CHAPTER ONE

An Introduction to Business Organizations

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I. INTRODUCTION

The study of business organizations is the study of the ways that people organize to carry on productive activities. It is an important subject because so many of the goods and services produced in our society are produced through the forms of organization examined in this book. The forms of organization studied in this book are used for businesses as small as a single boutique retail store to as large as General Motors Corporation. The corporate form, in particular, is also used by banks, universities, hospitals, municipalities, and many non-profit organizations and charities. The forms of organization studied in this book are everywhere in our society.

This is an especially exciting time to be studying business organizations. While concerns about business organizations not behaving in socially responsible ways have been around for a long time,[1] recent years have seen a renewed focus on such concerns, as well as the development of forms of business organization that seek to achieve social, cultural, or environmental aims in addition to traditional for-profit objectives. Questions about taking into account the interests of a wider range of stakeholders are raised throughout this book and Chapter 8 examines the growing popularity of, and forms for, what has been called "social enterprise." Greater attention is also now being paid to business organizations issues for Canada's Indigenous peoples. There are issues such as requirements for legal personality and the need for a corporate form and identity by First Nations and Indian Bands; the relationship between fiduciary duties of Indigenous leaders and directors of corporations; and concerns for liability protection, tax exemption, and economic development. Chapter 4 examines First Nations business organizations. Corporate governance has also seen significant change in recent years, much of which has been in the securities regulatory context. Chapter 7 provides an introduction to the securities regulatory context; corporate governance developments in the securities regulatory context are taken into account in many chapters, particularly Chapters 11 and 12, dealing with the role of directors and shareholder participation in corporate governance.

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1 See e.g. the debate between Adolf Berle and E Merrick Dodd in the 1930s, discussed in Chapter 10, Section II.

This chapter provides an introduction to the study of the law of business organizations. Many law students enter the study of business organizations with little or no background knowledge of business or the different ways in which persons may associate to carry on business. The purpose of this chapter is to provide a brief overview of many different forms of business organization.

The text and materials in this book are intended for use in courses that usually go by the name "business organizations" or "business associations."[2] A course in business organizations or business associations is about the way in which persons associate or organize to carry on a business. "Business," broadly defined, is that which keeps a person occupied.[3] In a business organizations course, the term "business" is used in a somewhat narrower sense that relates to the production or provision of, or trade in, goods or services, or, somewhat more narrowly still, as relating to the carrying on of those activities for profit. Although much of this book focuses on the organization of for-profit activities, a broader notion of business as including for-profit, not-for-profit, or a combination of for-profit and not-for-profit activities is useful because it brings together a wide range of organizational forms, discussed in this chapter and elsewhere in this book, that share the characteristics of being organizational forms for the governance of the production of, or trade in, goods or services. The book, therefore, discusses not only for-profit forms of business organization but also not-for-profit forms, forms that can combine for-profit and not-for-profit objectives, and forms of organization for Indigenous businesses that may involve a for-profit objective as well as broader Indigenous community objectives.

Most of us engage in some form of productive activity every day. This activity may involve working at home by preparing meals, washing clothes, or cleaning. Many people will also go out to work each day and participate, in some way, in a collective process that provides goods or services for people other than themselves or those they live with at home or are related to. It may be at a hair salon, a video shop, an automobile factory, a shipyard, a construction site, a non-governmental organization office, a law office, the offices of a firm of accountants, and so on. The factory, shipyard, or construction site might be said to ultimately produce products—for example, cars, ships, or houses. The other activities listed above might be said to provide services of various types. While some products or services might be produced by a single individual acting entirely on their own, most will involve joint activity.

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2 The course is called "Business Associations" at University of Victoria, University of Calgary, Osgoode Hall Law School (York University), University of Windsor, Queen's University, McGill University, Thompson Rivers University Faculty of Law, and Schulich School of Law (Dalhousie University). It is called "Business Organizations" at University of British Columbia, University of Saskatchewan, University of Toronto, University of Ottawa, and University of New Brunswick. The corresponding courses go by the name "Corporations Law" at University of Alberta and "Corporate Law" at Western University.

3 *The Oxford English Dictionary*, 2nd ed (Oxford: Oxford University Press, 1989), vol II gives many meanings for the word "business." One of them (definition 13 a) says, "In a general sense: action which occupies time, demands attention and labour." This definition is consistent with the definition of the phrase "carrying on business" that the Supreme Court of Canada in *Backman v Canada*, 2001 SCC 10, [2001] 1 SCR 367 noted was defined in Black's Law Dictionary as "to hold one's self out to others as engaged in the selling of goods and services." The Supreme Court in *Backman* also noted the definition of "carrying on business" given by Cartwright J in *Gordon v R*, [1961] SCR 592 (citing *Smith v Anderson* (1880), 15 Ch D 247 (CA)) who said that it involved, "(i) the occupation of time, attention and labour; (ii) the incurring of liabilities to other persons; and (iii) the purpose of a livelihood or profit."

Each of these activities, or businesses, typically requires some form of facility in which the work can be done, equipment for doing the work, and supplies of various sorts. For instance, the hair salon will normally require space in a building, and may require equipment such as chairs, sinks, cabinets, and hair dryers. It will need an inventory of the goods used to provide its services to customers. The space in the building may be leased and paid for out of the revenues of the business. It may even be possible to lease the equipment. But some of the things used in the business may require that some funds be invested in the acquisition of those things. Although it is possible that a single individual provides all the funds needed to carry on the activity, the funds usually come from more than one source.

The various business activities referred to above, which most persons participate in each day, thus involve relationships with other persons. In these activities, persons work together to provide the goods or services. These activities normally require funds that come from more than one source, which means that there are relationships with, and between, the fund providers.

The various business activities referred to above also create relationships with the persons who supply goods or services used in carrying on the activity. There are also relationships with the persons who consume the goods or services produced. Business activities usually have an impact on other persons, either in the local community or beyond, even where those other persons are not involved directly in the activities, in consuming the goods or services produced by the business, or in supplying goods or services used in the business. The persons directly involved in providing the goods or services as investors, managers, or employees; those involved as suppliers or consumers; or others affected by the activities of a business are often referred to as "stakeholders."[4]

The law of business organizations might, at a broad level, be said to be about relationships between persons involved in activities to provide goods or services for persons other than themselves or the persons they live with at home or are related to. It is about law relating to the ways in which persons associate with each other or organize themselves to carry on the activities that produce, provide, or trade in goods or services. The associations or organizations used by persons to produce, provide, or trade in goods or services can, as noted above, involve everything from a local diner to a multinational enterprise with hundreds of billions of dollars in assets. They can be used in the services provided by a bank, hospital, university, or municipality. A course in business associations, therefore, involves the study of law that relates to activities and relationships that are an important part of the lives of virtually everyone.

While a course in business organizations is about the law relating to the relationships noted above, it is not about all of the law implicated in such relationships. The wide range of laws implicated in those relationships include, for example, employment law, competition law, environmental law, tort law, and contract law. A course in business organizations usually focuses on for-profit productive activities and primarily on the relationships among the equity investors, creditors, and the persons who manage the business. It may also consider not-for-profit forms of organization or forms of organization that combine both for-profit and not-for-profit objectives. Courses in business organizations typically focus primarily on

4 The term "stakeholder" has come to be used in the corporate law, or business associations, context to refer to persons who are affected by the carrying on of a business activity and therefore may have an interest in—that is, a concern about—how that business is conducted.

partnership law, corporate law, and securities law. One should bear in mind that although a course in business organizations focuses on partnership law, corporate law, and securities law, it inevitably has links to many other areas of law including, to name a few, agency law, contract law, insolvency law, and civil procedure.

In Canada and the United States, and in many other jurisdictions around the world, stakeholders other than investors and managers, such as the employees and the local and broader communities, do not typically have a direct say in how the business will be run or managed. The interests of these other stakeholders are addressed in other areas of law. Employee interests are addressed in, for example, contract law relating to employment, employment standards legislation, labour relations legislation, and health and safety regulations. Relationships with consumers are addressed in laws such as competition laws, consumer protection laws, tort law, and product safety regulations. Relationships with suppliers are addressed by laws such as contract law and competition law. Relationships with creditors are partly addressed by laws relating to business associations, but are also addressed more generally by bankruptcy laws, personal property securities legislation, banking law, fraudulent conveyance laws, and fraudulent preference laws. The local and broader community interests may, in part, be addressed through laws such as environmental protection laws, tort laws, and tax laws.

The approach to protecting the interests of other stakeholders in business activities (other than investors, creditors, and managers) described in the last paragraph is not the only approach that can be taken. The approach noted in the previous paragraph has been criticized and it has been suggested, for instance, that the interests of these other stakeholders might be more effectively addressed if they were given a more direct say in how a business is run. Some jurisdictions, such as Germany and Sweden, do, indeed, require direct employee representation on the board that oversees the management of a business organization.[5] The approach in North America tends to reflect the approach to protection of the various stakeholders described in the above paragraph. One may wish to keep this North American tendency in mind while reading the materials, as well as competing approaches such as requiring direct employee representation on the board and other approaches mentioned in these materials or those that you may think should be adopted. Is the approach to protecting the interests of other stakeholders referred to in the previous paragraph an appropriate approach? Are there other approaches that would better protect the interests of other stakeholders?

One should bear in mind that the features of the various forms of business organization discussed in this book involve policy choices. When reading about the various features of

5 Laws requiring employee representation on the board that oversees the management of a business organization are referred to as employee co-determination laws. On the history of employee co-determination laws in Germany, see Ewan McGaughey, "The Codetermination Bargains: The History of German Corporate and Labour Law" (LSE Law, Society and Economy Working Papers 10/2015). There are also employee co-determination laws in Sweden, France, and the Netherlands. For Sweden, see *The Employment (Co-Determination in the Workplace) Act* (1976:580) and the *Board Representation (Private Sector Empoyees) Act* (1987:1245), both online: <http://www.government.se/government-policy/labour-law-and-work-environment/1976580-employment-co-determination-in-the-workplace-act-lag-om-med-bestammande-i-arbetslivet/>; see also the discussion in e.g. Jenny Julén Votinius, "Employee Representation at the Enterprise—Sweden," online: <http://www.jil.go.jp/english/reports/documents/jilpt-reports/no.11_sweden.pdf>. For a discussion of employee co-determination in France and the Netherlands (as well as other countries in Europe) see <worker-participation.eu>.

different forms of business organization in this chapter and throughout the rest of this book, ask why different forms of business organization have adopted the features they have and whether the policy choices made about such features are the right ones.

Section II, immediately below, sets out a sample fact pattern to give context to some of the forms of organization discussed in this chapter. Section III briefly describes various ways in which persons associate with each other for the purpose of carrying on for-profit business activities. Section IV provides a brief introduction to some accounting concepts that can be useful in the study of business associations.

II. A SAMPLE FACT PATTERN WITH AN INTRODUCTION TO SOME IMPORTANT TERMINOLOGY

The purpose of this section is to provide a relatively simple set of facts for a simple business. The fact pattern also provides an opportunity to introduce some important terminology that can be understood in the context of the fact pattern and which will be encountered later in the book. Other terms will also be introduced later on in the book.

A. A Fact Pattern

Aya Nang had put aside $75,000 to invest in her own business and managed to convince a bank to give her a $50,000 loan. With these funds, she set up a convenience store that she called "Quick Buys" in the town where she had grown up. She had in mind not only that persons could come and shop at the store, but also that persons could order goods from her store that she would deliver. She leased 1,200 square feet of space in a small mall located on the busiest road in the town. She used the funds she had saved and the funds loaned by the bank to install lighting, a cash counter, shelving, freezers, and storage cabinets. She also bought a cash register and an inventory of goods to sell in the store. She was able to buy some of the goods she bought to stock her inventory on credit—that is, the suppliers of the goods delivered them not for cash on delivery but simply on Aya's promise to pay for the goods at a later date. When the store is in operation there will be various expenses. These will include the cost of goods sold in the store, the monthly rental fee, the monthly interest payments on the bank loan, and the cost of electricity for lighting, heating, and air conditioning.

The bank loan carried a set rate of interest to be paid in equal monthly installments. The $50,000 advanced (the "principal amount" of the loan) was to be repaid to the bank at the end of five years. The bank, however, was concerned that the business might do poorly before the end of the five years. If that caused Aya to not have sufficient assets to pay off all her debts other than the bank loan, then Aya's assets could be long gone before the principal amount on the loan came due at the end of five years. The bank wanted to be able to take action to get the principal and any unpaid interest on the loan back if there were signs that the cash being earned in carrying on the business might not be enough to pay off the debts incurred in carrying on the business as they came due for payment. To address this concern, the bank put various provisions in the loan agreement. For instance, the loan agreement specified that the ratio of the sum of cash, any amounts due on credit advanced by Aya (that is, where she delivered goods to customers in return for their promise to pay at a later

date), and the cost of inventory on hand be twice as great as the sum of amounts due on any credit received in purchasing inventory or for expenses incurred. This was intended to assure that the cash obtained in carrying on the business or that would be obtained in the near future (that is, from sale of inventory in the store or collections from customers who had purchased on credit) would be more than ample to pay amounts owed to suppliers for goods Aya had purchased on credit.

The loan agreement also provided the bank with a "security interest"—what is sometimes referred to as "collateral." This would permit the bank to seize and sell specified assets belonging to Aya in the event that she breached specified provisions of the loan agreement, such as the requirement to pay interest or principal and the requirement, referred to above, to have cash and near-term sources of cash that are twice as great as amounts due on credit. The proceeds from the sale of the assets could then be used to pay amounts owing to the bank. The bank's security interest under the loan agreement extended to all of Aya's assets, including those used in the business and those she owned for her personal use. The loan agreement also provided that Aya obtain approval from the bank before she received any other loans—that is, from persons other than the bank—except for credit she received on goods or services she acquired.

B. Investment, Equity, Debt, and Trade Creditors

Investors in a business are persons who provide funds that are used to acquire assets or employ workers that will be used in the business. They provide the funds in exchange for some future payment that will return the funds to them plus an amount that compensates them for not having the use of the funds themselves while they are invested.

In the fact pattern, Aya is an equity investor. The term "equity" in this context refers to a right to receive a "residual" (left over) amount. In Aya's business she will have revenues from the sale of goods in the store. Out of these revenues Aya will have to cover expenses such as the cost of the goods she sells in the store, the rent, the interest, electricity, and so on. But if the revenues generated by the business are sufficient to cover these expenses, she will be entitled to the residual, or left over, amount. This residual of revenues less expenses incurred in generating those revenues is the "profit" (sometimes also called the "net income") of the business. If the business is brought to a close and all the assets used in the business are sold off, the proceeds will first need to be used to pay all the outstanding creditors such as the bank and persons who supplied goods on credit. Once those obligations are met, Aya can retain the remaining, or residual, proceeds (subject, though, to claims that her personal (that is, non-business) creditors may have against her).

While Aya is the equity investor, the bank and the persons who supplied goods to Aya on credit are also investors. They are collectively referred to as the "creditors." The persons who supplied goods or services on credit are generally referred to as "trade creditors." The bank and the trade creditors have provided some of the funds used to acquire the assets that are used by Aya in carrying on the convenience store business. Instead of being entitled to a "residual" amount as Aya is, they are entitled to receive fixed payments. The trade creditors normally receive the amount they charged for goods or services supplied. The bank is entitled to receive fixed payments of interest and, at the end of the term of the loan (five years in the case of the loan to Aya), the principal amount of the loan. Such future fixed payment

obligations are referred to as "debt" and the funds provided in return for fixed future payment obligations are referred to as "debt finance."

Not all investments break down into equity investors who invest in exchange for residual claims and debt investors who invest in exchange for fixed payments. Investments can be made in exchange for a virtually infinite variety of possible benefits. Later in the text you will encounter forms of investment that are made partly in exchange for fixed future payments and partly in exchange for residual claims—that is, investments that consist of an overlap of debt and equity.

With this starter set of facts and terminology in mind, Section III provides a brief look at several forms of business association.

III. FORMS OF BUSINESS ORGANIZATIONS

A. Agency

Agency is not normally treated as a form of business organization in the sense that the other forms of business organization discussed below are. It is, however, noted here to begin with since a great deal of business activity is conducted through agents and agency is essential to the way many forms of organization, such as a partnership or a corporation, carry on business. You will encounter two different agency concepts in this book: (1) the legal concept of agency, and (2) an economics concept of agency. Each is briefly described below.

1. Legal Concept of Agency

In the legal conception of agency, an "agent," broadly defined, is a person who affects the legal relations of another person, called the "principal."[6] The agent can affect the legal relations of the principal in several ways, but does so primarily through entering into contractual relationships on behalf of the principal. If, for example, A (as agent) enters into a contract with X on behalf of P (the principal), A having disclosed to X that she is acting on behalf of P, the contract will be a contract between X and P (and not a contract between X and A). The principal can also be vicariously liable for the torts committed by the principal's agent.

Agency, as noted above, is not normally considered a form of business association. Agents do not need to be (although they may be) investors in a business either as creditors or equity investors. Agency relationships are mentioned here, however, because of their importance in various forms of business association. Aya, operating as a sole proprietor, may find, perhaps as the business expands, that she cannot deal with all her customers and suppliers all the time. From time to time, she may need to have someone else deal with some of her customers or suppliers on her behalf. In the partnership and corporate forms of business association that are the primary focus of this book, agency is essential. Partners, for instance, are agents for each other. Corporations must almost invariably also engage agents to carry on the day-to-day business activities of the corporation.

6 In GHL Fridman, *The Law of Agency*, 7th ed (London: Butterworths, 1996) at 11, "agency" is defined as "the relationship that exists between two persons when one, called the *agent*, is considered in law to represent the other, called the *principal*, in such a way as to be able to affect the principal's legal position in respect of strangers to the relationship by the making of contracts or the disposition of property."

2. Economics Concept of Agency

In the economics concept of agency, an agency relationship is said to arise where "one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent."[7] The focus in the economics concept of agency is on the costs that can arise in such a relationship.

Suppose that in the fact pattern, set out above in Section II, Aya Nang had provided all the funds for the business—that is, without borrowing any funds from the bank. Suppose also that Aya Nang did not engage any employees, but did all the work herself. Aya would then be carrying on the business entirely on her own behalf (ignoring, for the moment, other possible stakeholders in her business). If Aya chose to slack off on a particular day and thereby lost $1,000 of profits she would otherwise have made in her business, then she would bear the entire $1,000 loss herself. Suppose instead that Aya got another person to invest in the business and agreed to share half the profits with that other person. Suppose also that the other investor is not taking part in running the business, leaving Aya to run the business herself. Now if Aya slacks off on a particular day and thereby loses $1,000 of profits that would otherwise have been made in the business, Aya bears only one half of that loss (that is, $500)—the other investor bears the other half of the loss ($500). Aya is, in part, acting on behalf of that other investor. She may, or may not, be an agent in the legal sense, but she is an agent in the economics sense in that her work in carrying on the business is, in part, being done on behalf of the other investor. The risk that Aya may slack off and cause a loss to the other investor is a cost of this "agency relationship." It is this kind of cost that in the economics concept of agency is referred to as an "agency cost." This economics concept of agency is explored in more detail in Chapter 9.

B. For-Profit Forms of Business Association

1. Sole Proprietorship

a. Single Equity Investor

In a sole proprietorship there is just a single "equity" investor, referred to as the sole proprietor. In the fact pattern set out above in Section II.A, Aya is a sole proprietor. She is the person (the only person) entitled to receive the residual amounts—that is, the profits of the business and the proceeds of a sale of the assets of the business net of amounts owing to creditors.

7 See Michael C Jensen & William C Meckling, "Theory of the Firm, Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3:4 J Financial Economics 305 at 308; see also, Clifford W Smith Jr, "Agency Costs" in John Eatwell, Murray Milgate & Peter Newman, eds, *The New Palgrave: A Dictionary of Economics*, 1st ed (London: Palgrave Macmillan, 1987), where it is said that "[a]n agency relationship is defined through an explicit or implicit contract in which one or more persons (the principal(s)) engage another person (the agent) to take actions on behalf of the principals. The contract involves the delegation of some decision-making authority to the agent." The implicit contract referred to here would not necessarily be a legally binding contract, but would involve one person acting on behalf of another.

b. "Unlimited" Liability

You will notice in the fact pattern that the bank made the loan to Aya. Aya is the person who will be legally obligated to pay the interest and principal to the bank. It was also Aya who bought the light fixtures, cash counter, shelving, freezers, storage cabinets, cash register, and an inventory of goods. Aya will have the legal title to these assets. Aya will have to pay the creditors. Aya will be the person who is legally obligated to pay the rent. Where a person operates a business as a sole proprietor there is no legally recognized entity separate from the sole proprietor that enters into arrangements with banks, lessors, suppliers, or customers.

There are numerous implications of the fact that where a person carries on a business as a sole proprietor there is no separate legally recognized business entity. As indicated in the last paragraph with reference to the fact pattern, it is the sole proprietor who owns the assets of the business and who contracts personally with the bank, suppliers, employees, and customers of the business. If torts occur in carrying on the business (perhaps a customer is injured by slipping on an unmarked wet floor), then the sole proprietor will be personally liable for the damages. Where the sole proprietor obtains a loan to provide funds used in acquiring assets for the business under a loan agreement, such as the one between Aya and the bank, the sole proprietor will be personally obliged to comply with the terms of the loan agreement. If there is a default on the loan (for example, non-payment of interest or principal or some other breach of the loan agreement), then the bank can normally enforce its claim against the sole proprietor's assets used in the business and the sole proprietor's personal assets. This is the normal result because sole proprietors are obliged to meet their obligations to the bank. Where those obligations are not met, the bank can claim damages from the sole proprietor. If those damages are not paid by the sole proprietor, the bank can seek execution against the sole proprietor's assets. The sole proprietor's assets are all the assets the sole proprietor owns, and these include both the assets held for carrying on the business and those held for personal use. The law makes no distinction between these assets—they are all assets owned by the sole proprietor.

There are other forms of business association in which the liability of equity investors is limited to the amount they have invested in the business. However, as can be seen from the discussion above, the sole proprietor does not normally have limited liability, or, as it is sometimes loosely expressed, the sole proprietor has "unlimited liability." The sole proprietor is personally liable, and execution against all of the sole proprietor's assets may be obtained to satisfy claims against the sole proprietor.

Carry this lack of a legally recognized entity separate from the sole proprietor one step further. If the sole proprietor takes out a personal loan, perhaps for a vacation or to buy a car for personal use, and then defaults on that loan, the unpaid lender can seek compensation from either the business or personal assets of the sole proprietor, or both.

There are two further qualifying notes. First, the sentence concerning the bank loan noted that "the bank can *normally* enforce its claim against the sole proprietor's assets used in the business or the sole proprietor's personal assets." However, the sole proprietor may be able to obtain a so-called non-recourse loan in which the lender (such as a bank) agrees to have recourse only to the assets of the business and no recourse to the borrower's personal assets. Indeed, the sole proprietor might, at least theoretically, obtain non-recourse arrangements with any persons who advance credit to the sole proprietor or who enter into contractual relations with the sole proprietor in relation to the business. For instance, such an

arrangement might be made with a lessor. Such an arrangement might also be made with all the suppliers who advance goods on credit, although the cost of making such arrangements may be prohibitively high where the number of creditors is large and the amounts of credit involved are small. It is important to bear this possibility in mind, since it is possible for a sole proprietor to obtain a degree, perhaps even a substantial degree, of limited liability by making a series of such arrangements. Of course it will not be possible to make such an arrangement with potential future tort creditors, and for these potential liabilities it may behoove the sole proprietor to obtain insurance. Banks are also unlikely to agree to such a limitation.

The second qualifying note is that one often hears reference to an "incorporated sole proprietorship." Usually it is intended to mean that there is a person who is the single equity investor by virtue of being a sole shareholder in a corporation through which the business is carried on. The combining of the word "incorporated" with the words "sole proprietorship" can cause confusion. The corporate form, as discussed further below, is a recognized separate legal entity. It can also, subject to qualifications we will note later, provide limited liability for the equity investors (the shareholders). As noted above, with a sole proprietorship there is no legally recognized entity that is separate from the sole proprietor through which the business is run, and it does not provide limited liability for the sole proprietor—the sole proprietor would have to contract separately for limited liability with all the persons with whom the sole proprietor deals.

c. Management (or Governance)

Aya will manage the convenience store business, making decisions on a day-to-day basis. For the most part, she can make these decisions on her own and will not have to consult with other persons. However, she does not have complete control over the management of the business. The bank has put constraints on her management decisions. She must, for instance, make sure that the sum of cash, any amounts due on credit advanced by her, and the cost of inventory on hand is twice as great as the sum of amounts due on any credit received in purchasing inventory or for expenses incurred. If she does not do this, she faces the risk that the bank might choose to exercise rights under the loan agreement that arise in the event she does not maintain this ratio. Sole proprietors may face constraints such as these in arrangements with major creditors who seek to protect their investments in the business.

d. No Perpetual Existence

The existence of the sole proprietorship comes to an end on the death of the sole proprietor. It may be continued for a time in the administration of the estate after the sole proprietor's death, but once the assets of the estate have been distributed, neither that sole proprietor nor his or her estate will be carrying on the business—there will be a new sole proprietor and thus a new sole proprietorship.

2. Partnership

Aya has been operating the business for some time now. Many people come to the store and it is a success. Aya wants to expand by leasing more space in the building where the store is located. This will involve an increase in the total rental payments, require the installation of

more shelving and cabinets, and, if increased business materializes, likely lead to increased accounts receivable. It will mean that there will be a larger stock of goods—that is, inventory—in the store at any given time. All this is going to require funds. All of Aya's funds are tied up in the store already. The success of the store has already led to the need to fund larger amounts of inventory and accounts receivable, as well as the need to keep greater amounts of cash on hand to pay for goods acquired, so the bank loan has increased to nearly 60 percent of the total assets used in the business. Consequently, the bank is reluctant to extend further financing. Aya seeks funds from her close friend Tomi. After some discussion, Tomi agrees to advance $100,000 in exchange for a share of the profits from the business, thereby making Tomi an equity investor. To entice Tomi to join her in the store business, Aya has agreed to having Tomi make important business decisions jointly with her.

The arrangement between Aya and Tomi is known as *partnership*. Partnership involves more than one equity investor, each equity investor being referred to as a partner. Typically, each of the partners has some say in how the business is managed. Partnerships are discussed in further detail in Chapter 2.

The partners may conduct business through agents and they may hire employees. The partners may manage the business directly themselves or they may hire a manager or management team and limit their role to overseeing the management of the partnership business. Agency relationships are an important element of partnership law because, unless otherwise provided, the partners themselves are considered to be agents for each other.

The partnership will typically also borrow funds, so there will usually be one or more creditors. As with sole proprietorship, these creditors have a stake in the business and may impose constraints on the way the partners manage the business.

In most jurisdictions, partnerships are not recognized as separate legal entities. Thus a "partnership" cannot enter into contracts with other persons.[8] Instead it is the partners who enter into contracts with others. Where a tort arises in the conduct of the business, the partners themselves will be responsible either directly or vicariously for their part in the commission of the tort. In other words, the partners are personally liable. Further, since the partnership is not recognized as a separate legal entity, assets of the business are not owned by the "partnership," but instead are owned by the partners.

Under the common law, and under several partnership statutes, the relationship between the partners comes to an end on the death or bankruptcy of any one of the partners. A partnership may be reconstituted thereafter, and there may be statutory or agreed-on provisions for its reconstitution, but the partnership that existed before the death or bankruptcy of a partner no longer exists.

The concept of partnership was developed under the common law. The common law developed rules governing the relationship between the partners themselves and between partners and third parties. These rules have been codified in statutes in common law jurisdictions across Canada. The rules governing the relationships between the partners are *default rules*. Default rules are rules that apply where the parties have not made their own

8 One of the consequences of this is that a partner cannot be "an employee of the partnership" since the partnership, not being recognized as a separate legal entity, cannot enter into a contract of employment with a partner. An arrangement could, however, be made in which the partners agree as part of their overall partnership agreement to pay a wage or salary to a particular partner for particular services provided by that partner.

rules by express or implied agreement. In the partnership context they are rules that apply where the partners have not expressly or by implication specified their own rules to govern their relationship. For instance, if Aya and Tomi did not discuss the proportion in which they would share in the profits of the business, then partnership laws would normally have a default rule that would indicate what their shares would be. If Aya and Tomi did set out their own terms on the sharing of profits, then the partnership law default rule would not apply.

3. Limited Partnership

Tomi, who joined Aya in the partnership above, might instead be willing to advance funds, but might not be interested in participating in the control or management of the business (perhaps due to time constraints and other commitments). If Tomi is not going to take part in the management or control of the business, then Tomi might want to consider becoming a limited partner. A "limited partnership" is a type of partnership (that is, more than one equity investor) that has one or more partners whose liability is limited to the amount of their investment and one or more "general partners" whose liability is not so limited. In the example, Tomi could be a limited partner and Aya could be the general partner. Tomi's liability would then be limited to the investment Tomi made (or agreed to make) in the business, while Aya would continue to be personally liable for debts incurred in carrying on the business. This ability to limit the liability of investors may be crucial in attracting investors. Many investors may be unwilling to invest without this sort of limit on their potential liability. Limited partnerships are discussed in further detail in Chapter 2.

The right to form a limited partnership was not a creation of the common law. The right to form a limited partnership has instead been provided for by statute. A limited partnership can only be created by registration pursuant to the statute of the jurisdiction in which one wishes to register. Statutes in common law jurisdictions that provide for limited partnership often restrict the involvement of the limited partners in the running of the partnership business.[9] The statutes may provide, for instance, that limited partners may not take part in the "control" of the business, or, as in some statutes, that limited partners may not take part in the "management" of the business. That is why, in the example given in the paragraph above, Tomi's lack of interest in taking part in the control or management of the business suggests that in negotiations with Aya, Tomi might want to raise the possibility of being a limited partner.

Limited partnership is also similar to partnership in that the limited partnership is not a legally recognized separate entity. Thus, the partners (both general and limited) collectively own the assets of the partnership business. Further, as noted with non-limited partnerships discussed above, contracts between the limited partnership and others are, unless otherwise provided, contracts between those others and all the partners, both general and

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9 This continues to be the case in Canadian limited partnership legislation: see e.g. Alberta *Partnership Act*, RSA 2000, c P-3, as amended, s 64; British Columbia *Partnership Act*, RSBC 1996, as amended, s 65; Ontario *Limited Partnerships Act*, RSO 1990, c L.6, as amended, s 13(1). Limited partnership legislation in the various states of the United States also restricted the involvement of limited partners in the running of the partnership business until 2001. Since then many states have amended their limited partnership legislation by adopting s 303 of the *Revised Uniform Limited Partnership Act*, which eliminates this restriction.

limited. While, given their restricted involvement in the running of the business, the limited partners may not be directly liable for torts committed in carrying on the business, they may be vicariously liable for the acts of agents and employees engaged in the carrying on of the business. However, as noted, the liability of the limited partners is limited to the amount of their investment.

4. Limited Liability Partnership

Another type of partnership that has recently been provided for in several jurisdictions in Canada is a "limited liability partnership." Be careful here. Although the name for this type of partnership is similar to "limited partnership," it is a different concept. Legislation allowing for limited liability partnerships responded to concerns about an increasing scope of liability in large partnerships, particularly professional partnerships. The problem in large professional partnerships was that where one partner had engaged in acts that led to liability in tort (for example, for negligence) all the other partners were vicariously liable even though they may have had nothing to do with the particular tortious behaviour.

Several provinces have legislation permitting limited liability partnerships.[10] The model for limited liability partnership adopted in most provinces allows professionals (for example, doctors, lawyers, accountants, and engineers) to form a limited liability partnership in which partners are not liable for the acts of their fellow partners or employees unless they were directly supervising the activity that caused the loss.[11] This model is known as "partial shield" limited liability. Some jurisdictions, such as British Columbia, Ontario, Saskatchewan, and New Brunswick, allow for "full shield" limited liability partnerships in which the liability of partners is limited not just with respect to liability arising from the acts of fellow partners or employees but also from debts owing to creditors of the firm generally.[12]

Law firms, for example, often operate as limited liability partnerships, signalled by the use of the letters "LLP" as a suffix to the partnership name. Otherwise, the limited liability partnership functions like an ordinary partnership. As with an ordinary partnership, the limited liability partnership would not be recognized as a separate legal entity. Limited liability partnerships are discussed in further detail in Chapter 2.

10 See e.g. Alberta *Partnership Act*, RSA 2000, c P-3, as amended, Part 3; British Columbia *Partnership Act*, RSBC 1996, as amended, Part 6; Manitoba, *Partnership Act*, CCSM c P30, Part III; New Brunswick *Partnership Act*, RSNB 1973, as amended, c P-4, Part III; Nova Scotia *Partnership Act*, RSNS 1989, s 334, Part II; Ontario *Partnerships Act*, RSO 1990, c P.5, as amended, ss 44.1 to 44.4; Saskatchewan, *Partnership Act*, RSS 1978, c P-3, as amended, Part IV.

11 See e.g. Manitoba, *Partnership Act*, *supra* note 10, s 69; *New Brunswick, Partnerships and Business Names Registration Act*, RSNB 1973, c P-5 (as amended by SNB 2003, c 14, s 7), s 8.1; Nova Scotia *Partnership Act*, *supra* note 10, s 51; Ontario *Partnerships Act*, *supra* note 10, s 44.2; Alberta *Partnership Act*, *supra* note 10, ss 81 and 82; Saskatchewan, *Partnership Act*, *supra* note 10, s 86. The British Columbia limited liability partnership is not restricted to professional partnerships: see the British Columbia *Partnership Act*, *supra* note 10, ss 96 and 97.

12 British Columbia *Partnership Act*, RSBC 1996, as amended, s 104; New Brunswick *Partnership Act*, RSNB 1973, as amended, c P-4, s 48; Ontario *Partnerships Act*, RSO 1990, c P.5, as amended, s 10(2); Saskatchewan, *Partnership Act*, RSS 1978, c P-3, as amended, s 80.

5. Corporations

If a business is likely to incur losses in the early stages, it may make sense for tax reasons to operate the business as a sole proprietorship or partnership (or limited partnership). This would allow losses incurred in the business to be applied against other sources of income that Aya, or Aya and Tomi, might have.[13] However, when Aya sought further financing from Tomi, her business had been a success for some time. The business had been doing well enough to expect reasonable profits in the future and Aya's accountant suggested that instead of continuing as a sole proprietor, or entering into a partnership or limited partnership with Tomi, she consider carrying on the business through a corporation. This, the accountant noted, would allow Aya and Tomi to take advantage of a small business deduction for tax purposes.[14]

The corporate form of organization is the main topic of discussion in this book, occupying some or all of the discussion in Chapters 3 through 15. Corporations are often said to have three key features: separate existence (or separate legal entity/personality), limited liability, and perpetual existence. Each of these key features is briefly noted below. Three other features of a corporation are sometimes also noted: free transferability of shares, centralized management, and a measure of shareholder control over management. As discussed further in Section III.B.5.f below, these various features of the corporate form are not imperative but involve policy choices.

The equity investors in for-profit corporations are referred to as shareholders and the business is managed or supervised through a board of directors. The nature of shares and the management structure of for-profit corporations are also briefly noted below.

a. Separate Existence (Separate Legal Entity/Personality)

Unlike sole proprietorships and partnerships, a corporation is recognized as a separate legal entity. Consequently, the corporation can enter into contracts with other persons and is liable in the event that it breaches those contracts. Since the corporation can contract with other persons, it can borrow from other persons and it can buy goods on credit. Thus, a

13 Under the *Income Tax Act,* RSC 1985, c 1 (5th Supp), as amended, a taxpayer includes in his or her income income from various sources such as employment, business, or property and deducts losses from sources such as employment, business, or property. Deducting losses from sources of income reduces overall taxable income and thereby reduces the amount of tax payable. The *Income Tax Act* treats corporations as separate taxpayers. A shareholder in a corporation cannot deduct losses that a corporation has incurred since the corporation is a separate taxpayer. The *Income Tax Act* does not treat partnerships as separate taxpayers. Instead the profit or loss of a partnership is calculated and then allocated to partners in accordance with the allocation of profits and losses under the partnership agreement. If the partnership suffers a loss, it is allocated to the partners (such as Aya and Tomi) and a partner can deduct that loss from other sources of income the partner may have. A sole proprietor's business is also not treated as a separate taxpayer under the *Income Tax Act*. Consequently, a loss incurred in a sole proprietorship business can be deducted from other sources of income the sole proprietor may have. While losses incurred by a corporation can be carried forward to be deducted from income in future years, the benefit of the deduction is deferred to those future years and may never arise if the corporation does not make a profit in future years.

14 See the *Income Tax Act*, *ibid*, s 125.

corporation, as a separate legal entity, can have creditors. Because of its separate legal existence, the corporation can also be liable for torts arising from carrying on the business conducted through the corporation. The corporation, since it is a separate legal entity, can own assets. Thus, the corporation normally owns the assets used in the business.

b. Shareholders

Normally, a corporation will have several equity investors. It was common in the past to require a minimum number of equity investors in a corporation (for example, five or seven).[15] In Canada, however, corporate statutes generally allow for corporations with only one equity investor.

The interests of equity investors in for-profit corporations are divided into shares, and the equity investors are typically referred to as shareholders. These shares consist of bundles of legal rights that investors can assert primarily against the corporation. These shares do not, however, give the shareholders legal title to the assets of the corporation. It is the corporation, as a separate legal entity, that has legal title to the assets. Shares are presumed to be freely transferable; however, as will be seen in Chapter 7, the trading of shares in privately held companies can be subject to significant securities regulatory constraints. It is also common in privately held companies to impose significant restrictions on the transfer of shares.

In the example above, Aya, instead of operating as a sole proprietor, could carry on the business through a corporation. She could be the sole shareholder in the corporation. If Tomi joined Aya as an equity investor in the business, Tomi would also be a shareholder in the corporation. The assets used in the business—for example, the light fixtures, cash counter, shelving, freezers, storage cabinets, inventory of goods for sale and accounts receivable—would be owned by the corporation. Aya as shareholder, or Aya and Tomi as shareholders, would have rights associated with the shares they owned. These rights might include, for example, the right to share in a distribution of profits of the corporation (as a "dividend"); the right to share in a distribution of the net proceeds of liquidation on the dissolution of the corporation; and the right to vote on important matters concerning the corporation (such as the election of the directors for the corporation, which is discussed further in Section III.B.5.e below).

c. Limited Liability

The liability of the shareholders in a corporation is typically limited to the amount of their investment. In that respect their position is similar to that of limited partners in a limited partnership. However, unlike a limited partnership, there is no constraint on the extent to which shareholders can become involved in the management of the business. Thus, if Aya were the sole shareholder, she could take part in the management of the business and still have her liability limited to the amount she had invested in the business. If Aya and Tomi

15 See e.g. *The Companies Act, 1862* (UK), 25 & 26 Vict, c 89, s 6, which required seven or more persons for the formation of an incorporated company without limited liability. In Canada, see e.g. the *Canada Corporations Act*, RSC 1970, c C-32, s 5, which required not less than three persons to form a company under the Act; and see e.g. the *Nova Scotia Companies Act*, RSNS 1900, c 128, s 6, which required three persons for the incorporation of a company under that Act.

were shareholders, either or both of them could take part in the management of the business and still have their liability limited to the amount they had invested in the business.

When Aya approaches Tomi to ask him to invest in the business, Tomi might be willing to invest under two key conditions. First, he might want to take part in the management of the business along with Aya. Second, he might also indicate that he is not willing to invest unless his potential liability is limited to the amount of his investment. As noted above, a limited partnership would not work to limit Tomi's liability to the amount he has invested if Tomi takes part in the "control" or "management" of the business. A corporation would, however, allow Tomi to invest as a shareholder in the corporation and would allow him to take part in the management of the business without incurring the same risk of losing his limited liability as a shareholder. As noted above in the discussion of limited partnerships, the ability to offer investors limited liability may be crucial to attracting investors.

While corporate statutes typically do limit the liability of the shareholders to the amount of their investment (or the amount they have agreed to contribute), it is possible to have a corporate statute that does not provide such a limited liability protection. The earliest corporate statute in England did not provide limited liability.[16] Unlimited liability companies are provided for in corporate legislation in Alberta, British Columbia, and Nova Scotia.[17] Thus it is still possible for a corporation to have a separate legal personality, but have equity investors whose liability is not limited to the amount they have invested.

d. Perpetual Existence

While a corporate statute could theoretically require a limit on the length of time for which a corporation could exist, corporate statutes typically do not impose such requirements. Thus a corporation, recognized as a separate legal entity, could exist indefinitely. Its existence can be, as it is sometimes said, "perpetual." Shareholders can become bankrupt or die, and it will not affect the continued existence of the corporation.

Thus, for example, if Aya was the sole shareholder and she died, her shares would pass to her executor or administrator and then perhaps be passed on to her heirs. The corporation would not come to an end. It would continue to exist in the same way it had before Aya's death, even though there was a change in the persons who were the shareholders in the corporation. If Aya and Tomi were partners and sold their partnership interests to Smith and Jones, the Aya and Tomi partnership in the business would come to an end. Even though the business itself might be carried on by Smith and Jones in exactly the same way it had been carried on by Aya and Tomi, it would still be a new partnership. The partners would be Smith and Jones and, subject to meeting certain requirements on the

16 The first general statute of incorporation in England was enacted in 1844: see the *Joint Stock Companies Act*, 7 & 8 Vict, c 110. That Act did not provide for limited liability: see e.g. sections XIII, XXV, and LXVI. Limited liability was made available for joint stock companies by the *Limited Liability Act*, 18 & 19 Vict, c 133. A revised act for the incorporation of joint stock companies was enacted in the following year and it provided for limited liability for shareholders: see the *Joint Stock Companies Act*, 1856, 19 & 20 Vict, c 47, s LXI; see also the discussion of limited liability in Christopher Nicholls, *Corporate Law* (Toronto: Emond Montgomery, 2005) at 77-82.

17 See Part 2.1 (ss 15.1 to 15.9) of the *Business Corporations Act*, RSA 2000, c B-9; Part 2.1 (ss 51.1 to 51.9) of the *Business Corporations Act*, SBC 2002, c. 57; and the *Companies Act*, RSNS 1989, c 81, ss 9(c), 12, and 68; see also the discussion of Nova Scotia unlimited liability companies in Nicholls, *supra* note 16 at 83-84.

retirement of Aya and Tomi as partners, Smith and Jones would be the persons liable for the subsequent debts incurred in the business, not Aya and Tomi. If, instead, Aya and Tomi had become shareholders in a corporation through which the business was carried on, they could sell their shares to Smith and Jones and the corporation would continue on as it had before. With Aya and Tomi as shareholders, the debts or other obligations incurred in carrying on the business would have been the debts or other obligations of the corporation. After the sale of the shares to Smith and Jones, subsequent debts or obligations incurred in the carrying on of the business through the corporation would be the debts or obligations of the corporation just as they had been before the transfer of the shares. The assets acquired by the corporation for the purpose of carrying on the business while Aya and Tomi were shareholders, along with any additional assets acquired by the corporation, would continue to be the assets of the corporation after Smith and Jones replaced Aya and Tomi as the shareholders of the corporation.

e. Management (or Governance) Structure

In corporations with many shareholders, the shareholders generally do not control the day-to-day management of the corporation's business. Instead, it is common to have a management team that may hold very few, or possibly even no, shares in the corporation. The basic framework for the management of corporations is that shareholders elect a board of directors. That board of directors then appoints officers of the corporation who either manage the day-to-day business of the corporation themselves or delegate various management responsibilities to other persons they hire on behalf of the corporation.

A corporation has no physical existence, so it cannot negotiate contracts or conduct business without the assistance of human beings. Thus, a corporation must act through its board of directors[18] or through agents appointed by the board of directors on behalf of the corporation. As a separate legal entity, the corporation can also hire employees (although it would do so through the board of directors or its agents appointed by the board of directors).

While this basic structure for a corporation can involve a high degree of centralization of management in a hierarchical structure, the corporate form is actually quite flexible. Even a corporation with a large number of shareholders can be structured to allow for decentralized management. Shareholder control over the management of the corporation is effected primarily through a right to elect the directors of the corporation.[19] If the directors are replaced, the newly elected directors can then appoint new persons as corporate officers to carry on the day-to-day management of the business.

This basic structure for a corporation that has many shareholders can be, and usually will be, varied where the corporation has only a few shareholders. Where the corporation has only a few shareholders, the shareholders often become directly involved in management.

In the example above, Aya, as a sole shareholder in a corporation incorporated to carry on the business, could elect herself as the sole director of the corporation. She could then

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18 The board of directors acts collectively, usually through majority vote. The board of directors acting in this way is treated as the "directing mind" of the corporation.

19 Shareholders also typically have the right to approve a limited range of particular corporate transactions such as amalgamation, a sale of all or substantially all the assets of the corporation, or a dissolution of the corporation.

appoint herself as an officer of the corporation. She might, in her capacity as the sole director of the corporation, or in her capacity as an officer of the corporation with authority delegated to her by herself as sole director, engage one or more employees or agents to assist her in carrying on the business of the corporation. Aya could also, if she wished, elect other persons as directors of the corporation who might then appoint Aya or other persons as officers of the corporation. If Tomi joined Aya as a shareholder in the corporation, then Aya and Tomi could elect one or both of themselves as directors and appoint one or both of themselves as officers. They could also elect persons other than themselves as directors of the corporation and those directors could appoint Aya or Tomi as an officer of the corporation, appoint both of them as officers of the corporation, or appoint other persons as officers of the corporation. Aya and Tomi can be employees of the corporation. In entering into such an employment contract, they would not be contracting with themselves because the employer would be the corporation as a separate legal entity.

If the business grows and seeks additional funds, it may need to raise a portion of those funds through equity investments. In the context of a for-profit corporation, this is done by issuing more shares. The shares might be sold to many shareholders, perhaps thousands of shareholders, or even millions of shareholders. The usual legal model for the management of a corporation involves shareholders voting to elect directors who then manage the corporation or supervise the management of the corporation. The directors of the board appoint officers who manage the day-to-day affairs of the corporation. These officers would normally also be given authority to hire employees on behalf of the corporation and perhaps also to delegate some aspects of their authority to these employees. The legal model thus allows for the creation of a hierarchical management structure that can be a simple structure or a large and complex structure. It allows a considerable degree of flexibility in the corporate management structure, thus allowing the corporate structure to respond to a wide range of circumstances varying from a corner store to a multinational, multi-billion-dollar enterprise.

f. Policy Choices

While reading this book, bear in mind that the features of a corporation described above, or indeed of other forms of business organization, do not arise because of the operation of some physical laws of nature—they arise because of policy choices. One might create a form of organization, perhaps referred to as a "corporation," that has a separate existence, but does not have limited liability or perpetual existence. One might, indeed, create a form of organization with any combination of the features of separate personality, limited liability, and perpetual existence (or the features of free transferability of shares, centralized management, or shareholder control over management). Each is possible, and the creation of an organization with all of these features is a policy choice.

Similarly, the management structure of a corporation is also a policy choice. The law might instead call for the election of a board of directors by some corporate stakeholder other than shareholders, some combination of corporate stakeholders, or some completely different approach. As suggested earlier in this chapter, one might approach the protection of the interests of stakeholders other than shareholders by allowing those other stakeholders to have a more direct say in the management of businesses rather than protecting them indirectly through various other laws such as consumer protection laws, employment laws, and so on.

Discussion of the corporate form of organization occupies a large part of this book. It is a form of organization, with modest variations, that has endured for a very long time. One might want to ask why this form continues to be widely used and perhaps also whether it should continue to be widely used.

6. Limited Liability Companies

In Section III.B.5.c above, concerning corporations, it was noted that one of the characteristics that corporations normally have is limited liability for their equity investors (although this is not necessarily so). It thus seems a bit odd that in the United States there would be an additional type of corporate entity referred to as a "limited liability company." The US limited liability company combines features of partnerships and corporations. The members of a limited liability company can elect to treat it as a partnership for federal tax purposes. This allows the income of the limited liability company to be treated as income of the members and taxed in their hands. This so-called flow-through taxation can be beneficial for the members of the limited liability company.[20] Although a partnership or limited partnership would provide this sort of flow-through tax treatment, the limited liability company provides the additional benefits of separate corporate personality and limited liability.

7. Unlimited Liability Companies

The Nova Scotia *Companies Act*[21] has long allowed for "unlimited companies" based on similar provisions in earlier United Kingdom companies acts.[22] With the unlimited liability company, shareholders are jointly and severally liable for the debts of the company. Although the Nova Scotia unlimited company was seldom used, it became popular when tax advisers in the United States became aware of it and realized it had tax advantages under US tax laws for investment in Canada by US investors. In particular, it allowed US investors to avoid a degree of double taxation of corporate income by allowing the income not to be taxed in the corporation, but to flow through to investors so that it was taxed only once in their hands as shareholders. Many Canadian subsidiaries of US corporations were being

20 There are two potential advantages of flow-through taxation. One is that, as discussed in the context of the Canadian *Income Tax Act*, *supra* note 13, losses that flow through to individual investors can be deducted against other sources of income, thereby reducing taxable income, which reduces the amount of tax payable. The other potential advantage to investors in the United States is that there is a degree of double taxation of corporate income—that is, the income is taxed once in the hands of the corporation and then again in the hands of shareholders when dividends are paid. There is a degree of double-taxation of corporate income in the United States: see the discussion in e.g. Kyle Pomerleau, "Eliminating Double Taxation through Corporate Integration," Fiscal Fact No 453 (Tax Foundation, February 2015), online: <https://taxfoundation.org/eliminating-double-taxation-through-corporate-integration>. Flow-through tax treatment means the income will be taxed only in the hands of the investors—the shareholders in a limited liability company.

21 RSNS 1989, c 81.

22 See e.g. *The Companies Act, 1862* (UK), 28 & 29 Vict, c 89, s 6, which provided that persons could form "an incorporated Company, with or *without* limited liability" (emphasis added). The *Nova Scotia Companies Act*, RSNS 1900, c 128, s 6 also referred to the incorporation of a company "with or *without* limited liability" (emphasis added).

incorporated using the Nova Scotia unlimited liability form. These incorporations in Nova Scotia brought revenues to the province by way of incorporation fees. In 2005 Alberta sought to obtain similar incorporation fee revenues by also allowing for the incorporation of unlimited liability companies, and British Columbia did the same in 2007.[23]

8. *United States "C Corporations" and "S Corporations"*

One may from time to time hear of a "C corporation." That expression arises under federal income tax law and describes a corporation that is taxed separately from its shareholders. In the United States, a C Corporation must file an income tax return and pay tax on the income it earns from carrying on the business of the corporation. The expression "S corporation" also arises under federal income tax law and describes a corporation that is not taxed separately from its shareholders—it does not have to file a federal income tax return or pay tax on the income it earns from carrying on the business of the corporation. Instead, like the tax treatment of partnership income, the income flows through to the shareholders and is taxed in their hands only and not in the hands of the corporation. The shareholders are taxed on their *pro rata* share of the income of the corporation based on their relative rights as shareholders to receive income of the corporation. To qualify as an S corporation, the corporation must have just one class of shares and no more than 75 shareholders who, subject to limited exceptions, have to be individuals who are citizens or residents of the United States.[24] For S Corporation treatment, the qualifying corporation must file an election with the Internal Revenue Service to be treated as an S corporation.[25]

9. *Business Trusts*

It is also possible to use a trust to set out a management structure for a business. A trust used for this purpose is usually referred to as a "business trust."[26]

a. What Is a Trust?

The type of trust that is used in a business trust is an express trust. An express trust is one that one or more persons intended to create. It involves one or more persons referred to as "settlors," who put the title to property in trust in the hands of one or more persons who are referred to as "trustees," with instructions that the trustees hold that property for the bene–fit of other persons who are referred to as "beneficiaries." The settlors, trustees, and

23 See SA 2005, c 8, s 9, adding Part 2.1, ss 15.1 to 15.9 to the *Business Corporations Act*, RSA 2000, c B-9; and see the *Financial Statutes Amendment Act, 2007*, SBC 2007, c 7, adding Part 2.1 on unlimited liability companies to the *Business Corporations Act*, SBC 2002, c 57.

24 See 26 US Code § 1361—S Corporation defined, art A.

25 *Ibid*; see also § 1362(a).

26 Sometimes the term "business trust" is used to describe any trust that is used for commercial purposes. Others use the term "commercial trust" to refer to trusts created for commercial purposes, generally leaving the expression "business trust" to refer to a trust that is set up as a form of association for carrying on business.

beneficiaries can all be different persons, or settlors can also be either trustees or beneficiaries or both.

The details of the operation of the trust can be set out in a document (the "trust instrument," which is often given the title "declaration of trust"), and the law allows for a great degree of flexibility as to what can be done in terms of how the trust will operate. The law does not recognize the trust as a separate person (although the *Income Tax Act* effectively does so, but only for the purpose of determining the taxable income for a trust). Since a trust is not a separate legal entity, it is the trustees who have title to the assets and who can transact with respect to those assets on behalf of the beneficiaries.

b. The Business Trust Form of Association

i. Investors as Settlors and Beneficiaries

With this short note on the express trust one can quickly see how a trust can be set up to look quite similar to a corporation. Equity investors can invest by settling funds on one or more trustees who are charged with a duty to manage those funds on behalf of beneficiaries. The beneficiaries are the investors themselves.

ii. Creating Equivalents to the Shares, the Board of Directors, and Officers

Investor beneficial interests can be divided up into units resembling shares. The trust instrument can provide for the election of the trustees by the investor-beneficiaries, thus replicating the board of directors of the corporation. The trustees can be given authority to delegate aspects of their management duties to others, thus allowing them to engage agents and hire persons who can be given management duties similar to those given to officers of corporations.

iii. Limited Liability

Since it is the trustees that have the authority to deal with the assets, it is the trustees who would normally be liable with respect to contracts or torts arising in the conduct of the business. Thus, as long as the investor-beneficiaries are not trustees they will have some protection against personal liability that *may* roughly approximate the limited liability of shareholders in a corporation. Since the trustees are carrying on the business, it will be the trustees who enter into contracts (either themselves or through agents) and who will be liable for torts committed in the conduct of the business (either directly or vicariously). Since the investors do not normally themselves enter into contracts concerning the conduct of the business, they will not be liable as parties to such contracts. The investors will not normally be directly or vicariously liable for torts committed in the conduct of the business, since the investors do not normally conduct the business activities of the business trust, either themselves or through agents or employees.

There are, however, two main potential sources of liability risk for investors. One is based on an implied right of trustees to be indemnified for their losses by beneficiaries in some situations. The other is based on the possibility that the trustees will also be considered agents of the investors in some situations. The trustees can waive any right they may

have to indemnification, thus avoiding the otherwise implied right of trustees to have the beneficiaries (who are the investors in a business trust) indemnify them for their losses. With respect to the potential agency argument, the likelihood of the trustees being considered agents for the investors is small as long as the investors do not have significant control over the business. Thus, by having the trustees waive any right they might have to indemnification from the investors, and as long as the investors do not have significant control over the conduct of the business, the risk of personal liability of the investors should be remote.[27]

c. Example

Although it would be unusual to use a business trust as a structure for a business such as the Quick Buys convenience store business (for reasons noted in Section III.B.9.d below), one can consider how this might be done. Aya and Tomi could settle funds on persons they selected as trustees for the purpose of running the store business. The trustees could acquire the assets needed to carry on the business and then carry on the business. Profits from the business could be distributed to Aya and Tomi as beneficiaries of the trust. A trust instrument (often entitled "declaration of trust") could set out the terms of the trust. This might, for instance, allow Aya and Tomi as beneficiaries to elect trustees on a regular basis. It could set out the rights of beneficiaries to share in the distribution of the profits of the business and to share in the net proceeds if the business were brought to an end, the assets were sold, and the debts incurred by the trustees were paid off. The trustees could be given authority to delegate certain of their duties to other persons who might thereby have a similar function to officers of a corporation.

Since it would be the trustees who carry on the business, the trustees would be liable for the debts incurred in carrying on the business. If, therefore, Aya and Tomi were trustees, they would be liable for the debts of the business. Consequently, if Aya and Tomi wanted to recreate the limited liability they might have in a corporation, they could not be trustees themselves. They would also have to make sure that the declaration of trust included a clause in which the trustees waived their right to indemnification. In addition, they would have to be careful that the degree of control they were able to exert over the trustees did not have the effect of making the trustees their agents. If the trustees could be construed as being agents for Aya and Tomi, then Aya and Tomi would be liable as principals for debts incurred or vicariously liable for torts committed in the carrying on of the business.

d. Situations in Which Trusts Are Currently Used as a Form of Business Association

The trust is not normally used as a form of business association in the way described in the example above. The main problem with using a trust in the way described in the example is that the *Income Tax Act* deems a trust to dispose of its assets every 21 years. This deemed disposition of assets triggers capital gains tax. The *Income Tax Act* deems a disposition

27 See the discussion in e.g. R Flannigan, "Beneficiary Liability in Business Trusts" (1982-84) 6 E & TQ 278; and Mark R Gillen, "Income Trust Unitholder Liability: Risk and Legislative Response" (2005) 42 Can Bus LJ 325 at 332-43.

because tax on capital gains arises only on a disposition of a capital asset and one could use a trust, even under the common law remoteness of vesting perpetuity rule, that would last for quite a long time (potentially many years more than just 21 years) without a disposition of the assets of the trust. Assets held by a sole proprietor, a partnership, or a corporation are not subject to this 21-year deemed disposition rule. Exceptions are, however, made for certain types of trusts. Mutual fund trusts and real estate investment trusts (REITs) are not subject to the 21-year deemed disposition rule.[28] Trusts are, therefore, often used for mutual funds and real estate instatement funds.[29]

i. Mutual Fund Trusts

A mutual fund collects funds from many investors and invests them in a diversified portfolio of investments in securities such as shares in corporations, debentures, government bonds, and commercial paper. This allows investors to get a diversified portfolio much more cheaply than they would be able to obtain on their own. It can also provide investors with the benefit of investment expertise of mutual fund managers, which the investors may lack themselves. Organization of a mutual fund as a trust allows for the income on the mutual fund investments to flow through to mutual fund investors (the beneficiaries of the trust) without a tax first being imposed on the mutual fund trust as long as the income of the mutual fund is distributed to investors. The use of a trust for a mutual fund with the benefit of this tax flowthrough treatment would be strongly discouraged if the mutual fund trust was required to pay capital gains tax on all its assets every 21 years because of the 21-year deemed disposition rule for trusts. An exception to the 21-year deemed disposition rule is therefore made for mutual fund trusts.[30]

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28 The 21-year deemed disposition rule is in s 104(4) of the *Income Tax Act*, *supra* note 13. It applies to "every trust," but in defining "trust" s 108(1) states that in applying s 104(4) "trust" does not include "a trust that, at that time, is a unit trust." The definition of "mutual fund trust" in s 132(6) requires that a "mutual fund trust" be a "unit trust resident in Canada." A trust that qualifies as a "mutual fund trust" will therefore not be a "trust" for the purposes of s 104(4) and will therefore not be subject to the 21-year deemed disposition rule in s 104(4). A "unit trust" is defined in s 108(2). A real estate investment trust will also be exempt from the 21-year deemed disposition rule if it qualifies under the *Income Tax Act* as a "mutual fund trust."

29 In the 1990s, creative tax practitioners came up with a way of reorganizing a business to use a trust to get the benefit of flowthrough taxation, which could avoid a degree of double taxation of corporate income. It also took advantage of low rates of taxation for certain types of investors, such as those saving for retirement and investors who were not residents of Canada. The basic idea was to create a trust for investment in a particular business that met the requirements for a "mutual fund trust" under the *Income Tax Act*. That way, the trust could rely on the mutual fund trust exemption from the 21-year deemed disposition rule for trusts. The *Income Tax Act* was amended to cut off this particular use of the trust for a particular business or for a small number of businesses. The amendment was done in such a way as to preserve the exemption from the 21-year deemed disposition rule for mutual fund trusts and real estate investment trusts that maintained a portfolio with many investments. For further details on this "business income trust" phenomenon and the changes that brought it to an end, see Robert Yalden, Janis Sarra, Paul Paton, Mark R Gillen, Ronald Davis & Mary Condon, *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery, 2008) ch 12 at 1111-73.

30 See *supra* note 28.

ii. Real Estate Investment Trusts

A real estate investment trust is similar to a mutual fund. Funds are collected from numerous investors and are invested in various real estate investments. Like the mutual fund trust, the use of a trust for such a pooling of real estate investments allows the income on the real estate investments to be taxed only in the hands of the investors, and not first taxed in the hands of the trust, as long as the income on the real estate investment portfolio is distributed to the investors. The use of a trust for such a real estate investment fund would be strongly discouraged if the trust was required to pay capital gains tax on all its assets every 21 years due to a 21-year deemed disposition rule for trusts. The 21-year deemed disposition rule does not apply where the real estate investment trusts qualifies under the *Income Tax Act* as a mutual fund trust.[31]

C. Not-for-Profit Forms of Association

Although the primary focus of this book is on for-profit forms of association, it is worth noting that the common for-profit forms of business association have their analogues in the not-for-profit sector. For example, there are not-for-profit corporations and not-for-profit unincorporated associations, which share some similarities with partnerships.

1. Societies or Not-for-Profit (or Non-Profit) Corporations

It is common to have separate statutes for the incorporation of not-for-profit (or non-profit) corporations that will carry on their activities on a not-for-profit basis. Persons taking on a role somewhat similar to shareholders in for-profit corporations are typically referred to as members. The members usually elect a board of directors or an executive committee that will manage or supervise the management of the not-for-profit corporation's activities. The board of directors or executive committee may then engage agents and hire others to carry on the activities of the corporation.

In addition to voting to elect a board of directors or an executive committee, voting by members will also typically be required to amend the articles, bylaws, or other constitutional documents of the not-for-profit corporation. The members may also be persons who receive the benefits from the activities performed by the not-for-profit corporation.

The expression "not-for-profit" or "non-profit" corporation is used to describe such corporations in many jurisdictions in Canada.[32] In some Canadian jurisdictions there is a separate not-for-profit corporation statute styled "Corporations Act" in contrast to the for-profit corporation statute, typically styled "Business Corporations Act."[33] In other Canadian jurisdictions, both for-profit and not-for-profit companies or corporations can be formed under

31 See *supra* note 28.

32 See e.g. the *Canada Not-for-profit Corporations Act*, SC 2009, c 23; in Saskatchewan, see *The Non-profit Corporations Act*, SS 1995, c N-4.2.

33 See e.g. the Ontario *Corporations Act*, RSO 1900, c C.38 and the Ontario *Business Corporations Act*, RSO 1990, c B.16; in Alberta, see the *Companies Act*, RSA 2000, c C-21, part 9, and the Alberta *Business Corporations Act*, RSA 2000, c B-9; and in New Brunswick, see ss 16 and 18 of the *Companies Act*, RSNB 1973, c C-13 and the New Brunswick *Business Corporations Act*, SNB 1981, c B-9.1.

a single general statute of incorporation styled a "Corporations Act" or a "Companies Act."[34] However, both British Columbia and Nova Scotia have a "Societies Act" that allows for the incorporation of societies that will carry on their activities on a not-for-profit basis.[35]

Societies, or not-for-profit corporations, are often used to carry on charitable activities. However, charities do not have to be set up as not-for-profit corporations. They could be organized as trusts or as unincorporated associations.

Not-for-profit corporations get special tax treatment under the *Income Tax Act*.[36] The *Income Tax Act* taxes income and capital gains. A not-for-profit corporation, as the name suggests, is not intended to earn a profit. Although it may earn a surplus in a given year, as long as that surplus does not accumulate for a prolonged period, the not-for-profit corporation will not be subject to tax under the *Income Tax Act*.[37] If the not-for-profit corporation carries on charitable activities and becomes registered as a "registered charity," receipts can be given to persons who make donations to the corporation so that they can claim tax credits for their charitable donations.[38] What constitutes a "charitable activity" is, for the most part, determined according to the trust law definition of "charitable purposes." It is important for a charitable not-for-profit corporation (or other charitable organization) to maintain its status as a registered charity if it wants to continue to allow its donors to get tax credits for their charitable donations.

2. Unincorporated Associations

Although persons who carry on business in common with a view to profit are considered to be partners, if they act in common but not for profit and have not formed a corporation, they are described as members of an "unincorporated association."

An unincorporated association is not recognized as a separate legal entity and therefore cannot enter into contracts with other persons—it is the members of the unincorporated association who are parties to contracts entered into in carrying on the activities of an unincorporated association. An unincorporated association cannot be responsible for a tort committed in carrying on the activities of the unincorporated association because it is not recognized as a separate legal entity. It is, instead, the members who will be responsible for torts committed in carrying on the activities of the unincorporated association. The members may be considered agents for each other in the carrying on of the activities of the unincorporated association, and the members can engage other agents and employees. Amounts owed to creditors with respect to debts incurred in carrying on the activities of an unincorporated association will be owed by the members of the unincorporated association, not the unincorporated association because it is not a recognized legal entity capable of incurring debts either by way of contract or tort.

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34 See e.g. part II of the Prince Edward Island *Companies Act*, RSPEI 1974, c C-14 (ss 89 to 91); for Manitoba, see part XXII of the *The Corporations Act*, CCSM c C225; and for Newfoundland and Labrador, see part XXI of the *Corporations Act*, RSNL 1990, c C-36.

35 See e.g. the BC *Societies Act*, SBC 2015, c 18; and the Nova Scotia *Societies Act*, RSNS 1989, c 435.

36 RSC 1985, c 1 (5th Supp.), as amended, ss 149(1)(l).

37 See paras 8 and 9 of the income tax *Interpretation Bulletin*, IT-496R on non-profit organizations, online: <http://www.cra-arc.gc.ca/E/pub/tp/it496r/it496r-e.html>.

38 See the *Income Tax Act*, *supra* note 13, ss 118.1 and 149.1.

D. Combined for-Profit and Not-for-Profit Forms of Business Association

The primary objective of the partnership and corporate forms of association described above is normally profit. Profit is, in fact, part of the definition of partnership in partnership legislation. The discussion under this heading is about forms of business association that may pursue profits but may also pursue other objectives. An important part of the objectives of co-operative associations and mutual organizations discussed below is to serve their members. Some more recent forms of association, discussed below under the heading "social enterprise," may also combine a profit objective with one or more not-for-profit objectives.

1. Co-operative Associations

Much of what was said earlier about corporations applies to co-operative associations since co-operative associations are corporate forms of organization.[39] For instance, as a corporation, a co-operative association is treated as a separate legal entity with potential perpetual existence. It has shareholders (referred to as members),[40] and it has directors and officers. A key distinguishing feature of a co-operative form of organization is that it is subject to co-operative principles.[41] A common principle for co-operative corporations is that there is one vote per member[42] instead of the normal one or more votes per share approach in for-profit corporations. Another common co-operative principle is that the co-operative corporation is organized to serve the common needs of the members of the co-operative.[43] This principle

39 See e.g. the Ontario *Co-operative Corporations Act*, RSO 1990, c 35, s 1(1), which defines "co-operative" to mean "a *corporation* carrying on an enterprise on a co-operative basis" (emphasis added); see also the BC *Co-operative Association Act*, SBC 1999, c 28, s 1(1), which defines "association" to mean "an association *incorporated* … under this Act" (emphasis added).

40 "Member" was a term used in English companies acts to refer to the shareholders of a company: see e.g. *The Companies Act*, 1862 (UK), 25 & 26 Vict, c 89. It was also the term used in e.g. *An Act for the Incorporation and Regulation of Joint Stock Companies and Trading Corporations*, RSBC 1897, c 44, and the Nova Scotia *Companies Act*, RSNS 1989, c 81. The members of a co-operative corporation typically hold shares: see e.g. the Ontario *Co-operative Corporations Act*, *supra* note 39, s 25, which states that "the authorized capital of a co-operative shall be divided into shares." Section 26(2) states that "where a co-operative has only one class of shares, that class shall be membership shares," and s 26(3) states that "where a co-operative has more than one class of shares, one class shall be membership shares … , and the other shares shall consist of one or more classes of preference shares." On classes of shares and the meaning of preference shares, see Chapter 6.

41 See e.g. the Ontario *Co-operative Corporations Act*, *supra* note 39, s 1(1), which defines "co-operative basis" to mean that the corporation is "organized, operated and administered upon the following principles and methods." See also the BC *Co-operative Association Act*, *supra* note 39, s 8(1), which states that a co-operative association incorporated under the Act "must carry on business on a co-operative basis," and s 8(2), which sets out co-operative principles. See also the *Cooperatives Act*, SA 2001, c C-28.1, s 2; *The Co-operatives Act*, CCSM c C223, s 4(1); *Co-operative Associations Act*, RSNS 1989, c 98, s 2(d); and *The Co-operatives Act*, 1996, SS 1996, c C-37.3, s 3.

42 See e.g. the Ontario *Co-operative Corporations Act*, *supra* note 39, s 1(1), which in its definition of "co-operative basis" includes among the co-operative principles the principle that "each member or delegate has only one vote" and see the BC *Co-operative Association Act*, *supra* note 39, s 40(1), which states that "a member has one vote on all matters to be decided by the members," and s 40(2) adds that "a member's right to vote derives from membership and not membership shares."

43 See e.g. the BC *Co-operative Association Act*, *supra* note 39, s 8(2)(a), which states that "membership in the association is open in a non-discriminatory manner to persons who can use the services of the association."

of serving the common needs of members is reflected in a further common co-operative principle that profits of the co-operative corporation are shared among the members on the basis of how much they use the services of the organization, not on how many shares they own.[44] For example, co-operative corporations often distribute profits to their members in the form of lower prices or reduced fees for services.

2. Mutual Organization

A mutual organization is very similar to the co-operative association described above. Like the co-operative association, it is formed for the benefit of the members of the organization and usually operates on a non-profit basis with the members benefiting from the services of the mutual organization. Unlike co-operative associations formed under co-operative association legislation, a mutual organization is not set up through a specific statute for the formation of mutual organizations, but can be set up as a corporation (such as a society or not-for-profit corporation),[45] or it may operate as an unincorporated association.[46] The members of the mutual organization typically provide capital through payment of fees instead of contributing capital in exchange for shares. Fees paid by members may be for services such as banking, mortgages, property or crop damage protection for farmers, fire insurance, retirement benefits, disability or sickness insurance, or assistance to needy members.

The mutual form of organization has a long history. It has been used in England for "building societies" that provided mortgages to its members and for "friendly societies" that provided pensions, co-operative banking, or insurance services. It has been used for farmers to protect against property damage (such as a barn fire) or crop damage due to bad weather. In the past, stock exchanges, including the Toronto Stock Exchange, were often organized as mutual organizations for member brokers. Many well-known insurance companies, such as Mutual of Omaha and Lloyds of London, have operated as mutual organizations.

A "mutual organization" should not be confused with a "mutual fund." A mutual fund is typically organized as a corporation or trust that pools funds from investors to invest in a diversified portfolio of securities such as shares, corporate debentures, and government bonds or treasury bills.[47]

3. Social Enterprise

Chapter 8 of the book focuses on social enterprise. "Social enterprise" has been defined by the Canadian federal government's Ministry of Innovation, Science, and Economic Development in the following way:

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44 See e.g. the Ontario *Co-operative Corporations Act*, *supra* note 39, s 1(1), which in its definition of "co-operative basis" includes among the co-operative principles the principle that "any surplus funds arising from the business of the organization, after providing for such reasonable reserves and interest or dividends, unless used to maintain or improve services of the organization for its members or donated for community welfare or the propagation of co-operative principles, are distributed in whole or in part among the members, … (ii) in proportion to the volume of business the members have done with or through the organization."

45 See above Section III.C.1.

46 See above Section III.C.2.

47 See above Section III.B.9.d.i.

> A social enterprise seeks to achieve social, cultural or environmental aims through the sale of goods and services. The social enterprise can be for-profit or not-for-profit but the majority of net profits must be directed to a social objective with limited distribution to shareholders and owners.[48]

Under this definition social enterprise may include charitable organizations since they sometimes carry on profit-making activities to a limited degree—for example, running a cafeteria or a gift shop—and directing the profit to the organization's charitable activities. Not-for-profit corporations can also earn profits, or surpluses, as long as these are ultimately directed to the corporation's not-for-profit objectives. Co-operative and mutual forms of organization may also pursue social, cultural, or environmental objectives.

In addition, for-profit corporations may, at least to some degree, also seek to achieve social, cultural, or environmental objectives. Even where a for-profit corporation's objective is a pure profit objective, it has long been recognized that it can follow socially responsible activities that can reasonably be said to promote its profit-making objectives. The modern Canadian approach to the fiduciary duties of directors and officers recognizes that the directors and officers may take into account the interests of stakeholders other than just the shareholders. Further, while it has been held in the past that the presumed objective of a for-profit corporation is the pursuit of profit, corporate statutes, even for-profit corporate statutes, do not provide that the sole object of the corporation is profit and do not preclude the inclusion of other corporate objectives. There have, however, been a number of recent attempts to provide for forms of organization, usually corporate forms, that either make it clear that not-for-profit objectives will be pursued in addition to for-profit objectives or that attempt to provide a clearer legal basis for pursuing not-for-profit objectives in addition to for-profit objectives.

Recently, several new forms of organization have been developed that attempt to facilitate the pursuit of social, cultural, or environmental aims through the sale of goods and services. These include benefit corporation statutes in the United States[49] and legislation

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48 Government of Canada, Directory of Canadian Social Enterprises, online: <http://www.ic.gc.ca/eic/site/ccc_bt-rec_ec.nsf/eng/h_00016.html>.

49 For example, since August of 2013, a "Public Benefit Corporation" can be formed under Delaware Corporation Law that is "a for-profit corporation … that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner" and that must, in its certificate of incorporation, identify one or more specific public benefits that it will pursue. See Title 8 (Corporations), Chapter 1 (General Corporation Law), Subchapter XV (Public Benefit Corporations) (79 Del Laws, c 122, § 8) s 362(a). For a general discussion of this legislation, see Felicia R Resor, "Benefit Corporation Legislation" (2012) 12 Wyo L Rev 91 at 101-2 and 106-13. A historical precursor to benefit corporation statutes was the "B Corp" designation provided by an organization known as "B Lab," which would certify a corporation as a "B Corporation" based on an impact assessment of the corporation's governance, labour, community, and environmental practices: see "Performance Requirements," online: B Corporation website <https://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/performance-requirements> (visited 4 April 2017). Another development in the United States was the low-profit limited liability company, which used the limited liability company form (see Section III.B.6 above) with branding as low-profit relating to its social goals: see e.g. Robert M Lang Jr, "The New Way to Organize Socially Responsible and Mission Driven Organizations" (2007) 5 ALI-ABA 203 at 205-6; Cody Vitello, "Introducing the Low-Profit Limited Liability Company (L3C): The New Kid on the Block" (2011) 23 Loy Con L Rev 565; and Thomas Kelly, "Law and Choice of Entity on the Social Enterprise Frontier" (2009) 84 Tulane L Rev 337.

allowing for the formation of Community Interest Corporations in the United Kingdom[50] and Nova Scotia[51] with similar legislation in British Columbia allowing for the formation of Community Contribution Corporations.[52]

E. Other Business Association Forms

1. Joint Ventures[53]

A business may also be carried on as a "joint venture." The term "joint venture," in a general, non-legal, sense, is used to describe a relationship among persons who agree to combine skills, property, funds, time, resources, knowledge, and/or experience to pursue some common objective. Typically, each member of the joint venture has some control over the management of the joint activity and agrees to share in the profits and losses of the activity. There is, however, no precise legal meaning of the term "joint venture." A "joint venture" is not recognized as a separate legal entity.

The agreement to set up the joint venture could be a partnership agreement. The members of the joint venture might, for instance, be two separate corporations carrying on the joint venture through a partnership. The terms of the joint venture agreement would then appear in the partnership agreement.

A joint venture might also be carried on through a corporation. Two corporations, for instance, each with their own separate business activities, might set up a separate corporation through which they carry on a joint venture. Each of the joint venture corporations could be shareholders in the joint venture corporation. Key terms of their joint venture

50 In the United Kingdom, part 2 of the *Companies (Audit, Investigations and Community Enterprise) Act 2004*, UK 2004, c 27 provided for the formation of (or conversion of an existing company into) a "community interest company" (or CIC, usually pronounced "kick"). A community interest company is one that satisfies a community interest test (see s 36(5)(b) for new companies and s 38(4) for existing companies), and the community interest test is met if a reasonable person might consider that its activities are being carried on for the benefit of the community (s 35). On the formation of a community interest company, see also the website of the Office of the Regulator of Community Interest Companies, <https://www.gov.uk/government/organisations/office-of-the-regulator-of-community-interest-companies>.

51 See *An Act Respecting Community Interest Companies*, SNS 2012, c 38 (which came into force on 15 June 2016); see also the *Community Interest Companies Regulations*, NS Reg 121/2016. For a discussion of the Nova Scotia community interest company, see Pauline O'Connor, "The New Regulatory Regime for Social Enterprises in Canada: Potential Impacts on Nonprofit Growth and Sustainability," Centre for Voluntary Sector Studies, Ryerson University, Working Paper Series vol 2014(1), online: Centre for Voluntary Sector Studies <http://www.ryerson.ca/content/dam/cvss/AODAforms/datedPapers/WP 2014.1.OConnor-Social EnterpriseRegRegime.FINAL.Working Paper. Oct.21.2014.pdf> (visited 4 April 2017) at 31-32.

52 This was provided for in amendments to the BC *Business Corporations Act* that came into effect in July 2013: see the *Finance Statutes Amendment Act*, SBC 2012, c 12, s 8, which amended the BC *Business Corporations Act*, SBC 2002, c 57 by adding part 2.2, ss 51.91 to 51.99 (brought into force on 29 July 2013—BC 63/2013). See the discussion of the BC community contribution company in O'Connor, *supra* note 51 at 28-31; and Michael Blatchford & Margaret Mason, "Introducing the Community Contribution Company: A New Structure for Social Enterprise" (presented for the Legal Education Society of Alberta, November 2013), online: Bull Houser <https://www.bht.com/sites/default/files/LESA- C3 paper.pdf> (visited 4 April 2017).

53 For a brief but more extended discussion, see e.g. J Anthony van Duzer, *The Law of Partnerships and Corporations*, 3rd ed (Toronto: Irwin Law, 2009) at 76-79.

agreement might be contained in a "shareholders' agreement" entered into by each of them as shareholders in the joint venture corporation.

The terms under which the joint venture is to be operated may simply be set out in a contract with no partnership being created and no corporation being formed for carrying on the joint venture business.

2. *Franchises*[54]

Franchises are also often used in the business context. A franchise is an arrangement in which a franchisor grants a franchisee one or more rights, such as the right to sell the franchisor's products, use its business name, adopt its methods, or copy its symbols, trademarks, or architecture over a specified period of time in a specified place. The right to use the business name, or other licensed rights, is what is referred to as the franchise. That business name is usually associated with a particular way of carrying on business. The franchisor often also provides marketing support and training in the franchisor's method of carrying on business. In exchange, the franchisee pays a royalty or licence fee to the franchisor.

A franchise arrangement has one or more of three basic elements: the provision of know-how by the franchisor, image recognition provided by the franchisor's marketing support, and the benefit of joint purchasing power allowing for quantity discounts.

The key legal element of a franchise is the licence to use the name, trademark, etc., provided by the franchisor to the franchisee. The arrangement involves an exchange, and thus involves a contract. The contract is usually written, although it could be an oral contract. Franchises are governed by provincial law because they deal with contracts that fall under provincial powers with respect to property and civil rights.

The "franchise"—that is, the licence—is not a separate legal entity capable of contracting on behalf of itself. However, the franchisor could be a sole proprietor, partnership, or corporation, but it is nearly always a corporation. The franchisee could likewise be a sole proprietor, partnership, or corporation, but is most often a corporation.

3. *Multiple Contracts*

a. Business Activity Carried On Through a Series of Separate Contractual Arrangements

The various ways of associating to carry on business described above involve arrangements among persons as to how they will carry on a particular business activity. An alternative legal means of securing a co-operative business activity is through a series of separate contracts. Consider a simple item like a cheap plastic pen. One might arrange for the delivery of the ink, nib, and tube to another person who, subject to contractual terms, agrees to put these items together and ship them to another person to be inserted into the housing for the pen (with arrangements that housings be delivered to the person who puts the ink-filled tube and nib into the housing). One could make contractual arrangements with yet another person to distribute the product, and contractual arrangements might also be made for another person to market the product.

54 See van Duzer, *ibid* at 21-22, and see generally Frank Zaid, *Franchise Law* (Toronto: Irwin Law, 2005).

Each of these contracts could have terms dealing with how the particular stage in the production process is to be carried out, with further terms as to the consequences of a breach of the contract. Ultimately, one might break everything down to the point that there are no group or joint activities. Instead, every step could be done by separate persons acting independently subject to the terms of separate contractual arrangements. The whole production and distribution process could thus be coordinated through a series of explicit contracts.

b. Transaction Costs (Negotiating, Monitoring, and Enforcing)

In many business activities the multiple contract approach could involve very high costs in terms of negotiating each separate contract and in terms of monitoring and enforcing the performance of each contract. Consequently, it may be more cost-effective to have some form of organization or association to coordinate activities in a way that would be less costly than negotiating, monitoring, and enforcing numerous separate contractual arrangements.

c. Forms of Business Association as Means of Reducing Transaction Costs

Business associations of various forms might thus be seen as methods of organizing co-operative activity to reduce these negotiating, monitoring, and enforcement costs. As the organization grows in size and complexity, the cost of further organization might begin to outweigh the cost of separate contracts. At that point, further efforts at formal organization may not be worthwhile.

F. Summary

This section has examined a wide range of forms of business organization. Both legal and economic concepts of agency were noted because of the importance of agency in business relationships generally and its central importance in most forms of business organization. Various for-profit forms of business organization were then considered, including sole proprietorship, partnership, limited partnership, limited liability partnership, corporations (including a note on unlimited liability companies, C corporations, and S corporations), and business trusts (including mutual funds and real estate investment trusts). Not-for-profit corporations or societies were then briefly noted, along with unincorporated associations. Forms of business organization that can combine for-profit and not-for-profit activities were then noted, including co-operative associations and the mutual form of organization. Mention was also made of the concept of social enterprise. Last, mention was made of other ways of organizing to carry on business, such as joint ventures and franchises. The possibility of carrying on a business activity through a series of contracts was noted as a contrast to forms of organization that internalize transactions, and also with a view to introduce the notion that one way to understand the use of certain forms of business organization is as a means of reducing transactions costs that would likely be associated with organizing a business activity through a series of separate contractual arrangements.

IV. SOME SIMPLE ACCOUNTING

Some simple principles of accounting can be useful in the commercial law context generally. There are aspects of the study of business associations where some simple accounting concepts can also be useful. Perhaps the most obvious use of accounting principles is in the requirement for financial disclosure in a number of contexts. This section is intended to provide a simple introduction to some basic financial statements and a few important terms.

Four commonly used financial statements under international financial reporting standards (IFRS) are:

1. the "statement of financial position" (in the past also referred to as a balance sheet);
2. the "statement of comprehensive income" (which includes a "statement of earnings" arising from the business [sometimes also called a "statement of profit/loss"] and a statement of other sources of income or loss);
3. the "statement of changes in equity"; and
4. the "statement of cash flows."

The notes below focus on what, for our purposes, are the more important of these statements—the statement of financial position and the statement of earnings. A simple statement of changes in equity and a simple statement of cash flows are also provided below so one can get a very general sense of what these statements are about.

The objective here is not to learn the complexities of financial accounting in a few pages, but merely to see, in very simple and general terms, the kind of information that these common financial statements seek to convey. Later in the book reference will be made to the requirement since the beginning of 2011 that public corporations follow IFRS in presenting their financial statements. The IFRS are the culmination of years of effort to address country-to-country variation in financial reporting standards that made it difficult to compare financial statements prepared according to the financial reporting standards of one country with financial statements prepared according to different financial standards in another country. Private corporations can use IFRS in preparing their financial statements, but they can also use what are referred to as accounting standards for private entities (ASPE) based on Canadian accounting standards that differ in some respects from the IFRS.

Examples of financial statements are provided below on the basis of a simple fact pattern. These statements don't strictly follow proper accounting standards because the purpose is to provide simple examples without delving into the potential complexities of accounting.

A. The Statement of Financial Position (or "Balance Sheet")

The statement of financial position is usually displayed in a top-down format, but it is sometimes displayed in a left-right format. The left-right format makes its "balance" quality somewhat sharper. In the left-right format one lists the "assets" of the business on the left-hand side. One lists the "liabilities and equity" on the right-hand side. The right-hand side shows where funds for the business were obtained. The assets side (the left-hand side) shows what was done with those funds. If one accounts on the asset side for what was done with every cent of the funds received, then the asset side and the funds side should be equal—that is, they should balance.

The top-down format shows the assets first, followed by the liabilities and equity. Either way, the statement of financial position, or balance sheet, briefly put, shows the source of funds for the business and the uses of those funds.

B. The Statement of Earnings and Statement of Comprehensive Income

The statement of earnings part of the statement of comprehensive income shows the revenues of the business less the expenses of the business. The revenues could be from, for example, "sales" of goods or services, "royalties," "licence fees," or "rental income." These are listed first and totalled. Then expenses are listed and totalled and the total expenses are deducted from the total revenues. That is the essential nature of the statement of earnings, although various steps may be taken to separate various expenditures and to show the profits net of these expenditures. For instance, in a retail business there is usually a section called "cost of goods sold" that separates the cost of the goods acquired for retail from the other expenses of the business, and often shows revenues less cost of goods sold as "gross profit." Other expenses would then be deducted to arrive at net income. The other expenses would include interest expense, taxes, and an expense that recognizes the depreciation of assets that deteriorate in value over time or through use. The statement is referred to as a statement of comprehensive income because, in addition to showing the profit or loss from carrying on the business (or businesses), it also separately shows other sources of increases or decreases to assets or increases or decreases in liabilities (other than those due to contributions by investors or distributions to investors).

C. Assets, Liabilities, and Equity

Generally speaking, "assets" are things acquired for the business that will have a continuing value to the business (usually beyond one year). As noted above, the sources of funds are styled "liabilities and equity." The liabilities are set out first, followed by the equity. "Liabilities," or "debt," in the strictest sense, represent fixed obligations. For instance, a loan from a bank usually involves an obligation to pay back the fixed amount that was loaned with fixed periodic payments for the use of the money determined by reference to a rate of interest. Sometimes goods or services may be acquired for the business on credit—that is, buy now and pay later. The payment will be a fixed amount or a fixed amount plus a fixed rate of interest. "Equity," in the strict sense, is the entitlement to residual amounts—that is, amounts that are left over. Persons who have advanced funds as an "equity" investment share in the profits that are the residual amount of revenues left after payment of expenses, including interest expense. If the business is brought to an end and the assets are sold off, the equity investors are also entitled to the amount left over after the liabilities have been paid.

D. Trade Credit, Accounts Payable, and Accounts Receivable

As noted above, sometimes goods or services will be acquired for a business on credit. This credit is typically referred to as "trade credit." Trade credit extended to the business by suppliers of goods or services will appear on the liabilities section of the statement of financial position as "accounts payable"—that is, an account that must be paid. Sometimes the

business itself will extend trade credit to others. For instance, it may sell goods or provide services and allow the buyer of the goods or services to pay for them later. The vendor will have a contractual right to collect the amount. In other words, the vendor has a "chose in action." This will be reflected on the vendor's statement of financial position as an asset, typically in an account referred to as "accounts receivable"—that is, an amount the vendor is entitled to receive, or collect, at some point.

E. A Statement of Financial Position (Balance Sheet) for the Sample Fact Pattern Sole Proprietorship

Recall from the fact pattern set out in Section II that Aya Nang had put aside $75,000 to invest in her own business and that she borrowed $50,000 from a bank. Suppose Aya bought lighting for $15,000, shelving for $10,000, a cash counter for $8,000, freezers for $30,000, a cash register for $3,000, and had storage cabinets installed at a cost of $12,000. Suppose also that she started her business with $40,000 of inventory, of which $15,000 had been acquired on credit. Because she acquired $15,000 worth of her inventory on credit, she will have to pay this amount at some point in the future. It appears on the statement of financial position set out below as "Accounts Payable." Suppose the rate of interest on the loan from the bank requires her to make interest payments of $500 every month. A statement of financial position reflecting this information is set out below.

QUICK BUYS
STATEMENT OF FINANCIAL POSITION
As at the beginning of the business

Assets	
Cash	$ 22,000
Inventory	40,000
Shelving	10,000
Freezers	30,000
Cash Register	3,000
Light Fixtures	15,000
Cash Counter	8,000
Storage Cabinets	12,000
Total Assets	$140,000
Liabilities and Owner's Equity	
Liabilities:	
Accounts Payable	$ 15,000
Bank Loan	50,000
Owner's Equity:	75,000
Total Liabilities and Owner's Equity	$140,000

The statement of financial position above is intended to give a simple picture of this key financial statement. Under "Liabilities and Owner's Equity" it shows Aya's source of funds for her business. Her funds came from her own investment of $75,000, the bank loan of $50,000, and the accounts payable of $15,000 (because those who provided goods on credit are partly financing Aya's inventory of goods for sale). Under "Assets," it shows how the funds

were used with the amounts spent on inventory, shelving, freezers, the cash register, lighting, the cash counter, and storage cabinets, together with the amount of cash remaining after those purchases. If the uses of every dollar of every source of funds in the "Liabilities and Owner's Equity" are accounted for in the assets of the business, then the dollar value of the sources of funds should equal the dollar value of the uses of funds.

The statement of financial position above shows the total sources of funds (the "Liabilities and Owner's Equity") to be $140,000. The "Assets" (or uses of funds) shows the total uses of funds to be $140,000. Thus, the statement of financial position balances: the total sources of funds balances with (or equals) the total uses of funds. It is a picture of the assets, liabilities, and equity in the business at a particular point in time. In the example above, it is a picture of the assets, liabilities, and equity in the business at the point in time that the business is about to start operating.

This simple presentation of a statement of financial position hides many potentially more difficult accounting questions. For instance, should Aya's right to the use of the leased property be treated as an asset? Accountants have considered this and do indeed recognize a lease as an asset in certain circumstances. That then requires a method for assessing the value of the lease. If the lease is recognized as an asset, then what is the corresponding source of funds for that asset? The lighting, shelving, freezers, and the cash register may well be "fixtures." If so, then they might not belong to Aya and she might simply have the right to use those fixtures for the life of the lease. This would depend on the lease agreement. If Aya does not own those "fixtures," then it might not be appropriate to list them as assets. They would, however, be improvements to the property that might make the lease that much more valuable to Aya. Should this be recognized in some way? These are questions that we will leave to the accountants. For now, the point is to be aware of a statement of financial position as an important financial statement and to have a basic understanding of what a statement of financial position shows.

A perusal of the statement of financial position highlights some of the stakeholders in a business. These include the equity investors and the creditors. It also highlights some of the decisions that will have to be made in the management of the business—for example, what long-term assets should be acquired (such as the equipment Quick Buys purchased); how much cash or inventory should be kept on hand; what kind of credit terms should be offered to customers, since this will affect the level of accounts receivable and how much will actually be collected on sales made; what proportion of the business should be financed with debt relative to equity; and what proportion of the debt should be long-term debt and what proportion should be short-term debt.

F. A Statement of Earnings, Revised Statement of Financial Position, Statement of Changes in Equity, and Statement of Cash Flows for the Sample Fact Pattern Sole Proprietorship

Suppose that over the course of one month of operations Aya has sales at her store that have a total value of $96,500 and that $66,500 of these sales were made for cash. The other $30,000 of sales were made on credit—that is, the customers promised to pay for the goods at a later date. Aya also made purchases of goods for sale amounting to $50,000. At the end of the month she had a remaining inventory of goods for sale of $35,000. She still owed $20,000 for goods she purchased on credit. Her interest expenses

on the loan came to $500, she paid rent of $10,000, and she incurred a cost of $1,000 for heating and lighting. Aya made cash payments for the interest expense, the rent expense, and the heating and lighting expense. She had cash on hand at the end of the month of $32,000.

1. Statement of Earnings

The statement of earnings set out below is based on this information.

QUICK BUYS
STATEMENT OF EARNINGS
For the month ended [Date]

Revenues (Sales)		$96,500
Less: Cost of Goods Sold		
Beginning Inventory	$40,000	
Add: Purchases	50,000	
Total Goods Available for Sale	90,000	
Less: Ending Inventory	(35,000)	
Cost of Goods Sold		55,000
Gross Profit		41,500
Less: Expenses		
Rent	10,000	
Heating and Lighting	1,000	
Interest	500	
Total Expenses		11,500
Net Earnings		$30,000

A statement of earnings shows the net earnings (or net income or profit) or loss of the business for a given period of time. The profit is the revenues less the expenses incurred in generating those revenues. The revenues in Aya's business come in the form of "sales." In other businesses they might be lease or rental fees, franchise fees, or royalties. The particular statement of earnings above is set out for a retail business to reflect the profits from sales less the cost of the goods sold (often referred to as the "gross profit"). Don't get caught up in trying to figure out how the "cost of goods sold" is calculated. The purpose here is to get a sense of what these kinds of statements look like and of the kind of information they generally provide, rather than being able to create them. Other expenses are then deducted from the gross profit. Statements of earnings from different types of businesses—for example, manufacturing or rental—may be constructed in somewhat different ways; however, the common feature of statements of earnings is that they show net earnings or loss determined by showing revenues less expenses.

2. Revised Statement of Financial Position

We can also have a look at how the statement of financial position changes as a result of one month of operations. Recall that the statement of financial position shows the assets, liabilities, and equity at a particular point in time. The statement of financial position below shows the situation at the end of the first month of operations.

QUICK BUYS
STATEMENT OF FINANCIAL POSITION
As at the end of the first month

Assets		
Cash		$ 32,000
Accounts Receivable		30,000
Inventory		35,000
Shelving		10,000
Freezers		30,000
Cash Register		3,000
Light Fixtures		15,000
Cash Counter		8,000
Storage Cabinets		12,000
Total Assets		$175,000
Liabilities and Owner's Equity		
Liabilities:		
Accounts Payable		$ 20,000
Bank Loan		50,000
Owner's Equity:		
At Beginning of Month	$75,000	
Increase in Owner's Equity	30,000	
At End of Month		105,000
Total Liabilities and Owner's Equity		$175,000

There are some important differences to note between the statement of financial position at the beginning of the month and the statement of financial position at the end of the month. First, the "Accounts Receivable" figure of $30,000 reflects the fact that $30,000 of Aya's sales were made on credit. The other important difference is that the statement of financial position at the end of the month shows that Aya's equity has increased by $30,000, the amount of the profits for the month. One should note that this profit of $30,000 is not some special pot of cash that is sitting somewhere. It is part of the sources of funds that have been used in acquiring the assets that the business has at the end of the month. If Aya wants to withdraw some of the profits, she will have to either reduce the cash on hand (which may not be advisable since the cash may be needed to meet short-term payment obligations), borrow more funds, or sell off some of the assets of the business. When, and how, one makes a distribution of profits is another important decision in the management of the business.

Notice that the assets have increased by $35,000 since the beginning of the month (from $140,000 at the beginning of the month to $175,000 at the end of the month). This includes $30,000 of accounts receivable that were not there before and $10,000 more of cash (cash of $22,000 at the beginning of the month and cash of $32,000 at the end of the month), less a decrease in inventory of $5,000 (from $40,000 at the beginning of the month to $35,000 at the end of the month). There has also been a $35,000 increase in liabilities and owner's equity over the course of the month consisting of the $30,000 profit mentioned above and an additional $5,000 in accounts payable.

The statement of earnings for the month and the end-of-the-month statement of financial position set out above have avoided (no doubt improperly) some other important accounting

issues. For instance, some of the assets—for example, the shelving, freezers, cash register, light fixtures, cash counter, and storage cabinets—have been used for a month and may have deteriorated. Should this reduction in value be reflected on the statement of financial position? Should the statement of earnings reflect the cost of any such deterioration as an expense—usually called "depreciation"? If one does attempt to reflect changes in the value of assets on the statement of financial position, how should it be done? Does one attempt to assess the current market value of the assets, or should another technique be used? These again are questions we will leave to the accountants. However, some reflection on these questions should reveal that choices have to be made in determining how accounting statements are prepared. These choices can involve difficult trade-offs. For financial statements to be useful to investors it helps to have a degree of consistency not only for a given business enterprise from year to year, but between business enterprises so that reasonable comparisons can be made between financial statements. As we will see, financial disclosure is an important part of the disclosures made to persons investing, or considering investing, in business enterprises. Although we will not be examining the particular details of financial accounting, it is an important part of the overall regulatory scheme for business enterprises.

3. Statement of Changes in Equity

A statement of changes in equity shows the changes in the equity accounts in the statement of financial position. Fortunately for Quick Buys this statement is a simple one.

QUICK BUYS
STATEMENT OF CHANGES IN EQUITY
For the Month of [Date]

Owner's equity at the beginning of the month	$ 75,000
Add: Retained earnings	30,000
Owner's equity at the end of the month	$105,000

A statement of changes in equity for a corporation will often show a number of items. Like this simple statement of changes in equity for Aya's Quick Buys sole proprietorship business, it will show the equity investments of shareholders showing the amount received from prior sales of shares. It will show increases in share capital from additional sales of shares during the period under consideration and reductions in share capital from repurchases of shares during the period under consideration. It will show gains in retained earnings from net earnings during the period under consideration or it will show a reduction in retained earnings due to a net loss in the period under consideration. It will also show reductions in retained earnings from payments of dividends during the period under consideration.

4. Statement of Cash Flows

A key starting point for understanding the idea behind a statement of cash flows is that the statement of earnings set out above is done on an "accrual basis." That is, it records sales as revenues even when no cash is collected at the time of sale—that is, when a legal right to be paid arose—and it records expenses even if no cash went out at the time the expense was incurred—that is, when the legal obligation to make the payment arose. For instance, the

statement of earnings shows revenues from sales of $96,500, since sales in the amount of $96,500 were made even though only $66,500 was received in cash from those sales. The short facts also indicate that while Aya made purchases of goods for sale of $50,000, there was also an increase in accounts payable from $15,000 at the beginning of the month to $20,000 at the end of the month, and since the other expenses for interest, rent, and heating and lighting were paid in cash, this $5,000 increase in accounts payable came from purchases made on credit that were still unpaid at the end of the month—that is, only $45,000 in cash was actually paid out for the $50,000 worth of purchases.

A statement that shows cash flows can provide an additional source of important financial information concerning a business. Indeed, creating projected cash flow statements for future periods can be helpful in planning to deal with potential cash shortfalls or even excess accumulations of cash. Cash is needed to pay liabilities as they come due for payment, and failure to pay liabilities as they come due can have significant consequences for the business (including potentially causing the business to be brought to an end). Cash shortfalls will require some form of further financing in the form of, perhaps, further investments from equity investors or, more likely, additional borrowing (usually from a bank). It is helpful to be able to plan for that. Excess accumulations of cash are not good either because cash, even if in a bank account, will earn little or no return. It is better to invest those excess amounts of cash in investments that pay a return (such as government treasury bills or other forms of investment that can be sold and converted back into cash when needed for the business), make further purchases of assets to run the business (for example, expand Aya's store), or pay amounts out to investors (such as to the bank to reduce the bank loan, if possible, or to equity investors).

There are two methods of creating and presenting a cash flow statement. One is the direct method and the other is the indirect method. The indirect method is the form the cash flow statement usually takes. Unfortunately it is a method that is, at least initially, more difficult to understand. The basic idea behind the direct method is to identify sources of, or inflows of, cash, and to also show uses of, or outflows of, cash leaving a net gain or reduction in cash. A statement of cash flows for Aya's Quick Buys business after one month of operation using the direct method is shown below.

QUICK BUYS
STATEMENT OF CASH FLOWS
For the Month Ended [Date]
(Direct Method)

Sources of Cash	
Cash sales	$66,500
Uses of Cash	
Cash paid for purchases of supplies	
Purchases	$50,000
Less: Increase in Accounts Payable	5,000
Net	$45,000
Cash paid for expenses	
Interest	500
Rent	10,000
Heating and Lighting	1,000
Total uses of cash	56,500
Net Gain in Cash	$10,000

The indirect method begins with net income (or net earnings) and makes adjustments for items in the statement of earnings and the statement of financial position that did not involve cash inflows or outflows. It would not, for example, show the cash outflows for interest, rent, or heating and lighting that in the simple fact pattern were said to have been paid in cash. These cash items are already reflected in the statement of earnings as deductions in determining net income. A statement of cash flows for Aya's Quick Buys business after one month of operation using the indirect method is shown below.

QUICK BUYS
STATEMENT OF CASH FLOWS
For the Month Ended [Date]
(Indirect Method)

Net Earnings:		$30,000
Adjustments to convert net earnings to cash flows:		
Add:		
Decrease in inventory	$ 5,000	
Increase in accounts payable	5,000	
	$10,000	
Deduct:		
Increase in accounts receivable	($30,000)	
		($20,000)
Net Increase in Cash		$10,000

This indirect method begins with net earnings from the statement of earnings. That net earnings figure came, in part, from the top line of the statement of earnings, which shows $96,500 of revenues from sales. As the facts indicate, only $66,500 of those sales were for cash, with the remaining sales of $30,000 being on credit. This $30,000 of sales on credit is, on the facts given, reflected in the accounts receivable at the end of the month. That is $30,000 that was not received in cash, so it has to be deducted from the net earnings to adjust for that non-cash item. The increase in accounts payable is added, since that increase in accounts payable, on the facts given, came from purchases of goods on credit—that is, for which cash was not paid out. The decrease in inventory also represents a non-cash item. Part of the sales for the month came from inventory that was on hand at the beginning of the month, and that decrease in inventory became part of the expense of cost of goods sold on the statement of earnings. However, no cash went out during the month for that inventory because it was already on hand in inventory at the beginning of the month. The point here is not to understand how to produce a statement of cash flows but rather to see what, in general terms, such a financial statement would look like (usually using the indirect method) and what the statement is intended to show.

Statements of cash flows usually provide much more information than is shown in either of the versions of the statement of cash flows for one month of operations of the Quick Buys business. What is shown here is cash flows from operation of the business, which was all that was relevant on the facts given. One would normally see a breakdown for "investing activities" that, in the context of Quick Buys, might include cash outflows for cash paid to buy new equipment or cash inflows for cash received on the sale of old equipment. One often also sees a breakdown for "financing activities" that might, in the context of Quick Buys, include cash inflows from additional investments of cash by equity investors, or cash outflows from

cash payments to reduce the principal amount on the bank loan or cash payments out to equity investors reducing their investment.

G. A Corresponding Statement of Financial Position and Statement of Earnings for the Business Operated Through a Corporation

The statement of financial position and statement of earnings for a corporation will look quite similar to those for Aya's sole proprietorship above. However, the equity portion of the statement of financial position is usually labelled "Shareholders' Equity," with the investments made by shareholders set out under "Capital Stock" or "Shares," and the increases in equity from the profits of running the business enterprise set out as "Retained Earnings." Where the corporation has issued more than one type of share, the capital stock or shares account will be broken down into separate accounts for different types of shares.

Suppose Aya ran her business through a corporation called "Quick Buys Ltd." Suppose also that when the corporation was formed, 750 shares were issued to Aya at a price of $100 per share in exchange for Aya's investment of $75,000. The statement of financial position at the end of one month of operations might then look like the one set out below.

QUICK BUYS LTD.
STATEMENT OF FINANCIAL POSITION
As at the end of the first month

Assets		
Cash		$ 32,000
Accounts Receivable		30,000
Inventory		35,000
Shelving		10,000
Freezers		30,000
Cash Register		3,000
Light Fixtures		15,000
Cash Counter		8,000
Storage Cabinets		12,000
Total Assets		$175,000
Liabilities and Equity		
Liabilities:		
Accounts Payable		$ 20,000
Bank Loan		50,000
Shareholders' Equity:		
Capital Stock (750 shares issued at $100 per share)	$75,000	
Retained Earnings	30,000	
Total Shareholders' Equity		105,000
Total Liabilities and Owner's Equity		$175,000

As with the "Increase in Owner's Equity" above in the case of a sole proprietorship, the "Retained Earnings" do not represent a pot of cash that can be accessed. The "Retained Earnings" are just part of the source of funds that allowed for the acquisition of the various assets set out on the assets part of the statement of financial position. Here the cash on hand happens to be more than the retained earnings. However, where the business has made profits

for a longer period of time and new assets have been acquired or old assets replaced, it is not uncommon for the retained earnings to be much greater than the amount of cash on hand. If it is decided that some portion of the prior profits are to be distributed to the shareholders (in what is referred to as a "dividend"), then it will be necessary to come up with the cash to pay the dividend. This may require holding off on acquisitions to allow sufficient cash to accumulate, liquidating some of the assets of the business, borrowing funds, or issuing more shares in exchange for cash contributions.

A statement of changes in equity for a corporation would include, in addition to changes in retained earnings, changes in share capital from the sale of shares or from the repurchase of shares. A statement of cash flows for a corporation would, in showing cash flows from "financial activities," include cash inflows from sales of shares to investors and cash outflows from cash payments of dividends to shareholders or for the repurchase of shares.

V. CONCLUSION

This chapter has sought to highlight the importance of business organizations as a subject and its particularly topical character in light of the recent development of forms of organization that seek to achieve social, cultural, or environmental aims in addition to traditional for-profit objectives and in light of the current attention now being given to forms of business organization for Canada's Indigenous peoples. It also sought to provide an understanding of the study of business organizations as a study of the way people associate to carry on activities that will produce, provide, or trade in goods or services, doing so in forms of organization that range from very small to very large and that can involve either for-profit objectives, not-for-profit objectives, or both for-profit and not-for-profit objectives. It provided a sample fact pattern to provide context and then examined a wide range of forms of organization, including the main forms of organization that are examined in this book. The chapter also looked at some simple accounting and simple financial statements because financial statement disclosure will be referred to later in the book and it is useful to have a sense of the nature of that disclosure. Some simple accounting concepts can also be useful in understanding legal concepts in business associations. With this "birds-eye" view in place, the remainder of the book examines in more detail many of the topics highlighted in this chapter.

CHAPTER ELEVEN

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The previous chapter explored the stakeholder debate in respect of how corporations should be governed. This chapter examines in detail the role of directors and officers, including their statutory obligations; election, removal, and compensation of directors; and their authority and power. The courts, in assessing any impugned conduct of directors, will assess whether the directors made a reasonable decision, rather than a perfect decision, as discussed below. The chapter also discusses the composition of boards of directors, including requirements under both corporate law and securities law in Canada. It examines the need to consider more diverse boards of directors if we are to create sustainable corporate governance. It is important to note, as you work your way through the materials, that the Canadian governance structure is only one of several models of corporate governance. Countries such as Japan and Germany have different governance structures under their corporate laws, developed based on different social, political, and economic histories.

I. THE DUTIES OF DIRECTORS AND OFFICERS

Under corporations statutes, directors are responsible for governance of the corporation. Section 102(1) of the *Canada Business Corporations Act*, RSC 1985, c C-44 (CBCA) specifies that "Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation."[1] Section 136(1) of the British Columbia *Business Corporations Act*, SBC 2002, c 57 (BCBCA) specifies that the directors manage or supervise, subject to the articles of the company. Section 112 of the Québec *Business Corporations Act*, CQLR c S-31.1 (QBCA) specifies that the board of directors supervise management of the company subject to a unanimous shareholder agreement. This separation of powers is set out in the corporation's constating documents; the directors manage, not the shareholders.

Directors have fiduciary obligations both at common law and under corporations statutes to act in the best interests of the corporation. They also have a statutory duty of loyalty and duty of care. Chapter 13 discusses the scope of these duties and specific remedies that shareholders or others may have if those duties are breached. In addition to these duties, the

1 See also the Alberta *Business Corporations Act*, RSA 2000, c B-9 [ABCA], s 101(1). The Ontario *Business Corporations Act*, RSO 1990, c B.16 [OBCA], s 115(1) specifies that directors manage or supervise.

directors of issuing corporations must meet a series of other obligations under securities law and the national instruments promulgated by securities regulators. The directors must also not act in a manner that is oppressive to, unfairly prejudicial to, or unfairly disregards the interests of security holders and, in some cases, other parties. The contours of these obligations are discussed in Chapter 13 on fiduciary obligation and Chapter 14 on stakeholder remedies.

While for many years there was the suggestion that the directors and officers of a corporation had a fiduciary obligation to act in the best interests of shareholders, that view was disavowed in a series of judgments rendered by the Supreme Court of Canada (SCC). The SCC has held that the fiduciary obligation is owed exclusively to the corporation. (See *Peoples Department Stores Inc (Trustee of) v Wise*, extracted below at para 42; and *BCE Inc v 1976 Debentureholders*, 2008 SCC 69, [2008] 3 SCR 560.) In the context of determining an insolvency law question, the Supreme Court of Canada in *Peoples Department Stores Inc (Trustee of) v Wise* discussed the scope of duties of directors and officers, both for the financially healthy and financially distressed corporation. It held that the best interests of the corporation should not be read simply as the best interests of the shareholders; rather, from an economic perspective, the "best interests of the corporation" means the maximization of the value of the corporation.

Peoples Department Stores Inc (Trustee of) v Wise
2004 SCC 68, [2004] 3 SCR 461

MAJOR and DESCHAMPS JJ:

[31] The primary role of directors is described in s. 102(1) of the CBCA:

> 102(1) Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation.

As for officers, s. 121 of the CBCA provides that their powers are delegated to them by the directors:

> 121. Subject to the articles, the by-laws or any unanimous shareholder agreement,
> (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) a director may be appointed to any office of the corporation; and
> (c) two or more offices of the corporation may be held by the same person.

Although the shareholders are commonly said to own the corporation, in the absence of a unanimous shareholder agreement to the contrary, s. 102 of the CBCA provides that it is not the shareholders, but the directors elected by the shareholders, who are responsible for managing it. This clear demarcation between the respective roles of shareholders and directors long predates the 1975 enactment of the CBCA: see *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*, [1906] 2 Ch. 34 (CA); see also art. 311 CCQ.

[32] Section 122(1) of the CBCA establishes two distinct duties to be discharged by directors and officers in managing, or supervising the management of, the corporation:

> 122(1) 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.

The first duty has been referred to in this case as the "fiduciary duty." It is better described as the "duty of loyalty." We will use the expression "statutory fiduciary duty" for purposes of clarity when referring to the duty under the CBCA. This duty requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation. The second duty is commonly referred to as the "duty of care." Generally speaking, it imposes a legal obligation upon directors and officers to be diligent in supervising and managing the corporation's affairs.

[33] The trial judge did not apply or consider separately the two duties imposed on directors by s. 122(1). As the Court of Appeal observed, the trial judge appears to have confused the two duties. They are, in fact, distinct and are designed to secure different ends. For that reason, they will be addressed separately in these reasons.

A. The Statutory Fiduciary Duty: Section 122(1)(a) of the CBCA

[34] Considerable power over the deployment and management of financial, human, and material resources is vested in the directors and officers of corporations. For the directors of CBCA corporations, this power originates in s. 102 of the Act. For officers, this power comes from the powers delegated to them by the directors. In deciding to invest in, lend to or otherwise deal with a corporation, shareholders and creditors transfer control over their assets to the corporation, and hence to the directors and officers, in the expectation that the directors and officers will use the corporation's resources to make reasonable business decisions that are to the corporation's advantage.

[35] The statutory fiduciary duty requires directors and officers to act honestly and in good faith *vis-à-vis* the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. Directors and officers must serve the corporation selflessly, honestly and loyally: see K.P. McGuinness, *The Law and Practice of Canadian Business Corporations* (1999), at p. 715.

[36] The common law concept of fiduciary duty was considered in *K.L.B. v. British Columbia*, [2003] 2 SCR 403, 2003 SCC 51. In that case, which involved the relationship between the government and foster children, a majority of this Court agreed with McLachlin CJ who stated, at paras. 40-41 and 49:

> Fiduciary duties arise in a number of different contexts, including express trusts, relationships marked by discretionary power and trust, and the special responsibilities of the Crown in dealing with aboriginal interests … .
>
> What … might the content of the fiduciary duty be if it is understood … as a private law duty arising simply from the relationship of discretionary power and trust between the

> Superintendent and the foster children? In *Lac Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 SCR 574, at pp. 646-47, La Forest J noted that there are certain common threads running through fiduciary duties that arise from relationships marked by discretionary power and trust, such as loyalty and "the avoidance of a conflict of duty and interest and a duty not to profit at the expense of the beneficiary." *However, he also noted that "[t]he obligation imposed may vary in its specific substance depending on the relationship"* (p. 646) … .

• • •

[37] The issue to be considered here is the "specific substance" of the fiduciary duty based on the relationship of directors to corporations under the CBCA.

[38] It is settled law that the fiduciary duty owed by directors and officers imposes strict obligations: see *Canadian Aero Service Ltd. v. O'Malley*, [1974] SCR 592, at pp. 609-10, *per* Laskin J (as he then was), where it was decided that directors and officers may even have to account to the corporation for profits they make that do not come at the corporation's expense:

> The reaping of a profit by a person at a company's expense while a director thereof is, of course, an adequate ground upon which to hold the director accountable. *Yet there may be situations where a profit must be disgorged, although not gained at the expense of the company, on the ground that a director must not be allowed to use his position as such to make a profit even if it was not open to the company, as for example, by reason of legal disability, to participate in the transaction.* An analogous situation, albeit not involving a director, existed for all practical purposes in the case of *Phipps v. Boardman* [[1967] 2 AC 46], which also supports the view that liability to account does not depend on proof of an actual conflict of duty and self-interest. Another, quite recent, illustration of a liability to account where the company itself had failed to obtain a business contract and hence could not be regarded as having been deprived of a business opportunity is *Industrial Development Consultants Ltd. v. Cooley* [[1972] 2 All ER 162], a judgment of a Court of first instance. There, the managing director, who was allowed to resign his position on a false assertion of ill health, subsequently got the contract for himself. That case is thus also illustrative of the situation where a director's resignation is prompted by a decision to obtain for himself the business contract denied to his company and where he does obtain it without disclosing his intention. [Emphasis added.]

A compelling argument for making directors accountable for profits made as a result of their position, though not at the corporation's expense, is presented by J. Brock, "The Propriety of Profitmaking: Fiduciary Duty and Unjust Enrichment" (2000), 58 *UT Fac. L Rev.* 185, at pp. 204-5.

[39] However, it is not required that directors and officers in all cases avoid personal gain as a direct or indirect result of their honest and good faith supervision or management of the corporation. In many cases the interests of directors and officers will innocently and genuinely coincide with those of the corporation. If directors and officers are also shareholders, as is often the case, their lot will automatically improve as the corporation's financial condition improves. Another example is the compensation that directors and officers usually draw from the corporations they serve. This benefit, though paid by the corporation, does not, if reasonable, ordinarily place them in breach of their fiduciary duty. Therefore, all the circumstances may be scrutinized to determine whether the

directors and officers have acted honestly and in good faith with a view to the best interests of the corporation.

...

[42] This appeal does not relate to the non-statutory duty directors owe to shareholders. It is concerned only with the statutory duties owed under the CBCA. Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase the "best interests of the corporation" should be read not simply as the "best interests of the shareholders." From an economic perspective, the "best interests of the corporation" means the maximization of the value of the corporation: see E.M. Iacobucci, "Directors' Duties in Insolvency: Clarifying What Is at Stake" (2003), 39 *Can. Bus. LJ* 398, at pp. 400-1. However, the courts have long recognized that various other factors may be relevant in determining what directors should consider in soundly managing with a view to the best interests of the corporation. For example, in *Teck Corp. v. Millar* (1972), 33 DLR (3d) 288 (BCSC), Berger J stated, at p. 314:

> A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting *bona fide* in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered *bona fide* the interests of the shareholders.
>
> I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees: *Parke v. Daily News Ltd.*, [1962] Ch. 927. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.

The case of *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.* (1986), 59 OR (2d) 254 (Div. Ct.), approved, at p. 271, the decision in *Teck*, *supra*. We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.

[43] The various shifts in interests that naturally occur as a corporation's fortunes rise and fall do not, however, affect the content of the fiduciary duty under s. 122(1)(a) of the CBCA. At all times, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.

[44] The interests of shareholders, those of the creditors and those of the corporation may and will be consistent with each other if the corporation is profitable and well capitalized and has strong prospects. However, this can change if the corporation starts to struggle financially. The residual rights of the shareholders will generally become worthless if a corporation is declared bankrupt. Upon bankruptcy, the directors of the corporation transfer control to a trustee, who administers the corporation's assets for the benefit of creditors.

[45] Short of bankruptcy, as the corporation approaches what has been described as the "vicinity of insolvency," the residual claims of shareholders will be nearly exhausted. While shareholders might well prefer that the directors pursue high-risk alternatives with a high potential payoff to maximize the shareholders' expected residual claim, creditors in the same circumstances might prefer that the directors steer a safer course so as to maximize the value of their claims against the assets of the corporation.

[46] The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency." That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability. In assessing the actions of directors, it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for shareholders and improve the position of creditors. If unsuccessful, it will not qualify as a breach of the statutory fiduciary duty.

[47] … In resolving these competing interests, it is incumbent upon the directors to act honestly and in good faith with a view to the best interests of the corporation. In using their skills for the benefit of the corporation when it is in troubled waters financially, the directors must be careful to attempt to act in its best interests by creating a "better" corporation, and not to favour the interests of any one group of stakeholders. If the stakeholders cannot avail themselves of the statutory fiduciary duty (the duty of loyalty, *supra*) to sue the directors for failing to take care of their interests, they have other means at their disposal.

[48] The Canadian legal landscape with respect to stakeholders is unique. Creditors are only one set of stakeholders, but their interests are protected in a number of ways. Some are specific, as in the case of amalgamation: s. 185 of the CBCA. Others cover a broad range of situations. The oppression remedy of s. 241(2)(c) of the CBCA and the similar provisions of provincial legislation regarding corporations grant the broadest rights to creditors of any common law jurisdiction: see D. Thomson, "Directors, Creditors and Insolvency: A Fiduciary Duty or a Duty Not to Oppress?" (2000), 58 *UT Fac. L Rev.* 31, at p. 48. One commentator describes the oppression remedy as "the broadest, most comprehensive and most open-ended shareholder remedy in the common law world": S.M. Beck, "Minority Shareholders' Rights in the 1980s," in *Corporate Law in the 80s* (1982), 311, at p. 312. While Beck was concerned with shareholder remedies, his observation applies equally to those of creditors.

[49] The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to, *inter alia*, the exercise of discretion by a court in granting standing to a party as a "complainant" under s. 238(d) of the CBCA as a "proper person" to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA, or to bring an oppression remedy claim under s. 241 of the CBCA.

• • •

B. The Statutory Duty of Care: Section 122(1)(b) of the CBCA

[54] As mentioned above, the CBCA does not provide for a direct remedy for creditors against directors for breach of their duties and the CCQ is used as suppletive law.

[55] In Quebec, directors have been held liable to creditors in respect of either contractual or extra-contractual obligations. Contractual liability arises where the director

personally guarantees a contractual obligation of the company. Liability also arises where the director personally acts in a manner that triggers his or her extra-contractual liability. See P. Martel, "Le 'voile corporatif'—l'attitude des tribunaux face à l'article 317 du Code civil du Québec" (1998), 58 *R du B* 95, at pp. 135-36; *Brasserie Labatt ltée v. Lanoue*, [1999] QJ No. 1108 (QL) (CA), *per* Forget JA, at para. 29. It is clear that the Wise brothers cannot be held contractually liable as they did not guarantee the debts at issue here. Extra-contractual liability is the remaining possibility.

[56] To determine the applicability of extra-contractual liability in this appeal, it is necessary to refer to art. 1457 CCQ:

> *Every person* has a duty to abide by the *rules of conduct* which lie upon him, according to the circumstances, usage or law, so as not to cause injury to *another*.
>
> Where he is endowed with reason and fails in this duty, he is responsible for any injury he causes to another person by such fault and is liable to reparation for the injury, whether it be bodily, moral or material in nature.
>
> He is also liable, in certain cases, to reparation for injury caused to another by the act or fault of another person or by the act of things in his custody. [Emphasis added.]

Three elements of art. 1457 CCQ are relevant to the integration of the director's duty of care into the principles of extra-contractual liability: who has the duty ("every person"), to whom is the duty owed ("another") and what breach will trigger liability ("rules of conduct"). It is clear that directors and officers come within the expression "every person." It is equally clear that the word "another" can include the creditors. The reach of art. 1457 CCQ is broad and it has been given an open and inclusive meaning. See *Regent Taxi & Transport Co. v. Congrégation des Petits Frères de Marie*, [1929] SCR 650, *per* Anglin CJ, at p. 655 (rev'd on other grounds, [1932] 2 DLR 70 (PC)):

> … to narrow the *prima facie* scope of art. 1053 CC [now art. 1457] is highly dangerous and would necessarily result in most meritorious claims being rejected; many a wrong would be without a remedy.

This liberal interpretation was also affirmed and treated as settled by this Court in *Lister v. McAnulty*, [1944] SCR 317, and *Hôpital Notre-Dame de l'Espérance v. Laurent*, [1978] 1 SCR 605.

[57] This interpretation can be harmoniously integrated with the wording of the CBCA. Indeed, unlike the statement of the fiduciary duty in s. 122(1)(a) of the CBCA, which specifies that directors and officers must act with a view to the best interests of the corporation, the statement of the duty of care in s. 122(1)(b) of the CBCA does not specifically refer to an identifiable party as the beneficiary of the duty. Instead, it provides that "[e]very director and officer of a corporation in exercising their powers and discharging their duties shall … exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." Thus, the identity of the beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors. This result is clearly consistent with the civil law interpretation of the word "another." Therefore, if breach of the standard of care, causation and damages are established, creditors can resort to art. 1457 to have their rights vindicated. The only issue thus remaining is the determination of the "rules of conduct" likely to trigger extracontractual liability. On this issue, art. 1457 is explicit.

[58] The first paragraph of art. 1457 does not set the standard of conduct. Instead, it incorporates by reference s. 122(1)(b) of the CBCA. The statutory duty of care is a "duty to abide by [a] rule of conduct which lie[s] upon [them], according to the … law, so as not to cause injury to another." Thus, for the purpose of determining whether the Wise brothers can be held liable, only the CBCA is relevant. It is therefore necessary to outline the requirements of the duty of care embodied in s. 122(1)(b) of the CBCA.

[59] That directors must satisfy a duty of care is a long-standing principle of the common law, although the duty of care has been reinforced by statute to become more demanding. Among the earliest English cases establishing the duty of care were *Dovey v. Cory*, [1901] AC 477 (HL); *In re Brazilian Rubber Plantations and Estates, Ltd.*, [1911] 1 Ch. 425; and *In re City Equitable Fire Insurance Co.*, [1925] 1 Ch. 407 (CA). In substance, these cases held that the standard of care was a reasonably relaxed, subjective standard. The common law required directors to avoid being grossly negligent with respect to the affairs of the corporation and judged them according to their own personal skills, knowledge, abilities and capacities. See McGuinness, *supra*, at p. 776: "Given the history of the case law in this area, and the prevailing standards of competence displayed in commerce generally, it is quite clear that directors were not expected at common law to have any particular business skill or judgment."

[60] The 1971 report entitled *Proposals for a New Business Corporations Law for Canada* (1971) ("Dickerson Report") culminated the work of a committee headed by R.W.V. Dickerson which had been appointed by the federal government to study the need for new federal business corporations legislation. This report preceded the enactment of the CBCA by four years and influenced the eventual structure of the CBCA.

[61] The standard recommended by the Dickerson Report was objective, requiring directors and officers to meet the standard of a "reasonably prudent person" (vol. II, at. p. 74):

> 9.19(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> • • •
>
> (b) exercise the care, diligence and skill of a reasonably prudent person.

The report described how this proposed duty of care differed from the prevailing common law duty of care (vol. I, at p. 83):

> 242. The formulation of the duty of care, diligence and skill owed by directors represents an attempt to upgrade the standard presently required of them. The principal change here is that whereas at present the law seems to be that a director is only required to demonstrate the degree of care, skill and diligence that could reasonably be expected from him, having regard to his knowledge and experience—*Re City Equitable Fire Insurance Co.*, [1925] Ch. 425—under s. 9.19(1)(b) he is required to conform to the standard of a reasonably prudent man. *Recent experience has demonstrated how low the prevailing legal standard of care for directors is, and we have sought to raise it significantly.* We are aware of the argument that raising the standard of conduct for directors may deter people from accepting directorships. The truth of that argument has not been demonstrated and we think it is specious. The duty of care imposed by s. 9.19(1)(b) is exactly the same as that which the common law imposes on every professional person, for example, and there is no evidence that this has dried up

> the supply of lawyers, accountants, architects, surgeons or anyone else. It is in any event cold comfort to a shareholder to know that there is a steady supply of marginally competent people available under present law to manage his investment. [Emphasis added.]

[62] The statutory duty of care in s. 122(1)(b) of the CBCA emulates but does not replicate the language proposed by the Dickerson Report. The main difference is that the enacted version includes the words "in comparable circumstances," which modifies the statutory standard by requiring the context in which a given decision was made to be taken into account. This is not the introduction of a subjective element relating to the competence of the director, but rather the introduction of a contextual element into the statutory standard of care. It is clear that s. 122(1)(b) requires more of directors and officers than the traditional common law duty of care outlined in, for example, *Re City Equitable Fire Insurance*, *supra*.

[63] The standard of care embodied in s. 122(1)(b) of the CBCA was described by Robertson JA of the Federal Court of Appeal in *Soper v. Canada*, [1998] 1 FC 124, at para. 41, as being "objective subjective." Although that case concerned the interpretation of a provision of the *Income Tax Act*, it is relevant here because the language of the provision establishing the standard of care was identical to that of s. 122(1)(b) of the CBCA. With respect, we feel that Robertson JA's characterization of the standard as an "objective subjective" one could lead to confusion. We prefer to describe it as an objective standard. To say that the standard is objective makes it clear that the factual aspects of the circumstances surrounding the actions of the director or officer are important in the case of the s. 122(1)(b) duty of care, as opposed to the subjective motivation of the director or officer, which is the central focus of the statutory fiduciary duty of s. 122(1)(a) of the CBCA.

[64] The contextual approach dictated by s. 122(1)(b) of the CBCA not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration. The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care. However, even with good corporate governance rules, directors' decisions can still be open to criticism from outsiders. Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, have tended to take an approach with respect to the enforcement of the duty of care that respects the fact that directors and officers often have business expertise that courts do not. Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule," adopting the American name for the rule.

[65] In *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 OR (3d) 177, Weiler JA stated, at p. 192:

> The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks

> to see that the directors made a *reasonable* decision *not a perfect* decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board's decision. This formulation of deference to the decision of the Board is known as the "business judgment rule." The fact that alternative transactions were rejected by the directors is irrelevant unless it can be shown that a particular alternative was definitely available and clearly more beneficial to the company than the chosen transaction. [Emphasis added; italics in original; references omitted.]

[66] In order for a plaintiff to succeed in challenging a business decision he or she has to establish that the directors acted (i) in breach of the duty of care and (ii) in a way that caused injury to the plaintiff: W.T. Allen, J.B. Jacobs and L.E. Strine, Jr., "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law" (2001), 26 *Del. J Corp. L* 859, at p. 892.

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

The second definitive judgment rendered by the Supreme Court of Canada in respect of director obligations was in *BCE Inc v 1976 Debentureholders*. The SCC held, in that case, that although directors must consider the best interests of the corporation, it may be appropriate, although not mandatory, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders. This judgment is discussed in Chapters 14 and 15 in the context of the oppression remedy and a takeover transaction. For purposes of this chapter, of note is the following excerpt.

BCE Inc v 1976 Debentureholders

2008 SCC 69, [2008] 3 SCR 560

THE COURT (MCLACHLIN CJ and BINNIE, LEBEL, DESCHAMPS, ABELLA, and CHARRON JJ):

[37] The fiduciary duty of the directors to the corporation originated in the common law. It is a duty to act in the best interests of the corporation. Often the interests of shareholders and stakeholders are co-extensive with the interests of the corporation. But if they conflict, the directors' duty is clear—it is to the corporation: *Peoples Department Stores*.

> [38] The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation. The content of this duty varies with the situation at hand. At a minimum, it requires the directors to ensure that the corporation meets its statutory obligations. But, depending on the context, there may also be other requirements. In any event, the fiduciary duty owed by directors is mandatory; directors must look to what is in the best interests of the corporation.
>
> [39] In *Peoples Department Stores*, this Court found that although directors must consider the best interests of the corporation, it may also be appropriate, although not mandatory, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders. As stated by Major and Deschamps JJ., at para. 42:
>
>> We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.
>
> As will be discussed, cases dealing with claims of oppression have further clarified the content of the fiduciary duty of directors with respect to the range of interests that should be considered in determining what is in the best interests of the corporation, acting fairly and responsibly.
>
> [40] In considering what is in the best interests of the corporation, directors may look to the interests of, inter alia, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule. The "business judgment rule" accords deference to a business decision, so long as it lies within a range of reasonable alternatives: see *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.); *Kerr v. Danier Leather Inc.*, [2007] 3 S.C.R. 331, 2007 SCC 44. It reflects the reality that directors, who are mandated under s. 102(1) of the CBCA to manage the corporation's business and affairs, are often better suited to determine what is in the best interests of the corporation. This applies to decisions on stakeholders' interests, as much as other directorial decisions.

Hence, in Canada, the Supreme Court has clarified that the duties of directors and officers are to the corporation, not to a particular set of stakeholders such as shareholders or creditors. While directors may consider the interests of particular stakeholders in their strategic planning and decision-making, their fiduciary obligation is limited to acting in the best interests of the corporation. Directors may, however, owe a duty of care to particular stakeholders, and the contours of this duty are still developing.

Directors can have two relationships with the same investor. In *Sharbern Holding Inc v Vancouver Airport Centre Ltd*, 2011 SCC 23, [2011] 2 SCR 175, the Supreme Court of Canada held that a corporation had a non-fiduciary issuer–investor relationship with the investor (principal) who was alleging misconduct, and a fiduciary principal–agent relationship with the principal once it became a manager. The latter relationship gave rise to an obligation to act in the interests of the principal. However, this relationship was entered into with the knowledge that there would be common management of two hotels; thus, the fiduciary

relationship was circumscribed by the contractual bargain and the knowledge that the corporation would be simultaneously balancing fiduciary obligations; essentially the principal consented to the agent's conflict of interest (at paras 143, 150). On the facts, the court held that the principal had failed to demonstrate that a failure to disclose compensation differences was material in the circumstances, and the appeal was dismissed.

NOTES AND QUESTIONS

1. The Supreme Court of Canada in *Peoples Department Stores Inc (Trustee of) v Wise* held that "best interests of the corporation" means the maximization of the value of the corporation, citing *Teck Corp v Millar* (1972), 33 DLR (3d) 288 (BCSC), and that directors can consider the interests of employees and communities in acting in that best interest. In your view, does that give directors sufficient direction as to how they should exercise their decision-making powers?

2. The Supreme Court of Canada also held that there was a duty of care to various stakeholders. In your view, what kinds of decisions by directors might breach that duty of care?

3. Section 119 of the new QBCA now includes a statutory duty of care "to act with prudence and diligence, honesty and loyalty and in the interest of the corporation" in addition to obligations imposed by the *Civil Code of Québec*, CQLR c CCQ-1991. Considering the reasoning in the *Peoples Department Stores Inc (Trustee of) v Wise* judgment, how does the court address the interplay of Canadian common law corporations statutes and Québec civil law?

In *Nielsen (Estate of) v Epton*, below, the issue was whether a corporate director owes a personal duty of care to corporate employees. An employee, Nielsen, was killed while operating a hoist to lift a spreader beam at the shop of his employer, Fabtec. The beam was designed in a manner in which it could not safely latch onto the type of hoist used, and the beam fell and struck Nielsen. Epton, Fabtec's president and chief executive, was not present at the time of the accident, but had issued specific instructions to Fabtec's onsite supervisor to install the beam. The company did not have a safety policy with regard to operating the hoist. Nielsen's estate sought to hold Epton personally liable in negligence for acts and omissions in his capacity as a director. The plaintiff alleged that Epton failed to ensure that the accident did not occur when he knew or ought to have known that the beam could not safely latch onto the hoist, and that Epton failed to set out proper workplace safety measures. Epton had not purchased coverage for himself as a director under Alberta's *Workers' Compensation Act*, RSA 2000, c W-15. Had he done so, any claim would have been dealt with under that statute and a separate tort action against Epton would have been precluded.

In comprehensive reasons reported at *Nielsen (Estate of) v Epton*, 2006 ABQB 21, the trial judge concluded that Epton owed a personal duty of care to Nielsen. The court apportioned 50 percent of the blame to Epton and found Epton vicariously liable for the blame apportioned to another corporate employee, Edworthy, and a volunteer crane operator, Atwood. The judgment was appealed. On appeal, Epton argued that the trial judge erred in applying the law of directors' liability by failing to distinguish between Epton's actions as a director, his actions as a worker, and the actions of Fabtec; erred in finding that Epton breached the relevant standard of care in the absence of evidence establishing that standard of care; and erred in finding Epton vicariously liable as a director for the acts of Atwood and Edworthy. The Alberta Court of Appeal held the following.

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COSTIGAN JA (for the court):

[20] It is settled law that a corporate director may have a personal duty of care and may be liable for acts that are in themselves tortious: *Montreal Trust Co. of Canada v. ScotiaMcLeod Inc.* (1995), 129 D.L.R. (4th) 711, 26 O.R. (3d) 481 (C.A.); *Blacklaws v. 470433 Alberta Ltd.* (2000), 84 Alta. L.R. (3d) 270, 2000 ABCA 175.

[21] The trial judge was careful to distinguish between acts, duties and standards attributable to Epton and those attributable to Fabtec. He found that Epton had a personal duty to oversee workplace safety and that he did nothing to design or implement acceptable workplace safety standards. Those findings, coupled with the findings that Epton was involved in the first lift attempt and knew the spreader beam did not properly fit the hoist hook and safety latch, amply support the conclusion that Epton's acts were tortious in themselves.

[22] *Viva voce* evidence of the appropriate standard of care is not invariably necessary. In this case the trial judge referenced statutory authority for the standard of care and, in any event, found that Epton's conduct fell short of any reasonable standard. We discern no reviewable error in those conclusions.

[23] Nor did the trial judge apply the wrong test in apportioning liability. It is clear, on the whole of his reasons, that he assessed comparative blameworthiness of the parties and that his percentage allocations are reasonable.

[24] However, the trial judge erred in law in finding Epton vicariously liable for the tortious acts of Edworthy, a Fabtec employee, and Atwood, the volunteer crane operator.

[25] Historically, vicarious liability was imposed on masters for the acts of their servants. Liability arose because the master exercised control over the servant: G.H.L. Fridman, *The Law of Torts in Canada*, 2nd ed. (Toronto: Carswell, 2002) at 277. Two policy reasons support vicarious liability: the provision of a just and practical remedy and deterrence of future harm: *Bazley v. Curry*, [1999] 2 S.C.R. 534, (1999), 174 D.L.R. (4th) 45 at paras. 26-36. We are not aware of any cases that have imposed vicarious liability on a corporate director for the tortious acts of a corporate employee or volunteer.

[26] The respondents suggest three bases for Epton's vicarious liability. First, they argue that Epton can be considered an employer because the definition of "employer" in the *Occupational Health and Safety Act*, R.S.A. 1980, c.O-2 includes some corporate directors. This statutory definition is not sufficient to establish the requisite factual underpinnings for vicarious liability.

[27] Second, they cite *Blackwater v. Plint*, [2005] 3 S.C.R. 3, 2005 SCC 58 [Blackwater] and argue that Epton need not be an employer as long as he is a "controlling agent." In *Blackwater*, the United Church of Canada was found vicariously liable for sexual assaults perpetrated by a dormitory supervisor at a residential school. The Church hired, fired and directly supervised the perpetrator. The court imposed vicarious liability on the Church because it was an employer of the perpetrator in every sense of the word.

[28] Epton was not the employer of Edworthy or Atwood. Moreover, the *indicia* used in *Blackwater* to support the finding that the Church had sufficient control over the

perpetrator to be found vicariously liable are absent on the facts of this appeal. Accordingly, Epton was not an employer or controlling agent as those terms are used in *Blackwater*.

[29] Finally, the respondents say Epton is vicariously liable because he had a non-delegable duty as a director to ensure the health and safety of Fabtec's workers. But that is a basis for Epton's direct liability. It cannot also be a basis for imposing vicarious liability.

[30] There is no doubt that Fabtec employed Edworthy and could be vicariously liable for Edworthy's tortious acts. It is less clear, but arguable, that Fabtec could also be vicariously liable for Atwood's tortious acts. Fabtec's potential vicarious liability satisfies the two policy reasons for the imposition of vicarious liability. The fact that the *Workers' Compensation Act* prevents Fabtec from being vicariously liable in this case is not a principled reason for imposing vicarious liability on Epton. Some compensation for Nielsen's death is available under the scheme of that legislation.

[31] Therefore, on the facts of this appeal, Epton was not an employer or controlling agent and there is no principled policy reason for imposing vicarious liability on him. Accordingly, Epton is not vicariously liable for 49% of the blame.

[32] In the result, the appeal is allowed in part and Epton's liability is reduced to 50% of the loss.

QUESTIONS

1. Do you think that the court in *Nielsen (Estate of) v Epton* articulated the appropriate test for finding a duty of care by directors?
2. Are there any other factors that should comprise the duty of care?

II. INDEPENDENCE OF CORPORATE BOARDS

A. Outside Directors

CBCA s 102(2) requires that at least two directors of a publicly traded corporation be outside directors.[2] BCBCA s 120 requires at least three directors for a publicly traded corporation, but does not have an outside director requirement. However, it is important to remember that under securities legislation, issuers are required to have independent directors, as discussed below.

The Toronto Stock Exchange report *Where Were the Directors?* (Toronto: TSX, 1994) recommended that boards of exchange-listed corporations consist of a majority of "unrelated" directors. An unrelated director is

> a director who is free from any interest in any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding.

2 ABCA s 101(2). Ontario requires at least one-third of directors to be outsiders: OBCA s 115(3).

The report noted that a management director would not be an unrelated director. The corporation should describe its system of corporate governance in its annual report or information circular, including the analysis of who constituted an unrelated director. The report also suggested that the audit committee should consist exclusively of outside directors. It further recommended that the corporation should enable individual directors to engage outside advisers at the expense of the corporation in appropriate circumstances. In May 1995, the TSX adopted a bylaw requiring disclosure of corporate governance practices for TSX-listed companies.[3] Under securities law, there are disclosure requirements for director independence in issuing corporations, as is discussed at length below.

"Independent" outside directors now comprise the majority of board memberships in Canadian public corporations, and only one-quarter of board members of firms of all asset sizes are employees of the firm.[4] The larger the firm, the higher the proportion of outside directors. On a narrower definition of outside director, excluding non-employee directors with a business or family relationship to the firm, they still amount to 55 percent of board membership, with a higher proportion for Canadian-owned, widely held corporations.[5] As of 2011, another study found that the percentage of Canadian firms where all outside directors are independent has risen to 71 percent.[6]

Outside directors will frequently have had some business relationship with the firm prior to their appointment. Pursuant to CBCA s 102(2), the statutory standard of what constitutes an outside director is persons who are "not officers or employees of the corporation or its affiliates," and a requirement that would be met by the corporation's retired executives, by its outside counsel, and by other retained advisers such as investment bankers. Such directors may not be wholly independent of management's influence. However, a useful kind of outside director is likely one with some relation to the firm, since the flow of information between the firm and its bankers, underwriters, and lawyers is thereby facilitated. If board composition might affect firm wealth, it should not be supposed that one kind of board is optimal for every firm. The best board composition may be more easily achieved with a minimum of mandatory rules.

Outside directors have an important role in protecting the interests of stakeholders in a corporation, particularly one that is widely held, such that shareholders and others are not closely monitoring the activities of inside directors. An important function of the board is to supervise the officers of the company; hence a certain number of directors must be independent to allow this oversight and monitoring.

Professors Gilson and Kraakman have suggested that the role of outside director should be recast as a full-time professional director who would have the requisite expertise and would serve on the boards of perhaps six corporations. These professional directors would be chosen by institutional investors who might organize a separate clearing house to

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3 See TSX Bylaw s 19.17, now incorporated into TSX Company Manual s 472 and referenced to NI 58-101, *Disclosure of Corporate Governance Practices.*

4 Thomas H Mitchell, *Canadian Directorship Practices: A Profile 1984* (Ottawa: Conference Board of Canada, 1984) at 19-21.

5 *Ibid*.

6 Karla Thorpe, *2011 Canadian Directors' Compensation and Board Practices* (Ottawa: Conference Board of Canada, 2011).

coordinate action among institutional investors for the selection of directors.[7] This proposal is contested by Professors Rock and Coffee, who question the effectiveness of having institutional investors choose and monitor professional directors, arguing that they may not have sufficient incentive to monitor the professional directors and would also face a conflict of interest because the boards on which professional directors would serve would often be clients or potential clients of the institutional investor.[8]

One issue is whether the risk of personal liability for outside directors will act as a deterrent to attracting such directors. A study by Black, Cheffins & Klausner suggests not.[9] They analyzed the out-of-pocket liability risk facing outside directors, and concluded that this risk is very low, far lower than many commentators and board members believe. Their research found only 13 cases in 25 years in which outside directors of public companies have made out-of-pocket payments, most involving fact patterns that they conclude are not likely to recur today for a company with a state-of-the-art directors and officers (D&O) insurance policy. They suggest that if a corporation has a D&O policy with appropriate coverage and sensible limits, outside directors will be potentially vulnerable to out-of-pocket liability only when (1) the company is insolvent and the expected damage award exceeds those limits, (2) the case includes a substantial claim under securities legislation, and (3) there is an alignment between outside directors' or other defendants' culpability and their wealth. They also observe that the principal threats to outside directors who perform poorly are the time, aggravation, and potential harm to reputation that a lawsuit can entail, not direct financial loss.

The need for board independence is discussed in the following excerpt.

Janis Sarra & Vivian Kung, "Corporate Governance in the Canadian Resource and Energy Sectors"

(2006) 43 Alta L Rev 905 at 910-11

The first indicator of effective corporate governance is the necessity of board independence. If directors are to engage in effective oversight, they need to be able to critically and independently assess the actions of managers. Independence is implicated in all ten indicators because without board independence, the rest of the governance measures are likely to be less effective. However, independence as an indicium of effective governance should be defined as not only unrelatedness in terms of financial interest (other than shareholdings); it should also include the ability of a director to critically examine, and where necessary challenge, the strategic and operational decisions of corporate officers where the director believes a particular decision or strategy is or may not be in the overall

7 RJ Gilson & R Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan L Rev 863 at 872-76.

8 B Rock, "The Logic and (Uncertain) Significance of Institutional Shareholder Activism" (1991) 79 Geo LJ 445 at 453-78; and JC Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum L Rev 1277 at 1329-36.

9 Bernard S Black, Brian R Cheffins & Michael D Klausner, "Outside Director Liability" (2006) 58 Stan L Rev 1055, online: <http://ssrn.com/abstract=894921>.

best interests of the corporation. Inside directors have information advantages that may assist in critical assessment of corporate performance, although their critique may be tempered given their economic dependence on continued employment and concern about reputational capital. Hence, while they are not "unrelated," they bring information to the board room that can contribute to overall board independence.

All of the advantages and disadvantages of outside and inside directors need to be considered in constructing the optimal mix of board membership that encourages independent oversight. While the authors sought to unearth this facet of independence in the surveys, it was impossible to truly measure. Hence, the results reported here are those that meet securities and stock exchange criteria in terms of the meaning of independence or unrelatedness.

The TSX Corporate Governance Guidelines recommend that every corporation's board of directors should comprise a majority of "unrelated" individuals, defined as a non-management director that is free from any interest or relationship that either could or could reasonably be perceived to materially interfere with the director's capacity to act in the corporation's best interests, other than interests and relationships emanating from shareholding. The NYSE Rules require that listed companies have a majority of independent directors with no material relationship with the company. Material relationships may encompass "commercial, industrial, banking, consulting, legal, accounting, charitable, and familial affiliations." These definitions have been tightened in the US in the past two years, in the wake of Enron, WorldCom and other recent corporate failures that highlighted the challenges for independence. Those companies met statutory definitions of independence; however, indirect financial benefits, corporate climate and failure to effectively engage in oversight resulted in a complete failure of governance to the detriment of investors, employees and creditors alike.

The challenge for new independence criteria is not so much the prohibition of undisclosed self-dealing transactions, for which there is greater vigilance, but rather, whether the rules create the appropriate incentive effects in terms of truly engaged and independent oversight. One feature of this increased board independence is whether the board has a non-management board chair or a lead director, in order to offer some independence from the CEO or president of the corporation. Good governance practice also suggests that non-management directors convene sessions in the absence of inside directors on a relatively regular basis. This practice has become a requirement of the NYSE Rules and is recommended by the Canadian Securities Administrators (CSA) in its new corporate governance guidelines. The meetings of independent directors without inside directors and senior managers allow directors to speak candidly about issues or strategies that are of concern. Whereas five years ago, the notion of independent directors meeting separately was highly contested, it is now viewed as one more element to ensure real, and not just statutorily defined, independence.

The audit committee of a board of directors is particularly important as it has specific duties to review the corporation's financial statements prior to their approval by the board, and that acts as a liaison between the board of directors and the corporation's outside auditors. For publicly-traded corporations, a majority of the members of the audit committee must be independent—they must be neither officers nor employees of the corporation. The hoped-for independence of the audit committee is thought to provide an additional check on the audit process. Previously there was accounting scandals, in which

auditors were fashioning reporting where corporate officers were in a position to award lucrative consulting contracts to the same accounting firms appointed as the firm's auditors. Now regulatory provisions require most reporting issuers to establish an audit committee and include rules as to the composition and responsibilities of such committees.

B. The Need for Board Diversity

Canadian boards are also overwhelmingly male, even though, arguably, board diversity enhances corporate governance, as illustrated in the following two excerpts.

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

(2005) 79 St John's L Rev 1121 at 1125 (footnotes incorporated into text)

Although there are no precise figures, a recent survey found that only 7.4% of Canadian corporate board seats are held by women, with 353 women holding 431 directorships (Catalyst Perspective 2002). This is less than half the percentage in the United States and well below the 47% participation rate of women in the Canadian workforce (Statistics Canada, Employment by Age, Sex, Type of Work, Class of Worker and Province). Once public sector enterprises and non-profit corporations are included, women account for 16% of board members. Yet two in seven Canadian boards are still all-male. The number of racial minorities on Canadian boards is unknown, although one limited survey found that the figure was less than 2% (D. Brown, *A Quantum Leap: Canadian Directorship Practice* (1997); David Brown & Debra Brown, *Success in the Boardroom* (1998).

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Diversity on the corporate board can enhance corporate governance, in turn increasing enterprise wealth maximization. The Conference Board of Canada has reported that there are both practical and symbolic reasons to have diverse boards. Using gender as a proxy for diversity, it conducted a study aimed at measuring the results of gender diversity on boards. The Conference Board tracked corporations for six years and found that boards with two or more women directors in 1995 were far more likely to be industry leaders in profits six years later. It found that 94% of boards with three or more women explicitly monitor the implementation of corporate strategy, compared with 66% of all-male boards; 74% of boards with three or more women explicitly identify criteria for measuring strategy, compared with 45% of all-male boards; and 86% of boards with three or more women adopted a corporate code of conduct, compared with 66% of non-diverse boards. Where corporations had three or more women on the corporate board, the study found that 94% of boards ensured compliance with internal conflict of interest guidelines compared with 68% of all-male boards. Seventy-two percent of boards with two or more women conduct formal board performance evaluation, compared to 49% of all-male boards. These boards are more likely to have formal orientation and training programs and formal written limits to authority (Conference Board, "Women on Boards: Not Just the Right Thing, but the Bright Thing" (2002)).

Overall, the study concluded that an increased number of women on corporate boards is likely to enhance the oversight and monitoring activities of corporate boards. Its research found that "diversity on boards … does change the functioning and deliberative style of the board in clear and consistent ways" and that "good governance improves organizational performance over the long term, financially and non-financially." Important from an enterprise wealth maximization perspective, the Conference Board found that 86% of boards with three or more women have two-way communication between the corporation and its stakeholders, compared with 71% of all-male boards. It found that women are more likely to consider measures of innovation, and social and community responsibility; and that there is a correlation between women on boards and higher levels of customer and employee satisfaction. Finally, it concluded that women directors make a practical difference to the independence and activism of boards, and are more likely to implement and monitor the indicia of good governance developed by international organizations.

A more recent study found that boards have made little progress in the past decade in terms of diversity. The percentage of female directors is 10 percent, an increase from 8 percent in 2008. Currently, 18 percent of corporate boards have at least one director who is a member of a visible minority, an increase from 13 percent in 2008.[10] While, arguably, more diverse boards can enhance decision-making, there is some debate about just how effective outside directors, whatever their gender, race, or background, are in monitoring corporate management. First, outside directors are often not truly independent of management because they are often selected by management. Outside directors are themselves often executives of other businesses and thus share similar perspectives to management on just how closely managers should be monitored. Many outside directors will have similar backgrounds to management and share similar views. Outside directors can also lack the information, staff, expertise, or time to monitor management effectively. While the outside directors are expected to monitor the managers, an issue is: who monitors the outside directors? The market is unlikely to monitor outside directors any better than it monitors the inside directors.[11]

Bill C-25, *An Act to amend the Canada Business Corporations Act*, etc., 1st Sess, 42nd Parl (second reading and referral to Committee in the House of Commons 9 December 2016), if enacted, will require corporations to disclose annually to shareholders information on diversity among the directors and members of senior management. The proposed language is one of "comply or explain," requiring corporations to disclose representation and policies to address diversity, or to explain where there are no policies in place. This approach is consistent with the approach of Canadian securities regulators, and does not adopt an approach of mandating levels of representation, as required in some European jurisdictions.

10 Thorpe, *supra* note 6.

11 Gilson & Kraakman, *supra* note 7 at 872-76.

Aaron A Dhir, "Towards a Race and Gender-Conscious Conception of the Firm: Canadian Corporate Governance, Law and Diversity"
(2010) 35 Queen's LJ 569, online: <http://ssrn.com/abstract=1340726>
(footnotes omitted)

The representation of women and racialized persons on Canadian corporate boards is strikingly low and does not reflect Canada's current demographics and labour market availability. Women constitute just over 50 percent of the Canadian population, yet in 2007 they held only 13 percent of the director positions of Financial Post 500 companies (only a slight improvement of 1 percent from 2005). More than 40 percent of these corporations employed no female directors at all in 2007, and just 3.4 percent had women chairing the board. Another recent study found the proportion of Canadian female board members to be "15% less than the comparable U.S. boards." In fact, the reality is even more severe than these statistics indicate, given that some women occupy multiple board seats. Racialized groups account for over 16 percent of Canada's population. From 2001 to 2006, these groups grew at five times the overall growth rate. Persons born outside Canada represent 19.8 percent of the overall populace—the largest proportion in the last 75 years. Over the next three years, it is anticipated that immigrants "will account for 100 percent of Canada's net labour force growth." This is especially relevant as 75 percent of immigrants are racialized, with the majority of recent immigrants having been born in the Middle East and Asia. Despite these figures, studies indicate that racialized directors occupy a dismal 1.7 percent of Canadian corporate directorships, and that U.S. firms noticeably outperform comparable Canadian firms on issues of racial and ethnic board diversity.

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At a conceptual level, key aspects of the market-based rationale for enhanced board heterogeneity can be rooted in the organizational behaviour and economic theories of agency, transaction costs and resource dependence and have been summarized as follows:

> (1) diversity improves the ability of the board to monitor managers due to increased independence;
> (2) diversity improves the decision making of the board due to unique new perspectives, increased creativity, and non-traditional innovative approaches;
> (3) diversity improves the information provided by the board to managers due to the unique information held by diverse directors;
> (4) diverse directors provide access to important constituencies and resources in the external environment;
> (5) board diversity sends important positive signals to the labour market, product market, and financial market, and
> (6) board diversity provides legitimacy to the corporation with both external and internal constituencies.

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[I]n running the affairs of the corporation, Canadian directors (and officers) are required by statute to "act honestly and in good faith with a view to the best interests of the corporation." Recent developments in corporate law jurisprudence suggest that

> in discharging this fiduciary obligation, directors may consider the interests of non-shareholder constituents such as creditors, employees, consumers, suppliers, the environment and the broader community. As I have discussed elsewhere, numerous practical and conceptual difficulties accompany this development. However, leaving these difficulties aside, the reality is that while directors are not under a legal obligation to act on such considerations, they will not be in violation of their fiduciary duty if they do so. This case law represents a shift in how fiduciary obligations have been conceptualized under Canadian corporate law—a shift away from interpreting the "best interests of the corporation" as necessarily being synonymous with maximizing shareholder return. This, I think, should be of real interest to human rights advocates. The overseas operations of some Canadian corporations, primarily within the extractive industry, are continually impugned for their impact on human rights. Canada has more mining firms listed on its stock exchanges than any other country, and these exchanges represent "the world's largest source of equity capital for mining exploration and production both in Canada and abroad." When one disaggregates board composition statistics by industry, extractive companies are among the worst in terms of gender representation. This is particularly noteworthy, given the suggestion in some studies that boards with a critical mass of female directors are more likely to be attuned to non-shareholder interests. In other words, boards with broader levels of representation may be better situated to address the environmental, social and human rights impacts of transnational corporate conduct.

Although disclosure of board composition falls short of requiring boards to diversify, requiring greater transparency can create at least some marginal change as corporations seek to protect reputational capital. In 2015, the Canadian Securities Administrators published a study on the gender composition of publicly traded corporations,[12] finding that of 722 issuers, 49 percent of these issuers had at least one woman on their board, with more than a third of those companies having added a woman in the year prior; 60 percent had at least one woman in an executive officer position; and almost a third of the issuers with a market capitalization above $2 billion had adopted a written policy for identifying and nominating women directors.

NOTES AND QUESTIONS

1. Do you think it is necessary to regulate the number of unrelated or outside directors, or should this decision be made by shareholders?

2. Professor Dhir points out the importance of board diversity in board decision-making. Recall the judgment in *Yaiguaje v Chevron Corporation*, 2017 ONSC 135 at the end of Chapter 10. A diverse board may have been more attuned to issues of fundamental human rights of companies operating in foreign jurisdictions.

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12 CSA Multilateral Staff Notice 58-307, *Staff Review of Women on Boards and in Executive Officer Positions—Compliance with NI 58-101 Disclosure of Corporate Governance Practices* (28 September 2015).

The structure of Canadian corporations suggests that some regulatory intervention may be necessary to ensure that directors, officers, and controlling shareholders do not engage in self-dealing transactions to the detriment of investor interests. Corporate governance mechanisms are the means to ensure that this conduct does not occur, as directors are responsible for oversight and for acting in the best interests of the corporation. How a board structures its activities may have a direct impact on the level of accountability by officers for their overall strategic and risk management decisions. In Canada, such structures have not been regulated generally, although, as this section of the chapter reveals, in areas such as audit committees, regulators have imposed independence and financial literacy requirements as investor protection measures. For other aspects of governance, regulation has intervened largely to require disclosure of corporate governance practices.

C. Board Committees

Boards of directors function in a number of ways. Board committees, composed of several directors, can be a very important means of keeping careful oversight of particular corporate activities, or undertaking important tasks on behalf of the board. For example, a board's strategic planning committee works with officers to discern upside and downside market risks and help craft or approve long-term strategies for coping with or taking advantage of these risks. A board compensation committee undertakes research and makes recommendations with respect to compensation for the corporation's senior officers. The board will also have an audit committee, whose role is to work with the external auditors to ensure effective oversight of the corporation's financial records. Frequently, corporate law statutes do not require an audit committee unless the corporation is an issuer.

Board committees bring their recommendations to the board of directors as a whole for approval or further discussion. The committees allow individual directors to focus their efforts in particular areas of corporate activity, based on the skills that they bring to the board. Where a board comprises a small number of directors, these functions are frequently undertaken by the board as a whole. Board committees allow for some tasks, such as that of the compensation committee, to be undertaken by those directors who are independent, as they are not economically dependent on the CEO for their continued livelihood. Note that CBCA s 102(2) refers to the required number of directors for issuing corporations,[13] and s 158 refers to directors approving the financial statements.

Board committees are not regulatory requirements, although some aspects are viewed as best practice. Similarly, there is no statutory or regulatory requirement that the CEO and the board chair be different individuals, although best practice suggests that this separation of roles enhances corporate governance. In Canada, given the closely held nature of corporations, the controlling shareholder is often both the CEO and chair of the board. Some corporations have addressed the inevitable conflicts of interest that such a structure creates by also creating the position of lead director, whose role is to ensure that the board of directors

13 Section 102(2) specifies: "A corporation shall have one or more directors but a distributing corporation, any of the issued securities of which remain outstanding and are held by more than one person, shall have not fewer than three directors, at least two of whom are not officers or employees of the corporation or its affiliates."

is operating with independent oversight and is not unduly influenced by the CEO/chair. While this strategy has been effective in a number of cases, it is easy to see how appointing a lead director in itself will not assure that a board operates effectively to provide an independent accountability check on inside directors. Yet, the enabling nature of corporate law means that it is for those individuals creating the corporation to make those decisions, and for shareholders, in their periodic voting for directors, to affirm such governance choices.

Publicly traded corporations must disclose information on their board committees and other governance practices, which in turn may pressure corporations into assessing whether their board structure and practices are as effective as they can be.

III. DIRECTOR APPOINTMENT, REPLACEMENT, AND REMOVAL

A. Few Minimum Requirements

While directors are encouraged to engage in good corporate governance practices, including strategic planning, upside and downside risk assessment, oversight and monitoring of the finances of the corporation, and monitoring of the decision-making activities of the corporation's officers, there are no mandated standards of corporate governance. However, there are an increasing number of regulatory instruments that require disclosure of corporate governance practices, as discussed later in this chapter.

Directors also have an obligation to dissent where they do not agree with board decisions, and recording of such dissent may act as a liability shield in some circumstances, if actions are brought against the directors for a decision that is contrary to law.

In modern corporations legislation, directors' mandatory qualification requirements are minimal. They must be natural persons, over 18 years of age, not bankrupt, and not of unsound mind, or, in the language of the BCBCA, "incapable of managing the individual's own affairs."[14] The draft amendments to the CBCA, if enacted, will also change the qualification language to "incapable," defined to mean "that the individual is found, under the laws of a province, to be unable, other than by reason of minority, to manage their property or is declared to be incapable by any court in a jurisdiction outside Canada" (proposed s 2(1), Bill C-25[15]). While for many years, directors had to be shareholders of the corporation—hence the expression "director's qualifying share"—most Canadian statutes no longer impose such a requirement.[16] QBCA s 109 specifies that "[u]nless otherwise provided in the articles, a director is not required to be a shareholder." However, in practice, directors are

14 CBCA s 105(1); ABCA s 105(1); BCBCA s 124(2)(b); and OBCA s 118(1). The OBCA was amended effective in 2007 to specify that "[a] person who has been found under the *Substitute Decisions Act, 1992* or under the *Mental Health Act* to be incapable of managing property or who has been found to be incapable by a court in Canada or elsewhere" is ineligible to be a director: OBCA, s 118(1), as amended by SO 2006, c 34, Schedule B, effective 1 August 2007. The QBCA s 108 specifies: "Any natural person may be a director of a corporation, except persons disqualified for the office of director under the Civil Code or persons declared incapable by decision of a court of another jurisdiction."

15 Bill C-25, *An Act to amend the Canada Business Corporations Act, the Canada Cooperatives Act, the Canada Not-for-profit Corporations Act, and the Competition Act*, 1st Sess, 42nd Parl (second reading and referral to Committee in the House of Commons (9 December 2016).

16 CBCA s 105(2); ABCA s 105(2); BCBCA s 125; and OBCA s 118(2).

often compensated through a mix of stipends and shares or share options. Publicly held corporations must have at least three directors, while closely held corporations may have as few as one.[17]

Janis Sarra & Vivian Kung, "Corporate Governance in the Canadian Resource and Energy Sectors"
(2006) 43:4 Alta L Rev 905 at 906-7

> Enterprise wealth maximization is an objective that is aimed at long-term sustainability of the corporation, not merely short-term return to investors. It also takes account of multiple stakeholders in terms of inputs to the corporation, including equity investors, secured and unsecured lenders, trade suppliers, employees and the communities in which corporations operate. … Best practice now suggests that corporations should establish a nominating committee that is composed entirely of unrelated directors. This committee should be responsible for identifying qualified candidates, selecting or recommending to the board selection of director nominees, and retaining outside advisers and search firms to locate candidates. A key aspect is to develop and approve a set of criteria for potential directors, in terms of the board's strategic needs and requirements. Board diversity is generally thought to enhance the capacity of the board to engage in critical oversight and to bring diverse relational and other assets to the oversight task, in turn maximizing enterprise wealth. Boards should manifest an array of skill sets and backgrounds in order to have oversight expertise in all aspects of the corporation's operations. Moreover, sufficient minority group representation is arguably linked to good corporate governance. This diversity may be particularly relevant where corporations are operating in multiple jurisdictions with different cultural and economic norms.

However, there would be substantial information costs for constituency representatives to become informed participants on the board. Participation by various constituencies, especially employees, may direct the attention of the board to day-to-day operating-level concerns at the expense of focus on strategic concerns. However, it may also identify production and other strategic synergies that only those who have direct experience can offer. There may also be potential for opportunistic behaviour by constituencies that have contractual arrangements with the corporation. However, this risk already exists with directors that have commercial contracts with the company on whose board they sit. Hence, there are both benefits and costs associated with stakeholder representation on corporate boards.

The most frequently cited example of employee representation on the board of directors is the approach to employee co-determination in Germany. In Germany, public corporations, called *Aktiengesellschaften* in German, have a mandatory two-tiered board system consisting of a management board and a supervisory board of non-management directors. In

17 CBCA s 102(2); ABCA s 101(2); BCBCA s 120; and OBCA s 115(2) specify that there not be fewer than three directors. QBCA s 106 specifies that publicly held corporations must have at least three directors, two of whom are not employees of the corporation.

businesses other than the coal, iron, and steel industries, for which there is a separate co-determination statute, one-third of the supervisory board must consist of employee representatives in firms having fewer than 2,000 employees, and one-half of the supervisory board must be employee representatives in *Aktiengesellschaften* with more than 2,000 employees. There is no requirement for employee co-determination in corporations statutes in Canada. However, s 101(8)(b) of the Saskatchewan *Business Corporations Act* provides that the articles can provide for the election or appointment of directors by creditors or employees of the corporation.[18]

Participation on the board of directors may be an effective technique for protecting employees where, as noted above, they make firm-specific human capital investments. An employee representative on the board of directors may also assist in overcoming informational asymmetries between corporate management and employees. Creditors of the corporation might also be represented on the board of directors; however, creditors typically have defined terms for their loans and can protect their interests through a variety of contractual devices such as taking security interests in assets of the corporation or creating various legal rights when the corporation fails to meet tests of financial soundness. Hence, they may have less need for the protection that representation on the board of directors may afford. This situation can change when a firm is in financial stress and creditors become involved as the residual claimants.

Under a different approach, Dutch corporate law specifies that the board is to act in the interest of the company and all its stakeholders; and it reserves positions on the board for social interests and social responsibility.[19] Finally, one could consider consumer representation on the board as a way to possibly assist consumers in addressing problems such as the health hazards associated with a corporation's products. However, there are difficulties in determining who would be representative of consumers. Alternatively, consumer concerns can be addressed through advisory committees and may not require board representation.

B. Residency Requirements

Previously, corporate law statutes specified that a majority of directors must be resident Canadians; see e.g. the previous s 118(3) of the OBCA. Under the 2006 amendments to OBCA s 118(3), effective 2007, at least 25 percent of the directors of a corporation other than a

18 SBCA s 101(8) reads: "The articles may provide for the election or appointment of a director or directors: … (a) for terms expiring not later than the close of the third annual meeting of shareholders following the election; … (b) by creditors or employees of the corporation or by a class or classes of those creditors or employees." Section 97(2) of that statute specifies that a corporation shall have one or more directors, and a publicly held company is to have not fewer than three directors, at least two of whom are not officers or employees of the corporation or its affiliates.

19 Waheed Hussain, "The Law Should Make Boards More Diverse," *New York Times* (4 July 2012), online: <http://www.nytimes.com/roomfordebate/2012/07/04/who-are-corporate-directors-working-for-anyway/the-law-should-make-boards-more-diverse>. J van Bekkum, JBS Hijink, MC Schouten & JW Winter, "Corporate Governance in the Netherlands," (December 2010) 14.3 *Electronic Journal of Comparative Law*, online: <http://www.ejcl.org/143/art143-17.pdf>.

non-resident corporation must be resident Canadians, but where a corporation has fewer than four directors, at least one director must be a resident Canadian.[20] The CBCA and ABCA have the same requirements, demonstrating a move away from Canadian residency requirements.

The underlying notion for residency requirements appears to be that Canadian citizens will be more responsive to Canadian national interests in the operation of a corporation's affairs than non-citizens would be. However, directors are to manage the corporation for the purpose of maximizing firm wealth consistent with the dictates of the law, not to promote national interests, and hence the trend away from stringent residency requirements. The BCBCA has no director residency requirements. British Columbia's decision not to include a residency requirement in its corporations statute was aimed at making it competitive in attracting firms, and was made in recognition of the global nature of many Canadian-based corporations.

C. Election of Directors

When a corporation is formed, a notice of the first directors of the corporation is sent to the director or other administrative official responsible for the administration of the corporations statute.[21] The first directors hold office from the date of incorporation to the date of the first meeting of shareholders, which must be held within 18 months of incorporation.[22] Thereafter, directors are elected by an "ordinary resolution" of the shareholders.[23] An ordinary resolution is a resolution passed by a majority of the votes cast by shareholders who voted on the resolution.[24]

CBCA s 106(3) specifies that shareholders must elect directors at each annual meeting of the corporation, and CBCA s 133 requires the directors to call an annual meeting not later than 15 months after the last preceding annual meeting.[25] The requirement of shareholder election of directors apparently may not be waived, not even where the authority of the board of directors has been reduced by a unanimous shareholder agreement under s 146(1).

The election of directors is one of the most important matters on which the shareholders vote. Since the directors have oversight of the corporation, the election of directors is a significant method by which shareholders can exercise some control over the way in which the corporation is managed. The potential for such a change in control of the voting rights gives management an incentive to act in the interests of shareholders. If one considers adopting a normative view of the corporation that the directors and officers, in acting in the best interests of the corporation, should consider the interests of a broad range of stakeholders, then this incentive to act in the interest of one stakeholder group can be problematic.

20 OBCA, as amended, SO 2006, c 34, Schedule B, adding s 19(3).

21 CBCA ss 106(1) and 133; see also ABCA s 106(1) and s 94(1) of the *Companies Act*, RSNS 1989, c 81 [NSCA].

22 CBCA ss 106(2) and 133(1)(a); ABCA ss 106(2) and 132(1)(a); OBCA ss 94(1)(a) and 119(1); BCBCA s 182(1); and NSCA, First Schedule, s 74.

23 CBCA s 106(3); ABCA s 106(3); and OBCA s 119(4).

24 CBCA s 2(1); ABCA s 1(w); and OBCA s 1(1).

25 See also ABCA ss 106(3) and 132(1)(a); OBCA ss 94(1)(a) and 119(4); BCBCA s 182(1)(b); and NSCA s 83(1).

Note that Bill C-25, *An Act to amend the Canada Business Corporations Act*, etc., which received second reading in December 2016, proposes changes to the election of directors under the CBCA. It proposes that 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 *ending* not later than the close of the third annual meeting of shareholders following the election. It proposes a shorter period for distributing corporations—directors are to hold office for a term ending not later than the close of the next annual meeting of shareholders following the election, allowing for some exceptions.

The proposed amendments also provide, for a prescribed corporation, a separate vote of shareholders with respect to each candidate nominated for director. If enacted, it will effectively prohibit slate elections, consistent with existing requirements applicable to TSX-listed CBCA corporations. The Bill proposes majority voting, whereby, under specified circumstances, if there is only one candidate nominated for each position available on the board, each candidate is elected only if the number of votes cast in their favour represents a majority of the votes cast for and against them by the shareholders who are present in person or represented by proxy, unless the articles require a greater number of votes. Currently CBCA s 106(3), however, remains in effect as described above.

D. Term of Office

Commonly, the term of a director begins with the annual shareholders' meeting at which she or he is elected and runs until the next annual meeting. However, the articles may provide for directors' terms of up to three years.[26] Under BCBCA s 128(1), the term of office is usually set out in the articles, memoranda, or bylaws.[27] Directors may also be re-elected without limit. If no directors are elected at a meeting where directors should be elected, the incumbents remain in office until successors are chosen.[28]

Rather than providing that all of the directors are to be elected at the same time, the corporation's articles may provide that directors' terms are staggered. This strategy ensures that there is continuity on the board after any given election, and also serves as a benefit to existing management because it prevents the complete ousting of a board by shareholders in one meeting. However, in a number of corporations, the constating document now requires annual election of the entire board as a means of providing another accountability check on the activities of directors. This issue is discussed further in Chapter 15 on mergers and acquisitions.

A corporation, shareholder, or director may apply to court to resolve any controversy with respect to an election or appointment of a director, and the court may make "any order it thinks fit," including one restraining the person whose election or appointment is disputed from serving and ordering a new election under judicial supervision.[29]

26 CBCA ss 106(3) and (5); ABCA ss 106(3) and (6); and OBCA ss 119(4) and (6).

27 QBCA s 110 states: "The directors are elected by the shareholders, in the manner and for the term, not exceeding three years, set out in the by-laws."

28 CBCA s 106(6); ABCA s 106(7); OBCA s 119(7); QBCA s 143; and NSCA, First Schedule, s 117.

29 CBCA s 145; see also ABCA s 144 and OBCA s 107.

E. Filling of Vacancies

Generally, directors have the power to fill vacancies on the board.[30] However, this rule is subject to numerous exceptions. For instance, the directors may not fill a vacancy in their number that results from an increase in the number or minimum number of directors or from the failure by the shareholders to elect the number or minimum number of directors required by the articles.[31]

F. Increasing the Size of the Board

The board has the ability to increase its size by up to one third, and thus add directors if the articles allow it. For example, CBCA s 106(8) specifies that "[t]he directors may, if the articles of the corporation so provide, appoint one or more additional directors, who shall hold office for a term expiring not later than the close of the next annual meeting of shareholders, but the total number of directors so appointed may not exceed one third of the number of directors elected at the previous annual meeting of shareholders."

G. Ceasing to Hold Office

A director ceases to hold office during her or his term of office when he or she dies, resigns, becomes disqualified, or is removed from office by a resolution of the shareholders.[32]

H. Removal of Directors

Under most corporations statutes, shareholders have the right to remove directors by ordinary resolution.[33] Under BCBCA s 128(3), shareholders may remove a director by special resolution, or in accordance with the memorandum or articles, which can specify a lesser vote than a special majority.[34] The shareholders' meeting that approves the removal of a director may also fill the vacancy that results from the removal of a director.[35] The directors may fill the vacancy caused by the removal in the event that shareholders fail to do so.

Shareholders can also seek to have directors removed under the oppression remedy provisions of corporations statutes. In *Aurum, LLC v Calais Resources Inc*, the British Columbia Supreme Court ordered removal of directors. Its reasoning is set out below.

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30 CBCA s 111(1); ABCA s 111(1); BCBCA s 131, and OBCA s 124(1).

31 CBCA s 111(1); ABCA s 111(1); and OBCA s 124(1).

32 CBCA s 108; ABCA s 108; BCBCA s 128(1); OBCA s 121; and NSCA, First Schedule, s 114.

33 CBCA s 109(1); ABCA s 109(1); and OBCA s 122(1). QBCA s 144 specifies that "[u]nless the articles provide for cumulative voting, the shareholders may by ordinary resolution at a special meeting remove any director or directors."

34 See also NSCA, First Schedule, s 119.

35 CBCA s 109(3); ABCA s 109(3); OBCA s 122(3); and BCBCA s 131(a).

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THE COURT:

[2] Aurum is a limited liability company with a registered and records office in Cheyenne, Wyoming. The company is involved in investing and mining operations in North America. Aurum is the majority shareholder in Calais.

[3] Calais is a company incorporated in British Columbia with a registered and records office in Vancouver, British Columbia, and an office in Nederland, Colorado. Calais' business is mineral exploration. It is engaged in the acquisition of properties and the exploration of mineral and metals, primarily gold and silver. Calais has interests in mine operations in Colorado and Nevada.

[4] Mr. Young and Mr. Hendricks are officers, as well as directors, of Calais. Mr. Hendricks is the vice-president and general manager; Mr. Young the president, chief operating officer and acting chief executive officer of Calais. Both men reside in Colorado. Mr. Daher, the third director, lives in Chilliwack, British Columbia. Mr. Young has been a director of Calais since 2005 and Mr. Hendricks since 1998.

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[13] On August 13, 2015, through counsel, Aurum sent a requisition to Calais and the directors requiring them to call a general meeting within four months and to provide notice within 21 days pursuant to section 167 of the BCA. The requisition sets out the purpose of the proposed meeting as follows:

1. Passing a special resolution to remove all the existing directors with the exception of Tom Hendricks; and
2. Electing or appointed Michael Markiewicz and Bryan Read as directors.

[14] Calais' articles and the BCA require the company to hold an annual general meeting at least once every calendar year and not more than 15 months after the annual reference date for the preceding calendar year. Calais has not held an AGM for many, many years.

[15] Section 128 of the BCA and article 14.10 allows for the removal of directors and the election or appointment of new directors by way of special resolution. The petition record suggests the directors did not take any action in response to the requisition. Much later in their formal response to the petition filed in February 2016 they stated they had taken steps to "make arrangements to call a general meeting to be held as soon as reasonably possible given the logistical and other requirements that must be met to properly call such a meeting." Their evidence provided no details about what steps they may have taken up to that time.

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[33] [In an earlier judgment with respect to these parties,] Justice Greyell rejected all of those positions and found Aurum paid proper consideration for the shares issued in the three transactions referred to above.

[34] At paragraph 24 and following he wrote:

> [24] Article 3.4 of Calais' Articles of Association provides that no share shall be issued *until* (my emphasis) it is fully paid. The share certificates issued by Calais were each signed

> by Mr. Young and Mr. Hendricks as President and Secretary as "fully paid and non-accessible common stock." The Board resolution approving the issuance of the shares set the share prices of .0005 cents and .0007 cents per share as, in each instance "the board of directors believes it to be in the best interests of the company" to issue shares at that price.
>
> [25] The stock subscription agreements attached to each transfer provided that each transfer set out the "purchase price for the shares." I am satisfied from the material before me Aurum paid for the shares in Calais by paying a number of Calais' outstanding debts. Aurum has demonstrated that in the material before me and the schedule of payments made on behalf of Calais.
>
> [26] While the respondents complain about the payments made by Aurum, they have not produced any substantive evidence that such payments were improper or contrary to the agreement initially reached with Aurum for the stock purchase.
>
> [27] This application has been outstanding for a number of months. The respondents have had more than ample time to produce substantive evidence to support their position. There simply is no evidence. In fact, the evidence before me is to the contrary, that is that Aurum was to invest funds as described earlier. There is no evidence Aurum was to invest more funds into Calais than the funds it paid in exchange for the shares it received in 2014.

[35] The order he granted not only set aside Mr. Young's 3,750,000,000 shares and validated Aurum's shares, but it also specified the petitioner was entitled to attend the general shareholders meeting set for June 2016 and vote in accordance with its shareholdings. Further, the order set the record date for May 6, 2016.

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Analysis

[77] Bearing in mind the legal rights of Aurum as a shareholder and a majority shareholder under the BCA and Calais' articles, and the chronology of events set out above, including the findings of fact made by Greyell J., his order and others, it is clear that Aurum held a number of reasonable expectations that were breached by various unfairly prejudicial, if not oppressive, acts of the respondents.

[78] Turning to the BCE analytical framework, the first question is whether the stated expectations are reasonable based on an objective and contextual analysis. The petition itself identified the combination of conduct by the respondents that Aurum regards as oppressive or unfairly prejudicial. During the hearing the petitioner made submissions about its expectations based on that conduct. I will discuss some, but not all, of those expectations

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[81] This case is somewhat unusual insofar as it involves a majority as opposed to a minority shareholder alleging oppression and unfairly prejudicial conduct. Both the articles and the BCA provide that Calais must hold an annual general meeting and not more than 15 months after the annual reference date for the preceding calendar year, subject to specific exceptions which do not arise here such as waiver or deferral by a unanimous resolution of the shareholders entitled to vote at such a meeting. Section 167 of the BCA provides that a shareholder with an aggregate of at least 5% of the issued shares of the company that carry the right to vote may requisition a general meeting for the purpose of transacting any business that may be transacted at a general meeting. Upon

receiving a valid requisition the company must hold a meeting within four months of receiving the requisition to transact the business set out in that requisition regardless of the articles, and must notify the shareholders and the directors of the meeting subject to a number of exceptions, none of which are supported by the evidence here.

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[84] All shareholders have the right to vote in some circumstances. Section 173(2) of the BCA provides that unless the memorandum or articles provide otherwise, a shareholder has one vote for each share held. For the most part ordinary resolutions are passed at general meetings by a simple majority of votes passed, and special resolutions are passed by a special majority. Article 11.2 sets out that special majority at two-thirds of the votes cast. In Aurum's requisition, it sought to pass a special resolution removing two of three directors. Again, given the findings of Greyell J., and bearing in mind the petitioner's efforts to assert its right, their expectation that its position as a majority shareholder not be diluted for this purpose was entirely reasonable.

[85] Speaking more broadly, it is difficult to imagine how any company could reasonably avoid holding an AGM for what is now over 12 years. Voting at shareholders' meetings is the primary means by which any shareholder participates as an owner of a company. While the cases indicate some delay in the holding of required meetings will be accepted if it is for a legitimate business reason, the historic circumstances here are extreme and Mr. Young's explanation of financial hardship is simply not adequate. The only further explanation for the failure to schedule a meeting since the petitioner sent its requisition is essentially the same, the shortage of funds. The respondents blame the petitioner for that shortage but that notion has been dismissed by Greyell J.

[86] To summarize, I find the petitioners held, and continue to hold, reasonable expectations that it will be acknowledged as a shareholder and permitted to exercise its legal rights under the articles and the BCA, which given the validity of its shareholdings and the size of those shareholdings include the right to compel the holding of an annual general meeting and the bringing of a special resolution seeking the removal of existing directors, as well as the election of new directors.

[87] In my view, the evidence makes it clear that the respondents have repeatedly breached the petitioner's reasonable expectations. What is particularly troubling is the absence of evidence to justify the various positions they have taken and the allegations they have made throughout this proceeding to explain their conduct, as well as their ongoing breaches of those expectations contrary to the court's findings and orders, as well as steps they have agreed to with the petitioner.

[88] After denying Aurum was a valid shareholder, refusing to produce its shareholders list for a period of time, on unreasonable grounds, causing shares to be issued to Mr. Young for the purpose of diluting Aurum's majority shareholding interest so as to prevent it from exercising its legal rights discussed above, and in particular to vote in a new slate of directors, Calais did not respond to the petitioner's requisition. After the petition was brought the respondents called a general shareholders' meeting and set a record date that would have precluded the petitioner from being notified and voting. Then they issued a list recognizing the petitioner as a shareholder, but maintaining Mr. Young's majority position. They agreed that the date of the AGM would be changed and held instead in June 2016, and to deliver notice of the meeting to all members with a record date falling after the dates upon which the application was set to be heard, which they further agreed

would be in May 2016. They also agreed the notice would advise all shareholders that a directorship vote was to occur at the meeting and reference would be made to the candidates proposed by Aurum after the hearing before Greyell J. occurred.

[89] His order essentially confirmed the meeting for June 14, 2016, specified the petitioner was entitled to attend and vote in accordance with its shareholdings, and set the record date for May 6, 2016. Despite his reasons for decision and the terms of the order, and the arrangements they had agreed to, the respondents then filed another response to the petition that stated all shares issued to Aurum should be set aside. It made new allegations related to the validity of the share issuance. It further stated Calais considered the record date for the AGM in June to be May 1, 2014 and that Aurum not be permitted to vote in breach of the order, what they had agreed to through counsel and article 10.6 which provides the record date must not be set more than two months before the meeting, or in the case of an AGM, four months. The provision further specifies the record date must not precede the meeting date by fewer than 21 days if the company is a public company.

[90] Prior to this hearing the respondents filed affidavit evidence in which Mr. Young acknowledged the petitioner's ongoing request for notice of the AGM and then raised for the first time concerns about the nominees for directorship proposed by Aurum in August 2015, as well as a third nominee, on the grounds they were not independent given their involvement with Pure Path.

[91] At the hearing itself, Mr. Hendricks submitted the cost of notifying the shareholders was prohibitive, given the absence of any funding from Aurum. He also argued that the proposed nominees were not independent. Nothing in the BCA or the articles supports the asserted requirement for independence.

[92] In the result, the respondents did not provide notice of the AGM as agreed in March 2015 and as contemplated by Greyell J.'s order, and then they again asserted a record date contrary to the order that would, again, disentitle Aurum to notice and to vote at the AGM as well as continuing to insist Aurum was not a valid shareholder.

[93] Apart from reiterating positions that have been previously dismissed before Greyell J., Mr. Hendricks focused very much on the personal sacrifices both he and Mr. Young had made in terms of time and money as opposed to the interests of Calais itself. That is also the thrust of the submissions contained in his letter to the court that followed the hearing. It is abundantly clear that both men are pre-occupied with the personal impact of losing their roles as directors and officers in the event Calais' application to remove them and replace them is granted.

[94] In my view the circumstances of this case are similar, but worse, than those in *Burdeny v. K & D Gourmet Baked Foods and Investments Inc.*, [1999] B.C.J. No. 953 (S.C.) where Justice Levine, as she then was held:

> [39] There is no question that Donald was entitled, as a shareholder of the company, to have access to the company's financial records (*Company Act*, section 171) and to receive the latest financial statement and auditor's report upon request (*Company Act*, section 172(3)). He was also entitled to attend or consent to the business to be conducted at an annual general meeting (*Company Act*, sections 139-40), and to receive the annual financial statement and auditor's report (*Company Act*, sections 145 and 178), unless the audit has been waived by unanimous resolution of the shareholders (*Company Act*, section 179).

> [40] In considering whether the failure of the company to comply with these provisions of the *Company Act* is "oppressive" or "unfairly prejudicial" to Donald, the question is not simply whether his legal rights have been breached, but whether his equitable rights have been detrimentally affected [citations omitted].
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> • • •
>
> [47] I conclude from the failure of the company to comply with the provisions of the *Company Act* "that the affairs of the company [were] being conducted … in a manner oppressive to one or more of the members." It is clear that at the time Donald filed the petition he had no means to confirm or dispel his suspicions concerning the company's finances. He was prevented from reviewing the company's financial records, he had not been given any financial statements, the company's finances had never been audited, and the company had not held annual general meetings as required by the *Company Act*. There is no evidence that Donald had consented to waiving the statutory requirements concerning annual general meetings or the appointment of an auditor. In my view a shareholder who is put in such a situation is dealt with unfairly "in the matter of his proprietary rights as a shareholder."

[95] I conclude that the respondents' ongoing conduct outlined above and in particular its failures to comply with the provisions of the BCA and the articles, its attempt to dilute Aurum's shareholdings for the sole purpose of interfering with the exercise of its legal rights as a majority shareholder, and their persistence in this conduct, contrary to the court's decision and orders, is unfairly prejudicial, if not oppressive to the petitioner.

[96] As noted above, section 227(3) of the BCA provides the court with express authority to remove and replace directors. This is considered an exceptional remedy. The court is also empowered to make any interim or final order it considers appropriate. This very broad discretion is tempered by the statutory requirement that the court must act with a view to bringing the matters complained of to an end.

[97] In regarding the circumstances here as exceptional. They justify the removal of the existing directors. It is very clear Mr. Young and Mr. Hendricks together will continue to engage in the conduct outlined above directed at preventing their replacement as directors. However, I regard a somewhat more modest remedy as sufficient to prevent any such further conduct.

[98] Given the permits and licences held personally by Mr. Hendricks, in the absence of a concrete transition plan, I am not ordering his removal. Instead, I order Mr. Young and Mr. Daher removed (if he has in fact not formally resigned). I also order the appointment of Aurum's three nominees as directors of Calais on an interim basis.

[99] I further require Mr. Hendricks, the interim directors, and Calais, to schedule an AGM for a date no more than 90 days from today at which an election of directors will be held. The record date remains the date set by Greyell J. This company must begin a new era of compliance with the legal requirements that govern the holding of AGMs.

[100] The notice to the shareholders will include copies of the orders made in this proceeding, the reasons of Greyell J., and my reasons for decision which I will endeavor to release as soon as possible upon a request for a transcript being received.

[101] The petitioner's further request for an order requiring the handing over of the material set out at paragraph 1(c) of their petition is also granted.

NOTES AND QUESTIONS

1. On what basis did the court in *Aurum, LLC v Calais Resources Inc* remove the directors? Do you think the remedy ordered was effective?

2. Consider again for a moment the fact pattern that has been used throughout this text. Aya Nang has built the company from its beginning, yet now she holds only 50,000 shares out of a total of 160,000 shares, which means that the shareholders could vote to remove Aya as a director of the corporation. What do you think the policy rationale is for giving shareholders the power to remove, if they so decide, the founder of a corporation?

IV. AUTHORITY OF DIRECTORS

As noted above, it is the directors who have the authority to manage or to oversee management of the corporation.[36] Corporate statutes often specifically allocate other powers to the directors. CBCA s 115(3) provides that the directors cannot delegate their powers with respect to certain matters such as filling a vacancy among the directors, issuing securities, declaring dividends, purchasing, redeeming, or otherwise acquiring the shares issued by the corporation, or adopting, amending, or repealing bylaws of the corporation.[37]

A. Adoption, Amendment, or Repeal of the Bylaws

The CBCA and other corporate statutes also give the directors the power to adopt, amend, or repeal bylaws.[38] The power of the directors to adopt, amend, or repeal bylaws is subject to the articles, the bylaws, or a unanimous shareholder agreement. The power of the directors with respect to the bylaws is also qualified by the requirement that any change the directors make in the bylaws must be put before the shareholders at the next annual meeting of shareholders. A change in the bylaws made by the directors is effective until the shareholders' meeting and is effective thereafter only if approved by the shareholders or approved as amended.[39]

B. Borrowing Powers

The directors also have the power to borrow, subject to the articles, the bylaws, or a unanimous shareholder agreement.[40] The directors may also delegate the power to borrow to a director, a committee of directors, or an officer, subject to any restriction on this power to delegate in the articles, the bylaws, or a unanimous shareholder agreement.[41]

36 CBCA s 102; ABCA s 101(1); BCBCA s 136(1); and OBCA s 115(1).

37 See also ABCA s 115(3) and OBCA s 127(3).

38 CBCA s 103(1); ABCA s 102(1); OBCA s 116; and QBCA s 113.

39 Under the BCBCA, a special resolution is still needed: BCBCA s 259(2).

40 CBCA s 189(1); ABCA s 103(1); and OBCA s 184(1).

41 CBCA s 189(2); ABCA s 103(2); OBCA s 184(2); and NSCA, First Schedule, s 71.

C. Declaration of Dividends

Directors have the power to declare dividends and, under most corporate statutes, this power cannot be delegated.[42] CBCA s 115 specifies that the company may declare a dividend and s 134(1) adds that the directors can set the record date for dividends.[43] The declaration of dividends is subject to a solvency test.

V. APPOINTMENT AND COMPENSATION OF OFFICERS AND THE DELEGATION OF POWERS

Some of the most significant powers of directors are designating and appointing officers of the corporation, determining the compensation of officers, and delegating management powers to officers.[44] These powers are exercised subject to the articles, the bylaws, or a unanimous shareholder agreement.

Widely held corporations are typically managed by officers appointed by the directors, leaving the directors in a largely supervisory role. However, the power of directors to appoint officers who manage the corporation remains a significant authority, since shareholders can exercise their voting powers to replace the directors, who can then replace the officers of the corporation. Many issuing corporations now have a committee of the board of directors that has the responsibility for recruitment and retention of officers, and succession planning. The committee is frequently composed of all or a majority of outside directors, with the purpose of recruiting the best possible officers with minimal interference or influence by inside directors.

Directors may also remove officers. The power to remove officers is key to the effectiveness of the election and removal of directors as a shareholder control device, because shareholders can express their dissatisfaction with the directors where the directors do not remove in a timely manner officers who are shirking or engaged in inappropriate conduct. However, removing the officers may permit them to assert actions for wrongful dismissal.

There is a trade-off between preserving the removal of managers as a shareholder control device and providing managers with long-term contracts and compensation in the event that the long-term contract is terminated. The corporation may benefit if the officer is willing to accept less compensation in return for the security of a long-term contract. With the hope of long-term reward, managers may be more willing to invest their human capital in the firm. Offering managers a long-term employment contract, with damages for premature termination, can be efficient, since the managers have a greater incentive to seek long-term rewards in the firm.

42 CBCA s 115(3)(d); ABCA s 115(3)(d); OBCA s 127(3)(d); and NSCA s 158.

43 CBCA ss 115 and 171(1).

44 CBCA s 121. See also ABCA s 121; BCBCA s 141; OBCA s 133; and QBCA ss 115, 116, and 117.

VI. DIRECTORS' MEETINGS

The mechanics of calling and holding board meetings are usually specified in the corporation's bylaws. Subject to the articles or bylaws, the quorum is a majority of the board or a majority of the minimum number of directors in the articles.[45] In Nova Scotia, a quorum is two or more directors, or as the directors think fit.[46] Notice to the directors is mandated, but can be waived under most corporate statutes.[47] Meetings by conference call are permitted.[48] No meeting need be held to transact business where all of the directors sign a written resolution in lieu of the meeting.[49] Meetings of one-person boards are validated, without which a meeting would require at least two persons.[50]

VII. THE BUSINESS JUDGMENT RULE

Directors have responsibility for oversight of the corporation's activities. Shareholder views and voting can sometimes clash with the views of directors regarding the future direction of the corporation. Directors and officers have an obligation to act in the best interests of the corporation and that fiduciary obligation requires directors to be duly diligent in their activities and decision-making. Directors also owe a duty of care and loyalty. The courts have held that where there are complaints regarding alleged failure of the directors to meet their common law or statutory duties, the court will defer to the business judgment of the directors where they have been duly diligent and have made decisions that were informed in all the circumstances. While business judgment is discussed at length in Chapter 13, it is important to consider how it fits with the notion of the relationship between the corporate board and the corporation's stakeholders.

The deference by the courts to business judgments is an important aspect of the law, because the courts frequently do not have the business or commercial expertise to assess all decisions made by directors and officers. Moreover, well-functioning boards have diverse types of directors with different skills and backgrounds, and, collectively, their business expertise is much greater than that of the courts, even where a particular judge has some commercial expertise. If directors and officers are acting in a good-faith and duly diligent manner in their decision-making, but they err in some way that causes a financial loss or a specific harm to the corporation or its stakeholders, there is a risk that courts may assess their decisions after the fact using the benefit of hindsight that was not available to the officers at the time of their decision. Often business and managerial decisions are time-sensitive and made with less than ideal information, directors assessing the upside and downside risks of the decision and having to act expeditiously and responsibly.

45 CBCA s 114(2); ABCA s 114(2); and OBCA s 126(3).

46 NSCA, First Schedule, s 129.

47 CBCA s 114; ABCA s 114; and OBCA s 126.

48 CBCA s 114; ABCA s 114; BCBCA s 140(1)(b); and OBCA s 126(13).

49 CBCA s 117; BCBCA s 140(3); ABCA s 117; and OBCA s 129.

50 ABCA s 114(8); CBCA s 114(8); OBCA s 126(12); and BCBCA s 140(4).

A failure to give deference to business judgments that are made in good faith and on a duly diligent basis could encourage shareholder or creditor actions where they are unhappy with officers' decisions in hindsight and could create inappropriate incentive effects for such stakeholders. Moreover, directors and officers may be unwilling to act or to make particular decisions out of fear that those decisions will be overturned by the courts, in turn creating an ineffective or paralyzed governance structure.

However, deference to business judgments cannot be completely unfettered. In the disclosure context, for example, where directors and officers of issuing corporations are required to disclose material changes, if deference to business judgments is too great, it will create incentives for issuers not to disclose and then seek the protection of the business judgment rule to justify that business decision.[51] In turn, it may prevent material information from being disclosed in a timely manner, creating barriers for investors in establishing claims of breach of statutory disclosure requirements. In the takeover context, as discussed in Chapter 15, the courts will assess the process of board decision-making in order to assess the level of deference to be accorded to their business judgments in the circumstances.

Hence, directors and officers must be duly diligent in their decision-making, which includes ensuring that they are informed, have considered various courses of action, and have made the decision in the best interests of the corporation. Assessment of this decision-making is largely, but not exclusively, a process inquiry by the courts, as there are instances in which the court will assess the substantive decision based on a standard of reasonableness in the circumstances. The courts will assess the reasonableness of the decision, not whether it was a perfect one; and if directors have acted within a range of reasonableness, the court will not substitute its own opinion for that of the board, even though subsequent events may have raised doubts about the validity of the decision (see *Peoples Department Stores Inc (Trustee of) v Wise*, below).

On finding that directors owe a duty of care under CBCA s 122, the Supreme Court of Canada in *Peoples Department Stores Inc (Trustee of) v Wise* made a strong statement regarding deference by the courts to directors' and officers' business judgments.

Peoples Department Stores Inc (Trustee of) v Wise
2004 SCC 68, [2004] 3 SCR 461

MAJOR and DESCHAMPS JJ:

[64] The contextual approach dictated by s. 122(1)(b) of the CBCA not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration. The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care. However, even with good corporate governance rules, directors' decisions can still be open to criticism from outsiders. Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, have tended to

51 Janis Sarra, "Disclosure as a Public Policy Instrument in Global Capital Markets" (2007) 42 Tex Intl LJ 231.

take an approach with respect to the enforcement of the duty of care that respects the fact that directors and officers often have business expertise that courts do not. Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the "business judgment rule," adopting the American name for the rule.

In *UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc* (2004), 250 DLR (4th) 526, 32 CCEL (3d) 68 (Ont CA), the Ontario Court of Appeal endorsed the lower court finding that the business judgment rule "recognizes the autonomy and integrity of a corporation and the expertise of its directors" since they are "in the advantageous position of investigating and considering first-hand the circumstances that come before it and are in a far better position than a court to understand the affairs of the corporation and to guide its operation" (at para 6). On the facts, the Ontario Court of Appeal held that the director's deliberations fell far short of the exercise of prudent judgment (at para 7). The Ontario Superior Court in *UPM-Kymmene Corp v UPM-Kymmene Miramichi Inc* (2002), 214 DLR (4th) 496 (Ont Sup Ct J) held the following in respect of how the business judgment rule is to be applied:

> [156] However, directors are only protected to the extent that their actions actually evidence their business judgment. The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions. Courts are entitled to consider the content of their decision and the extent of the information on which it was based and to measure this against the facts as they existed at the time the impugned decision was made. Although Board decisions are not subject to microscopic examination with the perfect vision of hindsight, they are subject to examination.

The issue of business judgment and where it fits into the court's consideration of shareholder remedies and deference to the business decisions is discussed further in Chapter 13.

VIII. CLOSELY HELD CORPORATIONS

The majority of corporations in Canada are closely held corporations, ranging from very small family businesses to large enterprises controlled by a few shareholders. As of 2012, small businesses employed 7.7 million employees in Canada, comprising 69.7 percent of the total private sector labour force, and Industry Canada reports that 98 percent of the 1.08 million small businesses in Canada in 2013 had 1 to 99 employees.[52]

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52 Janis Sarra, "An Opportune Moment—Retooling the Bankruptcy and Insolvency Act to Address Micro, Small and Medium Enterprise (MSME) Insolvency in Canada" in Janis P Sarra & BE Romaine, eds, *Annual Review of Insolvency Law 2016* (Toronto: Carswell, 2017) 119.

There is no universally accepted definition of a closely held corporation. However, a closely held corporation is normally considered to have the following characteristics: (1) there are relatively few shareholders; (2) most or all of the shareholders participate actively in the management of the corporation; (3) there is no established market for the shares of the corporation; and (4) frequently, there is a restriction on the transfer of the shares of the corporation.

This form of incorporation is very popular in Canada because sole proprietors or partnerships that begin to expand their businesses often seek the protection offered by the limited liability provisions of corporate statutes, while being able to continue the management and control of the business. Closely held corporations can take advantage of the enabling provisions of corporate statutes because they do not have the transaction costs of bargaining basic divisions of powers, shareholder rights, and remedies. This corporate form allows for administrative efficiencies through the use of provisions such as waiver of notice to shareholders' meetings and resolutions by unanimous consent in lieu of meetings. It can also assist in controlling agency costs, because shareholders of closely held corporations are able to control the actions of directors through unanimous shareholder agreements where they determine that such decisions should be made by the shareholders themselves. Closely held corporations also frequently have restrictions on share transfers and issuing of capital in order to protect the interests of existing shareholders, given that there is often not a market for their shares. These unique features of the closely held corporation are discussed below.

Given the nature of closely held corporations, the corporate governance structures suitable for such corporations may be different from structures suitable for widely held corporations. With fewer shareholders and most or all of the shareholders taking part in the management of the corporation, there may be less need for monitoring devices imposed in the context of widely held corporations, such as mandatory proxy solicitation. The efficiencies achieved by allocating the management of the business and affairs of the corporation to directors and their delegated officers are not as significant where there are only a few shareholders. A small group of shareholders may more readily assemble to deal with an array of matters of a management nature. With relatively few shareholders in a closely held corporation, the individual shareholders usually have a significant stake in the corporation and have an incentive to protect their investments through more active participation in the day-to-day affairs of the corporation.

Because of these differences, corporate laws typically provide for different treatment for closely held corporations. When "private corporation" was originally defined in Canadian corporations statutes, the upper limit on the number of shareholders was often set between 25 and 50. However, the ceiling on the number of individual shareholders that a corporation might have and still maintain a substantial identity between owners and managers is probably more like 10 or 12. Most closely held corporations have a lower value than widely held ones, but that is not universally true.

Many other countries have a separate statute for closely held corporations. In Canada, the early corporate statutes did not distinguish between closely held corporations and widely held corporations. However, in 1910, British Columbia adopted a "private company" concept that had been adopted a few years earlier in England. The term "private company" attempted to define corporations having characteristics of closely held corporations and generally provided relief from financial disclosure requirements. Subsequently, most Canadian jurisdictions also adopted this approach. When changes were made to Canadian

corporate statutes in the 1970s and 1980s, the private company concept was eliminated in most jurisdictions on the basis that it was difficult to precisely define a closely held corporation. The "private company" distinction was generally replaced with a series of permitted modifications to the basic legislative framework that were of a kind most likely to be used only by a closely held corporation.

The courts have been reluctant to interfere with closely held companies and the arrangements made among shareholders to protect their interests. The following case is an example.

Re Barsh and Feldman
(1986), 54 OR (2d) 340 (H Ct J)

VAN CAMP J: This is an application under s. 106(1) of the *Business Corporations Act, 1982* (Ont.), c. 4, for the following:

> 1. an order requiring a meeting of the shareholders of the corporation; 2. an order to vary the requirements of a quorum as set out in By-law 1 so that only two shareholders, holding at least 51% of the issued shares, are required to be present instead of the present requirement of the three shareholders who each hold one share.

Section 106 of the *Business Corporations Act, 1982* is as follows:

> 106(1) If for any reason it is impracticable to call a meeting of shareholders of a corporation in the manner in which meetings of those shareholders may be called or to conduct the meeting in the manner prescribed by the by-laws, the articles and this Act, or if for any other reason the court thinks fit, the court, upon the application of a director or a shareholder entitled to vote at the meeting, may order a meeting to be called, held and conducted in such manner as the court directs and upon such terms as to security for the costs of holding the meeting or otherwise as the court deems fit.
>
> (2) Without restricting the generality of subsection (1), the court may order that the quorum required by the by-laws, the articles or this Act be varied or dispensed with at a meeting called, held and conducted under this section.
>
> (3) A meeting called, held and conducted under this section is for all purposes a meeting of shareholders of the corporation duly called, held and conducted.

Under s. 94 of the *Business Corporations Act, 1982* the directors are required to call an annual meeting of shareholders not later than 15 months after holding the last preceding annual meeting and may, at any time, call a special meeting of shareholders. The last meeting of shareholders and of directors was held on April 8, 1966. On May 27, 1985, Barsh, holding one of the three shares, requisitioned the directors under s. 105 of the *Business Corporations Act, 1982* to call a meeting of shareholders for the certain purposes stated. Under s. 105, the directors were required to call the meeting of shareholders. No such meeting has been called.

Feldbar Construction Company Limited was incorporated in November, 1954, as a private company with restrictions on the transfer of shares. Hyman Feldman, Benjamin Barsh and his son, Harvey Samuel Barsh, each subscribed for one common share. Hyman Feldman and Benjamin Barsh each invested $20,000. Harvey Samuel Barsh made no

investment of capital, but was to perform services for the corporation in lieu of a capital investment. The services were to be those of a builder and developer.

The corporation carried on the business of acquiring real property and building houses on portions thereof. The two tracts of land that it now owns are vacant parcels which were acquired over 20 years ago. Some 40 houses were built and sold on one parcel of land between 1960 and 1966. At that time, the corporation became relatively inactive and ceased to hold meetings.

Benjamin Barsh died in 1983. His son, Harvey Samuel, exercised an option under the will to purchase his father's share. He now holds his father's share in the corporation as a bare trustee for S. & E. Consultants Limited as to a one-half interest and each of Stella Rudolph, his sister, and Joseph Barsh, his brother, as to a one-quarter interest. The shares of S. & E. Consultants Limited are owned by him and his wife. Since 1983, Harvey Samuel Barsh has wished to see the two tracts of land developed and has formed certain plans to this effect. Mr. Feldman had shown little, if any, interest in these plans until at least August, 1985. In late 1984, Barsh proposed buying out Feldman's interest. Feldman did not return to Barsh the resolutions to effect the transfer of the share of the deceased or the resolution of the shareholders electing the corporate solicitor as a director. It was at this time that Barsh requisitioned the special meeting of shareholders. Negotiations continued for the purchase of Feldman's interest and for the amendment of By-law 1 which would have the effect of eliminating the need for his attendance or vote at a meeting of shareholders and directors and his removal as a signing officer. A new general by-law is required to conform with the requirements of the *Business Corporations Act, 1982*. Although Feldman states that he is now willing to meet with the applicants to formulate a joint policy for the development or disposition of these properties, the prior delay makes it doubtful that the parties can agree. However, Feldman has given an undertaking through his counsel to sign a resolution for the annual meeting, approving the annual financial statements, electing the officers, appointing a director to replace the deceased and to approve the transfer of the share of the deceased to Barsh, in trust. This obviates the necessity of the meeting of shareholders.

I am of the opinion that the facts do not support the exercise of discretion to change the quorum. The result would be that one of three equal shareholders was effectively locked into a company in which he had no control. The quorum here was not to permit attendance of a shareholder, but to ensure that there would be no corporate action, except on the consent of all. Each shareholder has an equal interest. If there is no such consent obtainable, then there are provisions for the winding-up of the Corporation. None of the shareholders wish a winding-up, but unless they can agree it is the only alternative. The corporation was carefully structured so that no shareholder could control it. The affidavit of Feldman shows that because the other two shares were held by father and son, to give Feldman protection all decisions of directors and shareholders would require his consent and all cheques drawn on the corporate account would require his signature. That agreement was reflected in the provisions of ss. 3 and 4 of By-law 1 providing for a quorum of three persons at meetings of shareholders and directors. The banking resolution of the directors was enacted to require the signature of Feldman on the company cheques. The letters patent give one vote for each share held, but there can be no meetings unless all are present, that is, unless all agree. The obligation to have a general meeting can be met by an agreed agenda. The answer to the problem of disagreement among the shareholders

> is not to compel a meeting whereby two of the three equal shareholders may outvote the third. The answer is the winding-up of the corporation. When none of them wish that winding-up, they can find a compromise.
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> • • •
>
> The corporation in this application was carefully structured to require agreement of the three equal shareholders. This court should not intervene to effectively remove the need for agreement by the third shareholder. The application is dismissed. In the circumstances, there should be no costs.

IX. DIFFERENT TREATMENT UNDER MODERN CANADIAN STATUTES

The following modifications are available to closely held corporations:

1. *Waiver of notice to shareholders' meetings.* A shareholder can waive notice to a shareholders' meeting.[53] While shareholders in widely held corporations can waive notice to meetings under this provision, it is most likely to be used by closely held corporations, where shareholders can be more readily contacted with respect to a meeting.
2. *Resolutions by unanimous consent in lieu of meeting.* In lieu of having shareholder resolutions passed at a meeting of shareholders, shareholders' resolutions can be passed by having the resolution in writing signed by all the shareholders entitled to vote on the resolution.[54] Unanimous consent to the resolution in writing would be difficult to obtain in the context of a widely held corporation and is thus an option that is normally limited to a closely held corporation.
3. *Avoiding proxy solicitation requirements.* The expense of proxy solicitation and the preparation of a proxy circular is likely to outweigh substantially any possible gains for shareholders in closely held corporations when the shareholders have a sufficient stake in the corporation to keep themselves well informed and to exercise their voting rights. Thus, some statutes specify that corporations that have not made a distribution of their shares to the public are not subject to the mandatory proxy solicitation requirements.[55]
4. *Dispensing with an auditor.* The shareholders of a corporation that has not made a distribution of its shares to the public can also dispense with the requirement of having an auditor, limited to corporations with assets not exceeding $2.5 million and gross operating revenues not exceeding $5 million.[56] This provision will most often be used by closely held corporations where it is possible to avoid what can be substantial costs of having a full audit conducted.

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53 CBCA s 136; ABCA s 135; BCBCA s 170; and OBCA s 98. QBCA s 168 states that "[a] shareholder or director may waive notice of a shareholders meeting. Their attendance at the meeting is a waiver of notice of the meeting unless they attend the meeting for the sole purpose of objecting to the holding of the meeting on the grounds that it was not lawfully called or held."

54 CBCA s 142; ABCA s 141; BCBCA s 182(2); OBCA s 104; NSCA s 92(1); and QBCA s 178.

55 See e.g. CBCA s 149(2).

56 CBCA s 163; ABCA s 163; BCBCA ss 203(2) and (3); and OBCA s 148. QBCA s 239 specifies that shareholders of a corporation other than a reporting issuer may decide to not have an auditor.

5. *Financial disclosure.* A corporation that has not made a distribution of its shares to the public can also avoid having to publicly file its financial statements. Corporate statutes also explicitly recognize single shareholder corporations and provide that where the corporation has only one shareholder, the shareholder's presence in person or by proxy constitutes a meeting.[57]

X. SHAREHOLDER AGREEMENTS

The most significant modifications for closely held corporations are the statutory provisions that allow a closely held corporation to modify the default allocation of the power to manage the business and affairs of the corporation to the directors. CBCA s 102 allocates the power to manage to the directors, but this authority is subject to a unanimous shareholder agreement.[58]

Shareholders can enter into agreements whereby they agree as to how they will vote their shares. Shareholders can unanimously agree to remove management powers from directors and allocate them to the shareholders.[59] Unanimous agreement among the shareholders is not an agreement that is likely to be achieved in the context of a widely held corporation. The explicit authority given in CBCA s 146(2) for the use of a shareholder agreement to reallocate the powers assigned to directors responded to the concern raised by the following case.

Ringuet v Bergeron

[1960] SCR 672, 24 DLR (2d) 449 at 680-82, 683-84, 685 (footnotes omitted)

JUDSON J (Abbott and Ritchie JJ concurring): The respondent sued the appellants for a declaration that against each of them, he was entitled to certain shares of the St. Maurice Knitting Mills Limited registered in their names. In the Superior Court the learned trial judge dismissed the action. The Court of Queen's Bench (Appeal Side) allowed the appeal and maintained the action. The two unsuccessful shareholders now appeal to this Court.

The action was brought on an agreement dated August 3, 1949, between the respondent and the appellants. At that time these parties and four other persons each held 50 shares of the St. Maurice Knitting Mills Limited, a company incorporated by letters patent under Part I of the [then] Québec *Companies Act*. These shares constituted all the issued capital stock of the company. The purpose of the agreement was to provide for the acquisition of 50 shares from one Frank Spain and the division of these shares among the parties. With these 50 shares divided among them the parties then had control of the company and they agreed, among other matters to vote for their election to the Board of Directors; to ensure the election of the appellant Ringuet as president of the company, of the appellant Pagé as vice-president and general manager, and of the respondent Bergeron as

57 CBCA s 139(4); ABCA s 138(4); BCBCA s 172(3); and OBCA s 101(4).

58 See also ABCA s 101 and OBCA s 115.

59 CBCA s 146; ABCA s 146(1)(c); and OBCA s 108(2).

secretary-treasurer and assistant general manager of the company, all at stated and agreed salaries. They also agreed to vote unanimously at all meetings of the company and provided for a penalty for breach of the contract.

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Two or three months later the parties also purchased the shares of another shareholder Robert Sevigny and divided them among themselves in accordance with the agreement. On the completion of this purchase, there remained only five shareholders in the company: the two appellants, the respondent, the mis-en-cause Gerard Jean, and Zénon Bachand. On February 3, 1950, the three parties to the first agreement entered into another agreement and included in this one the mis-en-cause Gerard Jean. The purpose of this agreement was to provide for the admission of Gerard Jean into the controlling group and for the acquisition of the shares of Zénon Bachand, the last of the minority shareholders. Two shares were issued from the treasury and the total issued shares were equally divided among the four individuals with the result that each held 88 shares. The contract of February 3, 1950, to which Jean was a party, contains no provision corresponding to clause 12 of the contract of August 3, 1949. It does not purport to replace or alter the earlier contract, which remains in full force and effect.

From August 3, 1949 to June 14, 1952 the three parties to the first contract observed its terms. There had during this period been certain increases in salary which were properly authorized and fixed by mutual consent. On June 14, 1952, the appellant Maurice Pagé, at a directors' meeting, began to take steps to oust the respondent from the management of the company, and at a shareholders' meeting held on July 21, l952, the appellants and Jean voted themselves in as a new board of directors. The respondent says that he had no notice of this meeting and did not attend. He was not nominated and no votes were cast for his election as director of the company. The new board of directors held a meeting following the shareholders' meeting. Ringuet was elected president, Pagé was elected vice-president and Jean, secretary-treasurer. The respondent was thus completely excluded from the management of the company. He brought his action alleging that the appellants in failing to vote for his election to the board of directors and in not ensuring that he be appointed assistant general manager and secretary-treasurer, had violated the contract of August 3, 1949, and that he was entitled to enforce the penalty provided in clause 12 of the agreement. He claimed a transfer of 88 shares from each defendant. The facts were admitted in the pleadings and the sole defence was that the contract was contrary to public order.

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The point of the appeal is therefore whether an agreement among a group of shareholders providing for the direction and control of a company in the circumstances of this case is contrary to public order, and whether it is open to the parties to establish whatever sanction they choose for a breach of such agreement.

Did the parties of this agreement tie their hands in their capacity as directors of the company so as to contravene the requirements of the Québec *Companies Act*, which provides (s. 80) that "the affairs of the company shall be managed by a board of not less than three directors"? [now QBCA s. 176] I agree with the reasons of the learned Chief Justice that this agreement does not contravene this or any other section of the Québec *Companies Act*. It is no more than an agreement among shareholders owning or proposing to own the majority of the issued shares of a company to unite upon a course of policy or

> action and upon the officers whom they will elect. There is nothing illegal or contrary to public order in an agreement for achieving these purposes. Shareholders have the right to combine their interests and voting powers to secure such control of a company and to ensure that the company will be managed by certain persons in a certain manner. This is a well-known, normal and legal contract and one which is frequently encountered in current practice and it makes no difference whether the objects sought are to be achieved by means of an agreement such as this or a voting trust. Such an arrangement is not prohibited either by law, by good morals or public order.
>
> It is important to distinguish the present action, which is between contracting parties to an agreement for the voting of shares, from one brought by a minority shareholder demanding a certain standard of conduct from directors and majority shareholders.
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> • • •
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> I have the greatest difficulty in seeing how any question of public order can arise in a private arrangement of this kind. The possibility of injury to a minority interest cannot raise it. If this were not so, every arrangement of this kind would involve judicial enquiry. Minority rights have the protection of the law without the necessity of invoking public order. This litigation is between shareholders of a closely-held company. The agreement which the plaintiff seeks to enforce damages nobody except the unsuccessful party to the agreement. No public interest or illegality is involved.
>
> *I would dismiss the appeal with costs.*

One device that alerts prospective investors to the existence of a shareholder agreement is to print on any share certificates a legend indicating that the shares are subject to restrictions on transfer in a shareholder agreement. The transferee of shares is bound by the agreement if the share certificate bears a legend referring to the shareholder agreement, or if he or she has actual notice of it.[60] When the certificates bear a restrictive legend, the shares are called "letter stock."

If a shareholder agreement is not unanimous, however, it is not so clear that actual notice of it will bind the purchaser of the shares. In *Greenhalgh v Mallard*, [1943] 2 All ER 234 (CA), certain of the corporation's shareholders had entered into an agreement to vote so as to give the plaintiff effective control of the corporation. Shortly thereafter, certain of the parties sold their shares to someone not a party to the agreement. The plaintiff sued for a declaration that the purchaser was bound by the voting agreement. The court held that no intention was revealed on the face of the agreement either that its duration should be longer than the period during which a particular party would continue to own his or her shares, or that a party was to be restrained from selling his or her shares.

XI. BINDING THE DIRECTORS' DISCRETION

While shareholders are generally free to agree on how they will vote to elect directors, an agreement that fettered the discretion of directors might be impeached. The underlying

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60 CBCA ss 146(3) and 49(8).

notion is that the directors' fiduciary duty to advance the best interests of the firm requires that the directors be free to assess that interest and to act on their assessment.

However, officers' discretion is fettered by any long-term contract—for example, one retaining the services of a senior executive in a multi-year contract, with a right of damages for wrongful dismissal. These contracts are upheld on the basis that the decision whether firm value will be advanced through a long-term contract is one of business judgment best left to directors and officers. These agreements are not very different from shareholder agreements that provide for the appointment of officers or for their remuneration.

Under BCBCA s 137, the directors manage or supervise the affairs and business of the company subject to the articles. The standard form articles give the directors the powers of the company subject to those powers that the statute or the articles assign to the shareholders in a general meeting. Thus, the powers of the directors can be prescribed and assigned to shareholders in the articles—a unanimous shareholder agreement is not necessary. BCBCA s 137 reads:

Powers of directors may be transferred

137(1) Subject to subsection (1.1) but despite any other provision of this Act, the articles of a company may transfer, in whole or in part, the powers of the directors to manage or supervise the management of the business and affairs of the company to one or more other persons.

(1.1) A provision of the articles transferring powers of the directors to manage or supervise the management of the business and affairs of the company is effective

(a) if the provision is included in the articles at the time of the company's recognition or if the company resolved, by special resolution, to add that provision to the articles, and

(b) if the provision clearly indicates, by express reference to this section or otherwise, the intention that the powers be transferred to the proposed transferee.

(2) If the whole or any part of the powers of the directors is transferred in the manner contemplated by subsection (1),

(a) the persons to whom those powers are transferred have all the rights, powers, duties and liabilities of the directors of the company, whether arising under this Act or otherwise, in relation to and to the extent of the transfer, including any defences available to the directors, and

(b) the directors are relieved of their rights, powers, duties and liabilities to the same extent.

(3) If and to the extent that the articles transfer to a person a right, power, duty or liability that is, under this Act, given to or imposed on a director or directors, the reference in this Act or the regulations to a director or directors in relation to that right, power, duty or liability is deemed to be a reference to the person.

(4) A company may resolve to alter its articles, by special resolution, to alter a provision referred to in subsection (1.1).

However, it is common to use a unanimous shareholder agreement for companies incorporated on the basis that the unanimous shareholder agreement is easier and cheaper to amend, is not publicly filed, and can also be used to control how shareholder votes will be exercised.

NOTES AND QUESTIONS

1. Could CBCA s 146 be interpreted as an exclusive safe harbour in the case of a shareholder agreement? In other words, would a court refuse to enforce a non-unanimous shareholder agreement of the kind that was upheld in *Ringuet v Bergeron*?

2. Is there any risk under BCBCA s 137, in terms of prescribing the powers of directors and assigning them to shareholders in the articles instead of a unanimous shareholder agreement, or is this provision another example of administrative efficiency that the statute allows for closely held corporations?

XII. SHARE TRANSFER RESTRICTIONS

Where shareholders are not passive investors but are expected to take part in management, the identity of the shareholders will affect firm value. Even where active management duties are not contemplated, shareholders in closely held corporations will be greatly interested in the identities of the other members of the group because of the heightened possibility of hold-out strategies when decisions are made in small groups. For these reasons, a closely held corporation's charter will frequently provide for share transfer restrictions.

Transfer restrictions can achieve other aims. They may make it possible for the owners to maintain their relative share ownership, and therefore relative power, within the entity. In this way, they are analogous to pre-emptive rights upon a new share issuance. Transfer restrictions are also required if a firm is to take advantage of securities law private issuer exemptions, as discussed in Chapter 6, hence avoiding costly prospectus requirements. In addition, they may be drafted so as to provide liquidity to the estate of a deceased owner or to an owner who simply wishes to retire from the corporation, or where shareholders are deadlocked.

A. Types

At least five types of transfer restrictions can be identified:

1. *Absolute restrictions.* Under these restrictions, shareholders simply cannot sell. These restrictions are rarely used, except possibly in the start-up phase of a new corporation.
2. *Consent restrictions.* With these restrictions, a transfer of shares may be made only on approval of the corporation's board.
3. *First option restrictions.* This restriction is the most common type. The shareholder may not sell his or her shares or may not sell them to any person not already a shareholder of the corporation without first offering them to the corporation or to the remaining shareholders. The remaining shareholders would then have an option to buy the shares, either at the price that has been offered or at the price fixed by a valuer, who is often the corporation's auditor.
4. *Buy-sell agreements.* This restriction is similar to a first option restriction except that, as the name implies, the corporation or the other shareholders must buy the shares of the selling shareholder when the triggering event occurs. These provisions are very popular as a form of protection against the death of a shareholder. The estate of the deceased shareholder would then be obliged to sell his or her shares, and the corporation or the other shareholders would be obliged to buy them. In this way, a shareholder is able to make better provision for his or her family on death than were he or she simply to leave them shares in the firm. The transaction will frequently be financed through an insurance policy taken out on the life of the shareholder.

5. *Buyback rights.* Here, the corporation is given the right to repurchase shares on the occurrence of certain events, even if the shareholder does not want to sell. A typical event would be the termination of the shareholder's employment with the firm.

In general, a share transfer restriction may not be adopted by a firm that has made a public distribution of its shares.[61] However, under the CBCA, a public corporation may constrain the issuance or transfer of shares to, or their ownership by, persons who are not resident Canadians, in order to qualify under any federal or provincial law making a specified level of Canadian ownership a prerequisite for receipt of a licence, permit, or other benefit.[62] Section 46(1) specifies:

> 46(1) A corporation that has constraints on the issue, transfer or ownership of its shares of any class or series may, for any of the purposes referred to in paragraphs (a) to (c), sell, under the conditions and after giving the notice that may be prescribed, as if it were the owner of the shares, any of those constrained shares that are owned, or that the directors determine in the manner that may be prescribed may be owned, contrary to the constraints in order to
>
> (a) assist the corporation or any of its affiliates or associates to qualify under any prescribed law of Canada or a province to receive licences, permits, grants, payments or other benefits by reason of attaining or maintaining a specified level of Canadian ownership or control;
>
> (b) assist the corporation to comply with any prescribed law; or
>
> (c) attain or maintain a level of Canadian ownership specified in its articles.
>
> **Obligations of directors in sale**
>
> (2) Where shares are to be sold by a corporation under subsection (1), the directors of the corporation shall select the shares for sale in good faith and in a manner that is not unfairly prejudicial to, and does not unfairly disregard the interests of, the holders of the shares in the constrained class or series taken as a whole.
>
> **Effect of sale**
>
> (3) If shares are sold by a corporation under subsection (1), the owner of the shares immediately before the sale shall by that sale be divested of their interest or right in the shares, and the person who, but for the sale, would be the registered owner of the shares or a person who satisfies the corporation that, but for the sale, they could properly be treated as the registered owner or registered holder of the shares under section 51 shall, from the time of the sale, be entitled to receive only the net proceeds of the sale, together with any income earned on the proceeds from the beginning of the month next following the date of the receipt by the corporation of the proceeds of the sale, less any taxes on the proceeds and any costs of administration of a trust fund constituted under subsection 47(1) in relation to the constitution of the fund.
>
> **Subsections 51(4) to (6) apply**
>
> (4) Subsections 51(4) to (6) apply in respect of the person who is entitled under subsection (3) to receive the proceeds of a sale of shares under subsection (1) as if the proceeds were a security and the person were a registered holder or owner of the security.

A constrained share provision can be quite drastic in its operation because the directors are authorized to sell, as if they were the owner of the shares, any of those constrained shares

61 CBCA s 49(9).

62 See CBCA ss 46, 47, 49(9) to (11), and 174.

that are owned, as specified by s 46(1), above. The directors must select the shares to be sold in good faith and in a manner that is not unfairly prejudicial to, and does not unfairly disregard the interests of, the holders of the shares in the constrained class or series taken as a whole: s 46(2). On sale of the shares, the share owner is divested of interest or right in the shares, and is entitled to receive only the net proceeds of the sale, together with some income earned on the proceeds, as specified in s 46(3) above.

B. Validity

US courts, when confronted with share transfer restrictions, tend to emphasize shares-as-property and therefore to view transfer restrictions as falling into the suspect legal category of restraints on the alienation of property. English courts, in contrast, tend to view shares as predominantly contractual in nature, and have been relatively untroubled by doubts as to the validity of transfer restrictions.[63]

In *Edmonton Country Club v Case*, [1975] 1 SCR 534, the club was incorporated as a public corporation because its articles did not restrict to 50 the maximum number of shareholders, and one of its articles prohibited the transfer of shares to anyone without the consent of the directors, who might withhold consent "in their unfettered discretion." A shareholder claimed that the article was *ultra vires*. At 550, Justice Dickson rejected the attack, but with the observation that:

> Before we move to strike down such a power on the ground that it is unreasonable, we should, in my view, have some factual support for that conclusion. There is no evidence before us, nor is it alleged, that the directors have at any time in the almost 30-year history of the company acted in bad faith or arbitrarily or otherwise abused the power.

Laskin J, dissenting, would have struck out the article. At 550-51 he explained the difference of opinion between himself and Dickson J as follows:

> The difference between us is whether this arbitrary power, not related to any standard for the exercise of an unfettered discretion, should be controlled only in the context of a particular case requiring its exercise (as he would have it), or whether it should be struck out simply because it is on its face utterly arbitrary (as I would have it).

Today in Alberta, as federally, the statute does not permit a share transfer restriction in a public corporation. A CBCA corporation that desires share transfer restrictions must include them in its articles (CBCA s 6(1)(d)). The restriction thereby becomes part of the corporation's internal law, and transfers in contravention of it will not be registered by the corporation or its transfer agent. In addition, the restriction or a reference to it must be noted conspicuously on all share certificates. Otherwise, the restriction is ineffective against transferees without actual knowledge of it (CBCA s 49(8)).

63 See generally LCB Gower, "Some Contrasts Between British and American Corporation Law" (1956) 69 Harv L Rev 1369 at 1377-78.

XIII. THE CHOICE BETWEEN A CLOSELY HELD AND A WIDELY HELD CORPORATION

Whether a firm is closely or widely held will depend on a variety of economic considerations. A firm will go public only when doing so increases the value of the shares that were issued prior to the public distribution. If, instead, the firm is worth more as a closely held corporation, it will refrain from a public issue of its shares, or if it has already made a public issue of shares, it will seek to repurchase them from outside shareholders in a buyout transaction. The techniques by which a public firm may eliminate minority shareholders, and legal restrictions on such transactions, are discussed in Chapter 15. The cost of regulation of publicly traded companies also now acts as a factor in decisions regarding whether to become a publicly traded corporation or, increasingly, with the regulatory requirements discussed later in this chapter, the decision to go private to avoid the transaction costs associated with continuous disclosure and officer certification.

The availability of a resale market in securities of widely held firms is, of course, an advantage to investors. Shares in a closely held corporation are often made inalienable by the firm's charter. Moreover, even if the firm agrees to permit a resale, the shares will be very difficult to dispose of.

A further advantage of publicly traded corporations is easier access to capital markets. As a firm grows in value, it becomes harder to obtain financing solely through injections of equity from present shareholders. They may lack the assets to finance the acquisition of all available opportunities, and even were they able to do so, they might prefer to diversify their investments, rather than concentrate investment with a single firm. So long as a management's private funds plus the firm's internally generated funds do not enable it to accept all opportunities with a positive net present value, public markets in securities facilitate wealth creation.

Against these advantages of going public, one primary reason to remain or to become a closely held corporation is to economize on agency costs. Such costs arise as a consequence of the separation of ownership and control. One technique for reducing them is to assign to management a portion of the firm's residual value as part of its compensation package—for example, in the form of stock options. While agency costs will normally be greater in widely held firms, a special concern arises for the protection of minority shareholders in closely held corporations—their inability to sell their shares. Even if a market is available, shareholders in a closely held corporation might reasonably wish to restrict share transfers, since firm value will be tied to the identity of shareholders.

Management opportunism is a risk as a consequence of the greater valuation uncertainties surrounding closely held corporations, one reason small firms adopt broadly based governance structures in which all shareholders participate in management decisions. For example, shareholders in a closely held corporation will often agree to restrict the power of a majority of the board of directors, even giving veto rights to individual shareholders on some decisions. Although this strategy introduces a possibility of shareholder opportunism, it will also lower the agency costs of management misbehaviour.

Closely held corporations also face lower costs of disclosure given the reduced proxy solicitation and disclosure obligations. There are also tax advantages to closely held corporations.

QUESTION

How much judicial intervention in business affairs is justifiable?

XIV. CREATING NATIONAL CORPORATE GOVERNANCE GUIDELINES FOR PUBLICLY TRADED CORPORATIONS

Canadian securities regulators have adopted a national policy (NP) on corporate governance, NP 58-201, *Corporate Governance Guidelines*, which contains recommendations for good governance practice, as opposed to prescriptive requirements. They have also promulgated NI 58-101 for disclosure of corporate governance practices. The key elements of these documents are set out below. The policy choice is to require corporations that trade publicly to disclose their corporate governance practices; yet in respect of those practices, the guidelines are non-prescriptive. The guidelines recognize that there are some board practices, in terms of director and officer recruitment, education, committee structure, and codes of conduct, that assist in ensuring independent, informed, and diligent corporate governance.

As you read through the guidelines, consider whether mandatory disclosure will encourage corporate boards to assess their current governance practices. Consider whether the disclosure itself, while not mandatory, imposes particular normative directions on how corporations should structure their governance and, if so, whether it is an appropriate role for securities regulators. Consider also whether such disclosures are meaningful for investors, in terms of whether they will have the time and resources to monitor the governance practices of the corporations in which they invest.

National Policy 58-201, *Corporate Governance Guidelines*
(2005) 28 OSCB 5383 (footnote incorporated into text)

Part 1 Purpose and Application

1.1 Purpose of this Policy—This Policy provides guidance on corporate governance practices which have been formulated to:

- achieve a balance between providing protection to investors and fostering fair and efficient capital markets and confidence in capital markets;
- be sensitive to the realities of the large numbers of small companies and controlled companies in the Canadian corporate landscape;
- take into account the impact of corporate governance developments in the US and around the world; and
- recognize that corporate governance is evolving.

The guidelines in this Policy are not intended to be prescriptive.

. . .

Part 2 Meaning of Independence

2.1 Meaning of Independence—For the purposes of this Policy, a director is independent if he or she would be independent for the purposes of National Instrument 58-101 *Disclosure of Corporate Governance Practices*.

Part 3 Corporate Governance Guidelines

Composition of the Board

3.1 The board should have a majority of independent directors.

3.2 The chair of the board should be an independent director. Where this is not appropriate, an independent director should be appointed to act as "lead director." However, either an independent chair or an independent lead director should act as the effective leader of the board and ensure that the board's agenda will enable it to successfully carry out its duties.

Meetings of Independent Directors

3.3 The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance.

Board Mandate

3.4 The board should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the issuer, including responsibility for:

(a) to the extent feasible, satisfying itself as to the integrity of the chief executive officer (the CEO) and other executive officers and that the CEO and other executive officers create a culture of integrity throughout the organization;

(b) adopting a strategic planning process and approving, on at least an annual basis, a strategic plan which takes into account, among other things, the opportunities and risks of the business;

(c) the identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks;

(d) succession planning (including appointing, training and monitoring senior management);

(e) adopting a communication policy for the issuer;

(f) the issuer's internal control and management information systems; and

(g) developing the issuer's approach to corporate governance, including developing a set of corporate governance principles and guidelines that are specifically applicable to the issuer [Issuers may consider appointing a corporate governance committee to consider these issues. A corporate governance committee should have a majority of independent directors, with the remaining members being "non-management" directors].

The written mandate of the board should also set out:

(i) measures for receiving feedback from stakeholders (*e.g.*, the board may wish to establish a process to permit stakeholders to directly contact the independent directors), and

(ii) expectations and responsibilities of directors, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

In developing an effective communication policy for the issuer, issuers should refer to the guidance set out in National Policy 51-201 *Disclosure Standards*.

For purposes of this Policy, "executive officer" has the same meaning as in National Instrument 51-102 *Continuous Disclosure Obligations*.

Position Descriptions

3.5 The board should develop clear position descriptions for the chair of the board and the chair of each board committee. In addition, the board, together with the CEO, should develop a clear position description for the CEO, which includes delineating management's responsibilities. The board should also develop or approve the corporate goals and objectives that the CEO is responsible for meeting.

Orientation and Continuing Education

3.6 The board should ensure that all new directors receive a comprehensive orientation. All new directors should fully understand the role of the board and its committees, as well as the contribution individual directors are expected to make (including, in particular, the commitment of time and resources that the issuer expects from its directors). All new directors should also understand the nature and operation of the issuer's business.

3.7 The board should provide continuing education opportunities for all directors, so that individuals may maintain or enhance their skills and abilities as directors, as well as to ensure their knowledge and understanding of the issuer's business remains current.

Code of Business Conduct and Ethics

3.8 The board should adopt a written code of business conduct and ethics (a code). The code should be applicable to directors, officers and employees of the issuer. The code should constitute written standards that are reasonably designed to promote integrity and to deter wrongdoing. In particular, it should address the following issues:

(a) conflicts of interest, including transactions and agreements in respect of which a director or executive officer has a material interest;

(b) protection and proper use of corporate assets and opportunities;

(c) confidentiality of corporate information;

(d) fair dealing with the issuer's security holders, customers, suppliers, competitors and employees;

(e) compliance with laws, rules and regulations; and

(f) reporting of any illegal or unethical behaviour.

3.9 The board should be responsible for monitoring compliance with the code. Any waivers from the code that are granted for the benefit of the issuer's directors or executive officers should be granted by the board (or a board committee) only.

Although issuers must exercise their own judgement in making materiality determinations, the Canadian securities regulatory authorities consider that conduct by a director or executive officer which constitutes a material departure from the code will likely constitute a "material change" within the meaning of National Instrument 51-102 *Continuous Disclosure Obligations*. National Instrument 51-102 requires every material change report to include a full description of the material change. Where a material departure from the code constitutes a material change to the issuer, we expect that the material change report will disclose, among other things:

- the date of the departure(s),
- the party(ies) involved in the departure(s),
- the reason why the board has or has not sanctioned the departure(s), and
- any measures the board has taken to address or remedy the departure(s).

Nomination of Directors

3.10 The board should appoint a nominating committee composed entirely of independent directors.

3.11 The nominating committee should have a written charter that clearly establishes the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members and subcommittees), and manner of reporting to the board. In addition, the nominating committee should be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties. If an issuer is legally required by contract or otherwise to provide third parties with the right to nominate directors, the selection and nomination of those directors need not involve the approval of an independent nominating committee.

3.12 Prior to nominating or appointing individuals as directors, the board should adopt a process involving the following steps:

(A) Consider what competencies and skills the board, as a whole, should possess. In doing so, the board should recognize that the particular competencies and skills required for one issuer may not be the same as those required for another.

(B) Assess what competencies and skills each existing director possesses. It is unlikely that any one director will have all the competencies and skills required by the board. Instead, the board should be considered as a group, with each individual making his or her own contribution. Attention should also be paid to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic.

The board should also consider the appropriate size of the board, with a view to facilitating effective decision-making.

In carrying out each of these functions, the board should consider the advice and input of the nominating committee.

3.13 The nominating committee should be responsible for identifying individuals qualified to become new board members and recommending to the board the new director nominees for the next annual meeting of shareholders.

3.14 In making its recommendations, the nominating committee should consider:

(a) the competencies and skills that the board considers to be necessary for the board, as a whole, to possess;

(b) the competencies and skills that the board considers each existing director to possess; and

(c) the competencies and skills each new nominee will bring to the boardroom.

The nominating committee should also consider whether or not each new nominee can devote sufficient time and resources to his or her duties as a board member.

Compensation

3.15 The board should appoint a compensation committee composed entirely of independent directors.

3.16 The compensation committee should have a written charter that establishes the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members or subcommittees), and the manner of reporting to the board. In addition, the compensation committee should be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties.

3.17 The compensation committee should be responsible for:

(a) reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those corporate goals and objectives, and determining (or making recommendations to the board with respect to) the CEO's compensation level based on this evaluation;

(b) making recommendations to the board with respect to non-CEO officer and director compensation, incentive compensation plans and equity-based plans; and

(c) reviewing executive compensation disclosure before the issuer publicly discloses this information.

Regular Board Assessments

3.18 The board, its committees and each individual director should be regularly assessed regarding his, her or its effectiveness and contribution. An assessment should consider

(a) in the case of the board or a board committee, its mandate or charter, and

(b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board.

Pursuant to National Instrument (NI) 52-110, *Audit Committees*,[64] an audit committee member is independent if he or she has no direct or indirect material relationship with the issuer. The

64 NI 52-110, *Audit Committees* (17 November 2015), online: <https://www.bcsc.bc.ca/Securities_Law/Policies/Policy5/PDF/52-110__NI___November_17__2015>.

definition of material relationship is very detailed, capturing a number of relationships and situations.

NI 52-110 s 1.4(3) specifies that a "material relationship" is a relationship that could be reasonably expected to interfere with the exercise of a member's independent judgment, and includes

(a) an individual who is, or has been within the last three years, an employee or executive officer of the issuer;
(b) an individual whose immediate family member is, or has been within the last three years, an executive officer of the issuer;
(c) an individual who:
(i) is a partner of a firm that is the issuer's internal or external auditor,
(ii) is an employee of that firm, or
(iii) was within the last three years a partner or employee of that firm and personally worked on the issuer's audit within that time;
(d) an individual whose spouse, minor child or stepchild, or child or stepchild who shares a home with the individual:
(i) is a partner of a firm that is the issuer's internal or external auditor,
(ii) is an employee of that firm and participates in its audit, assurance or tax compliance (but not tax planning) practice, or
(iii) was within the last three years a partner or employee of that firm and personally worked on the issuer's audit within that time;
(e) an individual who, or whose immediate family member, is or has been within the last three years, an executive officer of an entity if any of the issuer's current executive officers served at that same time on the entity's compensation committee; and
(f) an individual who received, or whose immediate family member who is employed as an executive officer of the issuer received, more than $75,000 in direct compensation from the issuer during any 12 month period within the last three years.

NI 52-110 s 1.4(6) states that direct compensation does not include:

(a) remuneration for acting as a member of the board of directors or of any board committee of the issuer, and
(b) the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer if the compensation is not contingent in any way on continued service.

NI 52-110 s 1.4(7) states that an individual is not considered to have a material relationship with the issuer solely because the individual or his or her immediate family member

(a) has previously acted as an interim chief executive officer of the issuer, or
(b) acts, or has previously acted, as a chair or vice-chair of the board of directors or of any board committee of the issuer on a part-time basis.

Under NI 52-110 s 1.5, additional independence requirements include that an individual who

(a) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any subsidiary entity of the issuer, other than as remuneration for acting in his or her capacity as a member of the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee; or
(b) is an affiliated entity of the issuer or any of its subsidiary entities,
is considered to have a material relationship with the issuer.

NOTES AND QUESTIONS

1. One purpose of NP 58-201 is to provide guidance on corporate governance practices that is sensitive to the realities of the large number of smaller companies and closely controlled companies in Canada; do you think that the guidelines accomplish this objective?

2. The guidelines recommend that certain board committees, such as the nomination committee and the compensation committee, be composed entirely of independent directors; what is the policy rationale for such a suggested practice?

3. What is the process suggested in the guidelines by which new candidates can be identified as potential directors? In your view, does this process answer some of the questions raised earlier in this chapter about the lack of diversity on Canadian corporate boards?

4. What is the purpose of independent directors meeting on a regular basis without non-independent directors and corporate officers?

XV. SECURITIES LAWS DISCLOSURE REQUIREMENTS IN RESPECT OF CORPORATE GOVERNANCE

A. Voluntary Guidelines, Mandatory Disclosure

The corporate governance guidelines promulgated by Canadian securities regulators are not mandatory. However, effective 2005, there has been a national instrument, National Instrument 58-101, *Disclosure of Corporate Governance Practices*, which requires issuing corporations to disclose their governance measures. This requirement aligns with Canadian securities legislation, in which disclosure is the underpinning of investor protection and enhances the efficiency and integrity of capital markets.

National Instrument 58-101, *Disclosure of Corporate Governance Practices*
(2005) 28 OSCB 5377, as amended 17 November 2015

Part 2 Disclosure and Filing Requirements

2.1 Required Disclosure—

(1) If management of an issuer, other than a venture issuer, solicits a proxy from a security holder of the issuer for the purpose of electing directors to the issuer's board of directors, the issuer must include in its management information circular the disclosure required by Form 58-101F1.

(2) An issuer, other than a venture issuer, that does not send a management information circular to its security holders must provide the disclosure required by Form 58-101F1 in its AIF.

2.2 Venture Issuers—

(1) If management of a venture issuer solicits a proxy from a security holder of the venture issuer for the purpose of electing directors to the issuer's board of directors, the venture issuer must include in its management information circular the disclosure required by Form 58-101F2.

(2) A venture issuer that does not send a management information circular to its security holders must provide the disclosure required by Form 58-101F2 in its AIF or annual MD&A.

2.3 Filing of Code—

If an issuer has adopted or amended a written code, the issuer must file a copy of the code or amendment on SEDAR no later than the date on which the issuer's next financial statements must be filed, unless a copy of the code or amendment has been previously filed.

Part 3 Exemptions and Effective Date

3.1 Exemptions—

(1) The securities regulatory authority or regulator may grant an exemption from this rule, in whole or in part, subject to any conditions or restrictions imposed in the exemption.

(2) Despite subsection (1), in Ontario, only the regulator may grant an exemption.

3.2 Effective Date—

(1) This Instrument comes into force on June 30, 2005.

(2) Despite subsection (1), sections 2.1 and 2.2 only apply to management information circulars, AIFs and annual MD&A, as the case may be, which are filed following an issuer's financial year ending on or after June 30, 2005.

Form 58-101F1 for issuers sets out the scope of what must be disclosed, including the structure and independence of the board, its mandate, the continuing education received by directors, recruitment and compensation, and whether the board has adopted a code for ethical business conduct.

Form 58-101F1, *Corporate Governance Disclosure*
(2005) 28 OSCB 5379, as amended 25 October 2011

1. Board of Directors—

(a) Disclose the identity of directors who are independent.

(b) Disclose the identity of directors who are not independent, and describe the basis for that determination.

(c) Disclose whether or not a majority of directors are independent. If a majority of directors are not independent, describe what the board of directors (the board) does to facilitate its exercise of independent judgement in carrying out its responsibilities.

(d) If a director is presently a director of any other issuer that is a reporting issuer (or the equivalent) in a jurisdiction or a foreign jurisdiction, identify both the director and the other issuer.

(e) Disclose whether or not the independent directors hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance. If the independent directors hold such meetings, disclose the number of meetings held since the beginning of the issuer's most recently completed financial year. If the independent directors do not hold such meetings, describe what the board does to facilitate open and candid discussion among its independent directors.

(f) Disclose whether or not the chair of the board is an independent director. If the board has a chair or lead director who is an independent director, disclose the identity of the independent chair or lead director, and describe his or her role and responsibilities. If the board has neither a chair that is independent nor a lead director that is independent, describe what the board does to provide leadership for its independent directors.

(g) Disclose the attendance record of each director for all board meetings held since the beginning of the issuer's most recently completed financial year.

2. Board Mandate—Disclose the text of the board's written mandate. If the board does not have a written mandate, describe how the board delineates its role and responsibilities.

3. Position Descriptions—

(a) Disclose whether or not the board has developed written position descriptions for the chair and the chair of each board committee. If the board has not developed written position descriptions for the chair and/or the chair of each board committee, briefly describe how the board delineates the role and responsibilities of each such position.

(b) Disclose whether or not the board and CEO have developed a written position description for the CEO. If the board and CEO have not developed such a position description, briefly describe how the board delineates the role and responsibilities of the CEO.

4. Orientation and Continuing Education—

(a) Briefly describe what measures the board takes to orient new directors regarding

(i) the role of the board, its committees and its directors, and

(ii) the nature and operation of the issuer's business.

(b) Briefly describe what measures, if any, the board takes to provide continuing education for its directors. If the board does not provide continuing education, describe how the board ensures that its directors maintain the skill and knowledge necessary to meet their obligations as directors.

5. Ethical Business Conduct—

(a) Disclose whether or not the board has adopted a written code for the directors, officers and employees. If the board has adopted a written code:

(i) disclose how a person or company may obtain a copy of the code;

(ii) describe how the board monitors compliance with its code, or if the board does not monitor compliance, explain whether and how the board satisfies itself regarding compliance with its code; and

(iii) provide a cross-reference to any material change report filed since the beginning of the issuer's most recently completed financial year that pertains to any conduct of a director or executive officer that constitutes a departure from the code.

(b) Describe any steps the board takes to ensure directors exercise independent judgement in considering transactions and agreements in respect of which a director or executive officer has a material interest.

(c) Describe any other steps the board takes to encourage and promote a culture of ethical business conduct.

6. Nomination of Directors—

(a) Describe the process by which the board identifies new candidates for board nomination.

(b) Disclose whether or not the board has a nominating committee composed entirely of independent directors. If the board does not have a nominating committee composed entirely of independent directors, describe what steps the board takes to encourage an objective nomination process.

(c) If the board has a nominating committee, describe the responsibilities, powers and operation of the nominating committee.

7. Compensation—

(a) Describe the process by which the board determines the compensation for the issuer's directors and officers.

(b) Disclose whether or not the board has a compensation committee composed entirely of independent directors. If the board does not have a compensation committee composed entirely of independent directors, describe what steps the board takes to ensure an objective process for determining such compensation.

(c) If the board has a compensation committee, describe the responsibilities, powers and operation of the compensation committee.

8. Other Board Committees—If the board has standing committees other than the audit, compensation and nominating committees, identify the committees and describe their function.

9. Assessments—Disclose whether or not the board, its committees and individual directors are regularly assessed with respect to their effectiveness and contribution. If assessments are regularly conducted, describe the process used for the assessments. If assessments are not regularly conducted, describe how the board satisfies itself that the board, its committees, and its individual directors are performing effectively.

There is a separate form for corporate governance disclosure for venture issuers, Form 58-101F2.[65]

Hence, while the corporate governance guidelines are not prescriptive, securities regulators require extensive disclosure of corporate governance practices, particularly where they do not align with best practices. One issue is whether the disclosure is really meaningful for investors, as they may not have the time or resources to effectively monitor governance practices. However, institutional investors do have considerable interest in these disclosures, and given the volume of their investments, have a direct interest in monitoring corporate governance. An important policy question is, thus, whether the benefits of enhanced disclosure and thus ability to assess governance practice outweigh the additional costs to corporations. The requirement to report means that the board of directors must turn its mind to its governance practices, which may ultimately result in the board taking action to enhance its governance.

A further important question is how these securities law requirements, which are aimed more generally at the public interest in protecting security holders, align with corporate law requirements, in which directors and officers are given considerable scope and discretion to make governance decisions in the best interests of the entity as a whole, and not merely for one party with a financial stake in the corporation. Recall the discussion in Chapter 10 with respect to directors concerning themselves with other stakeholders with a direct or indirect investment in the firm. While such stakeholders may benefit from the increased transparency that securities governance disclosure requirements offer, there can be an inherent tension in how corporate governance advances their individual interest in the corporation's activities.

NOTES AND QUESTIONS

1. Why should disclosure of governance practices differ between privately held corporations and issuing corporations?

2. In your view, what is the right balance between common law and statutory approaches to corporate governance; specifically, should the interventions of regulators and courts be limited to ensuring that appropriate processes are followed?

3. Do securities regulatory governance requirements conflict with the interests of other stakeholders such as creditors and employees?

B. Financial Reports

Financial statements for the preceding year must be placed before the shareholders at every annual meeting, and they must also be sent to shareholders in advance of the meeting. Under the CBCA and several other corporate statutes, the period for sending out these documents is not less than 21 days before the meeting.[66] In the case of widely held corporations, the financial statements will be included in the proxy circular and will contain a

65 Form 58-101F2, *Corporate Governance Disclosure (Venture Issuers)* (2005) 28 OSCB 5382, as amended 25 October 2011.

66 CBCA ss 155 and 159; ABCA ss 155 and 159; and OBCA s 154.

balance sheet, income statement, statement of retained earnings, and statement of changes in financial position.[67] These financial statements must be prepared in accordance with the standards of the Canadian Institute of Chartered Accountants.[68] If the corporation is an issuing corporation, the financial statements must be filed and thus available for public scrutiny. Securities legislation contains similar financial statement filing requirements. See also the discussion in Chapter 6 regarding continuous disclosure requirements. Publicly traded companies must disclose in their Annual Information Form (AIF) their social and environmental policies, as well as risk factors such as environmental and health, as set out below:

> Form 51-102F2, *Annual Information Form,* effective 30 June 2015
>
> *5.1 General* (1) Describe the business of your company and its operating segments that are reportable segments as those terms are described in the issuer's GAAP. For each reportable segment include:
>
> (k) Environmental Protection
> The financial and operational effects of environmental protection requirements on the capital expenditures, profit or loss and competitive position of your company in the current financial year and the expected effect in future years.
>
> *(4) Social or Environmental Policies*
> If your company has implemented social or environmental policies that are fundamental to your operations, such as policies regarding your company's relationship with the environment or with the communities in which it does business, or human rights policies, describe them and the steps your company has taken to implement them.
>
> *5.2 Risk Factors*
> Disclose risk factors relating to your company and its business, such as cash flow and liquidity problems, if any, experience of management, the general risks inherent in the business carried on by your company, environmental and health risks, reliance on key personnel, regulatory constraints, economic or political conditions and financial history and any other matter that would be most likely to influence an investor?s decision to purchase securities of your company. If there is a risk that securityholders of your company may become liable to make an additional contribution beyond the price of the security, disclose that risk.
>
> (i) Disclose the risks in order of seriousness from the most serious to the least serious.
> (ii) A risk factor must not be de-emphasized by including excessive caveats or conditions.

C. Auditing of Financial Statements

The use of auditors antedates statutes mandating their use. It can be explained in terms of the concept of bonding—the auditor's report serves as a signal of the accuracy of the financial statements.[69] CBCA s 161 now requires the financials to be reported on by an auditor that

67 *Canada Business Corporations Regulations, 2001*, SOR/2001-512 [CBCR] s 72; Alberta *Business Corporations Regulation*, Alta Reg 118/2000 [Alberta BCR] s 21(1); and *General*, RRO 1990, Reg 62 [OBCA Reg] s 42.

68 CBCR ss 70 and 71; Alberta BCR s 21; and OBCA Reg ss 40 and 41.

69 Ross L Watts & Jerold L Zimmerman, "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence" (1983) 26 JL & Econ 613.

is "independent" of the corporation.[70] There is, however, an exemption for small firms that permits corporations that are not publicly held to dispense with the requirement of an auditor with the unanimous consent of shareholders.[71]

It is important to remember that while the financial statements are reported on by the auditor, they are the corporation's statements, and are not issued by it until they have been approved by its directors.[72] Unless exempted, the board of directors of an issuing corporation must appoint an audit committee, a majority of whose members must not be employees of the corporation or an affiliate.[73] The audit committee serves generally as a go-between for the board and the auditors, and is charged with examining the financial statements before they are submitted to the board for approval. For issuing corporations, securities regulators have issued new audit committee independence requirements. Although the CBCA-based statutes do not specify what manner of report the corporation's auditor is to make regarding the corporation's financial statement, the following, or words of similar purport, is the customary form of a "clean" auditor's report:

> We have examined the [list of financial statements]. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.
>
> In our opinion these financial statements present fairly the financial position of the company as at [year end] and the results of their operations for the year then ended in accordance with generally accepted accounting principles.

In a clean opinion, the auditor generally opines as to two matters: that the financial statements have been set out in accordance with International Financial Reporting Standards (IFRS) or "generally accepted accounting principles" (GAAP) and that they "present fairly" the financial position of the corporation. Generally accepted accounting principles and the International Financial Reporting Standards include at least those principles so recognized in the *CPA Canada Handbook*.[74] There is often more than one accounting principle that could be applied to a given situation, and the results may differ depending on which principle is used. Usually it is management's prerogative in such a case to choose among applicable principles, and an auditor is not obliged to qualify its opinion simply because it does not

70 See also ABCA s 161; BCBCA ss 204, 205, and 206; OBCA s 152; and NSCA ss 117 and 119A. QBCA ss 231-39 discuss the role of the auditor.

71 CBCA s 163; ABCA s 163; BCBCA ss 203(2) and 203(3); OBCA s 148; NSCA s 118; and QBCA s 239.

72 CBCA s 158; ABCA s 158; BCBCA s 225; OBCA s 159; and NSCA s 122(2).

73 CBCA s 171; ABCA s 171; BCBCA s 224; and OBCA s 158.

74 The Canadian Accounting Standards Board (AcSB) has adopted the mandatory use of International Financial Reporting Standards (IFRS) by all publicly accountable enterprises, replacing previous Canadian generally accepted accounting principles as the acceptable set of accounting standards, with implementation dates over a period from 2015 to 2019, and ongoing assessment and revision of standards as the implementation proceeds. While the Canada Revenue Agency does not specify that financial statements must be prepared following any particular type of accounting principles or standards, the AcSB requires publicly accountable enterprises to use IFRS in the preparation of all interim and annual financial statements. Most private companies also have the option to adopt IFRS for financial statement preparation: see International Financial Reporting Standards, online: Canada Revenue Agency <http://www.cra-arc.gc.ca/tx/bsnss/tpcs/frs/menu-eng.html>.

believe that the most appropriate principle was chosen. At some point, however, the issue of choosing among accounting principles begins to shade into the "fairness" with which the financial position is being presented.

For a discussion of what constitutes fair presentation, see the judgment of the British Columbia Court of Appeal in *Kripps v Touche Ross & Co*, an excerpt of which is set out below.

Kripps v Touche Ross & Co
[1997] 6 WWR 421, 33 BCLR (3d) 254 (CA)

FINCH J (Rowles J concurring):

[62] In my respectful view, the statement that "financial statements present fairly the financial position of the company in accordance with generally accepted accounting principles" is ambiguous. It is neither a clear statement of opinion by the professional auditor that the financial statements present fairly the financial position of the company, nor that the financial statements are in accordance with generally accepted accounting principles. In the case at bar, the defendant argued that while the financial statements may present unfairly the financial position of the company (i.e., misrepresent that position), they are nevertheless in accordance with GAAP. Therefore, the defendant says, it is true to say that the financial statements present fairly the financial position according to GAAP. Therefore, it has made no misrepresentation in its auditor's report and is not liable.

[63] In my view, the critical issue is the effect of the auditor's report. The learned trial judge concluded that the failure to disclose the amount of arrears was an omission of a piece of material information, but that the capitalization of unpaid interest was the universal practice at the time and was in accordance with GAAP. He therefore concluded that since the capitalization of arrears was in accordance with GAAP, the defendant could not refuse to sign the standard form of auditor's report, regardless of whether the practice was misleading (at para. 93):

> If it was only a question of whether there was a fair presentation of the financial position, the qualifying words "in accordance with GAAP" would serve no purpose. But, as the *Handbook* provides, GAAP is *the* standard against which fair presentation is to be judged. The opinion auditors give is that the financial position is, in accordance with accepted principles, fairly presented. It is, in that sense, a qualified opinion of fair presentation, and the qualification cannot be ignored. [emphasis in original]

[64] It is my view that the aim of an auditor's report is to allow auditors to provide their professional opinion which may be relied upon as a guide to business planning and investment. GAAP may be their guide to forming this opinion, but auditors are retained to form an opinion on the fairness of the financial statements, not merely on their conformity to GAAP. A person to whom the auditor owes a duty of care who reads a standard auditor's report and concludes in reliance on it that the financial statements are fair is acting reasonably.

[65] I find support for this view in Section 5400 of the Handbook. 5400.14 sets out the standard form of auditor's report. 5400.16 states, in part:

> To permit all auditors to judge in a consistent manner whether financial statements "present fairly," there must be a standard against which those judgments can be made; generally accepted accounting principles provide such a standard.

In a given situation, the auditor may not feel able to give a clean opinion, in which case it may note that the opinion is "subject to" one or more qualifications. These qualifications may be required either because the auditor was unable to verify certain accounts in accordance with the standards for testing ordinarily applied to an audit, or because of the existence of certain "contingencies." The latter are customarily the subject of footnote disclosure. In an extreme case, the auditor might refuse to issue any opinion at all. Of course, it will be very damaging to the corporation's reputation if the auditor fails to issue an opinion or issues one subject to serious qualifications.

A negative report by an auditor can have negative effects on a corporation's share price. When PricewaterhouseCoopers LLP resigned in February 2005 as Mamma.com Inc's independent auditor after refusing to sign off on the small Internet search company's financial results for 2004, it was a signal to the market that there were problems with the financial records of the corporation. The corporation's share price dropped immediately by 32 percent as the market reacted.[75]

The auditor may also put a "going concern qualification" into its report, indicating that the auditor has some concern about the corporation's viability. Such a qualification can quickly and seriously erode share price as investors exit the corporation to preserve their investment.

Like a director, the auditor may be removed by ordinary resolution of the shareholders. The vacancy may be filled either by the shareholders at the meeting where it is created or, if not filled then, by the directors. At the end of its term, an auditor may in effect be removed by the directors if they fail to renominate the auditor. The CBCA-based statutes attempt to preserve some measure of true independence for the auditor, in light of management's practical ability to remove the auditor, by giving the auditor the right to attend and to speak at all meetings of the audit committee and of the shareholders. Whenever it is proposed to remove the auditor or to nominate another instead, or whenever the auditor proposes to resign, the auditor may submit to management a written statement of position that must be sent to the shareholders with management's proxy solicitation materials. In addition, corporations statutes often provide that no person is to accept an appointment as a corporation's auditor until the auditor has received from the predecessor auditor a written statement of the circumstances surrounding the predecessor's departure.

Canadian Securities Administrators (CSA) have also promulgated National Instrument (NI) 52-108, *Auditor Oversight*.[76] The express purpose of NI 52-108 is to contribute to public confidence in the integrity of financial reporting of reporting issuers by promoting high quality, independent auditing. Where a reporting issuer files its financial statements accompanied by an auditor's report, the instrument requires the reporting issuer to have the auditor's

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75 Simon Avery, "Mamma.com Shares Fall 32%," *Globe and Mail* (16 February 2005), online: <http://www.theglobeandmail.com/technology/mammacom-shares-fall-32/article20419792>.

76 (2004) 27 OSCB 874, as amended 30 September 2014.

report signed by a public accounting firm that is a participant in the Canadian Public Accountability Board (CPAB) oversight program for public accounting firms that audit reporting issuers, and in compliance with any restrictions or sanctions imposed by the CPAB.

D. Certification of Disclosure and Fair Presentation

There has been considerable debate regarding how best to make corporations accountable for the fairness and accuracy of annual filings, including financial statements of the issuing corporation. Canadian securities regulators have now made a policy choice that corporate officers will be responsible for financial statements. The chief executive officer (CEO) and the chief financial officer (CFO) are required to give assurances about the quality of disclosure, rather than requiring corporate boards to have express systems in place to monitor the financial disclosures of management. Canadian securities regulators have promulgated certification requirements to enhance the integrity of corporate disclosures.

Pursuant to NI 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings* (2008) 31 OSCB 7949, as amended 17 November 2015 and accompanying Form 52-109F1, certifying officers must certify the integrity of their disclosures. NI 52-109 created a new national instrument on officer certification. The instrument replaced a multilateral instrument that had previously been effective for all jurisdictions except British Columbia. NI 52-109 sets out disclosure and filing requirements for all reporting issuers, other than investment funds. The objective of the requirements is to improve the quality, reliability, and transparency of annual filings, interim filings, and other materials that issuers file or submit under securities legislation. The instrument applies to both corporate and non-corporate entities.

NI 52-109 requires an issuer's chief executive officer and chief financial officer, or persons performing similar functions to a CEO or CFO (certifying officers), to personally certify that the issuer's annual filings and interim filings do not contain any misrepresentations; that the financial statements and other financial information in the annual and interim filings fairly present in all material respects the financial condition, results of operations, and cash flows of the issuer; that they have designed or supervised design of disclosure controls and procedures (DC&P) and internal control over financial reporting (ICFR); that they have caused the issuer to disclose in its MD&A any change in the issuer's ICFR that has materially affected the issuer's ICFR; and, on an annual basis, that they have evaluated the effectiveness of the issuer's DC&P and caused the issuer to disclose their conclusions about the effectiveness of DC&P in the issuer's MD&A.

Thus, the certifying officers are required to certify that the financial statements fairly present the financial condition of the issuer, that there are internal controls in place to ensure that material information is conveyed to decision-makers, and that they have disclosed to the auditor and audit committee any significant deficiencies in internal control and any fraud, material or not, that involved managers or other employees who have a significant role in the company's internal controls. Canadian issuers listed in the United States must also comply with the *Sarbanes-Oxley Act of 2002*.[77]

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77 *Ibid*.

The Companion Policy to NI 52-109[78] sets out the rationale:

PART 4—FAIR PRESENTATION, FINANCIAL CONDITION AND RELIABILITY OF FINANCIAL REPORTING

4.1 Fair presentation of financial condition, financial performance and cash flows

(1) *Fair presentation not limited to issuer's GAAP*—The forms included in the Instrument require each certifying officer to certify that an issuer's financial statements (including prior period comparative financial information) and other financial information included in the annual or interim filings *fairly present* in all material respects the financial condition, financial performance and cash flows of the issuer, as of the date and for the periods presented.

This certification is not qualified by the phrase "in accordance with generally accepted accounting principles" which is typically included in audit reports accompanying annual financial statements. The forms specifically exclude this qualification to prevent certifying officers from relying entirely on compliance with the issuer's GAAP in this representation, particularly as the issuer's GAAP financial statements might not fully reflect the financial condition of the issuer. Certification is intended to provide assurance that the financial information disclosed in the annual filings or interim filings, viewed in its entirety, provides a materially accurate and complete picture that may be broader than financial reporting under the issuer's GAAP. As a result, certifying officers cannot limit the fair presentation representation by referring to the issuer's GAAP.

Although the concept of fair presentation as used in the annual and interim certificates is not limited to compliance with the issuer's GAAP, this does not permit an issuer to depart from the issuer's GAAP in preparing its financial statements. If a certifying officer believes that the issuer's financial statements do not fairly present the issuer's financial condition, the certifying officer should ensure that the issuer's MD&A includes any necessary additional disclosure.

(2) *Quantitative and qualitative factors*—The concept of fair presentation encompasses a number of quantitative and qualitative factors, including:

(a) selection of appropriate accounting policies;

(b) proper application of appropriate accounting policies;

(c) disclosure of financial information that is informative and reasonably reflects the underlying transactions; and

(d) additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, financial performance and cash flows.

4.2 *Financial condition*—The Instrument does not formally define financial condition. However, the term "financial condition" in the annual certificates and interim certificates reflects the overall financial health of the issuer and includes the issuer's financial position (as shown on the statement of financial position) and other factors that may affect the issuer's liquidity, capital resources and solvency.

4.3 *Reliability of financial reporting*—The definition of ICFR refers to the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP. In order to have reliable financial reporting and financial statements to be prepared in accordance with the issuer's GAAP, the amounts and disclosures in the financial statements must not contain any material misstatement.

The System for Electronic Document Analysis and Retrieval (SEDAR) is the central repository of public securities documents and information filed by public companies and investment funds with the Canadian Securities Administrators. The objective of the filing system and its

78 Companion Policy 52-109CP, *Certification of Disclosure in Issuers' Annual and Interim Filings* reflecting amendments made effective 1 January 2011 in connection with Canada's changeover to IFRS.

Internet access is to allow public access to information on issuing corporations, without a fee to investors, in order to enhance investor awareness of the business and affairs of public companies and investment funds and to promote confidence in the transparent operation of capital markets in Canada.[79] Electronic filing has allowed issuing corporations to reduce the time and cost of filing documents with each provincial securities regulator separately, as it provides a central repository of the information.

The following excerpt explains the notion of fair presentation of the issuer's financial condition under the new certification requirements.

> **Mary Condon, Anita Anand, Janis Sarra & Sarah Bradley,**
> ***Securities Law in Canada: Cases and Commentary*, 3rd ed**
> (Toronto: Emond, 2017)
>
> ***A. Fair Presentation***
>
> The certification that the financial information fairly presents the issuer's financial condition is an important aspect of the assurances given by the issuer's officers, because it is broader than affirming that documents comply with GAAP (soon to be IFRS). "Fairly present" means a materially accurate and complete picture of the issuer's financial condition. Fair presentation includes but is not necessarily limited to selection of appropriate accounting policies; proper application of appropriate accounting policies; disclosure of financial information that is informative and reasonably reflects the underlying transactions; and inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations, and cash flows (NI 52-109CP). Where an issuer is of the view that there are limitations to the issuer's GAAP-based financial statements as an indicator of its financial condition, the issuer should provide additional disclosure in its MD&A necessary to provide a fair and complete picture of the issuer's financial condition, financial performance, and cash flows (NI 52-109CP, s 4.1).

E. Reporting on Internal Controls

The CSA had developed MI 52-111, *Reporting on Internal Control over Financial Reporting*, which securities regulators in every Canadian jurisdiction except British Columbia had published for comment in February 2005. Proposed MI 52-111 was substantially similar to the requirements for internal control rules set out in s 404 of the *Sarbanes-Oxley Act* (S-Ox 404). If it had been enacted, management of an issuer would have been required to evaluate the effectiveness of the issuer's internal control over financial reporting, as at the end of the issuer's financial year, against a suitable control framework. The issuer would have been required to file a report of management on its assessment of the effectiveness of the issuer's internal control over financial reporting, including a statement as to whether the internal

79 SEDAR welcome page: <http://www.sedar.com/homepage_en.htm>.

control over financial reporting is effective; and a report of the issuer's auditor prepared in accordance with the CICA's auditing standard for internal control audit engagements.

After considerable public discussion, and in light of developments in the United States that appear to have backed away from some certification requirements under S-Ox 404 for smaller corporations, on 10 March 2006, the CSA reported that it was not going to proceed with MI 52-111.[80] In late 2006, the Securities and Exchange Commission issued a number of deregulatory orders and proposals intended to loosen requirements for smaller companies and lower reporting costs for issuing corporations in the United States.[81]

XVI. THE ROLE OF AUDIT COMMITTEES

As discussed above, the external auditor provides an opinion that the financial statements present fairly the financial position of the company and the results of its operations for the period in accordance with generally accepted accounting principles or the International Financial Reporting Standards. External auditors are retained by, and are ultimately accountable to, the shareholders. Hence, auditors have a right and duty to provide their views directly to the shareholders if they disagree with an approach being taken by the audit committee. Practically, however, auditors are usually recommended by the audit committee or corporate officers.

The regulatory requirements aimed at independence of audit committees are designed as an investor protection device, but serve more generally as an accountability check for all stakeholders. An audit committee is a committee of the board of directors that has responsibility for oversight of the financial reporting process, which includes accountability checks on managers' financial decisions and the solvency of the corporation; helping directors meet their responsibilities; providing better communication between the directors and the external auditors; enhancing the independence of the external auditor; increasing the credibility and objectivity of financial reports; and strengthening the role of the directors by facilitating in-depth discussions among directors, management, and the external auditor. Shareholders and other stakeholders face collective action problems in that they are dispersed and frequently hold too small a stake in the corporation to invest the time and energy required to monitor effectively the finances of the corporation. The audit committee of a corporate board, if its members are independent from the corporation's officers, can provide some assurance to stakeholders of the quality, integrity, and timeliness of disclosures.

In the aftermath of corporate scandals in the United States and concern that audit committees truly provide an independent assessment of the financial status of the corporation, Canadian regulators adopted NI 52-110, *Audit Committees*[82] to ensure that external audits are

80 BCSC 52-313, Status of Proposed Multilateral Instrument 52-111, *Reporting on Internal Control over Financial Reporting* and Proposed Amended and Restated Multilateral Instrument 52-109, *Certification of Disclosure in Issuers' Annual and Interim Filings*, CSA, , effective 10 March 2006, online: <https://www.bcsc.bc.ca/Securities_Law/HistPolicies/HistPolicy5/PDF/52-313__CSA_Notice_>.

81 S Labaton, "SEC Eases Regulations on Business," *New York Times* (14 December 2006), online: <http://www.nytimes.com/2006/12/14/business/14secure.html>.

82 NI 52-110, *Audit Committees*, effective 17 November 2016. The national instrument was formerly a multilateral instrument, MI 52-110, (2003) 26 OSCB 4884.

conducted independently of the issuer's management by assigning these duties to an independent audit committee. The objective of NI 52-110 is to encourage reporting issuers to establish and maintain strong, effective and independent audit committees that will enhance the quality of financial disclosure made by reporting issuers. It establishes requirements for the responsibilities, composition, and authority of audit committees.

An audit committee of a reporting issuer must be made up of a minimum of three directors of the issuer.[83] NI 52-110 requires that the audit committee must also be responsible for managing, on behalf of the shareholders, the relationship between the issuer and the external auditors.[84] In particular, it provides that an audit committee recommend to the board of directors the nomination and compensation of the external auditors.[85]

An audit committee must be directly responsible for overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review, or attestation services for the issuer, including the resolution of disagreements between management and the external auditors regarding financial reporting.[86] The audit committee must also be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information, including periodic assessment of the adequacy of those procedures. The audit committee must establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and for the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.[87] This latter requirement is a form of whistle-blowing protection, so that employees who believe that there is a problem with the integrity of the financial statements have a mechanism to report the problem to an independent committee that can then investigate.

The responsibilities are set out in NI 52-110, s 2.

NI 52-110, *Audit Committees*
effective 17 November 2016

Part 2 Audit Committee Responsibilities

2.1 Audit Committee

Every issuer must have an audit committee that complies with the requirements of the Instrument.

2.2 Relationship with External Auditors

Every issuer must require its external auditor to report directly to the audit committee.

83 NI 52-110, *Audit Committees*, s 3.1(1).

84 *Ibid*, part 2.

85 *Ibid*.

86 NI 52-110, *Audit Committees*, s 2.3(3).

87 *Ibid*, s 2.3(7).

2.3 Audit Committee Responsibilities

(1) An audit committee must have a written charter that sets out its mandate and responsibilities.

(2) An audit committee must recommend to the board of directors:

(a) the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer; and

(b) the compensation of the external auditor.

(3) An audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting.

(4) An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.

(5) An audit committee must review the issuer's financial statements, MD&A and annual and interim profit or loss press releases before the issuer publicly discloses this information.

(6) An audit committee must be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, other than the public disclosure referred to in subsection (5), and must periodically assess the adequacy of those procedures.

(7) An audit committee must establish procedures for:

(a) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

(8) An audit committee must review and approve the issuer's hiring policies regarding partners, employees and former partners and employees of the present and former external auditor of the issuer.

A. Independence of Audit Committees

Every member of an audit committee is required to be independent.[88] Independence means the absence of any direct or indirect material relationship between the director and the issuer that could, in the view of the issuer's board of directors, reasonably interfere with the exercise of a member's independent judgment.[89] Section 1.4 sets out a list of relationships with an issuer that would reasonably interfere with the exercise of the person's independent judgment and a list of related persons who are not eligible to serve on the issuer's audit committee, including an individual who is, or has been, or whose immediate family member is, or has been, an employee or executive officer of the corporation;

88 *Ibid*, ss 1.4 and 1.5.

89 *Ibid*, s 1.4(2).

and an individual who is or was affiliated with a current or former external auditor within a prescribed period. Also set out in s 1.4 are a host of other relationships that may give rise to a lack of independence.

A person or company is considered to be an affiliated entity of another person or company if one of them controls or is controlled by the other or if both persons or companies are controlled by the same person or company, or the person or company is both a director and an employee of an affiliated entity, or an executive officer, general partner, or managing member of an affiliated entity.[90] "Control" in the context of this instrument means the direct or indirect power to direct or cause the direction of the management and policies of a company, whether through ownership of voting securities or otherwise. A person is not considered to be an affiliated entity of an issuer if the person owns 10 percent or less of any class of voting equity securities of the issuer and is not an executive officer of the issuer.[91]

There are also provisions dealing with replacement of audit committee members where they cease to be independent, resign, or die, and for appointing new members.[92] An audit committee must have the authority to engage independent counsel and other advisers as it determines necessary to carry out its duties, to set and pay the compensation for any advisers employed by the audit committee, and to communicate directly with the internal and external auditors.[93]

B. Temporary Exceptions to Independence Requirements

Temporary exceptions to the independence requirements are available if the member is able to exercise the impartial judgment necessary for the member to fulfill his or her responsibilities as an audit committee member.[94] The individual granted the exemption cannot be the chair of the committee, and the exemption is not available unless the majority of the audit committee members are still independent.[95] The board of directors must first determine that reliance on the exemption will not materially adversely affect the ability of the audit committee to act independently.[96]

C. Financial Literacy

Canadian regulators have also now imposed financial literacy requirements for audit committee members. An individual is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements.[97] A

90 *Ibid*, ss 1.3(1) and (2).

91 *Ibid*, s 1.3(4).

92 *Ibid*, ss 3.4 and 3.5.

93 Ibid, s 4.1.

94 *Ibid*, s 3.6.

95 *Ibid*, s 3.7.

96 *Ibid*, s 3.9.

97 *Ibid*, s 1.5.

comprehensive knowledge of international financial reporting standards and generally accepted auditing standards (GAAS) is not part of the definition of financial literacy. Reporting forms require an issuer to disclose in its Annual Information Form (AIF) any education and/or experience of audit committee members that will provide the members with an understanding of the accounting principles used by the issuer to prepare its financial statements, as well as the ability to assess the general application of such accounting principles in connection with the accounting for estimates, accruals, and reserves.[98]

The issuer must also disclose any experience that the audit committee member has had in actively supervising persons engaged in preparing, auditing, analyzing, and evaluating financial statements. A director that is not financially literate can be appointed to the audit committee provided that the member becomes financially literate within a reasonable period of time following the appointment and the board of directors has determined that the appointment will not materially adversely affect the ability of the audit committee to act independently.[99] NI 52-110 does not require, as does the US *Sarbanes-Oxley Act of 2002*, Pub L no 107-204 Stat 745, that there be at least one "financial expert" on the committee. A number of Canadian issuers must, however, meet these requirements because they are cross-listed in the United States and subject to the requirements of the *Sarbanes-Oxley Act*.

D. Non-Audit Services to Be Approved

NI 52-110 requires the pre-approval of non-audit services by the audit committee.[100] Audit committees must adopt policies and procedures for the engagement of non-audit services, which include monetary limits and other factors relating to the independence of the auditor that allow the audit committee to make an informed decision regarding the impact of the service on the auditor's independence.[101] There are also provisions for *de minimis* non-audit services in which an audit committee satisfies the pre-approval requirement if the aggregate amount of the non-audit services is reasonably expected to constitute no more than 5 percent of total fees paid by the issuer and its subsidiary entities to the issuer's external auditor during the fiscal year in which the services are provided.[102]

The integrity of audit committee requirements in respect of audit services is also augmented by professional codes of conduct for auditors, promulgated previously by the Canadian Institute of Chartered Accountants and now by Chartered Professional Accountants (CPA) Canada, aimed at ensuring responsibility to clients for the integrity and quality of professional services delivered, including the objectives of competence, ethical conduct, and impartiality.[103]

98 *Ibid*, ss 1.6 and 3.8; and Form 52-110F1 (1 January 2011), ss 2 and 6.

99 NI 52-110, *Audit Committees*, ss 3.8 and 3.9.

100 *Ibid*, s 2.3(4).

101 *Ibid*.

102 *Ibid*, s 2.4.

103 Canadian Institute of Chartered Accountants, *Code of Conduct*, available online: <http://www.cica.an/files/codeconduct.pdf>.

E. Exemptions

Venture issuers are exempt from some of the audit committee composition and reporting obligations, but must complete a separate form for disclosure.[104] A US-listed issuer is also exempt from the audit committee composition, responsibilities, and reporting obligations if it is in compliance with the requirements of the US marketplace. If it is incorporated or continued in a jurisdiction in Canada, it must include the required disclosures in its AIF.[105]

XVII. CORPORATE CHARITY

A final issue in respect of boards of directors and corporate governance is the extent to which corporations can engage in charitable activities, including philanthropic donations and support of particular charitable organizations. Given the huge profits that many corporations earn, the question is whether charitable support comes within directors' obligations to act in the best interests of the corporation. The courts have consistently upheld the power of corporations to make charitable contributions on the basis of "enlightened self-interest." See e.g. *AP Mfg Co v Barlow*, 98 A.2(d) 581 (NJ 1953), where the court upheld the propriety of a gift of $1,500 to Princeton University over the objection of a minority shareholder.

In Canada, corporate charity is limited compared with many other countries. Corporate operating profits in Canada were $388.7 billion in 2014.[106] Total charitable donations were $13.3 billion,[107] Statistics Canada reporting that over $8.8 billion of these charitable donations were made by individuals,[108] meaning that at most, Canadian businesses donated $6.4 billion, or approximately 1.3 percent of their profits, to charitable causes. Low rates of giving by Canadian corporations may be a consequence of their accountability in competitive capital and product markets. Given the low rates of corporate charity, legal rules facilitating charitable contributions by corporations may have little effect.

Harry Arthurs offers another explanation for the lower rate of corporate charitable contributions in Canada than in the US and other countries. He argues that the unique form of "localized globalism" experienced by Canada has resulted in Canadian corporations operating as disempowered subsidiaries of large, primarily US-based, multinational enterprises. This disempowerment has not only economic consequences in terms of production and employment decisions, but also negative social consequences in terms of lost financial and other support for non-profit and charitable activities.

104 NI 52-110 *Audit Committees*, ss 6.1 and 6.2; and Form 52-110F2, effective 30 June 2015.

105 NI 52-110 *Audit Committees*, s 7.1; and Form 52-110F1, effective 1 January 2011.

106 Statistics Canada, "Financial and Taxation Statistics for Enterprises, 2014," *The Daily* (17 March 2016), online: <http://www.statcan.gc.ca/daily-quotidien/160317/dq160317c-eng.htm>.

107 Canada Revenue Agency, *Report on the Charities Program 2015-2016*, online: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/bt/nnlrprt/2015/Charities%20AR.eng.pdf>.

108 Statistics Canada, "Charitable Donors, 2014," *The Daily* (22 February 2016), online: <http://www.statcan.gc.ca/daily-quotidien/160222/dq160222e-eng.htm>.

Harry Arthurs, "The Hollowing Out of Corporate Canada?"
in J Jenson & B de Sousa Santos, eds, *Globalizing Institutions: Case Studies in Regulation and Innovation* (Aldershot, UK: Ashgate, 2000) at 44-45

The essence of the problem is that transnational companies and their subsidiaries constitute a considerable presence in Canada—a social, political and cultural presence as well as an economic presence. They are major consumers of producer services, powerful participants in policy networks and public debates, benefactors or sponsors of artistic, educational, sporting and humanitarian organizations and events, shapers of land markets, urban skylines and popular culture and, through the example they set in their employment practices, influential in defining local attitudes concerning gender, race and class … . [E] ach time a transnational corporation rejigs its organization chart, each time the role and structure of its subsidiaries is redefined, not just an enfeebled and vulnerable Corporate Canada but all Canadians are put at risk.

Laureen Snider has offered a critique of the influence of powerful corporate elites in Canada and their ability to influence corporate law policy. She has suggested that corporate crime has been argued into obsolescence through knowledge claims advanced through specific discourses by powerful elites; and that the acceptance of these knowledge claims cannot be understood without examining their relationship to the corporate lobbying that has, over the last two decades, legitimized virtually every acquisitive, profit-generating act of the corporate sector.

Laureen Snider, "The Sociology of Corporate Crime: An Obituary (or: Whose Knowledge Claims Have Legs?)"
(2000) 4 Theoretical Criminology 169 at 171

However, when it comes to crimes of the powerful—marketing unsafe products, maintaining unsafe workplaces, defrauding workers by insisting on unpaid overtime or demanding "voluntary" labour, dumping toxic waste, misrepresenting the benefits or not disclosing the risks of products—criminal law does not work. It is expensive, inefficient, ineffective, a club over the head when a whisper in the ear would suffice. The individuals and organizations that engage in what used to be called corporate crime, it seems, respond best to reasoned persuasion and rewards, to tax breaks and market incentives. Increased punitiveness only "works," it appears, for the impoverished, non-white, individual criminals who fill and overfill the prisons of modern democratic states.

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Key elites in the new world economy have heavy vested interests—billions of dollars, world reputations, the power of nation-states and entire regions—in getting some interpretations accepted and others rejected. Interpreting the "laws" of the market in accord with neo-liberal tenets, for example, reinforces efforts by dominant classes in the first world to extend their privilege in a number of ways. Interpreting scientific data in ways that "prove" genetically engineered plants are safe is worth trillions to the transnational companies that hold the patents on this genetic material, and to the nation-states which

> guarantee their legitimacy. Increasingly, dominant interests sponsor science directly (as publicly funded government and university laboratories are closed down), so certain kinds of questions are more likely to be asked, certain knowledges produced.

Hence, Snider views interest group pressure as a global phenomenon that affects the development of corporate law across multiple jurisdictions.

XVIII. CONCLUSION

This chapter has canvassed how directors are appointed and what their respective duties and obligations are. It examined the need for independence and diversity on boards of directors if there is to be meaningful governance oversight of the corporation. It also explored the role of board committees, including audit committees and their importance to effective governance oversight. For closely held businesses, shareholder agreements can shift the duties of directors to the shareholders themselves. The chapter also canvassed the developments in corporate governance by securities regulators, who have adopted a "comply or explain" approach. The next chapter examines shareholder participation rights as another important aspect of corporate governance.