be unfair remedy:** If unfair treatment hadn't happened, shares might be valuable since valued on going-concern basis. Unfair behaviour causes shares to be worthless. Fairest remedy to Meyer is for him to be bought out at price that removes the unfairness.
- **Interventionist approach (ignoring BJR principle) is appropriate only in narrow circumstances:** Normally, institutional incompetence leads to BJR. However, here, buyout valuation will require interventionist analysis. In this setting, fair value for shares is only remedy Meyer & Lucas can avail themselves of – market for corporate control and other controls will not help them. In such cases, courts may be ambitious re business questions.
- **Contractual approach adopts going-concern assumption:** We might characterize the decision as duty of no competition which bars parent from making the valid business decision to terminate a subsidiary. However, contractual approach might impute an implied term that the subsidiary will be operated in certain circumstances. Indeed, Meyer may not have agreed to purchase shares if windup was intended. Minority shareholders would not agree to term that majority controls ultimate fate of company. At the very least, if this assumption was undermined, Meyer should be informed and given discount on shares.

(g) Application of OR for Past Wrongs

Ford Motor Co. of Canada v. OMERS (OCA, 2006)

Handout

- **Synopsis**: Ford US using one-sided transfer prices to divert profits from Ford Canada minority SHs. OMERS buys shares in Ford and brings action under OR for past wrongs by Ford US. Held that OMERS cannot bring action under OR since court will look at the type of damage being sought to see if remedy can match the claim. OMERS was not seeking damages to be paid to FC, but instead sought personal damages. Allowing remedy in this case would create windfall since OMERS bought shares at depressed price.
- **Policy**: The price of recovering damages may be priced into the shares. The price of the shares is contingent on the legal rule, so it's circular to base the legal rule on the share price. If the suit is priced in, then even though there is no certainty of succeeding (i.e., there is some discount) O has still paid for the right to sue, so not really a windfall.

- Facts
  - For many years it was alleged that Ford US bought and sold assets from Ford Canada at transfer prices that were diverting profits to FUS, away from minority shareholders of FC; OMERS buys shares and sues under oppression remedy for past wrongs by FUS
- Issue
  - Can a shareholder claim a remedy that would compensate it for wrongs that arose prior to its acquisition of the shares?
- Decision

        - No
  - Reasons
    - **Remedy must match claim:** want to avoid characterizations of the claim being either derivative or personal in nature; the rule in *Foss v. Harbottle* created all sorts of problems as a result of this personal-derivative divide and the oppression remedy contemplates both. Instead, the court will look at the type of damages being sought; since O was not seeking damages to be paid to FC, but rather personal damages as an aggrieved person, it cannot get compensation for a wrong done to others (i.e., before O bought the shares)
    - **Buying into oppression would create windfall:** a remedy here would be a windfall to O b/c if this pricing system was taking advantage of minority shareholders, O would have purchased the shares at a depressed price, so would not have a loss
    - **Reasonable expectations are forward looking:** reasonable expectations have to do with what's going to happen in the future, so O should not get compensated for how it expected FUS would have behaved in the past
  - Notes
    - The price of recovering damages may be priced into the shares. The price of the shares is contingent on the legal rule, so it's circular to base the legal rule on the share price
      - If the suit is priced in, then even though there is no certainty of succeeding (i.e., there is some discount) O has still paid for the right to sue, so not really a windfall
    - Forward-looking expectation argument is also circular: if the court said that you could have an expectation that past conduct was fair then it would be ok to launch this suit
    - Even if there is the potential of a windfall, it's not necessarily a bad thing: it might create incentives to launch suits to keep management in line. So ex-ante, even the old shareholders might want to permit these windfalls
      - Compensation focus is narrow: if you'd rather have wrongdoing deterred then you shouldn't be too concerned about windfalls, especially since O, with its large shareholdings, might have better incentives to launch the suit

(ii) Shareholders' Rights: Voting

Background and Rationale: Agency Problems to be Avoided

- **Shirking**
- **Diversion of assets**
- **Caution in choosing investments:** Whereas shareholders are diversified, directors are less so. They may incorporate unsystematic risk into decision-making and, as a result, less risky.

- Concern about separate of ownership and control – leads to self-interested action
  - Mitigated by voting (possibilities):
    - (i) corporation run by democracy
    - (ii) representative democracy (directors)
  - These both overplay what a SH can do
    - (i) SH voting on every potential action is impractical
    - (ii) requires having good information about current directors and potential performance of new directors
  - Voting will always be plagued by collective action problems
    - If voting were perfect, then agency problems would not exist
- Ways in which voting is important?
  - (i) rational apathy problems (collective action problems)

- This is not true for large institutional SHs – since they will be instrumental in driving the result
- (ii) controlling SHs, thought of as both existing and potential ones, can influence directorial behaviour

Voting as a Remedy for Agency Problems

- **Voting rights in shares**
  - S.24(3): if there is one class of shares, each share is entitled to 1 vote and a residual claim on the dissolution of the corporation (these look like common shares)
  - S.24(4): if there are multiple share classes, the articles must designate the rights of each type of share, and at least one class must have the right to vote, and at least one class must have right to residual claim, but they otherwise need not be the same

SH Voting Rights Relating to Directors

106. (3) Election of directors – Subject to paragraph 107(b), **shareholders** of a corporation shall, by ordinary resolution at the first meeting of shareholders and at each succeeding annual meeting at which an election of directors is required, **elect directors** to hold office for a term expiring not later than the close of the third annual meeting of shareholders following the election.
(4) Staggered terms – It is not necessary that all directors elected at a meeting of shareholders hold office for the same term.

109. (1) Removal of directors – Subject to paragraph 107(g), the shareholders of a corporation may by **ordinary resolution at a special meeting** remove any director or directors from office.

137. (4) Nomination for director – A proposal may include nominations for the election of directors if the proposal is signed by one or more holders of shares representing in the aggregate **not less than five per cent** of the shares or **five per cent of the shares of a class of shares of the corporation entitled to vote** at the meeting to which the proposal is to be presented, but this subsection does not preclude nominations made at a meeting of shareholders.

- **Rationale for limitation:** At the meeting, proposing slate of directors will come too late to circulate meaningful information. However, since (i) materials are circulated at corporate expense, (ii) shareholder nominating directors gets shareholder list, and (iii) rationale among small shareholders is typically publicity-based, we institute minimum screen to ensure that shareholder has significant stake. Also, (iv) dissident information circulation will prompt reasonable management information circulation at the expense of company (time and money).

Other Voting

Mergers:

183. (1) Shareholder approval – The directors of each amalgamating corporation shall submit the amalgamation agreement for approval to a meeting of the holders of shares of the amalgamating corporation of which they are directors and, subject to subsection (4), to the holders of each class or series of such shares.
(3) Right to vote – Each share of an amalgamating corporation carries the right to vote in respect of an amalgamation agreement whether or not it otherwise carries the right to vote.

Sale of All or Substantially All Assets of the Corporation

Changing Articles of Incorporation

173. (1) Amendment of articles – Subject to sections 176 and 177, the articles of a corporation may by **special resolution** be amended to **…** (a) → (o)

- **Special resolution balances interests:** Underlying contract should be subject to change since exigencies lead to all long-term contracts being renegotiated. If only director approval were required for change, shareholders would be vulnerable to adverse changes. If unanimous shareholder approval were required, change would be virtually impossible (at least in the widely-held context). Special resolution (2/3 of votes cast) strikes a balance.

Pros and Cons of Voting

- **Voter rational apathy is the biggest obstacle:** Getting good information is costly, but benefits from voting are minimal. Also, chances of affecting outcome of vote are almost zero.

BUT

- **Institutional shareholders may affect vote:** Large shareholders that take significant stakes are more likely to gather information, be pivotal, or be influential among other voters. E.g. Ontario Teacher's Pension Plan informs others about how they intend to vote.
- **Facilitates market for corporate control:** Threat of takeover permits bidder to buy up shares and eradicate collective action problem.
- **Proxy contests**: Both sides may campaign to get info to shareholders. (relatively rare.)

(a) Permissible Limitations & Flexibility on Voting in Articles of Incorporation

Amendment to Articles:

176. (1) Class vote – The holders of shares of a class or, subject to subsection (4), of a series are, unless the articles otherwise provide in the case of an amendment referred to in paragraphs (a), (b) and (e), entitled to vote separately as a class or series on a proposal to amend the articles to … (a) → (h) [all relating to respective share class]

(5) Right to vote – Subsection (1) applies **whether or not shares of a class or series otherwise carry the right to vote**.

Share Class Rights:

24. (1) Shares – Shares of a corporation shall be in registered form and shall be without nominal or par value.

(3) Rights attached to shares – Where a corporation has only one class of shares, the rights of the holders thereof are equal in all respects and include the right

(a) to vote at any meeting of shareholders of the corporation;

(b) to receive any dividends declared by the corporation; and

(c) to receive the remaining property of the corporation on dissolution.

(4) Rights to classes of shares – The articles may provide for **more than one class of shares and, if they so provide,**

(a) the rights, privileges, restrictions and conditions attaching to the shares of each class shall be set out therein; and

(b) **the rights set out in subsection (3) shall be attached to at least one class of shares but all such rights are not required to be attached to one class**.

- If 1 class, that class has right to vote and right to residual claim. If more than 1 class, the AI must designate the rights of each type of share. At least 1 class must get the right to vote and 1 class must get residual claim. It does not say that a class must get both right to vote and residual claim.

140. (1) Right to vote – Unless the articles otherwise provide, each share of a corporation entitles the holder thereof to one vote at a meeting of shareholders.

Jacobsen v. United Canso Oil & Gas Ltd. [1990] (Alta. Q.B.)

P.697

- **Synopsis**: UC incorporated pursuant to Companies Act w/ 12 mm of 1 class of shares. By-law passed according to proper procedure, stating that a SH w/ over 1000 shares, could only get a maximum of 1000 votes. Held that the by-law contravened the CBCA and the vote restriction was invalid since can only have differential rights across share classes, not within a class.
- **Policy**: this decision makes sense since (i) incentives are attached to shares – the implications on a larger SH are likely bigger, thus he should have a proportionally larger vote (say); (ii) avoid confusion regarding changing voting rights when shares are transacted (and thus value could change), despite the potential risk on freedom or K for by-laws.
- Facts
  - United Canso was incorporated by letters patent in 1954 at the time of the *Companies Act*. There were 12 million common shares (only 1 class).
  - By-law 6 was enacted according to proper statutory procedure, permitting no more than 1000 shares to be voted for any one shareholder, regardless of the # of shares that one holds. The by-law was passed according to proper procedure.

- Certificates of continuance were issued with introduction of the *Canada Corporations Act* and finally the CBCA in 1979 causing the corporation to remain in place.
- Complainant argues that (i) by-law was always invalid; and failing that, (ii) it is invalid under CBCA.

- Issue
  - Does the Defendant's by-law contravene the provisions of the CBCA (or old *CA*)?
- Decision
  - The by-law does contravene the CBCA. Vote restriction is invalid.
- Reasoning (Forsyth J)
  - **Restrictions on Voting (By-Law)**
    - **The old law presumes one share, one vote unless separate class created:** United Canso argued that "1 share, 1 vote" is presumption "unless otherwise stated." However, *CA* only explicitly sanctioned differential rights across share classes, not within a class. As well, s. 33 requires rights to be explicitly stated on certificates only if more than 1 class – suggesting no need to specify if only 1 class due to irrebuttable presumption. This leads to conclusion that old *CA* did not permit deviation from "1 share, 1 vote." (The same reasoning used for *CCA*.)
    - **CBCA strengthens presumption of immutable 1 share 1 vote presumption:** The CBCA does not explicitly contemplate varying rights within a class. United Canso argues that the by-law meets s. 24(3) requirement of equality due to "equal limitation" on right to vote for a particular shareholder. Court rejects argument, saying it is equality across shares (not shareholders) that matters. All shares must be treated equally.
- Case Comment
  - **Rationale for equality across shares (not shareholders):**
    - **Share ownership is property right, not human right:** No democracy constraint.
    - **Incentives attach to shares:** Even small shareholders will want people with many shares to vote disproportionately since they will be more economically affected by how corporation does. *Ceteris paribus*, large shareholders have greater incentive to vote well – so they should get more votes. This will encourage institutional shareholder participation.
    - **Impediments to market for corporate control:** Limitation may deter people from buying over 1000 shares, rendering impotent the market for corporate control.
  - **Risk of confusion necessitates undermining ostensible contractual will:** Undermining validly-enacted by-law seems to undermine the contractual wishes of the parties, going against the contractual approach. BUT (i) we worry about confusion that will arise when vote changes hands – buyer may not know of change in rights (and price) associated with transaction. (ii) Changing corporate finance midstream is jarring – the company should have to amend articles to make this change. (iii) Contractual freedom is maintained by permitting the corporation to limit class votes by creating separate share classes.
- **Iacobucci (in class)**
  - **Why Equality is Required Within a Class?**
  - **<u>(1) Economic Basis</u>**: To ensure that there are correct voting incentives (representative of voters views) – thus, you don't want to restrict the impact of one SH's view (who owns substantially more shares) than another who owns fewer shares. This facilitates the goal of maximizing value
  - **<u>(2) Consistent w/ Contractarian approach</u>:** you can have inequality across shares, you just have to do so by having separate classes of shares.
  - **(3) Avoid confusion costs** that are not there when have equality among classes of shares

Bowater Canadian Limited v. R.L. Crain and Craisec Ltd. (1987)(O.C.A.) – p. 708

P.708

- **Synopsis**: class of special common shares, while held by initial holder, they carried 10 votes per share, but if they are not held by him, they only have 1 vote per share.
- **Held**: that such a provision on shares is not permitted since (i) it creates the possibility for confusion amoung buyers upon share purchase, (ii) creates risk of fraud, where parties sell shares w/ voting rights to other parties who don't know the shares also have step-down provision, (iii) these concerns are not overcome by the freedom of contract or buyer beware argument
- **Remedy**: change voting rights in shares to be equal, based on examination of party intentions (ex. meeting minutes). In this case, remedy is to give 10 votes to every share and disallow all step-downs.
- Facts
  - Crain's AI provide for special common shares and common shares, with equal entitlement over profits, but special common shares contain 10 votes per share if they remain with the initial holder and, if transferred, transferee only gets 1 vote per share. Also, the initial holder can convert the special shares to common shares prior to sale. Bowater purchased the shares, knowing full well of the restrictions and conditions on the shares, but challenged their validity. TJ found that this step-down provision violated s. 24(4) of the Act. From 24(3) and 24(4), TJ concluded that CBCA implicitly concluded that shares in the same class must have equal rights.
  - **Possible rationales for step-down provision:** (i) Company may want to maintain control but require additional liquidity. (ii) Gaining control will require family consent. (iii) Step-down binds future generations of family to company due to share incentives.
- Issue
  - Is the step-down provision (varying share rights by holder identity) valid?
- Decision
  - Violation of s. 24(4) of the CBCA.
- Reasoning (Houlden J.A.)
  - **Restrictions on Voting (AI)**
    - **Opportunity for fraud causes step-down to violate 24(4):** There is danger that buyers won't know their rights upon purchase. Confusion will ensue.
    - **Converting special to common in advance does not overcome concerns:** Antecedent **c**onversion does indirectly what step-down does directly.
    - **Remedy based on party intentions:** Remedy is 10 votes per share and no step-down. This finding is based on discerning the intentions of the parties from minutes of meetings.
- Case Comment
  - **Court does not articulate principle that voting incentives should attach to shares:** If Craisec sells half of shares, they also sell half of appurtenant incentives. However, they are not selling half the votes. If shares have same incentives, they should have same rights.
  - **Dual-class shares are potentially harmful but have rationale under contractual approach:** 24(4) permits dual-class shares even though they create perverse incentives. Dual-class is used to entrench control while still permitting equity capital to be raised. (1) Market for corporate control is undermined, as voting class can choose directors forever. However, contractual view would permit family to structure AI as they wish – providing notice to prospective non-voting shareholders (and discount to account for oppressive behaviour). (2) Being in control may be more meaningful to founders, especially in family setting – from wealth perspective, 2nd class may want entrenched management at

discount due to their expertise and motivation. (Note: This case involves a single share class.)
  - **Confusion rationale based on informational asymmetry**: Like with *Wolf v. Mohr* and director liability for torts, premise of contractual model is good information. Rights varying within a class threatens this principle at its core.
  - **Conversion should get around the problem, on court's reasoning**: Court did not permit conversion prior to sale. However, if rationale for decision is confusion, rationalizing shares so that buyer and seller have same benefits decreases risk of harm.
  - **Subjective intention is appropriate**: Court could not objectively measure party intention since individual rationales will be necessarily idiosyncratic.

(iii) Shareholders' Rights: Proposals

Residual Rule

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.

- This includes proposals to make changes: selling assets, amending AI, merging, etc.

Rationale: Shareholder proposals impose costs. If motivated by wrong purpose, costs are unjustifiable. Costs include (i) management time to develop convincing argument of its own position that is persuasive to shareholders, and (ii) scarce time at annual meeting which is normally used to hear management discuss business. In permitting shareholder proposals, balance must be struck between value and transaction costs.

Exceptions (Direct Shareholder Democracy) – 4 types:

1. Director Nomination

137. (4) Nomination for director - A proposal may include nominations for the election of directors if the proposal is signed by **one or more holders of shares representing in the aggregate not less than five per cent of the shares or five per cent of the shares of a class of shares of the corporation entitled to vote** at the meeting to which the proposal is to be presented, but this subsection does not preclude nominations made at a meeting of shareholders.

2. Article Amendment

175. (1) Proposal to amend – Subject to subsection (2), a director or a shareholder who is entitled to vote at an annual meeting of shareholders may, **in accordance with section 137**, make a proposal to amend the articles.

3. By-law amendment

103. (5) Shareholder proposal – A shareholder entitled to vote at an annual meeting of shareholders may, **in accordance with section 137**, make a proposal to make, amend or repeal a by-law.

4. Catch-all

137. (1) Proposals – Subect to subsection (1.1) and (1.2), a registered holder or beneficial owner of shares that are entitled to be voted at an annual meeting of shareholders may

(a) submit to the corporation notice of any matter that the person proposes to raise at the meeting (a "proposal"); and
(b) discuss at the meeting any matter in respect of which the person would have been entitled to submit a proposal.

(1.1) Persons eligible to make proposals – To be eligible to submit a proposal, a person

(a) must be, for **at least the prescribed period**, the registered holder or the beneficial owner of **at least the prescribed number of outstanding shares** of the corporation; or
(b) must have the **support of persons who, in aggregate**, and including or not including the person that submits the proposal, have been, for at least the prescribed period, the registered holders, or the beneficial owners of, at least the prescribed number of outstanding shares of the corporation.

- "Prescribed period" is 6 months; "Prescribed number" is the lesser of 1% or $2000 in shares.

(5) Exemptions – A corporation is not required to comply with subsections (2) and (3) if …

(b) it clearly appears that the **primary purpose of the proposal is to enforce a personal claim or redress a personal grievance** against the corporation or its directors, officers or security holders;

(b.1) it clearly appears that the proposal **does not relate in a significant way to the business or affairs of the corporation**; …
(d) substantially the same proposal was submitted to shareholders in a management proxy circular or a dissident's proxy circular relating to a meeting of shareholders held not more than the prescribed period before the receipt of the proposal and did not receive the prescribed minimum amount of support at the meeting …

- s. 51 of the regulations defines "prescribed minimum amount of support" as "within 5 years, 5% support if there has been 1 vote, 6% support if there has been 2 votes, and 10% support if there has been 3 votes.

Enforceability of Shareholder Proposals

- **Approval of new slate of directors [137.(4)] is binding.**
- **Amendment of articles [175.(1)] seems to be binding:** If passed by special resolution, we would think amendments were binding. However, nowhere does it explicitly state that the amendment must be adopted. The s. 175(2) right to dissent and be bought out subsequent to amendment adoption seems to contemplate implicit adoption. (Aside: Dissent right in s. 190 reinforces the contractual approach.)

175. (2) Notice of amendment – Notice of a meeting of shareholders at which a proposal to amend the articles is to be considered shall set out the proposed amendment and, where applicable, **shall state that a dissenting shareholder is entitled to be paid the fair value of their shares** in accordance with section 190, but failure to make that statement does not invalidate an amendment.

- **Amendment of by-laws [103.(5)] should be binding but unclear if it is:** In *Kelly*, we learned that in general, when by-laws are promulgated by directors, they must be voted on by shareholders to take effect. s. 103(2) codifies this protocol, but it refers only to director-promulgated by-laws from 103(1), not shareholder-proposed by-laws from 103(5). It makes sense that if shareholders have already endorsed a proposal by ordinary resolution, a vote would be unnecessary. This is a lacuna.

103. (2) Shareholder approval – The directors shall submit a by-law, or an amendment or repeal of a by-law, **made under subsection (1)** to the shareholders at the next meeting of shareholders, and the shareholders may, by ordinary resolution, confirm, reject or amend the by-law, amendment or repeal.

- **Question is especially interesting for s. 137 proposals:** There is no precedent for enforceability of shareholder-proposed and –endorsed general business propositions (e.g. stop a line of business). If directors continue with line-of-business, it's unclear how s. 137 interacts with s. 102, which gives management power to directors.
    - **Likely outcomes:** (1) If there is divided opinion on business model, this is where we might see successful proxy contest. (2) Directors will likely respond to vote that they don't support (e.g. stop selling microchips) by heeding advice in order to preserve their jobs. (3) **Most likely –** Shareholder proposals typically fail, which is why we don't know what would happen if they passed.

Medical Committee for Human Rights v. SEC (D.C., 1970) – p. 770

Facts: Proposal circulated to Dow Chemical asking Dow to cease selling napalm. Dow dragged its feet, and proposal came again next year. Dow excluded it again. Dow went to SEC to request review of decision not to circulate proposal. SEC decided not to challenge Dow's decision.

Decision: Court remands it back to SEC because SEC had to elaborate on its reasons.

Reasoning: (Tamm C.J.)

- **Legitimate shareholder and management concerns must be balanced:** In era of separation of ownership and control, we must take steps to ensure that shareholders are not removed from process.
- **Political motivation is not confined to shareholders:** Dow argued that shareholders were motivated politically. However, the Court responded, noting that the BOD may also have been acting politically, trying to appease the government by supplying it with napalm. This point was based on BOD statement that it didn't care how profitable napalm marketing was.

Case Comment

- **Scope for ethical and social choices should not be left for corporation:** This brings up the debate re what corporation's goals should be – profit maximization vs. profit maximization according to a code of ethics. Dangers of leaving these choices to the corporation are made clear by this case, where the company loses money but continues to sell a line of business.
- **Unclear motivations abound:** (1) At the time of the case, courts would be loathe to leave ethical decision-making to the government. (2) It's highly possible that the Medical Committee based its business proposal on profit-maximization criteria.

Varity Corp. v. Jesuit Fathers of Upper Canada (1987)(O.C.A.) – p. 772

Facts: Varity Corporation has an 18.95% interest in a South African corporation that makes farming machinery. They also have license agreement for production of diesel engines, associated with South African government. Shareholders, including Jesuit Fathers, have put forward proposal that company end its investments in South Africa due (i) to social and moral bankruptcy of apartheid and (ii) resulting unstable business environment. Varity BOD refuses to circulate proposal and applies to court for order permitting them to not include the proposal in shareholder mailing for the annual meeting. Jesuit Fathers say that in era where shareholder communication is difficult to effect, courts should be reluctant to uphold application to withhold.

Note: s. 131(5)(d) [now s. 137(5)(b & b.1)] used to exempt requests "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." The wording has been changed; however, the subject matter list informs our interpretation of current provision.

Issue: Is the company required to put the proposal in its mailing?

Decision: No.

Reasoning: (Austin J)

s. 137 Shareholder Proposal Exemption

- **Old s. 131 bars proposals where primary purpose is prohibited:** Jesuit Fathers submitted that specific business proposal – "Get out of South Africa" – had clear business purpose. However, underlying purpose was abolition of apartheid. Since this social goal was the primary purpose, the shareholder proposal need not be included.

Case Comment

- **Rationale for excluding proposal regardless of validity as business decision:** Party motivation is important since if primary motivation is political/religious, then meeting will become an inappropriate forum for discussion of morality of apartheid.
- **New statutory wording may uphold decision:** We must be weary that shareholders will dress up non-business proposals as business proposals to get publicity. Here, the decision to leave SA could may not be significantly related to corporation's business or motivation may be primarily personal.
- **Statute may not successfully curb illegitimate proposals:** The rules are not that restrictive. If the Jesuit Fathers had really wanted, the could have framed their argument differently by stressing the unstable SA business climate. This compares to the decision in *Ford*, where the decision seemed to be based on his explicitness about not caring about the bottom line.
- **Proxy contest is unsuitable substitute:** We might think that shareholders should set up proxy battle instead of issue proposal to avoid wasting time on individual issues. However, shareholders may not be equipped to run entire business; they may just care about 1 issue.
- **Allowing shareholders to avoid contracting with particular parties is antithetical to corporate form:** We learned in *Kelly* that shareholders are not permitted the opportunity to make certain types of decisions

(in that case, proxy by-laws). The rationale is the costs of coordinating collective action – which is why we have s. 102. If shareholders have non-profit objectives, they can enshrine them in the corporate charter, creating a more liberal proposal rule. However, absent explicitness, the assumption is that corporations are for-profit (for reasons discussed in the CSR section).

<u>Notes</u>

- **Politically-motivated proposals are inappropriate:** In ***Greenpeace Foundation of Canada v. Inco Ltd***. [1984](Ont. H.C.), Greenpeace circulated a proposal to limit SO^2 emissions to 247 tonnes. The proposal got 1.6% of votes. A year later, it sought a proposal to limit emissions to 47 tonnes. The Court determined that the proposals were substantially similar.
  - **Proposals may not be similar:** 247 tonnes and 47 tonnes are very disparate amounts, especially since costs of abatement increase disproportionately.
  - **Court may have been motivated by obvious political purpose:** (1) Greenpeace has clear political objectives. (2) The proposal imposes costs on the business with no identifiable benefits.
  - **Forum for proposal is inappropriate:** If pollution is excessive, this indicates that there is market failure. However, companies are not appropriate setters of environmental policy. Greenpeace should try to change regulatory framework.
- **Share threshold instituted to minimize soapbox risk:** 2 cases below involve low-cap shareholders submitting proposals yielding different results:
  - ***Michaud c. Banque nationale due Canada*** [1997](S.C.): Shareholder bought 1 share to various banks, then made proposals relating to various aspects of corporate governance. banks declined to submit Michaud's resolutions, so Michaud sought an order that the banks circulate the proposals. Court held that Michaud had standing, and banks were ordered to include the proposals in proxy materials. Court said banks could benefit from these discussions. Resolutions were ultimately defeated.
  - ***Verdun v. Toronto Dominion Bank*** [1996](S.C.C.): Beneficial owner of 2000 shares made 11 proposals to TD relating to structure and makeup of BOD and shareholder meeting procedures. Courts dismissed Verdun as not a registered shareholder entitled to vote. SCC agreed.
  - **Results would be reversed under new "prescribed number of shares" regulation:** *Verdun* and *Michaud* would be treated differently after 2001. Now, Verdun would win but Michaud would lose.
  - **This is best we can do to stem soapbox risk:** Verdun was notorious for using meetings as a soapbox. At the time, his proposals seemed unattractive. However, now, we would appreciate a good proposal prohibiting lawyers to serve as directors (to ensure that SDTs aren't coercively endorsed). So what do we do, if good business proposal is motivated by publicity? Well, best we can do to ensure that there is true business motivation is to institute share minimum, which makes it more likely that proposal is motivated by profit-maximizing potential. Though weak, this will screen frivolous proposals somewhat.