CORPORATE GOVERNANCE

Report of the Standing Senate Committee
on
Banking, Trade and Commerce

Chairman
The Honourable Michael Kirby

Deputy Chairman
The Honourable W. David Angus

August 1996

Ce rapport est disponible en français.

Erratum: In Issue No. 5 of the proceedings of the Task Force on Corporate Governance, on page 132, Mr. John F. Fraser's title should read "Director of several companies".

MEMBERSHIP

The Honourable Michael Kirby, *Chairman*

The Honourable W. David Angus, *Deputy Chairman*

and

The Honourable Senators:

Austin, Jack, P.C.
* Fairbairn, Joyce, P.C. (or Graham, Alasdair B.)
Hervieux-Payette, Céline, P.C.
Kelleher, James F., P.C.
Kenny, Colin
Kolber, E. Leo
* Lynch-Staunton (or Berntson, Eric)
Meighen, Michael Arthur
Perrault, Raymond, P.C.
St. Germain, Gerry, P.C.
Simard, Jean-Maurice
Stewart, John B.

**Ex Officio Members*

Note: The Honourable Senators Bacon, Buchanan, Hays, Oliver and Stratton served on the Task Force on Corporate Governance or were present at meetings at various stages during the course of this study.

Staff from the Research Branch of the Library of Parliament:

Mr. Gerald Goldstein, Chief, Economics Division; and
Ms. Margaret Smith, Research Officer, Law and Government Division

Staff from the Committees and Private Legislation Directorate:

Mr. Michel Patrice, Legislative Clerk; and
Ms. Lise Bouchard, Administrative Assistant.

Paul Benoit

Clerk of the Committee

ORDERS OF REFERENCE

Extract from the *Journals of the Senate*, Thursday, March 21, 1996:

"The Honourable Senator Graham, on behalf of Senator Kirby, moved:

THAT, the Standing Senate Committee on Banking, Trade and Commerce be authorized to examine and report upon the present state of the financial system in Canada;

THAT the papers and evidence received and taken on the subject during the First Session of the Thirty-Fifth Parliament and any other relevant Parliamentary papers and evidence on the said subject be referred to the Committee;

THAT the Committee be empowered to permit coverage by electronic media of its public proceedings with the least possible disruption of its hearings; and

THAT the Committee submit its final report no later than December 12, 1996.

The question being put on the motion, it was adopted."

Paul Bélisle

Clerk of the Senate

Extract from the *Journals of the Senate*, Thursday, March 28, 1996:

"The Honourable Senator St. Germain, on behalf of Senator Kirby, seconded by the Honourable Senator MacDonald (Halifax), moved:

THAT the Standing Senate Committee on Banking, Trade and Commerce, which was authorized by the Senate on March 21, 1996 to examine the present state of the financial system in Canada, be permitted, notwithstanding usual practices, to deposit a report on the said subject with the Clerk of the Senate, if the Senate is not sitting, and that the said report shall thereupon be deemed to have been tabled in the Chamber.

The question being put on the motion, it was adopted."

Paul Bélisle

Clerk of the Senate

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1. The Committee strongly recommends that a study be undertaken of the principles of corporate governance as they relate to Crown corporations. It is the view of the Committee that the general principles of corporate governance should apply to Crown corporations.

2. The Committee recommends that the *Canada Business Corporations Act* be amended to provide that the Act will be repealed within ten years unless reviewed and reenacted by a Parliament.

3. The Committee recommends that, subject to adequate safeguards, a number of technical and mechanical details that are currently part of the *Canada Business Corporations Act* be moved to the regulations under the Act and that the use of regulations to effect changes to the Act be broadened.

4. The Committee recommends that regulations made under the *Canada Business Corporations Act* be tabled in Parliament and that such regulations not take effect until thirty days after such regulations have been tabled.

5. The Committee recommends that the federal government consider incorporating by reference into the *Canada Business Corporations Act* provincial laws that overlap with provisions of the CBCA.

6. The Committee views the issue of director competency as a critical one and enthusiastically encourages educational initiatives designed to broaden and enrich the pool of directors, and potential directors, in Canada.

DIRECTORS' LIABILITY

7. The Committee recommends that subsection 123(4) of the *Canada Business Corporations Act* be amended to provide corporate directors with a due diligence defence. Directors would not be liable for wrongful payments by the corporation (s. 118), unpaid wages (s. 119) and breaches of duty (s. 122) where they exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the wrongful act.

8. The Committee recommends that reliance in good faith on financial statements, on the reports of experts and on information presented by officers and professionals be included as an element of the due diligence defence.

9. The Committee recommends that before enacting any new directors' liability provisions, the federal government clearly demonstrate that the provisions will have a positive impact on corporate conduct and will advance the purpose of the legislation in which it is contained.

10. The Committee recommends that the federal government review all federal legislation imposing personal liability on directors with a view to determining whether such liability has an impact on corporate conduct and advances the purposes of the legislation.

11. The Committee recommends that the federal government ensure that all federal laws that impose liability on directors provide directors with an effective due diligence defence.

12. The Committee recommends that the *Canada Business Corporations Act* be amended to include a due diligence defence that would apply to all federal statutes that impose liability on corporate directors, except where such statutes provide for a due diligence defence that is identical to or substantially the same as the defence established under the *Canada Business Corporations Act*.

13. The Committee recommends that there be no cap on directors' liability.

14. The Committee recommends that section 119 of the *Canada Business Corporations Act* be repealed and that the federal government focus its attention on measures in the *Bankruptcy and Insolvency Act* to cover employees' unpaid wages.

THE PROS AND CONS OF A NON-EXECUTIVE CHAIRMAN

15. The Committee strongly recommends that publicly traded CBCA corporations separate the positions of chairman of the board and chief executive officer. The Committee does not, however, recommend that the separation of these positions be enshrined in the CBCA.

RESIDENCY REQUIREMENTS FOR DIRECTORS

16. The Committee recommends that the existing CBCA residency requirement for the board of directors be maintained, but that it be eliminated for board committees.

INSIDER TRADING

17. The Committee recommends that the insider trading reporting provisions of the *Canada Business Corporation Act* be retained and modernized and duplicate filings be eliminated to the extent possible through exemption orders.

18. The Committee recommends that the time given for insiders to report trades, or declare that they have become insiders be decreased to within 10 days of their becoming an insider or making a trade.

19. The Committee recommends that the time period for persons to declare that they have become insiders or to report trades be prescribed by regulation rather than in the CBCA itself. This would make it easier to update and to harmonize federal time frames with those of the provinces.

SHAREHOLDER COMMUNICATION AND PROXY SOLICITATION RULES

20. The Committee recommends that the *Canada Business Corporations Act* be amended to require registrants to furnish to issuers, upon request, and within a fixed period of time, a list of all beneficial shareholders. This list could be used to communicate directly with non-registered shareholders in respect of matters relating to the business and affairs of a corporation. Intermediaries would be permitted to withhold the names and addresses of beneficial shareholders who have requested in writing that their names not be given to issuers.

21. The Committee recommends that the *Canada Business Corporations Act* be amended to encourage and facilitate communications among shareholders.

TAKE-OVER BIDS AND GOING-PRIVATE TRANSACTIONS

22. The Committee recommends that the *Canada Business Corporations Act* take-over bid threshold of 10% be increased to 20%.

23. The Committee recommends that the *Canada Business Corporations Act* be amended to extend the minimum bid period for a take-over bid to 45 days.

24. The Committee recommends that the minimum bid period be prescribed by regulation.

25. The Committee recommends that there be no changes to the *Canada Business Corporations Act* in relation to going-private transactions.

CORPORATE GOVERNANCE AND INSTITUTIONAL INVESTORS

26. The Committee recommends that the government assemble a database that will permit analysis of the role of institutional investors in markets in general, and in matters of corporate governance, in particular, within the next few years.

27. The Committee recommends that the government undertake a study of the foreign property rule on Canadian capital markets, with a view to phasing out this restriction in the near term.

BACKGROUND

On August 21, 1995, Industry Minister John Manley asked the Standing Senate Committee on Banking, Trade and Commerce to hold hearings with senior business people and investors on a number of broad strategic policy issues related to modernizing *the Canada Business Corporations Act* (CBCA). The Committee held such hearings in February 1996, in five cities, receiving submissions and hearing from 59 witnesses, members of Canada's corporate community who came forward voluntarily upon invitation from the Committee.

The CBCA was enacted in 1975 to revise and reform the law applicable to federal business corporations. The last significant amendments were made in 1978.

In 1994, Parliament approved Bill C-12, the first phase of amendments to the Act. These amendments were of a technical nature.

Bill C-12 also required the Minister of Industry to submit recommendations on further more substantive changes to the law to Parliament by June 1997. The Senate Banking Committee hearings and the report, based on these hearings, are a primary part of the process which will lead to the second phase of amendments to the CBCA.

The issues which were identified for discussion with stakeholders during phase II include :

- the liability of corporate directors, corporate auditors and others associated with a corporation;
- shareholder communications, both between a corporation and its shareholders and also among shareholders;
- citizenship and residency requirements currently imposed on boards of directors and on board committees;
- financial assistance granted by the corporation to directors, officers, shareholders and others;
- insider trading rules; and
- rules governing takeover bids.

A Backgrounder put out by Industry Canada (Appendix 1) listed a number of specific questions, the answers to which will shape the phase II amendments to the CBCA. This backgrounder notes the specific role of the Senate Banking Committee in the CBCA review process.

Finally, the Minister suggested that the Committee also look into the issue of auditors' liability (Appendix 2). The Committee felt this was really a stand-alone issue that merited a separate study. It became clear, from the views expressed at the hearings, that the issue of joint and several liability, affecting all professional advisors, warrants further investigation. The Committee will hold such a set of hearings shortly. During those hearings, recent developments in this area in Australia, the United Kingdom, and the United States will be reviewed.

In the United Kingdom, for example, the Law Commission recently undertook a feasibility study of whether the present system of joint and several liability ought be replaced by a system of proportionate liability. In its recently published consultation paper, the Commission stated that no change was called for. "The present law of joint and several liability, combined with extensive rights of contribution against defendants, is roughly fair ... a move to proportionate liability would merely replace harshness to defendants by unfairness to plaintiffs."(1)

In the United States, in 1995, Congress enacted into law a securities statute which retains joint and several liability only for perpetrating or knowing of securities fraud. Otherwise a proportionate liability scheme is introduced for those co-defendants that are found to be less culpable. At the state level, ten states have abandoned joint and several liability. A number of others have adopted proportionate liability generally, but with exceptions.

In Australia, the final report of an inquiry into the law of joint and several liability (initiated by the federal government and the government of New South Wales) was publicly released in February of 1995. The key recommendation was that the existing system of joint and several liability be replaced by liability which is proportionate to each defendant's degree of fault.

During the course of the hearings, two other issues arose which the Committee felt were of sufficient importance that separate chapters were warranted to deal with them. These include: the pros and cons of a nonexecutive chairman and the role of institutional investors in corporate governance (including the foreign property rule).

The report of the Committee contains a number of specific recommendations, each of which appears under the relevant chapter herein. However, the Committee made general recommendations which can appropriately be set forth in the introduction. The first of these is:

1. **The Committee strongly recommends that a study be undertaken of the principles of corporate governance as they relate to Crown corporations. It is the view of the Committee that the general principles of corporate governance should apply to Crown corporations.**

OVERVIEW

The 1970s and 1980s ushered in widespread reform of Canadian corporate statutes. Perhaps the most significant change took place in 1975 with the enactment of the *Canada Business Corporations Act*. Developed from a comprehensive report,(2) the CBCA was:

(1) "Law Commission Overhauls the Issue of Joint and Several Liability," *Insurance Day*, 15 May 1996, p. 8.

(2) Robert W. V. Dickerson, John L. Howard and Leon Getz, *Proposals for a New Business Corporations Law for Canada*, Information Canada, 1971.

... a synthesis of the best of what we could derive from the laws of the commonwealth and from the state laws in the United States and Canada ....[3]

The CBCA ... was conceived as a public policy instrument to establish a model for other corporation laws across Canada, both to get more uniformity for simpler administration and better administration even within the corporations themselves and also to have a Canadian corporation.[4]

In fact, the CBCA did become a model law, as statutes similar to it were passed in provinces such as Manitoba, Saskatchewan, Alberta, New Brunswick, Ontario and Newfoundland.[5]

The Canadian business and legal environment has changed considerably since 1975. The CBCA, however, has not kept pace with these changes. Aside from technical amendments passed in 1994 (Bill C-12), the CBCA has changed little since it was enacted.

Composed of ten large Canadian public companies, the Coalition for CBCA Reform, identified four principles that it determined were fundamental to a contemporary federal business corporations statute:

- flexibility
- efficiency
- certainty
- balance.

The Committee agrees that changes to the CBCA should be guided by these principles.

In making our recommendations, the Committee has sought to ensure that a revised CBCA would be able to keep pace with developments in corporate practice, corporate governance and the marketplace. A number of suggestions have been made as to how the CBCA could be updated and improved on a regular basis. These include: mandatory periodic review and revision of the Act; broadening the use of regulations; and incorporating by reference into the CBCA relevant provincial laws. These suggestions will be examined below.

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(3) Senate of Canada, *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:55, (Mr. John Howard).

(4) *Ibid.*, 1:83.

(5) Bruce L Welling, *Corporate Law in Canada*, Second Edition, Butterworths, 1991, p. 51.

A. Mandatory Review of the CBCA

The Committee strongly believes that periodic reviews have particular relevance for market framework legislation such as the CBCA. It is not uncommon for statutes to require a committee of Parliament to review their provisions and operation after a certain period of time. Statutes, such as the *Bank Act*, on the other hand, contain a "sunset" provision which states that banks will cease to carry on business after a specified period of time. In order to ensure that banks will continue to operate, Parliament must periodically enact new banking legislation.

The Committee notes, however, that there are no statutory mechanisms to require the continuing review and revision of the CBCA. It is the Committee's view that the CBCA should contain a "sunset" provision. Such a provision would ensure that the CBCA would be regularly scrutinized and updated.

> **2. The Committee recommends that the *Canada Business Corporations Act* be amended to provide that the Act will be repealed within ten years unless reviewed and reenacted by a Parliament.**

B. The Use of Regulations

The Coalition had this to say about the contents of the CBCA and the kinds of things that would be better dealt with in regulations:

> *The Act should address those elements of corporate governance that should be embedded in statute and changed only when there is sufficient cause and consensus to warrant amendment by Parliament. However, the Act could leave to the regulations many of the details and mechanics that are in the current statute....*(6)

The Committee favours the broader use of regulations to continue the process of modernizing and harmonizing the CBCA with provincial corporate and securities laws. Indeed, the Committee has already made specific recommendations that call for certain changes to the CBCA to be prescribed in regulations rather than in the CBCA itself.

Using regulations to effect changes to the CBCA, however, must be subject to certain safeguards to ensure that there is adequate consultation with interested parties and that the role of Parliament in the legislative process is not diminished. The Committee would not support the widespread use of regulations unless such safeguards were in place.

> **3. The Committee recommends that, subject to adequate safeguards, a number of technical and mechanical details that are currently part of the *Canada Business Corporations Act* be moved to the regulations under the Act and that the use of regulations to effect changes to the Act be broadened.**

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(6) Coalition for CBCA Reform, *Reforming the Canada Business Corporations Act Statement of Principles*, p. 3.

4. **The Committee recommends that regulations made under the *Canada Business Corporations Act* be tabled in Parliament and that such regulations not take effect until thirty days after such regulations have been tabled.**

C. Harmonization

The Committee recognizes that there is a considerable degree of overlap and duplication between certain provisions of the CBCA and those of provincial securities laws. This is particularly evident in the areas of insider trading and take-over bids.

This overlap and duplication can place a significant regulatory burden on individuals and corporations that are required to comply with the CBCA as well as the laws of several provinces.

The Committee urges the federal government to make a concerted effort to harmonize the federal and provincial requirements in these and other areas where overlap and duplication exist. This could be accomplished through the use of common language and definitions, the development of electronic filing and the use of orders that would exempt from the CBCA filing requirements similar reports that are required to be filed under provincial legislation.

More fundamentally, the Coalition suggested that the CBCA could incorporate by reference overlapping provincial laws.(7) Incorporation by reference is sometimes used when one legislative jurisdiction wishes to enact the same law as another jurisdiction. This technique allows both the current and future law of one jurisdiction to become the law of the incorporating jurisdiction.

As was noted before the Committee:

> *The CBCA will be a model for other corporate laws and they are likely to adopt any flexibility and harmonization methods promulgated under the CBCA. Thus, future innovation at the federal level will also be capable of being constantly incorporated at the provincial level. Harmonization of and with similar and overlapping laws is cost effective and time efficient. It can provide certainty, for example, if you are allowed to follow the recognized home jurisdiction rules rather than the similar but not identical rules that live in the CBCA...*(8)

The Committee acknowledges that incorporation by reference is a viable technique for promoting the harmonization and modernization of the CBCA.

5. **The Committee recommends that the federal government consider incorporating by reference into the *Canada Business Corporations Act* provincial laws that overlap with provisions of the CBCA.**

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(7) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:82, (Mr. John Howard).

(8) *Ibid.*, 1:69, (Ms. Rhonnda Grant).

D. Qualifications of Directors

The focus of the testimony before the Committee was, of course, on issues directly related to the process of corporate governance in general, and to provisions of the *Canada Business Corporations Act* in particular. The Committee notes, however, that an assumption of company director competence and understanding of the full responsibility of the job of directors permeates the testimony.

Witnesses talked about the serious responsibilities placed on directors in the existing environment, and about the relationship between these responsibilities and provisions of the *Canada Business Corporations Act*. Implicit in the discussion of many, explicit in that of others, was that directors must bring to the board a high level of skill if they are to provide the kind of advice and monitoring that are part of the obligations of a corporate director and that will ensure that Canadian companies are able to prosper in today's competitive global market place.

A number of witnesses, Sir Graham Day in particular, directly addressed the challenge of assembling a board given the skills and competencies of individuals, and the level of specific training which new directors have for their new job.

While there is no formal certification or institutional "stamp of approval" that an individual can obtain to say that he or she is ready for a board position, most directors do have some directly relevant board of directors skills as a result of their occupations - law and accounting, for example. In general, however, experience in the workplace has provided the basic background for those who are newly appointed to the position of director.

The Committee heard, from a number of witnesses, that companies are now addressing the training of new board members in a more formal manner than they did in the past. Structured processes involving material provided to the new director, seminars and meetings with officials of the company, are becoming more common.

Sir Graham Day suggested that in addition to such company-specific programs, more formal educational and training programs could be offered in a variety of locations and ways (classroom, electronic media) with the involvement of companies and institutions of higher education. Programs could be designed for new directors; refresher courses could be developed for those with more experience. The key point, however, is that there is considerable room for innovation in this area.

6. **The Committee views the issue of director competency as a critical one and enthusiastically encourages educational initiatives designed to broaden and enrich the pool of directors (as well as potential directors) in Canada.**

CHAPTER 1

DIRECTORS' LIABILITY

INTRODUCTION

A critical issue for corporate governance and for the Committee is directors' liability. The Committee was told that excessive liabilities can have a negative impact on the competitiveness of Canadian corporations if they serve to limit the number of qualified people who are willing to serve on corporate boards or cause valuable board members to resign when corporations most need their expertise.

Balanced against this is the need for accountability. Industry Canada's Directors' Liability Discussion Paper points out that "inadequate accountability can lead to harm to other parties and the environment, result in a serious misallocation of resources and impact negatively on Canadian prosperity. Corporate liability, including directors' liability, is an important and effective compliance and risk-allocation mechanism".[9]

The *Canada Business Corporations Act* (CBCA) and the various provincial corporate laws statutes impose statutory liabilities on directors of corporations. In addition, directors can be liable to the corporation for breach of their fiduciary and care duties. These duties and liabilities will be explored more fully in this chapter.

FIDUCIARY DUTY

A "fiduciary duty" is sometimes imposed upon individuals who are in a position to subject others to a risk of loss. Both the common law and the Civil Code of Quebec impose fiduciary duties on directors of corporations. One of the principal fiduciary duties of a director is to disclose and/or to avoid conflict of interest situations.[10]

(9) Industry Canada, *Canada Business Corporations Act, Discussion Paper, Directors' Liability*, November 1995, p. 1 ("Directors' Liability Discussion Paper").

(10) *Ibid.*, p. 4.

Under paragraph 122(1)(a) of the CBCA, every director and officer of a corporation in exercising his or her powers and in discharging his or her duties, shall "act honestly and in good faith with a view to the best interests of the corporation." This provision essentially codifies the common law in this area. The corporate laws of most of the provinces provide for a statutory duty of care which is either identical or substantially similar to it.(11)

The requirement that directors act honestly and in good faith and in the best interests of the corporation aims to ensure that directors will not place themselves in a position where their duty to act in the best interests of the corporation conflicts with their personal interests. This is a strict standard of behaviour which requires directors to set aside their own interests in favour of those of the corporation. Thus, directors owe their fiduciary duty to the corporation rather than to, other directors, employees, creditors or to society as a whole.(12)

The elements of the fiduciary duty have been aptly described in the following manner:

> *The fiduciary duty requires a director to be honest in his dealings with the other directors and with the corporation; not only must the director not actively mislead them, but also he or she should not conceal relevant or necessary information from them. He must not profit at the expense of the corporation, either by diverting opportunities or benefits from the corporation to himself, or by putting himself in a position of conflict. Any benefit that a director receives through his fiduciary position belongs to the corporation and he is accountable for it.*(13)

The leading case in Canada on the question of directors' fiduciary duties is *Canadian Aero Service Limited* v. *O'Malley*.(14) In this case, the Supreme Court of Canada stated that directors and senior officers of corporations stand "in a fiduciary relationship to [the corporation], which in its generality betokens loyalty, good faith and avoidance of a conflict of duty and self-interest."(15) The Court also noted that "the general standards of loyalty, good faith and avoidance of conflict of duty and self-interest to which the conduct of a director or senior officer

(11) The corporations laws of Nova Scotia, Prince Edward Island and Quebec, however, do not contain a comparable provision. In the first two provinces the common law would apply, while in Quebec the corporations legislation incorporates the civil law requirements with respect to such duties.

(12) The Regulatory Consulting Group Inc., *Directors' Absolute Civil Liability Under Federal Legislation*, Final Report, August 10, 1994, p. 6.

(13) *Ibid.*, p. 7.

(14) [1974] S.C.R. 592.

(15) *Ibid.*, p. 606.

must conform, must be tested in each case by many factors which it would be reckless to attempt to enumerate exhaustively."[16]

The fiduciary principle applies, *inter alia*, in situations where a director is involved in a material contract with the corporation or where he or she has a significant interest in an entity that is a party to a contract with the corporation. These situations are now dealt with in section 120 of the CBCA. This provision and similar provisions of provincial corporate legislation require directors to disclose the existence of their interest and to refrain from voting on any board of directors' resolution with respect to the contract.

STANDARD OF CARE

The second aspect of a director's duties is the duty of care. The standard for the duty of care, diligence and skill required of corporate directors is derived from the common law. A principal case in the area is *Re City Equitable Insurance Co. Ltd.*,[17] the findings of which are aptly summarized by Professor Bruce Welling, in the text *Corporate Law in Canada* as follows:

> *(i) a director need not exhibit a greater degree of skill than may reasonably be expected from a person of <u>his</u> [*] knowledge and experience;*
>
> *(ii) a director is not liable for errors in business judgment, as his primary function is to use his own particular talents in advocating corporate risk taking; and*
>
> *(iii) a director is not bound to give continuous attention to the affairs of the corporation. In the absence of grounds for suspicion he is fully justified in trusting corporate officials to be honest.*[18]

The standard has been codified in many corporate statutes and has been upgraded from a subjective to an objective standard[19] Paragraph 122(1)(b) of the CBCA provides a statutory duty of care that requires directors to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances" when

(16) *Ibid.*, p. 620.

(17) [1924] All E.R. Rep., 485 (Eng., C.A.).

(*) Underlining added.

(18) Welling, (1991), p. 330.

(19) Dickerson, Howard, Getz, *Proposals for a New Business Corporation Law for Canada*, 1971, Vol.1, p. 83.

exercising their powers and discharging their duties. Again, most provincial corporate statutes contain an identical or substantially similar provision.[20]

There is no definitive answer as to what actions on the part of directors constitute the conduct of a reasonably prudent person; much will depend on the circumstances of a particular situation.

The duty of care is not as strict as the fiduciary duty. This acknowledges that there are varying degrees of risk involved in corporate decision-making and that directors should not be penalized for making a wrong decision. Thus, if the directors acted properly in reaching a decision, looked at the necessary information, asked the appropriate questions and gave due consideration to a course of action, the courts will be reluctant to question the decision, even if it turns out to have been unsound from a business point of view.

DIRECTORS' STATUTORY LIABILITIES

A. Background

As mentioned earlier, the CBCA and various provincial corporate statutes impose statutory liabilities on directors of corporations. In addition, directors face potential liability under federal and provincial statutes for environmental offences, wages, source deductions from payrolls, GST remittances and retail sales tax, to name but a few areas. It has been suggested to the Committee that there are between 100 and 200 statutes in Canada that impose liability on directors. (Some of these statutes are referred to in Appendix 3).

Among the federal statutes that impose personal liability on directors are the *Atomic Energy Control Act,*[21] *Canadian Environmental Protection Act,*[22] *Fisheries Act,*[23] *Canada Business Corporations Act,*[24] *Bankruptcy and Insolvency Act,*[25] *Excise Tax Act,*[26] *Canada Labour Code,*[27] *Competition Act,*[28] *Canada Pension Plan,*[29] *Unemployment*

(20) In Nova Scotia and Prince Edward Island the common law test continues to apply. In Quebec, the Civil Code imposes a similar standard.

(21) R.S.C. 1985, Chap. A-16.

(22) R.S.C. 1985, Chap. 16 (4th Supp.), as amended.

(23) R.S.C. 1985, Chap. F-14, as amended.

(24) R.S.C. 1985, Chap. C-44, as amended.

(25) R.S.C. 1985, Chap. B-3, as amended.

(26) R.S.C. 1985, Chap. E-15, as amended.

(27) R.S.C. 1985, Chap. L-2, as amended.

(28) R.S.C. 1985, Chap. C-34, as amended.

(29) R.S.C. 1985, Chap. C-8, as amended.

Insurance Act,[30] *Income Tax Act,*[31] *Hazardous Products Act,*[32] *Hazardous Materials Information Review Act*[33] and *Transportation of Dangerous Goods Act, 1992.*[34]

Both the number of offences and the cumulative amount of fines for which directors can be held personally liable are significant. In the environmental area alone, directors can face potential liability under a number of federal and provincial laws. For example, under section 122 of the *Canadian Environmental Protection Act* a director will be liable for an offence committed by a corporation where he or she "directed, authorized, assented to, acquiesced in or participated in the commission of the offence." The Ontario *Environmental Protection Act*, on the other hand, provides that directors who fail to take all reasonable care to prevent a corporation from causing or permitting the discharge of a substance contrary to the Act are guilty of an offence. Penalties under these statutes include fines of several thousand dollars as well as imprisonment. These general environmental laws are bolstered by other statutes covering specific concerns such as pesticides, water pollution and mining, which also impose liability on directors for corporate acts.

Industry Canada's Directors' Liability Discussion Paper observes that:

> *The theory behind directors' civil liability is that the risk of being found liable will make directors more attentive to their legal obligations to manage the corporation. It is felt that this will prompt directors to become proactive in monitoring corporate compliance with the statutory requirements. It is expected that as a result they will ensure that preventative or control measures are implemented by the corporation to increase the probability of compliance and that (where appropriate) remedial measures will be implemented to mitigate and correct the consequences of non-compliance.*[35]

There are essentially two forms of directors' liability: direct liability and indirect liability. Direct liability applies to situations where a law requires a director to do something (such as file a report or maintain certain records) or to refrain from doing something. Indirect liability provisions in statutes make directors liable for a corporation's failure to comply with the law.[36]

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(30) R.S.C. 1985, Chap. U-1, as amended.

(31) R.S.C. 1985, (5th Supp.) C.1, as amended.

(32) R.S.C. 1985, Chap. H-3, as amended.

(33) R.S.C. 1985, c. 24, (3rd Supp.), as amended.

(34) S.C. 1992, C.34, as amended.

(35) Directors' Liability Discussion Paper, p. 24.

(36) Margot Priest, R. Mecredy-Williams, Barbara R. C, Doherty, James W. O'Reilly, *Directors' Duties in Canada: Managing Risk*, CCH Canadian Limited, 1995, p. 147.

The Hon. Donald Macdonald described four general categories of offences for which directors can be held liable in Canada.[37] The first are criminal or quasi-criminal offences. These are offences for which directors are punished for direct personal misconduct; an example is the violation of insider trading requirements.

The second relates to financial obligations where directors face personal liability for a corporation's failure to make certain monetary payments such as wages. Some of these offences impose absolute liability on directors.

Mr. Macdonald called the third category "public welfare obligations" – "regulatory" or "public welfare" statutes that impose liability on directors and officers as a means of encouraging good corporate citizenship. As he noted, normally directors will not be liable for such offences if they can demonstrate that they exercised reasonable care or "due diligence" to ensure that the corporation had complied with the legislative requirements.

The fourth category is the "knowledge-based" offence, for which a due diligence defence is available. As Mr. Macdonald noted: "these statutes generally provide for personal liability in the form of fines or imprisonment where a director or officer has 'directed, authorized, assented to, acquiesced in or participated in' the breach of the statute by a corporation."[38]

During the past few years, the issue of directors' liability has received considerable attention. High-profile resignations from the boards of significant Canadian corporations because of concerns over personal liability for corporate debts brought the issue to the attention of the media and the public at large.[39] The finding of personal liability for environmental damage against two directors of Bata Industries Ltd. continued to keep the issue in the spotlight.[40]

People began to refer to the phenomenon of "directors' chill" or "liability chill," the reluctance of qualified persons to become directors of corporations for fear of incurring significant personal liabilities. Concern was expressed about the potential loss of good directors and refusals to serve on corporate boards. One witness told the Committee that this so-called chill was affecting "the willingness of skilled and experienced members of the business and general community to serve as corporate directors,"[41] and called for a policy on

(37) *Proceedings of the Task Force on Corporate Governance*, Issue No. 6, 22 February 1996, 6:6-7, (Hon. Donald Macdonald).

(38) *Ibid.* p. 6:7.

(39) In 1992, the directors of Westar Mining, Canadian Airlines and Peoples Jewellers resigned over concerns about their liability.

(40) *R.* v. *Bata Industries Ltd.* (1992), 7 C.E.L.R. (N.S.) 245, affirmed (1993), 11 C.E.L.R. (N.S.) 208 (Ont. Gen. Div.).

(41) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:63, (Mr. D. Pekarsky).

directors' liability that would strike a fair and proper balance between the principle of directors' accountability to shareholders and their personal liability for corporate acts.[42]

The impact of directors' chill on small corporations is of particular concern. New businesses often do not have staff with the training or background required to foresee or plan for potential legal exposures or the financing to be able to obtain adequate directors' and officers' insurance. Mr. Jan Peeters, President of Fonorola Inc., was of the view that the various liabilities imposed on corporate directors posed a significant impediment to attracting qualified directors to sit on the boards of small and medium-size corporations.[43]

The 1994 Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada (TSE Report) examined the issue of directors' liability. The TSE Report accepts "in general terms the principle that imposing personal liability on directors is an acceptable and effective technique for influencing corporate conduct."[44] Nonetheless, it raised questions about the impact of directors' liability and the lack of a global view of the exposure of individuals to personal liability.[45]

Most witnesses who appeared before the Committee commented on the issue of directors' liability. Virtually all had concerns about the expansion of directors' liability over the past two decades and its collective impact on corporate governance and the conduct of business. The issue was summed up by Mr. L.R. Wilson, Chairman, President and Chief Executive Officer, BCE Inc. in the following manner:

> *In addressing directors' liability, we must ensure that capable men and women are encouraged to serve. Aside from large, well-financed, profitable, well-insured corporations, they should also be motivated to sit on the boards of other entities which need their assistance including corporations in financial difficulty or small entrepreneurial corporations whose success is essential to job creation and the economy of Canada.*
>
> *The challenge ... is to achieve an appropriate balance. The most able individuals must be encouraged to act as directors, to support reasonable business risk-taking to further the interests of the corporation, and to be diligent in discharging their duties. At*

(42) *Ibid.*,1:64.

(43) *Ibid.*, Issue No. 4, 20 February 1996, 4:29, (Mr. Jan Peeters).

(44) The Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors?*, December 1994, p. 33, para. 5.53.

(45) *Ibid.*, p. 35, para. 5.60.

the same time, these same individuals should not be exposed to unreasonable potential personal potential risk.[46]

The potential economic costs of directors' liability is a concern. Mr. Wilson highlighted its potential to constrain job creation if it made it difficult for businesses to attract highly qualified outside directors. Excessive risk aversion may also reduce innovation and adversely affect the competitiveness of Canadian businesses.[47]

B. Directors' Liability under the CBCA

The Directors' Liability Discussion Paper notes that under the CBCA directors can be liable:

- for authorizing the issue of shares for a consideration other than money where the consideration received is less than the fair equivalent of the money the corporation should have received (s. 118(1));
- for certain amounts paid by a corporation, (for example, financial assistance, share redemptions, dividends, or commissions) when the corporation is not solvent (s. 118(2));
- for unpaid debts owed to employees such as accrued wages and vacation pay (s. 119);
- for improper insider trading[48] (s. 131); and
- under the oppression remedy[49] (s. 241).

The corporations laws of a number of provinces, including Alberta, Saskatchewan, Manitoba, and Ontario, impose the same or substantially similar liabilities on directors.

(46) *Proceedings of the Task Force on Corporate Governance*, Issue No. 4, 20 February 1996, 4:63-64, (Mr. L.R. Wilson).

(47) *Directors' Absolute Civil Liability Under Federal Legislation*, Final Report, p. 68.

(48) Under the CBCA, improper insider trading involves corporate insiders such as directors who, in connection with transactions involving securities of the corporation, make use for their own benefit or advantage of confidential information that, if generally known, might reasonably be expected to affect materially the value of the securities.

(49) The oppression remedy allows a complainant to apply to the court for an order in respect of acts or omissions of a corporation or powers of corporate directors that are exercised in a manner that is oppressive or unfairly prejudicial to, or that unfairly disregard the interests of, any security holder, creditor, director or officer.

C. Defence Mechanisms

1. Good Faith Reliance Defence

The CBCA allows directors to raise a "good faith" defence to many of the liabilities to which they are subject under the Act. Under subsection 123(4), a director is not liable for improper share issuances or payments (s. 118), unpaid wages (s. 119), or breach of fiduciary duty and the duty of care (s. 122) if he or she has relied in good faith upon.

> *(i) financial statements represented to him or her by an officer or the auditor to reflect fairly the financial condition of the corporation; or*
>
> *(ii) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her.*

The Directors' Liability Discussion Paper has this to say about the good faith reliance defence:

> *The good faith reliance defence is deficient in the limited nature of the circumstances in which it can be used to exonerate a director. The good faith reliance defence allows directors to point to a reliable source of information as justification for their actions, but it does not permit them, in the absence of that specific justification, to show that they acted reasonably under the circumstances.*[50]

2. Due Diligence Defence

It has been suggested that the CBCA's good faith reliance defence be replaced by a due diligence defence for directors. Indeed, the recent report of the Toronto Stock Exchange Committee on Corporate Governance in Canada recommended that legislation which imposes liability on directors should ensure that directors are provided with an effective due diligence defence.[51] According to the Report:

> *The existence of a due diligence defence will motivate a board to establish a system within a corporation to ensure that the*

(50) Directors' Liability Discussion Paper, p. 23.

(51) The Toronto Stock Exchange Committee on Corporate Governance in Canada, December 1994, p. 36, para. 5.62.

corporate conduct which is the concern of the relevant law does not occur. The existence of the system is no guarantee that the conduct will not occur but the system should substantially reduce the risk.[52]

The Directors' Liability Discussion Paper describes due diligence in the following manner:

A director will act with due diligence if he/she exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the wrongful act. The standard is objective because a director must exercise the reasonable care and skill which an ordinary person might be expected to exercise in the circumstances.[53]

A number of the federal statutes that impose liability on directors also provide for a due diligence defence. The *Canadian Environmental Protection Act,* which imposes substantial monetary penalties and prison terms for violation of the Act, provides for a due diligence defence in connection with certain offences. Under section 125 of the Act a person will not be found guilty of an offence if it can be established that the person exercised "all due diligence" to prevent its commission. A similar provision is found in the *Fisheries Act.* A conviction will not be obtained under that statute if the person charged with an offence establishes that he or she exercised "all due diligence" to prevent the commission of the offence, or reasonably and honestly believed in the existence of facts that, if true, would render the person's conduct innocent (s. 78.6).

Directors can incur significant liabilities under the *Income Tax Act* if a corporation fails to deduct or remit taxes withheld from the salaries of its employees. A director will not be liable for these amounts, however, if he or she "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances" (s. 227.1(3)).[54]

What constitutes due diligence will depend upon the nature of the statute, the corporation and the situation. Nevertheless, it is possible to state generally that it encompasses:

- instituting a system for preventing non-compliance;
- training employees in employing the system;

(52) *Ibid.*

(53) Directors' Liability Discussion Paper, p. 24.

(54) This due diligence provision also applies to the directors' liability provisions of the *Canada Pension Plan* and the *Unemployment Insurance Act*.

- documentation;
- monitoring and adjusting the system;
- ensuring that adequate authority is given to the appropriate employees; and
- planning remedial action in the event of a failure of the system.[55]

Thus, directors should be aware of their own legal obligations as well as those of the corporation, be familiar with the corporation's operations and business affairs and know how the board functions. Directors should have the tools to carry out their duties; they should establish regular information-reporting systems, ensure that they have confidence in management, and consult expert advisors, where necessary. Directors should carry out their function diligently and document their activities, exercise independent judgment and communicate their goals and expectations.[56]

Virtually all witnesses who expressed a view on the issue of directors' liability felt that directors should be protected by a due diligence defence except in cases of dishonesty, fraudulent activity, bad faith and self-dealing. In other words, if there is attention to duty, involvement, integrity, independence of judgment and if directors take all reasonable steps to prevent a wrongful act, they should be exonerated from liability.[57] Witnesses also noted that the CBCA's good faith reliance defence is limited and may no longer be appropriate.

The Committee considered whether the good faith reliance defence should be retained as the sole defence for corporate directors under subsection 123(4) of the CBCA. In view of the overwhelming evidence in favour of a due diligence defence and the inherent weakness of the good faith reliance defence, the Committee strongly supports amending the CBCA to provide a due diligence defence for corporate directors. This would align the CBCA more closely with other federal statutes that impose liability on directors and provide greater fairness to directors. Such a defence would encourage corporations to put the appropriate due diligence systems in place, provide directors who fulfil the due diligence requirements with a measure of comfort as to their personal liabilities, and contribute to better corporate governance in Canada.

> **7. The Committee recommends that subsection 123(4) of the *Canada Business Corporations Act* be amended to provide corporate directors with a due diligence defence. Directors would not be liable for wrongful payments by the corporation (s. 118), unpaid wages (s. 119) and breaches of duty (s. 122) where they exercised the degree of care, diligence and skill**

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(55) *Directors' Duties in Canada: Managing Risk*, p. 28-29.

(56) *Ibid.*, p. 171-181.

(57) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:64, (Mr. D. Pekarsky).

that a reasonably prudent person would have exercised in comparable circumstances to prevent the wrongful act.

Although of the view that the good faith reliance defence should be replaced by a due diligence defence, the Committee would not want to see the good faith reliance defence completely removed from the CBCA. The due diligence defence could be partially defined in order to give directors and the courts some guidance as to what constitutes "acting reasonably in the circumstances." Reliance in good faith on financial statements, on the reports of experts, and on information presented by officers and professionals could be an element of due diligence. This would provide some certainty to directors yet allow the courts to add other elements to the definition.

8. The Committee recommends that reliance in good faith on financial statements, on the reports of experts and on information presented by officers and professionals be included as an element of the due diligence defence.

REVIEW OF DIRECTORS' LIABILITY LEGISLATION

Although the particular concern of the Committee is directors' liability as it pertains to the CBCA, the testimony before the Committee often dealt with directors' liability in a broader context. The Committee notes that directors' liability was also a significant theme of the submissions received by the TSE Committee on Corporate Governance.

The TSE Committee expressed concern with both the manner in which and the extent to which directors' liability has developed. Its principal concern was the incremental approach of the federal and provincial governments to directors' liability; it had been implemented on a statute-by-statute basis with little or no thought given to the cumulative impact of such liability or whether there should be a limitation on the exposure faced by directors.(58)

The TSE Committee recommended that the federal and provincial governments review all legislation imposing liability on directors to determine whether such liability is effective in influencing corporate conduct.(59) It then went on to recommend that after the completion of the review "all legislatures should repeal legislation imposing personal liability on directors which no longer serves the purpose for which it was enacted and that legislation

(58) The Toronto Stock Exchange Committee on Corporate Governance in Canada, p. 34-35, para. 5.59-60.

(59) *Ibid.*, p. 35, para. 5.60.

not so repealed be amended, if necessary, to ensure directors are provided an effective due diligence defence."[60]

A similar view was voiced by one witness who called upon the federal government to review all federal legislation imposing liability on directors with a view to placing reasonable limits on situations that give rise to such liability.[61] The witness suggested further that federal-provincial negotiations be instituted for the purpose of introducing similar constraints at the provincial level.

The Committee notes, however, that a Report of the Federal Government Interdepartmental Working Group on the issue of directors' liability does not share the business community's concern about the adverse impact of directors' liability. The Working Group concluded as follows:

> ... *the working group did not find sufficient evidence to conclude that directors' liability has become so severe that it could not be handled by the market. A review of statute-based liability and the enforcement record of federal regulators indicates that the practical exposure of outside directors to liability is limited. Some members of the working group remain concerned that directors of small businesses might have difficulty meeting the liabilities that have been placed on them. However, the working group did not find sufficient evidence to conclude that directors are resigning in significant numbers to avoid the liabilities that they face. The resignations of directors that received publicity have been isolated to a handful of companies that were in severe financial difficulty and that did not carry enough insurance to adequately protect their directors.*[62]

These conclusions notwithstanding, the Committee believes that directors' liability poses a significant problem in today's corporate landscape. Directors' liability provisions crop up in a myriad of statutes. The Committee wonders whether this is because there is a real need and legitimate policy purpose for imposing such liability or because it is part of a legislative drafter's checklist of "boilerplate" legislative provisions.

While acknowledging that imposing liability on corporate directors may, in some cases, serve a useful function and enhance compliance with legislated requirements, the Committee believes that it is essential to find the appropriate balance between a director's responsibility to the corporation he or she serves and to society and the community as a whole. As one witness noted:

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(60) *Ibid.*, p. 36, para. 5.62.

(61) *Proceedings of the Task Force on Corporate Governance*, Issue No. 4, 20 February 1996, 4:66, (Mr. L.R. Wilson).

(62) Interdepartmental Working Group Report on Directors' Liability, April 6, 1993, p. 27.

> *In my view, it serves the purpose of no one to threaten a director with personal ruin, nor does it speak to a logical legislative regime to have circumstances with compel directors to resign ... in times of distress, which is the very moment when sound, independent input is most needed. Neither should a director be placed at personal risk for exercising his or her best and honest judgment in overseeing necessary risk-taking by a corporation.*(63)

It is the Committee's view that legislation should not include a directors' liability provision unless it can be clearly demonstrated that the provision will have a positive impact on corporate conduct and will advance the purpose of the legislation.

9. The Committee recommends that before enacting any new directors' liability provisions, the federal government clearly demonstrate that the provisions will have a positive impact on corporate conduct and will advance the purpose of the legislation in which it is contained.

10. The Committee recommends that the federal government review all federal legislation imposing personal liability on directors with a view to determining whether such liability has an impact on corporate conduct and advances the purposes of the legislation.

11. The Committee recommends that the federal government ensure that all federal laws that impose liability on directors provide directors with an effective due diligence defence.

12. The Committee recommends that the *Canada Business Corporations Act* be amended to include a due diligence defence that would apply to all federal statutes that impose liability on corporate directors, except where such statutes provide for a due diligence defence that is identical to or substantially the same as the defence established under the *Canada Business Corporations Act*.

(63) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:64, (Mr. D. Pekarsky).

LIABILITY CAP

Whether there should be a cap on the liability of directors is an extremely contentious issue. This matter was widely debated in the United States in the late 1980s in the wake of the Supreme Court of Delaware's decision in *Smith* v. *Van Gorkom*.(64) Commonly known as the *Trans Union* decision, this case arose after the directors of Trans Union had approved a merger with another corporation. The draft merger agreement negotiated by Van Gorkom, the president and chief executive officer, was presented to the board of Trans Union with no prior notice and no documentation to review. After a discussion lasting less than two hours, the directors approved the merger. Notwithstanding that the share price negotiated as part of the merger was considerably higher than the prevailing market price of the shares, the Supreme Court of Delaware held the directors of the corporation liable to the shareholders for several million dollars.

The Trans Union decision had a marked impact on directors' liability in the United States. It is reported to have precipitated a crisis in directors' and officers' insurance and to have contributed to a liability chill on the part of directors.

State legislators responded to the fall-out from the decision in one of three ways. Some states revised their corporations laws to allow corporations to amend their charters to protect directors from liability for breach of certain types of duties -- the "charter approach." Others established a cap on the amount of damages that could be awarded against directors in specified circumstances -- the "cap on money damages option." Still others introduced a "self-executing" approach in which the directors' standard of care was determined by statute; in some cases it was relaxed, in others it was eliminated.

The Directors' Liability Discussion Paper describes each of these approaches as follows:

> *The "charter option" is the most popular; it was first enacted by Delaware in 1986. The 1986 amendments to the DGCL added section 102(b)(7) to permit a corporation in its articles, through shareholder approval, to eliminate or limit personal liability of its directors to the corporation and its shareholders for breach of fiduciary duty .... Under section 102(b)(7), shareholders may choose to fix any amount they want as a cap on liability and they may determine each particular cap according to the particular transaction at issue.*

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(64) 488 A2d 858 (Del. 1985).

The "cap on money damages approach'" enacted by the State of Virginia limits the damages that may be assessed against an officer or director in a suit by or in the right of the corporation or by stockholders directly to the greater of $100,000 or the amount of cash compensation received by the directors from the corporation for the last year. In addition, the provision permits the stockholders to reduce or eliminate (but not increase) this limit to the "monetary amount specified" in either the articles or by-law provision.

The "self-executing approach" ... means that the standard of liability is determined by the statute itself. Shareholders have no input into whether liability for monetary damages should attach to their directors in circumstances other than those prescribed by statute. For example, under the Florida statute, a director is not personally liable for monetary damages to the corporation or to any other person except in five defined circumstances.(65)

Capping directors' liability was an option discussed by a number of witnesses. Some witnesses spoke in favour of a cap, some were opposed, others were uncertain about its value and yet others, though unconvinced that it was necessary at this time, suggested they might support a cap if the liability situation worsened.

The President and Chief Executive Officer of BCE Inc. felt that consideration should be given to placing a cap on the potential liabilities of directors, except in specified situations. He cited the corporations legislation of the State of Virginia as a possible model. Mr. Wilson expressed concern about burdensome due diligence requirements, suggesting that artificial due diligence procedures and meaningless requirements might be implemented in order for directors to protect themselves against personal liability.

A long-time corporate director, Mr. William Dimma, expressed concerns about the time taken up with due diligence activities noting that the inevitable price of the due diligence defence is board meetings where considerable amounts of time are spent on due diligence procedures for the benefit of the directors. The feeling was that this prevents timely board decisions and creates unnecessary bureaucratic procedures. As one witness put it:

Legal or fairness opinions should not have to be obtained to justify every business decision. It should not be required that files are artificially constructed to demonstrate, after the fact, that all the right questions had been asked and appropriately documented.(66)

(65) Directors' Liability Discussion Paper, p. 41.

(66) *Proceedings of the Task Force on Corporate Governance*, Issue No. 4, 20 February 1996, 4:66, (Mr. L.R. Wilson).

The Hon. Douglas Everett suggested that a limit on liability might be a useful tool to prevent groundless lawsuits. Ms. Maureen Kempston Darkes, President and General Manager, General Motors of Canada Ltd., pointed out some of the issues that would have to be considered before a cap was legislated. More specifically, she stated:

> *... the question becomes if you impose such a cap, whether this would simply transfer the risk of the wrongdoing to the injured party. Given the potential liability faced by corporate directors today, one could argue that without some limit on the amount of liability, a corporation will not be successful in securing board appointments from the very best candidates ....*
>
> *Perhaps some general direction to legislators to consider the cumulative impact of directors' liabilities is the very best approach.*(67)

The Directors' Liability Discussion Paper points out several objections to capping directors' liability. First, placing a limit on the liability of directors has the effect of transferring liability and risk to other persons, such as the corporation, insurers and the injured party. Second, a cap would not adequately reflect the differences between large and small corporations. Third, the liability capping laws in the United States were a response to legal actions by shareholders against directors rather than to liabilities imposed by statute.(68)

Mr. Gordon Cummings, Chief Executive Officer of the Alberta Wheat Pool, echoed these concerns. He questioned whether it was proper to transfer the risk and liability from directors back to the injured party. He also wondered whether it was appropriate to impose a cap since the concern in Canada centres on directors' statutory liabilities rather than shareholders' actions. How to make a cap fair in all situations was also a concern.(69)

The TSE Committee explored and recommended against capping directors' liability. The Report states:

> *We do not think a cap could be effectively implemented simply through amendments to a corporation's governing statute. A cap would require coordination amongst the jurisdictions imposing personal liability on directors of a particular corporation – a practical impossibility.*(70)

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(67) *Ibid.*, 22 February 1996, 6:110, (Ms. M. Kempston Darkes).

(68) Directors' Liability Discussion Paper, p. 42.

(69) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:148, (Mr. G. Cummings).

(70) The Toronto Stock Exchange Committee on Corporate Governance in Canada, p. 36, para. 5.63.

The Committee considered the following options with respect to placing a cap on directors' liability:

1. recommending a cap on directors' liabilities;

2. recommending that the government study the question of capping directors' liability and report to the Committee within a specified period of time;

3. limiting directors' liability for breaches of their duty of care. Shareholders of the corporation could be allowed to include in the articles of the corporation a provision limiting the liability of directors of the corporation to its shareholders for monetary damages for breach in their duty of care. A minimum amount of liability could be imposed;

4. recommending against imposing a cap on directors' liability.

After discussions, the Committee concluded that it would not be appropriate to place a cap on the liabilities faced by directors. It is the Committee's view that the objections to a cap cited in the Directors' Liability Discussion Paper and mentioned in this chapter are valid. Perhaps more importantly, the Committee strongly believes that a cap could not be effectively implemented through the CBCA. To be truly meaningful, a cap would have to apply to liabilities imposed under federal and provincial legislation. Until such time as the federal and provincial governments can coordinate their efforts on this issue and reach a common solution, it would be more appropriate to seek other responses to the problem of directors' statutory liabilities. A review of the laws imposing liability on directors and the provision of an effective due diligence defence to directors would go a long way to alleviating the problem of directors' liability.

13. The Committee recommends that there be no cap on directors' liability.

LIABILITY OF MANAGEMENT

Some witnesses suggested that liability for corporate acts should rest with the corporation's management rather than with the directors. One witness argued forcefully for imposing statutory liability solely on corporate officers. He was of the view that independent directors should not bear these liabilities since they must rely on corporate officers for information about a corporation's activities. Others suggested that varying levels of legal responsibility between a corporation's officers and directors might be appropriate.

The notion of transferring liability from a corporation's directors to its management was positively received by other witnesses; for example, a corporate director and consultant said:

> *... if there has been criminal activity by a manager ... that is the individual who should be the first line of attack ... It is beyond me how a director should be picking up the freight for that if the director's responsibilities were acquitted appropriately.*(71)

Having management shoulder a greater liability burden is one way of recognizing the differences between outside and inside directors -- those who are independent and those who are managers. These differences can be described in the following manner:

> *... outside directors unless part of a special committee operate under a significant disadvantage in terms of their ability to monitor and control activities in the corporation. Inside directors, by contrast, are usually active as managers in the corporation or are controlling shareholders who have a strong economic incentive for investing substantially in monitoring and control activities. These directors are more familiar with the operations and circumstances of the corporation, enjoy more timely and more detailed access to information, are better placed to exert control over corporate actions, and receive a level of remuneration that is more commensurate with potential liability risks shouldered by directors under both statutory and common law.*(72)

Although the proposition that management rather than directors should bear the liability burden is compelling, the Committee does not have sufficient information about the implications of such a proposition to comment or express a view. At present, many of the statutes that impose liability on directors also impose the same liability on corporate officers. The question of whether these liabilities should be disproportionately borne by management, however, has important ramifications for corporate governance and these will have to be fully explored before any proposals in this area are brought forward.

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(71) *Proceedings of the Task Force on Corporate Governance*, Issue No. 2, 15 February 1996, 2:42, (Mr. W. Mackness).

(72) *Directors' Absolute Civil Liability Under Federal Legislation*, (1994), p. 73.

DIRECTORS' LIABILITY FOR WAGES

A. Background

Directors' liability for the wages of corporate employees has been a long-standing feature of Canadian corporate legislation. In fact, the Directors' Liability Discussion Paper notes that this form of liability has existed at the federal level since 1869.[73]

In recent years, much of the focus of the discussions about directors' liability has been on directors' liability to employees. A spate of high-profile resignations by directors in the early 1990s because of concerns that they could be liable for millions of dollars in obligations to corporate employees focused attention on the issue of directors' liability in general and the liability for employee wages in particular.

Subsection 119(1) of the CBCA provides that directors are liable for up to six months' wages owed to employees of the corporation. More specifically, it states that directors are jointly and severally liable to corporate employees for all debts not exceeding six months' wages for services performed by employees for the corporation. A director, however, will not be liable for wages unless:

- the corporation has been sued for the debt within six months after it became due and the debt remains unsatisfied;

- the corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months after the proceedings were commenced; or

- the corporation has instituted bankruptcy proceedings and the claim for wages has been proved within six months after the proceedings began.

In addition, there will be liability for wages only if the director is sued while he or she holds office or within two years after he or she has ceased to be a director.

Under subsection 123(4) of the CBCA, a director can be exonerated from liability for unpaid wages if he or she relied in good faith upon:

> (i) financial statements represented to him or her by an officer or the auditor to reflect fairly the financial condition of the corporation; or

(73) Directors' Liability Discussion Paper, p. 5.

> (ii) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her.

Directors' liability for wages is an exception to the more general principle that a person is not responsible for the debts of another. The liability arises in situations where a corporation cannot meet its financial obligations to its employees; in other words, when a corporation becomes insolvent.

In the 1993 decision in *Barrette* v. *Crabtree Estate*,[74] the Supreme Court of Canada was asked to determine whether termination pay was a "debt" within the meaning of subsection 119(1), for which corporate directors would be liable. The Court held that directors' liability was limited to debts for services performed for the corporation and that termination pay was not a debt for such services but rather a claim arising from the termination of the employment relationship.

Writing for the Court, Madam Justice L'Heureux-Dubé noted the following observations about the purpose of section 119:

> *For lack of any other reason it occurs to me that what must have been had in view, was to protect to a limited extent those who were employed by such companies in positions which do not enable them to judge with any special intelligence what is the company's real financial position. The directors have personally this knowledge or should have it, and if, aware of the company's embarrassed affairs, and specially of the danger of a speedy collapse and insolvency, they continue to utilize the services of employees who have no means of securing this knowledge and who give their time and labour upon their sole reliance, often, on the good faith and respectability of the company's directors, it is not inequitable that such directors should be personally liable, within reasonable limits' for arrears of wages, thus given to their service.*[75]

The Directors' Liability Discussion Paper points out that all provinces except the Atlantic Provinces impose liability on directors for wages. In some jurisdictions this is found in corporations legislation; in others, in employment standards legislation; and in yet others, in both.[76] In Saskatchewan, the *Business Corporations Act*[77] provides that directors

(74) (1993), 101 D.L.R. (4th) 66 (SCC).

(75) *Ibid.*, p. 76.

(76) Directors' Liability Discussion Paper, p. 7.

(77) R.S.S. 1978, c. B-10, s. 114.

are jointly and severally liable in accordance with the *Labour Standards Act* for all debts payable to employees for services performed for the corporation while they were directors. The Yukon *Business Corporations Act* contains a similar provision.[78] The corporate legislation of Manitoba, Alberta, and Ontario, on the other hand, has wage liability provisions that are substantially similar to section 119 of the CBCA.

At the federal level, directors' liability for wages is found in both the CBCA and the *Canada Labour Code*. Under section 251.18 of *the Canada Labour Code,* directors are jointly and severally liable for up to six months' wages in respect of corporate employees where the wage entitlement has arisen when the directors in question held office and recovery from the corporation is impossible or unlikely.

A fundamental question for the Committee was whether the CBCA should continue to impose liability on directors for wages. An equally important question was whether to include additional measures in *the Bankruptcy and Insolvency Act* to deal with employees' unpaid wages.

Witnesses commented on the significant potential liabilities faced by directors for employees' wages, particularly in labour-intensive industries. The President and Chief Executive Officer of Hudson's Bay Company noted that the total wage liability for his company for six months is in the order of $400 million.[79] Indeed, liability for wages was considered to be one of the most onerous of the many forms of directors' liability.

It was suggested that full consideration must be given to repealing section 119 of the CBCA. The President and Managing Director of Morgan Stanley Canada Ltd. asserted that directors' liability for wages was outmoded and should be eliminated. He gave the following rationale for his views:

> *As I understand it, that was developed about 100 years ago when corporations were closely held and when there was concern about unscrupulous owners and the way they dealt with employees. A lot has happened in 100 years. We now have widely held corporations carrying on business with tens of thousands of employees. It is the kind of provision that should be repealed.*[80]

Another witness made a strong plea for the repeal of section 119:

> *... section 119 should be struck out of the Canada Business Corporations Act. It is an anachronism that no longer fits business life 125 years after its first enactment. The section ... is*

(78) Revised Statutes of the Yukon, 1986, c. 15, s. 121.

(79) *Proceedings of the Task Force on Corporate Governance,* Issue No. 5, 21 February 1996, 5:11, (Mr. G. Kosich).

(80) *Ibid.*, 5:97, (Mr. Peter Dey).

completely contrary to the entire trend in corporate governance which has been underway in Canada during this past decade....

If it makes no sense to punish a board of directors in this way, that does not mean that the plight of employees of an insolvent firm should be forgotten. A provision protecting employees for sums owed by a corporate employer, but unpaid, more properly belongs in the Bankruptcy Act.[81]

Other witnesses supported the proposition of that wage liability is a matter for bankruptcy rather than corporations legislation.

B. Wage Liability under the *Bankruptcy and Insolvency Act*

Under the existing *Bankruptcy and Insolvency Act,* workers whose employer is bankrupt have a preferred claim[82] for six months unpaid wages up to $2,000 and for salespersons' expenses to a maximum of $1,000 covering the same period. Where an insolvent employer makes a proposal to reorganize its business under the Act, unpaid wages and salespersons' expenses up to these maximum amounts must be paid immediately after court approval of the proposal.

Since the early 1970s two possible methods have been discussed for compensating employees for lost wages when an employer becomes bankrupt: a wage-earner protection scheme; and a "super-priority" (first charge) for wage claims.

1. Wage-earner Protection Scheme

The concept of a wage-earner protection scheme dates back to the first attempt to amend the bankruptcy laws in 1975, when the Senate Banking, Trade and Commerce Committee rejected a super-priority for wage claims and proposed the creation of a wage protection fund, financed by contributions from employers and employees, from which outstanding wages could be claimed upon an employer's bankruptcy. The proposals for a wage-earner protection plan never became law but were revived in two subsequent studies of the bankruptcy legislation in 1981 and 1986 and were brought forward as part of the last round of amendments to the bankruptcy laws introduced in 1991 (Bill C-22).

The 1991 proposals called for the creation of a wage-earner protection fund, financed by contributions from employers, from which employees could claim unpaid wages, vacation pay and salespersons' expenses in the event that an employer became bankrupt, had been liquidated or had gone into receivership.

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(81) *Ibid.*, 22 February 1996, 6:9, (Hon. Donald Macdonald).

(82) A preferred claim ranks behind the claims of secured creditors but ahead of those of ordinary creditors.

The amount of the benefit to be paid out of the fund would have been set at 90% of an employee's unpaid wages and vacation pay earned within the preceding six months, up to a maximum of $2,000 and 90% of a salesperson's expenses during the same period, up to a maximum of $1,000. Pension contributions, severance and termination pay would not have been included.

The wage protection proposals were rejected by the parliamentary committee studying the legislation and did not make their way into law.

2. Super-priority

An alternative to a wage-earner protection plan would be to give employees a first charge on the assets of a bankrupt employer. This so-called super-priority would put employee wage claims ahead of the claims of all other creditors, including secured creditors.

Like the notion of a wage-earner protection plan, the concept of a super-priority for unpaid wages is not new. During some of the many ill-fated attempts to amend the bankruptcy legislation in the 1970s and early 1980s, proposals were made to grant employees a super-priority for unpaid wages. Over the years, numerous Private Members' bills have also attempted to put forward this proposal. In addition, in 1991, the House of Commons Standing Committee on Consumer and Corporate Affairs and Government Operations rejected a wage-earner protection scheme in favour of a super-priority for unpaid wages.

Past super-priority proposals were soundly rejected by members of the financial community who sought to maintain their priority as secured creditors. Concern was also expressed about the adverse impact that a super-priority might have on the ability of smaller or labour-intensive businesses to obtain financing.

C. View of the Committee

The Committee considered the following options with respect to directors' liability for wages.

1. imposing liability for wages on the officers of the corporation rather than on the directors;

2. imposing liability for unpaid wages on the major shareholders of the corporation rather than on the directors;

3. continuing to impose liability for unpaid wages on directors while having different levels of liability for directors who are officers, owners or managers and those who are outsiders;

4. repealing section 119 of the CBCA and replacing it with a provision of the *Bankruptcy and Insolvency Act*; and

5. retaining section 119 of the CBCA.

After discussion, the Committee concluded that the primary purpose of section 119 of the CBCA is to protect employees in the event of the bankruptcy or insolvency of the corporation. The Committee therefore supports the view that liability for unpaid wages should be dealt under the *Bankruptcy and Insolvency Act*. There are at least two reasons for this. First, wages constitute a debt owed to employees by the corporation and as such should be dealt with under the purview of a statute whose purpose is to provide for the orderly payment of debts.

Second, and perhaps most importantly, placing wage liability under the bankruptcy legislation would provide a consistent, nation-wide standard for wage liability applicable to all corporations in cases of bankruptcy.

14. The Committee recommends that section 119 of the *Canada Business Corporations Act* be repealed and that the federal government focus its attention on measures in the *Bankruptcy and Insolvency Act* to cover employees' unpaid wages.

THE PROS AND CONS OF A NON-EXECUTIVE CHAIRMAN

The pros and cons of a non-executive chairman was the subject of considerable discussion during the hearings. The TSE Report recommended that

> *Every board should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure that the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board, such as the governance committee, or to a director, sometimes referred to as the "lead director".*[(83)]

In the United States,

> *Typically the chair of the board will be the CEO, although there is much discussion about the separation of the two posts and there is increasing evidence that the practice is being adopted. However, while such a separation is often the subject of resolutions submitted by shareholders for presentation at annual meetings, there is no effort to separate the roles by rule or statute.*[(84)]

In fact

> *Because the chief executive is also the board chair in more than 80% of the country's publicly held corporations, it is not surprising that most chief executives view board empowerment with trepidation. Traditionally, corporate leaders have considered a powerful active board to be a nuisance and a force that could improperly interfere in the management of the company at worst. ... Chief executives who resist empowered boards must change their attitude. If they do not, they and their companies will be the losers because the empowered board is here to stay.*[(85)]

One of the most lucid discussions of this issue is presented by William G. Bowen in *Inside the Boardroom*, a study upon which one of the witnesses before the Committee based a part

(83) The Toronto Stock Exchange Committee on Corporate Governance in Canada, p. 41, para. 6:15.

(84) *International Task Force on Corporate Governance, Who Holds the Reins? An Overview of Corporate Governance Practice in Japan, Germany, France, United States of America, Canada and the United Kingdom*, International Capital Markets Group, June 1995, p. 58.

(85) Jay W. Lorsch, "Empowering the Board," *Harvard Business Review*, January-February 1995, p.107.

of his testimony. This section is based on Bowen's arguments in addition to the testimony of witnesses.

Bowen distinguishes between two kinds of non-executive chairman: one who was previously the CEO of the same company and one who is an outside director. It is his view that the board should have a non-executive chairman who was not previously the CEO of the same company.

The focus of the argument against an executive chairman is the feeling that this creates an excessive concentration of power in the hands of a single person.

> *A chairman/CEO wears two hats at the same time and you just can't do that and look good in both roles.... He/she is in a delicate position between the CEO and the board letting the CEO make necessary reports and recommendations, supporting the CEO, and sometimes even protecting the CEO. But at the same time, he/she must make certain that suggestions/challenges, even criticisms are heard and considered. In my view no one can do all that and be the CEO as well. I know; I tried it. If the chairman is also the CEO, he/she makes the agenda, conducts the meeting, presents management's recommendations, controls the discussion, and asks for support of his/her own recommendations. When one does all that and in addition usually picks his/her fellow board members, you have in my opinion a dictatorship. It may be benign and it may even be enlightened, but it is nonetheless a dictatorship. In my view, any chairman/CEO inevitably wears primarily his/her CEO hat and only occasionally takes on the far more neutral and impartial role of chairman of the Board.*[86]

There is clearly a fine line between asking penetrating questions and embarrassing a CEO. Given the existence of social norms of behaviour, is it reasonable to expect that directors will pursue problem areas in depth in front of a chairman who is also the CEO? In a healthy company this is obviously not a problem, but what happens if danger signs appear? Will the there be a delay in the recognition of emerging problems, which can lead to serious difficulties for the board later on? At what point will directors be willing to engage in discussion in the absence of the CEO/chairman?

Many witnesses before the Committee supported this point of view. According to one witness,

> *In my opinion, the chairman and the CEO should clearly be separate. ... The responsibilities of a chairperson with respect to a board involve being able to schedule meetings, obtain information and communicate directors' concerns to a senior officer or CEO. To*

(86) Kenneth Dayton quoted in William G. Bowen, *Inside the Boardroom*, John Wiley and Sons, 1994, p. 83,84.

have the same person taking one hat off and putting on another makes it virtually impossible to function, in my opinion. ... The temptation for any CEO not to misuse the board, but to control the board and to make it difficult for the board to function is irresistible.

I say that in the sense that they are not objective with respect to the team they have put together. If they have a group of senior executives, vice-presidents and finance people, et cetera, they think they are doing a great job. They think they are part of the team. If you do not think they are, then as a board member you have to go to the chairperson and say, "We want to examine this." Whereas if the chairperson is the president, you cannot help but offend that person because that person has put together that team. Now you are questioning their ability with respect to how they put it together. In my opinion, it is impossible for them to be that objective.[87]

The chairman/CEO model appears to decrease the likelihood of a genuine "second opinion." Splitting the two makes it clear that the CEO reports to the board and not the other way around.

In practical terms, the presence of a non-CEO chairman provides a structure whereby the board itself has a clearly understood role in nominating board members, appointing board committees, setting agendas and, if need be, selecting independent advisors to the board. These seemingly innocent-sounding powers ... can be very important. Finally, the presence of a separate chairman facilitates the regular review of the performance of the CEO and avoids any risk that a CEO might preside at a discussion of his own future.[88]

Many witnesses agreed with this view.

On any given issue, I think two heads are usually better than one. The more divergent views you bring to a process, the better it usually works.

Secondly, you may have certain experiences and certain other involvements that allow you to bring a different perspective to a question than an operating CEO would have because he is focused on a narrow range of issues.[89]

Further,

(87) *Proceedings of the Task Force on Corporate* Governance, Issue No. 2, 15 February 1996, 2:64-65, (Mr. Bob Kozminski).

(88) Bowen (1994), p.86.

(89) *Proceedings of the Task Force on Corporate* Governance, Issue No. 3, 19 February 1996, 3:30, (Mr. David J. Hennigar).

The board must balance the interests of the shareholders and managers. Since the board, like the shareholders, is not, and should not be, involved in the day-to-day management of the company, the board must fulfil its obligations in a different manner, and that is through selection, compensation, evaluation, dismissal, if necessary, and the succession planning for the CEO and the senior managers of the corporation. Allowing the same person to act as chair of the board and CEO creates an undeniable conflict in the exercise of these responsibilities and these distinct roles because it is not very likely that the CEO will fire himself.

In fact, we would suggest that the entire concept of corporate governance is predicated on the reality that the interests of managers can and do regularly diverge. We feel quite strongly that the ongoing failure to separate the role of the chairman of the board and the chief executive of the organization tilts this crucial balance in representation of interests in favour of management. For that reason, that should be discussed and perhaps enforced in a little different manner than the rest of the board composition issues.

...

The two functions are substantially different. No matter how bright and competent a person is, I do not believe one can ride two horses at the same time.[(90)]

Another witness added that the role of a non-executive chairman is

particularly relevant in the case where there is a substantial outside holding -- obviously, a controlling share but even a substantial minority share -- namely to make certain that you have someone there who will be judicious in the conduct of corporate proceedings and ensure that the special interest does not get treated unduly favourably in relation to the individual shareholders.[(91)]

While most witnesses favoured a non-executive chairman, many did add qualifications to the general rule.

I would make two exceptions. Where there is a majority shareholder who is active in the business, then to appoint somebody else as a

(90) *Ibid.*, Issue No. 5, 21 February 1996, 5:17-18, (Mr. Dale Richmond).

(91) *Ibid.*, Issue No. 6, 22 February 1996, 6:16, (Hon. Donald Macdonald).

chairman would be patently useless. The majority shareholder holds the votes and runs the company. How could anyone presume to have a position which would supersede that?

It would also be meaningless to have a separate chairman would be in a corporation which is controlled by a foreign multinational company. Quite a number of Canadian companies have shareholders other than the controlling shareholder. However, to suggest that somebody could be the intermediary between the boss in New York and the CEO of a subsidiary brings up the question: What does he do?

Clearly the director who sits at the table holding 60 percent proxies is de facto the chairman because the CEO of the Canadian subsidiary will report to that person. Why pretend that there is someone independent standing between those two parties? That is not the way it works.[92]

In addition, a number of witnesses argued that, in a young, growing company, the strong hand that is provided by an executive chairman is needed. Further, the smaller company does not need the added expense of a non-executive chairman. In the mature, widely held company, the split is particularly important.

In spite of these convincing arguments in favour of a non-executive chairman, Bowen notes that the idea has received very little support among CEOs. They argue that separation of the positions of CEO and chairman dilutes their power to lead their organizations effectively. Decision-making may become less clear-cut as the potential for rivalry between the chair and the CEO is created. This may result in compromise rather than decisiveness. There is also the possibility that the non-executive chair may shield the CEO from being accountable for poor performance (although this would seem more likely in the case of an executive chairman). Finally there is the question of who speaks for the organization in public. With two people speaking, what is the likelihood of confusion about corporate strategy or the situation of the organization?

One witness before the Committee discussed the origins of the idea of a non-executive chairman; the concept came from the work of Sir Adrian Cadbury in the British context.

To understand where he was coming from, you have to understand the composition of British boards as he found them.

From his account, two-thirds of the directors were typically executives of the company, and one-third were non-executives. Let us say you had twelve men sitting around a table, with a CEO and chairman, and he is surrounded by eight of his subordinates. Then

(92) *Ibid.*, Issue No. 4, 20 February 1996, 4:82, (Mr. Jim Burns).

he had four non-executive directors. Under those circumstances, I have a certain sympathy for Cadbury. It is an undue concentration of power for the CEO and chairman to be combined under those circumstances. The whole question of the board's independence becomes an issue.(93)

He went on to argue that in the Canadian context

In most large, widely owned Canadian companies, the circumstances are completely different. Usually a majority of the directors are independent directors. ...

Under these circumstances, there is really no problem. Even if I granted that there were a problem, it could not be solved by splitting the roles. The determined fellow will just work his way around that.(94)

One "troubled" American company, Apple, recently combined the positions of CEO, president and chairman. The witness suggested that

The new fellow wanted absolutely no doubt as to who was the boss; he took over all three titles, chairman, president, and CEO.(95)

The bottom line, for this witness, is authority.

One model out there describes management as a united group which sticks together. Then there is a board of directors over here and a bunch of shareholders over there. I can assure you that it does not work that way. There are a great number of conflicts and differing views within management. The possibility exists that if you go to one guy and do not get the answer you like, you try out the other guy to see if you can get the answer. That is why I say, ultimately, there must be a guy who is the final boss. He can say, "Listen, I represent the board because they delegated authority to me, and this is what we will do."(96)

(93) *Ibid.*, Issue No. 5, 21 February 1996, 5:149, (Mr. John D. McNeil).

(94) *Ibid.*

(95) *Ibid.*

(96) *Ibid.*, 5:153.

In the face of obvious contentiousness over this issue, Bowen explored the idea of a "lead" director, someone given formal recognition of an enhanced role on the board, who would act as an intermediary between the outside directors and the CEO/chairman. There is, however, the obvious psychological problem that may arise if one director is singled out as "special."

Witnesses before the Committee were generally not enthusiastic about the concept of lead director, arguing that this is not a title but a role.

> *In my experience with boards, therecan be two or three or four directors who might play a different role leading the board depending upon the subject. ... In a way, committee chairmen function as lead directors.*(97)

Bowen prefers to avoid the term "lead" director and to focus on a board committee on governance which would be responsible for the effective functioning of the board itself. Among its duties would be nominating new directors and reviewing the performance of existing directors. Such a committee would recognize the collective character of board governance.

Should the chairman/CEO split be legislated? Most witnesses saw the need for flexibility, particularly for companies in the early stages of development. One witness who favored the split, but not legislation to accomplish this outcome, stated:

> *I am seeing such a situation evolving without legislation, and three or five years from now the majority of companies in Canada of different sizes and different sectors will have a non-executive chairman.*(98)

The Committee is convinced of the value of separating the roles of chairman of the board and chief executive officer in a publicly traded corporation. Allowing the same person to act as chairman of the board and CEO creates an undeniable conflict in the exercise of the responsibilities of these two individuals. The Committee is, however, cognizant of the fact that special circumstances can arise in which combining the two roles may be the appropriate option.

The Committee considered the following options:

1. recommending that that the separation of the positions of chairman of the board and chief executive officer be legislated and apply to all publicly traded CBCA corporations;

(97) *Ibid.*, 5:150.

(98) *Ibid.*, Issue No. 6, 22 February 1996, 6:104, (Hon. Peter Lougheed).

2. recommending that that the separation of the positions of chairman of the board and chief executive officer be legislated but apply only to all widely held publicly traded CBCA corporations;

"By widely held" it is meant no person holds shares
(a) carrying more than 10 per cent of the voting rights attached to all outstanding shares of the CBCA corporation, or
(b) having an aggregate book value in excess of 10 per cent of the shareholder's equity of the CBCA institution.

3. recommending that publicly traded CBCA corporations separate the positions of chairman of the board and chief executive officer, but do not recommend incorporation of this provision in the CBCA.

After discussion, the Committee came to the following conclusion:

15. The Committee strongly recommends that publicly traded CBCA corporations separate the positions of chairman of the board and chief executive officer. The Committee does not, however, recommend that the separation of these positions be enshrined in the CBCA.

CHAPTER 3

RESIDENCY REQUIREMENTS FOR DIRECTORS

INTRODUCTION

The *Canada Business Corporations Act* contains seven residency requirements. One relates to the location of a corporation's registered office, another to the location of shareholder meetings, two deal with the location of corporate records and three with the residency of corporate directors. [(99)]

In August 1995, Industry Canada issued the discussion paper, *Directors' and Other Corporate Residency Issues* (Directors' Residency Discussion Paper). The paper dealt with a number of the residency provisions of the CBCA. The issue of directors' residency was the main focus of the witnesses who appeared before the Committee. As a result, this Chapter will be confined to a discussion of the CBCA directors' residency requirements.

BACKGROUND

The directors' residency provisions of the CBCA require a majority of directors to be resident Canadians,[(100)] that directors shall not transact business at a board meeting unless a majority of directors present are resident Canadians,[(101)] and that a majority of the members of each committee of the board be resident Canadians.[(102)]

These provisions, which were enacted in 1975, were designed to address concerns about the amount of direct foreign investment in Canada.[(103)] Many of these concerns were brought

(99) Industry Canada, *Canada Business Corporations Act Discussion Paper Directors' and Other Corporate Residency Issues*, August 1995. p. 1 (Directors' Residency Discussion Paper).

(100) The CBCA provides an exception to the majority requirement for holding corporations which earn less than five per cent of gross revenues in Canada. One-third of the directors of these corporations must be resident Canadians (s. 105(4)).

(101) CBCA ss. 114(3).

(102) CBCA, ss. 115(2).

(103) Directors' Residency Discussion Paper, p. 3.

forward in a number of studies of the issue of foreign investment in Canada which, among other things, discussed the need to provide for a Canadian presence on corporate boards.[104]

In addition to promoting Canadian national interests and ensuring that there would be a substantial Canadian presence on the boards of CBCA corporations, the directors' residency requirements were enacted to ensure that there would be directors resident in Canada who would be accountable for the actions of the corporation. It has been suggested that the residency requirements help to promote the enforcement of laws, especially where those laws make directors liable for corporate activities and provide a pool of local assets from which judgments can be satisfied. Thus it can be argued that, because they face potentially greater risks, local directors have a greater interest in seeing that a corporation abides by the law.[105]

The CBCA is not the only Canadian corporate statute with directors' residency requirements. The provincial corporate laws of Ontario, Alberta, Saskatchewan, Manitoba, Newfoundland and British Columbia have such requirements.[106] Four provinces, however - Nova Scotia, New Brunswick, Prince Edward Island and Quebec - do not impose directors' residency requirements.[107]

It is relatively easy to circumvent the application of the CBCA directors' residency requirements. The first and most obvious way is to incorporate in a jurisdiction that has no such requirements. Another is to use a unanimous shareholders agreement. Through such agreements, shareholders can restrict the powers of directors and transfer the directors' powers to themselves. Furthermore, a parent corporation can appoint nominee directors or choose directors who will not reflect a "Canadian perspective."[108]

It is also interesting to note that, even though resident Canadians must constitute a majority on board committees, there is no requirement that a quorum of resident Canadian committee members be present in order to conduct business.

There has been considerable debate about the need to impose residency requirements on corporate directors. Some argue that the requirements have an adverse impact on the ability of global-oriented Canadian companies to move into foreign markets. Others contend that the requirements serve to inhibit the inflow of investment capital into Canada.[109] Still others

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(104) *Report of the Royal Commission on Economic Prospects*, November 1957, *Foreign Ownership and the Structure of Canadian Industry*, Report of the Task Force on the Structure of Canadian Industry, January 1968, *Foreign Direct Investment in Canada*, 1972.

(105) Directors' Residency Discussion Paper, p. 7-8.

(106) *Ibid.*, p. 13.

(107) *Ibid.*, p. 9.

(108) *Ibid.*, p. 16.

(109) *Ibid.*, p. 1.

argue that they have outlived their usefulness in an era where the main concern is how to ensure that Canadian businesses become more active in foreign markets rather than to influence foreign investment in Canadian markets. In addition, as the Directors' Residency Discussion Paper points out, directors' residency requirements are not widespread, with only a few countries making them mandatory.(110)

Notwithstanding these concerns, support can be found for directors' residency requirements in terms of their potential to foster compliance with and enforcement of legal obligations, their ability to facilitate service of court documents, their role in promoting Canadian participation in the decision-making of multinational enterprises and their usefulness in aiding foreign firms to understand the political, social and economic environment of Canada.(111)

VIEWS EXPRESSED BY WITNESSES

Directors' residency was a topic of considerable discussion before the Committee. The basic argument in favour of residency requirements as expressed by one witness was that a company operating in Canada should have a board that will provide a Canadian perspective on issues discussed in board deliberations; further, it is in the national interest to embody such a requirement in a statute. According to one witness,

> *In my experience, it is typically advantageous to a company to secure advice from the best possible directors located in the country of operation. Our company tends to act that way wherever we operate. It would be unwise to establish operations in a foreign country without using local directors to help manage the business successfully.*
>
> *I have seen circumstances where the Canadian majority on a board made a difference for the better vis à vis the company and vis à vis Canada. Companies which are established in Canada with a foreign head office may not always appreciate the best way to proceed to the future. They are better served if there are a number of Canadian directors and a majority is sometimes better than not. My experience leads me to believe that this requirement is not something to which companies should object; it may well be in the best interests of Canada.*(112)

Further, the company referred to, which operates around the world, has not felt constrained in any way in attracting foreign directors by the requirement to have a majority of Canadian directors.

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(110) *Ibid.*, p. 22-23.

(111) *Ibid.*, p. 25.

(112) *Proceedings of the Task Force on Corporate Governance*, Issue No. 4, 4:71-72, (Mr. L.R. Wilson).

Another witness made a similar point in arguing for maintenance of the residency requirement.

Given the fact that, increasingly, there will be companies which are under the control of non-resident organisations, it is appropriate that a board should continue to have a majority of resident Canadians. It would be wise for an investor to do that anyway.

First, it is in its own interest to make sure that it has a good sounding board for what is happening in the country in which the board has its base and is making its principal decisions.

Second, the members of the board can also become good representatives of the company out in the broader community. There is a good practical reason why companies should do that. We should stick with the residency requirement.(113)

This witness also argued that the residency requirement should be extended to all committees of the board as well. Further, it is residency that matters, not citizenship. Canadians who have lived abroad for a long time may not be sensitive to domestic issues.

One witness argued that there is a role for a residency or citizenship requirement for directors

if a particular company or a particular industrial sector is considered to be so important to the national economy that it must, under no circumstances, run the risk of being managed other than with some view to the national interest.(114)

This is the only justification for a residency requirement.

Another witness was particularly strong in his opposition.

As a general rule, it is unfortunate that we need a majority of Canadian directors. If you are looking for significant corporate growth in this country, you must realise that there are only 20 million people living here from which to draw the required expertise. That is a pretty small pool. Dynamic corporate growth would lead to an interlocking situation where everyone wants the same group of directors because they have acceptance in the financial community. The concept of residency requirements is a little alien to the notion of going wherever you can to find the best directors possible.(115)

Support for the residency requirements was not overwhelming.

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(113) *Ibid.,* Issue No. 6, 22 February 1996, 6:17, (Hon. Donald Macdonald).

(114) *Ibid.,* 6:89, (Sir Graham Day).

(115) *Ibid.,* Issue No. 1, 13 February 1996, 1:32, (Mr. J.P. Bryan).

VIEWS OF THE COMMITTEE

The Committee considered the following options:

1. maintaining the residency requirement as is;

2. eliminating the residency requirement;

3. replacing the existing requirement with a less restrictive one such as:

    (i) a majority of the audit committee must be Canadian residents;

or

    (ii) at least two or three members of the board must be Canadian residents;

or

    (iii) maintaining the residency requirement for the board of directors but eliminating it for board committees.

The Committee was in agreement with the view that a company operating in Canada should have a board that will provide a Canadian perspective on issues that are discussed in board deliberations. As to embodying such a requirement in the CBCA, there was a consensus in the Committee, after discussion, that the requirement should remain. The Committee did not, however, see a need to extend this requirement to apply to board committees.

16. The Committee recommends that the existing CBCA residency requirement for the board of directors be maintained, but that it be eliminated for board committees.

THE INTERPLAY BETWEEN CORPORATE LAW AND SECURITIES LAW

Both the federal and provincial governments have the power to create corporations. The provincial power is found in section 92(11) of the *Constitution Act, 1867,* which gives provincial legislatures the power to make laws in relation to "the Incorporation of Companies with Provincial Objects." The federal incorporation power, while not explicitly set out in section 91 of the *Constitution Act, 1867*, is derived from judicial interpretation of the federal authority to make laws for the "peace, order and good government of Canada."

In practical terms, the division of powers between the federal and provincial governments means that a province can grant a provincially incorporated corporation the right to carry on business within the province of incorporation but not in other provinces. Provincially incorporated companies do, however, have the capacity to carry on business in other jurisdictions if they comply with the appropriate jurisdictional requirements. Corporations incorporated pursuant to federal law, on the other hand, are not limited by the boundaries of individual provinces and thus have the right to carry on business throughout Canada.

The power to incorporate companies must not be confused with the power to regulate the business activities of a corporation. The latter depends on two factors. These are aptly described by Professor Bruce Welling as follows:

> *One is the classic 'division of powers' question in Canadian constitutional law: is the particular activity the corporation wishes to pursue within one of the enumerated heads of power in s. 91 (federal) or s. 92 (provincial)? The other, more subtle factor, involves the corporate law question whether the activity is sufficiently intertwined with the essential nature of the corporation that legislation in relation to the activity is really legislation in relation to the very existence of the corporation.*[116]

The principal head of provincial power pertaining to the regulation of corporate activity is section 92(13) of the *Constitution Act, 1867,* which gives provincial legislatures the power to make laws with respect to "Property and Civil Rights in the Province." This broad power, which includes jurisdiction over labour relations and contracts, can be used to regulate the majority of corporate activities in a province, irrespective of the incorporating jurisdiction.

(116) Welling, (1991), p. 11.

It can be generally stated that most federally incorporated corporations carrying on business in a province will be subject to provincial laws pertaining to their activities.[117] The principal exception to this rule is that a province may not impair the "status and essential powers" of a federally-incorporated corporation. This means that a valid provincial law with the effect of impairing the essential powers of a federal company will not apply to the federal corporation.[118]

Many of the legal cases that have dealt with the "status and essential powers" question have arisen in the context of securities regulation, which has historically been dealt with at the provincial level. One case held that provincial legislation requiring all corporations to obtain a certificate from a provincial commission before selling their securities in the province was *ultra vires* in relation to a federally incorporated corporation's sale of its own shares. The court concluded that the ability of a corporation to raise capital was critical to its existence and that the application of the provincial statute to a federal company would constitute a substantial impairment of the status and essential capacities of the company.[119] On the other hand, a provincial law which required all securities brokers to be licensed and required corporations to sell securities through these licensed individuals was held to apply to federal corporations.[120]

There is a no clear line between between corporate law and securities law. One legal scholar notes that it is not easy to determine where one stops and the other begins. He explained the situation this way:

> *The borderline can perhaps best be explained as the point at which a corporation's shares are made generally available to anonymous investors rather than held exclusively among a group of people whose interrelationship is based on more than their common shareholdings. Among the closely knit group, many interpersonal issues are involved and most are likely to be resolved by reference to the statute and corporate constitution. When securities are made available to investors generally, whether by stock exchange listing or otherwise, the commodity aspect of the securities -- now more investment vehicles than tickets to participation in corporate government -- becomes more important.*[121]

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(117) It should be noted that aeronautics, broadcasting, telephone networks, atomic energy and interprovincial transportation, among other sectors, are federally regulated. In these cases, the essentials of a corporation's business activities would be governed by federal legislation.

(118) Peter W. Hogg, *Constitutional Law of Canada*, Third Edition, Carswell, 1992, p. 612.

(119) *Ibid.*, p. 614.

(120) *Ibid.*, p. 615 (*Lymburn* v. *Mayland* [1932] A.C. 318).

(121) Welling, (1991), p. 362-363.

The shifting nature of this line between corporate and securities law is evidenced in the regulation of insider trading -- an area that is governed by both corporate statutes and securities laws.

THE REGULATION OF INSIDER TRADING

A. Background

Generally, "insiders" are people who have access to confidential information about a corporation that can have a material impact on the value of the corporation's securities. Insider trading has been described as the purchase or sale of the securities of a company by a person who has access to confidential information not known to other shareholders or to the general public.[122] As Industry Canada's Insider Trading Discussion Paper points out, insider trading *per se* is not illegal. Insiders are permitted to trade in the securities of the corporation to which they are insiders, provided they are not in possession of confidential information. What is proscribed is insider trading based on material non-public information.[123]

In 1965, an Ontario government study on the securities legislation in Ontario, the Kimber Report, recommended that insider trading be regulated. The report did not propose the banning of insider trading but recommended that insiders be required to disclose trading activity and not engage in improper trading.[124]

These recommendations found their way into provincial legislation and into the *Canada Business Corporations Act* (CBCA).[125] At the provincial level, insider trading tends to be regulated by provincial corporations legislation and securities statutes, although some provinces do not have insider trading provisions in their corporations Acts. Insiders of CBCA corporations are often subject to provincial securities laws as well as the applicable provisions of the CBCA.

The fact that insiders of federally incorporated companies are subject to two reporting and liability regimes has been a source of concern. The overlap and duplication of the federal and Ontario requirements was the subject of a Supreme Court of Canada decision in the early 1980s. In the 1982 case *Multiple Access Ltd.* v. *McCutcheon*, the Supreme Court of Canada held that provisions of the Ontario *Securities Act*, which provided for compensation for loss suffered as a result of insider trading applied to a federally incorporated corporation even though the corporation was subject to similar insider trading requirements under federal law. The majority of the Court held that the insider trading provisions of the *Canada Corporations Act* and the

(122) *Multiple Access Ltd.* v. *McCutcheon et al.* (1982), 138 D.L.R. (3d) p. 3 (SCC).

(123) Industry Canada, *Canada Business Corporations Act, Discussion Paper, Insider Trading*, February 1996, p. 2-3 (Insider Trading Discussion Paper).

(124) J.R. Kimber, Chairman, *The Report of the Attorney General's Committee on Securities Legislation in Ontario*, Toronto, 1965.

(125) Insider trading provisions were first introduced into the *Canada Corporations Act* in 1970 and then into the *Canada Business Corporations Act* in 1975.

Ontario *Securities Act* were valid. Writing for the majority, Dickson, J. concluded that the impugned provisions of the *Canada Corporations Act* have a general corporate purpose and a rational, functional connection with company law.[126]

> *Providing safeguards against the malfeasance of the managers is strictly within what might properly be called the constitution of the company. The proper relationship between a company and its insiders is central to the law of companies and, from the inception of companies, has been regulated by the legislation sanctioning the company's incorporation.... [T]he impugned provisions of the Canada Corporations Act are directed at preserving the integrity of federal companies and protecting the shareholders of such companies; they aim at practices, injurious to a company or to shareholders at large of a company, by persons who, because they hold positions of trust or otherwise are privy to information not available to all shareholders.*[127]

The majority of the Court went on to find that the relevant sections of the Ontario *Securities Act* were also a valid exercise of provincial jurisdiction over property and civil rights and that these provisions did not "sterilize the functions and activities of a federal company nor ... impair its status or essential powers."[128] They found that insider trading provisions have both corporate law and securities law aspects. Because the majority considered these aspects to be of roughly equal importance, they felt that there was no reason to allow one to prevail over the other.

A minority of three judges, however, took a different view. They held that the federal insider trading provisions were *ultra vires,* while the Ontario *Securities Act* provisions were constitutionally valid. The minority concluded that the Ontario provisions were directed to regulating the holding and trading of securities in Ontario. The central thrust of the securities legislation was not the constitution of the corporation but the regulation of trading in the corporation's securities.[129]

With respect to the issue of the constitutional validity of the federal insider trading provisions, the minority held that these were not essential to the constitutional and functional aspects of a federal corporation and were therefore invalid.[130]

It is worth noting that the majority decision and, notwithstanding its conclusion with respect to the federal requirement, the minority decision in *Multiple Access* commented on the

(126) *Multiple Access Ltd.* v. *McCutcheon et al.* (1982), 138 D.L.R. (3d) p. 18 (SCC).

(127) *Ibid.*, p. 15.

(128) *Ibid.*, p. 19.

(129) *Ibid.*, p. 45.

(130) *Ibid.*, p. 48-49.

implications of the decision for a federal securities regulatory scheme. In this regard, Dickson J., stated:

> *I should not wish anything in this case to affect prejudicially the constitutional right of Parliament to enact a general scheme of securities legislation pursuant to its power to make laws in relation to interprovincial and export trade and commerce. This is of particular significance considering the interprovincial and indeed international character of the securities industry.*(131)

The minority also made it clear that the case was argued on specific grounds which did not include a claim that the federal insider trading provisions could be sustained under the federal trade and commerce power because of the extraprovincial nature of securities trading. They left the door open for federal intervention in the securities field.

> *I venture to say that there will be more and more challenges in the future to the dominant position now occupied by the securities exchange authorities of the province in which the major stock exchange of the country is located. As the magnitude and number of multi-provincial security transactions increase, the strain on the present unbalanced regulatory system will mount. It remains to be seen whether this will precipitate a change in the national appreciation of constitutional requirements and federal legislative policy. Until such a development occurs the disposition of this appeal must be found in the light of the positions herein taken by the parties. The reasons therefore reflect only the record as advanced by the proponents and opponents of the traditional arguments on the constitutional nature of corporate and securities legislation.*(132)

B. Insider Trading under the *Canada Business Corporations Act*

The insider trading provisions of the CBCA are found in Part XI of the Act. For the most part, they deal with insiders of "distributing corporations." A "distributing corporation" is defined as a corporation whose shares have been part of a distribution to the public and remain outstanding and are held by more than one person.

An "insider" is defined as a director or officer of a distributing corporation, a distributing corporation that purchases or otherwise acquires its own shares (except a redemption of redeemable shares) or shares issued by an affiliate, or a person who beneficially owns more than 10% of the shares of a distributing corporation or who exercises control or direction over more than 10% of the votes attached to shares of a distributing corporation.

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(131) *Ibid.*, p. 10-11.

(132) *Ibid.*, p. 49.

1. Requirement to File Reports

A person who becomes an insider of a distributing corporation is required within 10 days after the end of the month in which he or she becomes an insider to send a report to the Director under the CBCA. Further insider reports are required within 10 days following the end of the month in which there is any change in the person's interest in securities of a distributing corporation.

A person who without reasonable cause fails to file an insider trading report is subject to a maximum fine of $5,000 and/or to imprisonment for a term of up to six months. If the person is a corporation, any director or officer who knowingly authorized, permitted or acquiesced in the failure to file a report is also subject to the same penalties.

2. Prohibition against Speculative Trading

The CBCA prohibits insiders from selling shares that they do not own or have a right to own (short selling) and from buying or selling a call option or put option in respect of a share of a distributing corporation of which they are insiders (s. 130). Insiders can sell shares if they own the shares and have fully paid for them, if they own another share convertible into the share sold, or if they own an option or right to acquire the shares that were sold.

3. Civil Liability

Under subsection 131(4) of the CBCA, an insider (as defined in subsection 131(1)) who, in connection with a transaction in a security of the corporation, makes use of specific confidential information for his or her own benefit that, if generally known, might reasonably be expected to affect materially the value of the security, is liable to compensate anyone who has suffered a direct loss as a result of the transaction; and such an insider is accountable to the corporation for any direct benefit or advantage he or she has received. These liability provisions apply to transactions in connection with distributing and non-distributing corporations.

An action to enforce the rights granted by this provision must be commenced within two years after the discovery of the facts that gave rise to the cause of action or, where the transaction is required to be reported, within two years from the time of the reporting (s. 131(5)).

C. Insider Trading under Provincial Legislation

As mentioned earlier, insider trading is also governed by provincial legislation. A number of provincial securities laws require insiders to report trading in the shares of the corporations of which they are insiders. These reporting requirements apply to insiders who trade in the securities of "reporting issuers" -- corporations whose shares are widely traded and must file reports with provincial securities commissions. These laws also contain liability provisions in respect of improper insider trades.

Most provincial corporations statutes also contain insider trading provisions. In some provinces they deal only with the liability of insiders of corporations that do not offer their securities to the public (Ontario, Alberta); in others (Manitoba, Saskatchewan, British Columbia) they cover all corporations incorporated pursuant to the particular statute and do not distinguish between publicly traded and privately held corporations. Some provinces, however, such as Prince Edward Island, Nova Scotia and Quebec, have no insider trading provisions in their corporations laws.

AMENDING THE CBCA REQUIREMENTS

The Insider Trading Discussion Paper points to three approaches to amending the insider trading provisions of the CBCA. These are:

- eliminating the CBCA insider trading requirements in their entirety and leaving the regulation of insider trading to the provinces;

- eliminating only the insider reporting provision of the CBCA and leaving the collection of such information to the provincial securities statutes;

- maintaining the CBCA insider trading requirements while harmonizing them with the provincial requirements.[133]

A. Eliminating All CBCA Insider Trading Requirements

The Discussion Paper presents arguments for and against repealing all the CBCA insider trading provisions. The key arguments in support of this are that the provisions largely duplicate the requirements of provincial securities legislation with respect to public companies and constitute an unnecessary regulatory and financial burden on corporations. It has been suggested that these burdens may impair the competitiveness of federally incorporated companies.[134]

There are equally persuasive arguments against repealing the CBCA insider trading provisions. Again, the Discussion Paper points to the following:

(a) the regulation of insider trading fulfills important corporate law objectives such as the promotion of good relations between management and shareholders and dealing with conflict of interest situations;

(b) there would be only a small reduction in duplication and enforcement options would be limited;

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(133) Insider Trading Discussion Paper, February, 1996, p. 6.

(134) *Ibid.*, p. 7-8.

(c) there are still important differences among provincial securities laws and maintaining the CBCA requirements would guarantee a minimum level of regulation for CBCA corporations;

(d) the provisions allow the federal government to participate in the regulation of insider trading and to ensure uniform requirements for CBCA corporations;

(e) maintaining jurisdiction over insider trading allows the federal government to achieve its policy objectives in the field.(135)

Although insider trading was a topic of considerable discussion before the Committee, there was little mention of the need to eliminate the insider trading requirements of the CBCA. One witness, however, felt that the CBCA was not the right forum for addressing insider trading at the federal level.

The Committee believes that it is important to retain insider trading provisions within the CBCA. At the same time, the Committee recognizes that the present federal insider trading regime is outmoded and has been supplanted by provincial securities laws.

The Committee would prefer that the federal government direct its efforts toward harmonizing the CBCA's insider trading regime with provincial requirements in order to eliminate overlap and duplication.

The harmonization of federal and provincial requirements could be accomplished in a number of ways. One method would be through the incorporation by reference within the CBCA of relevant provincial securities law provisions.

Another way would be through the use of regulations; much of the federal insider trading regime could be set out in regulations under the CBCA. The use of regulations would allow the federal provisions to be updated as needed and ensure that change could be undertaken quickly.

B. Eliminating the Insider Reporting Provision of the CBCA

As mentioned earlier, the insider trading provisions of the CBCA have three components: insider reporting; a prohibition against speculative trading; and civil liability.

In addition to examining whether the CBCA insider trading provisions should be eliminated in their entirety, the Insider Trading Discussion Paper looked at the possibility of repealing only the insider reporting component of those provisions.

Virtually all insiders who are required to file a report under the CBCA must also file reports with the applicable provincial securities commissions. Although not identical, there is a

(135) *Ibid.*, p. 8-9.

substantial degree of overlap in the provincial securities law and the CBCA definition of "insider" and the provincial concept of "reporting issuer" and the CBCA notion of "distributing corporation." A CBCA "distributing corporation" is a "reporting issuer" for insider trading purposes except in the following circumstances:

- if a CBCA corporation distributes securities in a foreign country but not in Canada;
- if a CBCA corporation distributes securities only in Prince Edward Island, New Brunswick, the Northwest Territories or Yukon;
- if the provincial securities regulator exempts a reporting issuer from filing insider trading reports and a similar exemption is not granted under the CBCA.(136)

Furthermore, the CBCA has a somewhat broader definition of insider, which, unlike the definition in provincial securities laws, includes:

- distributing corporations that purchase securities of their affiliates;
- 10% shareholders of companies that become insiders of the distributing corporation or of which the distributing corporation becomes an insider and the directors and officers of the 10% shareholders;
- a director, officer or 10% shareholder of a distributing corporation who enters into a business combination with a body corporate.(137)

In spite of the differences, only a small group of persons would be subject to only the CBCA reporting requirements; the substantial majority of insiders fall under both regimes.

There have been efforts to ease the regulatory and paper burden on insiders who must report under more than one regime. The form for filing insider reports under the CBCA is identical to the form used under several provincial securities laws. Under section 127(8) of the CBCA the Director appointed under the Act can exempt persons from the requirement to file a report. In addition, section 258.2 of the CBCA, enacted in 1994 but not yet proclaimed, will allow the Director to issue a blanket exemption from CBCA filing requirements where similar reports are required to be filed under other federal or provincial legislation.(138)

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(136) *Ibid.*, p. 11.

(137) *Ibid.*, p. 12.

(138) Section 258.2 provides as follows: In the prescribed circumstances, the Director may, by order made subject to any conditions that the Director considers appropriate, exempt from the application of any provision of this Act requiring notices or documents to be sent to the Director such notices or documents or classes of notices or documents containing information similar to that contained in notices or documents required to be made public pursuant to any other Act of Parliament or to any Act of the legislature of a province as are specified in the order.

Insider trading reporting requirements were discussed at length before the Committee. While some witnesses made note of the duplicative filing requirements for insiders of CBCA corporations, they did not generally feel that the requirements were a major obstacle to doing business or a significant regulatory burden. That insiders of public corporations may have to comply with regulatory regimes at the federal level and with many of the provincial securities acts seemed to be accepted as a fact of business life in Canada.

Eliminating the insider reporting requirements was not a significant issue for the witnesses. Their concern tended to focus on the harmonization of federal and provincial legislative requirements. One witness asked that the CBCA "not codify areas that are still in flux or subject to constant change but, rather, that it establish a mechanism which can incorporate the best of the changes occurring in overlapping and inter-related rules, regulations and laws."(139)

Another witness put it this way:

> *... to achieve greater uniformity, there should be a tremendous amount of flexibility in the federal law, so that when someone does establish what is widely accepted as a better model -- let us say for regulating insider trading -- it is adopted in the federal law. That way, we get uniformity and the federal law is still seen as an exemplary and up-to-date model law for all other jurisdictions.*(140)

Yet another witness called for greater harmonization between the federal and provincial legislative provisions that affect capital markets. He expressed the following view:

> *My basic proposition is that the CBCA must be maintained in a state that works for the modern corporation, and if the federal government believes it has a role in capital market regulation and that role is discharged through provisions of the CBCA, then the terms of the CBCA that affect capital market activity must be, if not be uniform with provincial provisions, at least compatible or consistent with provincial provisions.*(141)

The Committee does not see a need to eliminate the CBCA insider trading reporting requirements. Where duplication and overlap exist, the Director under the CBCA should use individual and, when available, blanket exemptions to reduce the burden of duplicate filing requirements. In addition, every effort should be made to promote electronic filing and to modernize the relevant provisions of the CBCA.

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(139) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:69, (Ms. Rhondda Grant).

(140) *Ibid.*, 1:84, (Mr. John Howard).

(141) *Ibid.*, Issue No. 5, 21 February 1996, 5:80, (Mr. Peter Dey).

17. The Committee recommends that the insider trading reporting provisions of the *Canada Business Corporation Act* be retained and modernized and duplicate filings be eliminated to the extent possible through exemption orders.

MODERNIZING THE CBCA INSIDER REPORTING REQUIREMENTS

The Insider Trading Discussion Paper sets out a number of proposals for modernizing the insider trading provisions and the insider reporting requirements in particular. Of these, the time for filing insider trading reports was most widely discussed before the Committee. As a result, the following discussion will be confined to this area of concern.

Under the CBCA, insider reports must be filed within 10 days after the end of the month in which a person becomes an insider or makes a trade. The same time periods apply under Ontario, Manitoba, Nova Scotia and Newfoundland law. Other provinces, such as Alberta, British Columbia, Quebec and Saskatchewan, require reports to be filed within 10 days after becoming an insider or making a trade.(142)

Thus, under the CBCA, a trade that took place at the beginning of one month would not have to be reported until the tenth day of the following month. By the time the trade was published in the Corporations Bulletin, some three months would have elapsed since the trade had taken place.

A number of witnesses argued for more timely disclosure of insider trading. Some suggested that reports should be filed on the day the transaction is completed. The case for timely disclosure was aptly put by one witness in the following manner:

> *... one of the things you are very concerned about in a public company is timely disclosure. Timely disclosure means when you know, everyone else had better know. I have been an insider and reported to a number of organizations, and I am an insider on a number now. We report monthly. In essence, there is a month's delay. It seems to me, in the present era of universal instantaneous communications and computer-based tracking, that the appropriate time to report is the day the trade happens. That is possible to do. I suggest that anything later than the day the trade happens is, indeed, inconsistent with the concept of timely disclosure. Publishing a month an a half after a large block is traded that it was really an inside transaction is not timely information.*(143)

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(142) Insider Trading Discussion Paper, p. 14.

(143) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:149, (Mr. Gordon Cummings).

Although favouring more timely disclosure, another witness suggested that it may be difficult for some large institutional investors to report trades on a same-day basis.

The Committee supports the notion of more timely disclosure of insider activities. The Committee notes that the 1994 amendments to the CBCA (not yet in force) provide for the filing of notices and documents by electronic means.[144] Thus, the CBCA will be equipped to accommodate more timely disclosure.

The Committee would not favour a requirement for the same-day filing of insider reports, however, until such time as instantaneous communication is widespread and it has been established that insiders have the ability to comply with such a requirement. In the interim, the Committee, favours two proposals that would improve the timeliness of the reporting requirements:

18. The Committee recommends that the time given for insiders to report trades, or declare that they have become insiders be decreased to within 10 days of their becoming an insider or making a trade.

19. The Committee recommends that the time period for persons to declare that they have become insiders or to report trades be prescribed by regulation rather than in the CBCA itself. This would make it easier to update and to harmonize federal time frames with those of the provinces.

(144) CBCA, s. 258.1(1).

CHAPTER 5

SHAREHOLDER COMMUNICATION AND PROXY SOLICITATION RULES

INTRODUCTION

In August 1995, Industry Canada issued the discussion paper *Shareholder Communications and Proxy Solicitation Rules* (Shareholder Communications Discussion Paper).[145]

The issues addressed in the Discussion Paper include:

- whether the *Canada Business Corporations Act* should be amended to require intermediaries to provide share issuers with the lists of beneficial shareholders;

- whether to harmonize the CBCA with National Policy 41 by amending the definition of "registrant";

- whether to amend the CBCA with respect to:

  a) the record date for determining shareholders entitled to receive notice of annual or special meetings;

  b) the period which notice of annual meetings shall be sent to shareholders;

  c) the record date for purposes other than those regarding notice of or votes at annual or special meetings;

- whether the CBCA should provide for a fixed record date for the voting of shares;

- whether the CBCA should specify voting right entitlement for loaned shares;

- whether the rules governing the mandatory solicitation of proxies should be harmonized with provincial securities and corporate laws, specifically,

  a) whether the CBCA should be amended to require that the management of all distributing corporations should be covered by mandatory proxy solicitation rules;

  b) whether the CBCA should be amended to exempt management of a non-distributing corporation with fewer than 50 shareholders (rather than the current 15) from having to

(145) Industry Canada, *Canada Business Corporations Act, Discussion Paper, Shareholder Communications and Proxy Solicitation Rules*, August 1995.

send a form of proxy to each shareholder who is entitled to receive notice of a meeting of shareholders;

- whether the CBCA proxy solicitation rules should be amended in a manner similar to those recently adopted by the Securities and Exchange Commission in the United States, particularly in the area of communications among shareholders.

During its hearings, the Committee received a number of representations on the issue of whether the CBCA should be amended to require intermediaries to provide share issuers with lists of beneficial shareholders and the question of communications among shareholders. As a result, this chapter of the report is limited to a discussion of these issues.

COMMUNICATIONS BETWEEN CORPORATIONS AND SHAREHOLDERS

A. Background

The Shareholder Communications Discussion Paper describes three developments that have affected the ability of corporations to communicate with their shareholders: the nominee system, the depository system, and National Policy 41.

The discussion of these developments presented in the Discussion Paper is set out below.

B. The Nominee System

The CBCA provides that a corporation is required to send shareholders corporate information, such as notices of meetings, proxy-related materials, and audited financial statements. The growth of two kinds of shareholders -- beneficial and registered -- has made the sending of this material more problematic.

Beneficial shareholders are persons who have purchased shares and are entitled to dividends and capital gains but who may not be registered on the corporation's records for the purposes of voting at annual meetings. Often a depository, broker or other intermediary is listed as the registered owner.

The Discussion Paper points out that over the past few decades shareholder ownership practices have changed; in the past individual shareholders had possession of their share certificates and had their names recorded on the books of the corporation as shareholders while today shares of publicly traded corporations are registered in the names of nominees, rather than the individuals who have actually bought them.

Under the nominee system, intermediaries hold securities in "nominee form", and maintain a list of the beneficial owners they represent. Because the issuing corporation shows the intermediary as the registered shareholder, it does not know the beneficial owner of the shares.[146]

C. The Depository System

The growth of the depository system increased the distance between the corporation and its beneficial shareholders. In the 1970s, securities depositories were developed to facilitate the trading and settlement of securities by eliminating the need for delivery of share certificates between intermediaries. Most securities are held on deposit with clearing agencies for intermediaries and ownership changes are made through book-entry transfers in the appropriate accounts. An important aspect of the nominee and the depository systems is that when shares are traded, the shareholders' register of the corporation does not have to be changed.[147]

D. National Policy 41

National Policy Statement Number 41, instituted in 1987 by the Canadian Securities Administrators, sets out obligations for share issuers, intermediaries and clearing agencies with respect to shareholder communications. It creates a regime whereby issuers forward proxy materials to beneficial shareholders through the offices of intermediaries.[148]

NP 41 has been criticized on a number of fronts. Proposals are being examined that would allow corporations to obtain the names of the beneficial owners of its shares from intermediaries.[149]

AMENDMENTS TO THE CBCA

A number of witnesses who commented on shareholder communications described the changes that have occurred in the past two decades. One witness noted that it is now much more difficult to identify a corporation's shareholders.

> *... [I]n the early 1970s, ... it was quite frequently the case that one could identify 60 or 70 per cent of the shareholders, whether corporate or individual, in a large, widely held company, and keep a pattern of communication with them .... One would hear from individuals a lot more in those years.*

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(146) *Ibid.*, p. 3-4.

(147) *Ibid.*, p. 4.

(148) *Ibid.*, p. 4-5.

(149) *Ibid.*, p. 7.

Twenty years later, in the early 1990s, that proportion had dropped from 60 or 70 to about 10 per cent. The other 80 or 90 per cent of the shares of many large, widely held companies had become a kind of commodity that was bought and sold by way of computer programs by large financial institutions without any particular sense of continuing identification with the company as a shareholder.[150]

Another witness described the effect of having shares held electronically in the following manner:

Shares are now held electronically by brokers. They are held electronically by banks if they are used as collateral for loans. No paper is involved. If you insist on getting paper, they make it as difficult for you as they can. They charge you a special fee. They tie the transaction up so that if you want to sell the shares, you can never sell them in a timely way. You have to get the paper and transmit them yourself.... If you hold them electronically, the corporation that you own the shares in initially will not know who you are. The result is that you will not get the annual statements, the quarterly statements, or any other statement that the corporation may want to issue to its shareholders.

If you are a sophisticated shareholder, you can demand to get this information. It is now made available to you in connection with an annual meeting, but not in connection with quarterly statements or special communications.... Even if the companies provide this information, it arrives too late to be acted upon.[151]

Yet another witness described his frustration at not knowing who his shareholders are:

It is extremely frustrating for me not to know who my shareholders are. When I did an initial public offering a few years back, one of the great surprises was discovering the next day that I had lost track of who my shareholders were. I could not send communications directly to my shareholders....

I am working through a series of intermediaries. That is to say, I work with the trustee and the trustee distributes the documents to the shareholders. It is inconceivable, especially if you put yourself in my

(150) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:134, (Mr. Bob Blair).

(151) *Ibid.*, Issue No. 3, 19 February 1996, 3:24-25, (Mr. J. William E. Mingo).

> *context where I run a telecommunications company, not to know who the shareholders are and not to be able to make mass distributions to the shareholders. It is so easy today to do that. There are Internet access files, and so on. It is almost inexcusable.*[152]

Mr. L.R. Wilson commented on the need to establish effective lines of communication with shareholders and on the proposal contained in the Shareholder Communications Discussion Paper:

> *According to the TSE report on corporate governance, one of the principal responsibilities of a board is to ensure that the corporation has a policy in place to communicate effectively with its shareholders. In particular, the policy must accommodate feedback from shareholders. To achieve this objective and to establish effective lines of communication with our shareholders, we need the ability, first, to know who they are and, second, to be able to communicate directly with them.*
>
> *Currently, more than 70 per cent of BCE shares are held through nominees, including securities depositories. Under the current rules, we cannot communicate directly with our non-registered shareholders. I understand that the proposal from Industry Canada with respect to this issue is to allow direct communication with non-objecting beneficial shareholders but only with respect to "communications requirements under the CBCA associated with corporate governance."*
>
> *I see no reason to limit direct communication in this fashion. Unless a shareholder expressly requires that his or her identity be kept confidential, we should be able to communicate directly with all our shareholders on any matter concerning the business of the corporation in the same manner as we can with registered shareholders.*[153]

The general view expressed to the Committee was that the current system for communicating with shareholders does not work and must be improved. At best the present system is unsatisfactory, frustrating, costly, and time-consuming.

The Committee considered the present provisions of the CBCA and concluded that they must be amended to enhance shareholder communications.

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(152) *Ibid.*, Issue No. 4, 20 February 1996, 4:26, (Mr. Jan Peeters).

(153) *Ibid.*, 4:66-67, (Mr. L. R. Wilson).

20. **The Committee recommends that the *Canada Business Corporations Act* be amended to require registrants[154] to furnish to issuers, upon request, and with a fixed period of time, a list of all beneficial shareholders. This list could be used to communicate directly with non-registered shareholders in respect of matters relating to the business and affairs of corporation. Intermediaries would be permitted to withhold the names and addresses of beneficial shareholders who have requested in writing that their names not be given to issuers.**

In making the above recommendation to improve the ability of corporations to communicate with their shareholders, the Committee notes that other amendments may have to be made to the CBCA to broaden the definition of registrant to capture all intermediaries.

COMMUNICATIONS AMONG SHAREHOLDERS

A. Introduction

The Shareholder Communications Discussion Paper also deals with the issue of communications among shareholders.

Possible interpretations of paragraph 147(c) of the CBCA, which defines "communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy" as a solicitation, can result in significant problems for shareholders.

The Discussion Paper notes that under this definition, virtually all views expressed by shareholders, including informal discussions or personal letters criticizing management, could be deemed to be a solicitation under section 147. Violations of section 147 carry a fine as well as a term of imprisonment. In addition, violators could be required to prepare and send proxy materials to all shareholders.[155]

The Discussion Paper puts forward a number of recommendations to facilitate communications among shareholders. First, the paper recommends that oral and written communications between shareholders be exempt from the proxy circular and disclosure requirements. This exemption would be granted in cases where the person communicating was not seeking proxy authority and written communications were made public by other means.[156]

(154) Under section 147 of the CBCA a "registrant" is defined as " a securities broker or dealer required to be registered to trade or deal in securities under the laws of any jurisdiction".

(155) Shareholder Communications Discussion Paper, p. 27-28.

(156) *Ibid.*, Executive Summary p. iii.

Other recommendations for facilitating communications among shareholders set out in the Discussion Paper include:

- changing the definition of "solicitation" to specify that a shareholder could publicly announce how he or she intended to vote and provide the reasons for that decision without having to comply with the proxy rules;

- exempting solicitations conveyed by public broadcast or speech or publication from the proxy circular delivery requirements, provided a definitive proxy circular was on file with the Director under the CBCA;

- allowing corporations and other soliciting parties to commence a solicitation on the basis of a preliminary proxy circular publicly filed with the Director; and

- requiring corporations to provide shareholders with copies of any list of non-objecting beneficial owners where those names were in the corporation's possession, in addition to the list of registered shareholders, as currently required.(157)

The Discussion Paper points out that in 1992 the U.S. Securities and Exchange Commission amended its proxy rules to foster more open communications among shareholders.(158)

B. Views of the Witnesses

The witnesses who commented on the issue of communications among shareholders favoured changes to the proxy rules to enhance shareholder communications.

The Chairman, President and Chief Executive Officer of BCE Inc., while not opposing the relaxation of the proxy rules, was concerned that appropriate checks and balances be put in place to prevent abuse.

> *... [A]ny new rules which would expand the scope and manner of shareholder communications should drafted in a balanced way. Checks and balances should be put in place to ensure that the laudable objective of increased shareholder communication among themselves is achieved without allowing abuse of that system.*
>
> *... The timing and accuracy of information presented in the media should be regulated to ensure that the interests of the corporation and its shareholders generally are fairly balanced against those of dissident shareholders. A company should be allowed sufficient time to rebut or to explain a position or to correct factual inaccuracies in*

(157) *Ibid.*

(158) Shareholders Communications Discussion Paper, p. 30.

response to a media campaign initiated by a dissident shareholder.[159]

A detailed presentation on the proxy solicitation rules was made on behalf of the Ontario Teachers' Pension Plan Board. It expressed support for the changes proposed in the Discussion Paper. It was the view of the Teachers' Pension Plan Board that the rule changes would foster a higher level of corporate governance and free institutional investors to communicate informally among themselves. Because of the level of detail in this presentation, it is useful to quote a substantial portion of the remarks of the President and Chief Executive Officer:

> *Among the discussion papers to date, the area in which Teachers' as an institution has the most interest is that of the contemplated changes in the proxy rule governing shareholder communications. The changes that have been proposed in the proxy rules are ones that should be greeted with enthusiasm by anyone concerned with effective corporate governance in Canada. Effective corporate governance is an ongoing process built on the foundation of continuing involvement by shareholders in the affairs of the corporation and with one another. Shareholders must be informed. They must conduct continual research on the company. They must review policies, prospects and decisions. When questionable decisions are made, they must indicate their concern. When good ideas surface that the company should review, shareholders must prod the company to consider them. The company, for its part, must assess the preference of shareholders and the views of the market, which is its best critic, on whether value is being realized.*
>
> *This process is founded on continual communication. Shareholders must speak with many people in the market. They must speak with each other to learn whether their views are widely shared or are a minority opinion. They must be able to speak with the company, as individuals or as a group. When a problem surfaces, they must be able to discuss their concerns; when a corporate proposal is made that demands opposition, they must be able to act.*
>
> *The Canadian proxy rules ... create substantial barriers to this kind of continued, informal communication among shareholders. As a result; they reduce the effectiveness of the oversight process. The result is detrimental to shareholders, corporations and the integrity of the process itself. The reforms proposed in the directorate's discussion paper would rectify the most significant problems with the rules and thereby spur a healthier, more-effective and, importantly, less contentious governance process.*

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(159) *Proceedings of the Task Force on Corporate Governance*, Issue No. 4, 20 February 1996, 4:67, (Mr. L.R. Wilson).

The current proxy rules were designed to protect investors from being misinformed, misled or manipulated by proxy solicitation undertaken either by management or by outside investors. They accomplish this task by requiring soliciting parties to prepare, distribute and file a dissident proxy circular and to make detailed disclosure about his or her organization, investment intent and trading history. In addition, each specific communication, whether it be a letter, advertisement or speech, triggers a dissident proxy circular obligation. In contentious, heated proxy contests for control waged between a determined raider and an entrenched management team, there is conceivably an argument that such dissident proxy circular requirements make sense. Even in these situations, though, one can make a strong argument that the rules interfere in a fundamental way with freedom of speech and with investors' rights to communicate freely about property that they own.

However, the impact of the rules on contentious control situations is not my concern here. The reason that the present laws have a deep impact on corporate governance lies in the fact that they do not solely apply to such extreme situations. Instead, they apply to virtually any communication among investors about a significant issue of corporate policy. The key factor in the rules that leads to this result is the definition of the term "solicitation". Solicitation is defined to involve any communication that can reasonably be calculated to result in the giving, withholding or revoking of a proxy. This means, as a practical matter, that virtually any expression of opinion by one shareholder to another can be construed to be solicitation.

The rules were written with one reason; the intent was sound. The idea was to prevent unscrupulous shareholders and management from front-running the solicitation process. Historically, such front-running occurred with regularity in the U.S. market prior to the mid 1950s, when the American proxy rules were written to incorporate a restrictive definition of solicitation that was similar to the one currently embodied in the Canadian rules. However, good though the intent of the rules may have been, the result, in a world of institutional investors who wish to become actively involved in corporate governance, is chilling. Informal communication is the lifeblood of an effective, informed governance process. That kind of communication is shifted by the rules. Shareholders are significantly restricted in their ability to voice opinion to each other, discuss views and concerns, or discuss possible remedies, without first preparing a dissident proxy circular. The result is that shareholders, who would otherwise work in cooperation with each other and with management, are pushed into isolation. They conduct their activities *alone and guard against slips in communication that could be argued to be proxy solicitation.*

[T]he staff at the Ontario Teachers' Pension Plan feel the pinch of the rules on an ongoing basis. There have been many occasions in the past few years when the Teachers' Plan has been concerned about corporate performance, or opposed to a corporate action, or interested in providing input on a voting or other issue of corporate policy. In those circumstances, Teachers' staff has conducted rigorous research and often offered quiet advice to management and boards. We have the concern that communication among shareholders could be construed to constitute solicitation under the present proxy rules. We have been somewhat frustrated with this aspect of the Canadian regulatory framework, which is supposed to protect shareholders but presents a significant barrier to the most mundane and obvious action that shareholders could and should take to protect themselves, namely, talking to each other.

In our view, the changes to the rules that have been proposed by the directorate are an entirely appropriate redress to the present situation. Disinterested investors under the proposed rules would be allowed to communicate freely with fellow shareholders without the problems associated with preparing a dissident proxy circular. We believe that this proposed change would have a profound effect on efficiency of the corporate governance process and would free us and other institutions to communicate informally with one another about the companies in which we invest. It is our belief that changing the proxy rules in the manner contemplated by the directorate would eventually lead to a higher level of corporate governance.

There is some fairly convincing empirical evidence to support the predictions I have just made. From 1956 through 1992, the U.S. proxy rules were virtually identical to the present restrictive Canadian rules. In late 1992, after approximately three years of careful debate and review, the U.S. Securities and Exchange Commission revised the rules in a manner virtually identical to the reforms that have been proposed.

We have spoken at length to governance experts in the U.S. about the effects of the new rules, which were somewhat controversial, particularly among members of the corporate community at the time of their passage. There is virtually universal belief that the rules changes in the U.S. have been highly beneficial, spurring a new, desirable kind of informed corporate governance activity. This is *true across the spectrum of governance observers, including many who voiced concern about the rules before they were adopted.*[160]

The Committee supports the thrust of the Discussion Paper's proposals to promote open and meaningful communications among shareholders.

21. The Committee recommends that the *Canada Business Corporations Act* be amended to encourage and facilitate communications among shareholders.

(160) *Ibid.*, Issue No. 6, 22 February 1996, 6:26-28, (Mr. Claude Lamoureux).

CHAPTER 6

TAKE-OVER BIDS AND GOING-PRIVATE TRANSACTIONS

INTRODUCTION

A take-over bid can be described as "an offer to all or most shareholders to purchase shares of a corporation, where the offeror, if successful, will obtain enough shares to control the target corporation."(161) The *Canada Business Corporations Act* defines a take-over bid in somewhat different terms as:

> *an offer, other than an exempt offer, made by an offeror to shareholders at approximately the same time to acquire shares that, if combined with shares already beneficially owned or controlled, directly or indirectly, by the offeror or an affiliate or associate of the offeror on the date of the take-over bid, would exceed ten percent of any class of issued shares of an offeree corporation and includes every offer, other than an exempt offer, by an issuer to repurchase its own shares.*(162)

The take-over bid provisions of the CBCA were first enacted as part of the *Canada Corporations Act* in 1970 and subsequently transferred to the CBCA in 1975.(163) The principal objective of these provisions is to protect the rights and interests of the parties involved in a take-over bid – the offeror, shareholders and the target corporation. A measure of protection is given by provisions that:

- require information germane to the decision on whether to accept or reject an offer to be given to the shareholders to whom a take-over bid is made (offerees);
- give offerees a period of time in which to review the information and make a decision;
- require that the board of directors of the target corporation be given information relevant to their decision on whether to recommend acceptance or rejection of the bid;
- give the target corporation's board of directors a period of time in which to assess the take-over bid;

(161) Industry Canada, *Canada Business Corporations Act, Discussion Paper, Take-over Bids*, February 1996, p. 2, (Take-over Bids Discussion Paper).

(162) *Canada Business Corporations Act*, s. 194.

(163) Take-over Bids Discussion Paper, p. 4.

- ensure that the offer is made to all shareholders of the shares sought to be acquired; and
- require all shareholders to be treated equally with respect to price and the portion of their shares which are taken up in an oversubscribed partial bid.(164)

The take-over bid provisions of the CBCA apply to all corporations whose shares are publicly-traded or who have more than fifteen shareholders. Provincial securities laws also govern take-over bids. Where a CBCA corporation is the target of a take-over bid, it may therefore be necessary to comply with both the CBCA and the securities laws of the provinces where the securities of the corporation are publicly traded.(165)

In February 1996, Industry Canada issued the discussion paper, *Canada Business Corporations Act, Discussion Paper, Take-over Bids* (Take-over Bids Discussion Paper). The discussion paper examined three broad issues: (1) repealing the CBCA take-over bid provisions; (2) amending the CBCA take-over bid provisions; and (3) defensive measures. The paper recommended keeping the take-over bid provisions and set out 23 proposals for amending them.

The comments received by the Committee were largely concerned with issues such as the take-over bid threshold, extending the minimum bid period and defensive mechanisms.

TAKE-OVER BID THRESHOLD

The present take-over bid provisions of the CBCA apply if an offeror, after making a bid for shares of the target corporation, would control or own more than 10% of any class of shares of the target corporation. The take-over bid provisions of provincial securities statutes have a threshold of 20%. According to the Take-over Bids Discussion Paper, bidders normally must acquire at least 20% of a publicly traded corporation's shares in order to gain control over the corporation.(166)

In order to harmonize the federal and provincial take-over bid thresholds, the Discussion Paper recommends that the CBCA threshold be increased from 10 to 20%.(167)

The witnesses who commented on the threshold issue favoured changing the CBCA threshold to 20%. The Committee considered retaining the current CBCA threshold provision, but the case for harmonization is persuasive. The Committee supports harmonizing the federal and provincial take-over bid thresholds.

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(164) *Ibid.*, p. 3-4.

(165) *Ibid.*, p. 4.

(166) *Ibid.*, p. 13.

(167) *Ibid.*

22. The Committee recommends that the *Canada Business Corporations Act* take-over bid threshold of 10% be increased to 20%.

EXTENDING THE MINIMUM BID PERIOD

A. Background

The take-over bid provisions of the CBCA distinguish between a "bid for all shares" and a "bid for less than all shares." While in both situations, an offeree has to be given at least 21 days after the date of the bid within which to tender his or her shares to an offeror, other time periods vary. In a "bid for all shares" there is no limit on the maximum time period permitted for the deposit of shares after the date of a take-over bid, while in a "bid for less than all shares" the shares must be deposited within 35 days of the date of the bid. The minimum number of days that must expire before an offeror can take up shares tendered pursuant to a bid also differs; in a "bid for all shares" an offeror must wait 10 days after the date of the take-over bid to take up shares; in a partial bid, 21 days.(168)

The Take-over Bids Discussion Paper notes that CBCA corporations may have difficulties because the CBCA and provincial securities legislation do not contain the same time limits. The CBCA, for example, provides that shares deposited under a take-over bid can be withdrawn by an offeree shareholder up to ten days after the date of the bid; provincial securities laws, on the other hand, specify a 21-day withdrawal period.(169)

The Discussion Paper also suggests that the relatively short time periods provided in the CBCA may not give corporations and their directors sufficient time to consider a take-over bid properly, make recommendations to shareholders, and seek competing bids, if necessary.(170)

The idea of increasing beyond 21 days the minimum period that shareholders have to consider a bid has been discussed for some time. The Take-over Bids Discussion Paper notes that in 1990 the Canadian Securities Administrators proposed extending the minimum bid period as well as certain other relevant time periods from 21 days to 35 days. It also points out that in September 1995, the Ontario Teachers' Pension Plan Board recommended that the CBCA and provincial securities laws be amended to extend the minimum bid period from 21 to 35 days.(171)

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(168) *Ibid.*, p. 31.

(169) *Ibid.*, p. 29.

(170) *Ibid.*

(171) *Ibid.*, p. 29-30.

B. Defensive Mechanisms -- Poison Pills

Proposals for extending the minimum bid period are also driven by the increased use of "poison pills" or shareholder rights plans. Poison pills are plans designed to thwart unwanted take-over bids or to provide the corporation's management with more time to analyze a bid. They have the effect of extending the 21-day period that shareholders have to consider a bid and typically allow the target company to issue new shares at a significant price discount to existing shareholders except the bidder, in order to make the take-over prohibitively expensive.[172]

A recent issue of *Business Quarterly*[173] contained the following description of a shareholders right plan:

> *Under a shareholders rights plan, the holders of common shares of a company receive one right -- an option to buy more shares -- for each share held. The rights have a set expiry date and do not carry a vote. They are worthless initially because the price at which they can be exercised is set higher than the current market price. They trade together with the shares, so that a shareholder cannot sell a right without selling the share to which it is attached....*
>
> *If a so-called triggering event occurs, however, the rights begin trading separately from the shares. In Canada, the most common triggering event occurs when a group or individual (the acquiror) obtains more than a specified percentage of the shares (threshold level). Then the rights can be exercised to purchase shares at a 50% discount from the current market price. The rights of the group causing the triggering event, however, become void and cannot be exercised. All the shareholders except the acquiror can exercise their rights to purchase shares for half price. This action results in a substantial dilution in the share holdings of the acquiror, making it extremely expensive to attempt a takeover bid.*

There are essentially two competing views about the effects of poison pills: the shareholders' interest view and the management entrenchment view. According to the former, poison pills enable management to block a bid that is too low, force the bidder to make a more palatable offer or allow management to seek out another party with a better offer. This view suggests that the purpose of management's actions is to enhance shareholder wealth.[174]

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(172) *Ibid.*, p. 4

(173) Liza Kessler, Ameera Dawood, "Poison Pills: How Toxic Are They?", *Business Quarterly*, Summer 1995, Vol. 59, No. 4, p. 48.

(174) *Ibid.*, p. 49.

The management entrenchment view, on the other hand, suggests that poison pills are used for the benefit of management rather than of shareholders. Because senior managers and directors are usually replaced after a take-over, measures designed to deter or block a take-over are employed to preserve management positions.[175]

The early versions of the poison pill were often criticized by shareholders as giving too much discretion to management. Indications are that in Canada poison pills now appear to be less onerous and more acceptable to shareholders.

The view that the worst aspects of the poison pill have been eradicated was expressed by a number of witnesses who appeared before the Committee. One witness noted that poison pills have been modified significantly over the past two or three years largely in response to the concerns expressed by institutional investors.[176]

Mr. Jean-Claude Delorme put it this way:

> *Concerning the shareholder rights plan, and in particular the poison pills, the situation has changed greatly since the first poison pills came out at the beginning of the eighties. A great many corporations today have plans that are supposedly shareholder rights plans, and which, compared to what they were 10 or 15 years ago, are essentially acceptable.*
>
> *In a general way, shareholders tend to accept that type of plan inasmuch as it merely extends the deadline of a takeover bid.*
>
> *According to the legislation, there must be a minimum 21-day period. In some cases, this is complied with. In other cases, the circumstances would warrant a somewhat longer deadline, if only for the benefit of the shareholders or because of the complexities of a deal.*
>
> *You might consider the possibility of extending that time limit to, for example, 45 days.*[177]

Another witness gave a specific example of how his company's poison pill was altered after discussions with shareholders.

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(175) *Ibid.*

(176) *Proceedings of the Task Force on Corporate Governance*, Issue No. 3, 19 February 1996, 3:26, (Mr. J. William E. Mingo).

(177) *Ibid.*, Issue No. 4, 20 February 1996, 4:12, (M. Jean-Claude Delorme).

> *In our so-called "poison pill", we started with 90 days. We had that provision for five years, from 1990 to 1995. When we went for renewal, in the course of negotiations with the institutional shareholders, we had to drop it to 75. They voted for that because we were able to convince them that it is not possible in less than 75 days to make a valuation of an international company such as ours.*(178)

The consensus among witnesses who addressed the time period during which shareholders could deposit shares in response to a take-over bid was that the 21-day period was too short. Some were of the view that poison pills were a direct response to this; in other words, they served as an instrument to extend the 21-day period and to provide the time needed to properly consider or counter a take-over bid. Indeed, one witness suggested that keeping the time limit at 21 days would perpetuate poison pills.(179) Another felt that the shareholder rights plans in place today really just buy time. If the deposit period were extended to 45 days there might be fewer poison pills.(180)

Although there was a general consensus that the 21-day period was too short, and should be extended, witnesses had varying views as to what would be an appropriate period. The Take-over Bids Discussion Paper proposed that an offeree be given a minimum of 45 days from the date of a bid to deposit his or her shares. Some witnesses felt that a 45-day period would be acceptable. Others suggested something less than 45 days would suffice.

A different tack was taken by one witness. He felt that a legislated solution to the problem was not necessary. It was his view that shareholder rights plans are effective mechanisms for addressing this problem.

> *The take-over bid rules provide for 21 days before people can take up and pay for shares, and the comment is always made that a big complex multi-national corporation cannot respond effectively within 21 days to create shareholder value and to test the market for alternatives....*
>
> *Everyone recognized that, but the original 21 days was simply designed to give offeree shareholders time to absorb the information in the bid. It was not designed to enable the target shareholders and the target board of directors to manage the affairs of the corporation. That is a corporate responsibility.*

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(178) *Ibid.*, Issue No. 6, 22 February 1996, 6:134, (Mr. P. K. Pal).

(179) *Ibid.*

(180) *Ibid.*, Issue No. 1, 14 February 1996, 1:111, (Mr. George Watson).

The community, then, was creative. It came up with the shareholder rights plan as opposed to the poison pill. Through a mechanism, it was able to come up with a solution to the target directors' fiduciary obligation issues. Some companies need 90 days, some need 60 days and some need four or five months, but it was a response developed in the private sector that could be customized to the circumstances of each corporation. That is where it should stay. It does not need to be a legislated solution. The community has worked it out. Companies have come up with this mechanism. Shareholders get to vote on it. If they do not like it, they negotiate with the target board and come up with a consensus as to what works for them, whether it is 30 days, 60 days or 90 days. I only point that out because it is an example of where I think a private sector solution is more elegant and more effective than a legislated solution.(181)

The Committee notes that CBCA corporations may encounter problems because provincial securities laws and the CBCA do not specify the same time limits and because shareholders and management may not have enough time to examine a bid properly.

Poison pills and shareholder rights plans have served to extend the bid period. The evidence suggests, however, that these mechanisms would not be as prevalent if the minimum bid period were extended beyond 21 days. The Committee considered maintaining the present minimum bid period but, after discussions, concluded that the a longer period would be of greater benefit to shareholders.

23. The Committee recommends that the *Canada Business Corporations Act* be amended to extend the minimum bid period for a take-over bid to 45 days.

24. The Committee recommends that the minimum bid period be prescribed by regulation.

GOING-PRIVATE TRANSACTIONS

A. Introduction

In August 1995, Industry Canada issued the discussion paper *Going-Private Transactions*(182) (GPT Discussion Paper), in connection with its review of the *Canada Business Corporations Act*. According to the GPT Discussion Paper, the term "going-private transaction" or "GPT" is a "generic label applying to a variety of corporate transactions. The result of these

(181) *Ibid.*, Issue No. 5, 21 February 1996, 5:86-87, (Mr. Peter Dey).

(182) Industry Canada, *Canada Business Corporations Act*, Discussion Paper, Going-Private Transactions, (GPT Discussion Paper) August, 1995.

transactions is that the interests of a shareholder in the shares of the corporation are terminated with compensation but without consent and without the substitution of an interest of equivalent value in a participating security of the original corporation or a third party."[183]

Not all forms of GPTs are expressly referred to or permitted under the CBCA. Section 206 of the Act sets out the rules for compulsory acquisitions. The section permits an offeror who has obtained 90% of shares to which a take-over bid relates to acquire the remaining shares at the same price originally offered in the bid. An offeree may accept the offer or elect to demand fair value for the shares. In either case, the offeror becomes the owner of the shares upon payment of the appropriate consideration.

The GPT Discussion Paper points out that the former Director under the CBCA took the position that compulsory acquisitions were the only kind of GPT permitted under the CBCA.[184] In 1994, this policy was replaced by the current policy which permits GPTs where fairness can be assured.[185]

The GPT Discussion Paper examines the following five issues in connection with going-private transactions:

- Should the CBCA be amended to expressly permit GPTs? Should articulated standards be defined?

- If the CBCA is amended to expressly dictate the standards of fairness for GPTs, what should those standards be?

- Should GPTs be allowed for private companies? If so, in what circumstances?

- Should the CBCA be amended to confirm that share consolidations trigger dissent and appraisal rights?

- Should the CBCA be amended to allow compelled acquisitions?

B. Views of the Witnesses

Few witnesses commented on going-private transactions.

The chairman of the Alberta Securities Commission felt that going-private transactions where neither inherently good or bad. His main concern was the need for sufficient

(183) GPT Discussion Paper, p. 1.

(184) Corporations Directorate, Policy Statement, November 9, 1989.

(185) Corporations Directorate, Policy Statement, September 22, 1994.

disclosure.[186] The President and Chief Executive Officer of the Ontario Teachers' Pension Plan was of the opinion that the proposed reforms to going-private transactions were "in accord with the movement to a more self-regulating system of governance in which institutions play the critical role in ensuring appropriate outcomes."[187]

The most detailed presentation on GPTs was made on behalf of the Ontario Municipal Employees Retirement System (OMERS). OMERS' principal concern was that of fairness in protecting the rights of minority shareholders. Its President and Chief Executive Officer was of the view that:

> *... the current fairness opinion and valuation practices, although much improved, are still flawed from this perspective. We therefore recommend ... that valuations always be required in this process, that it be required that they be performed by independent, qualified and unconflicted valuators, and that sufficient disclosure be mandated for information to minority shareholders so that no matter who is representing the process, the minority shareholders themselves can be well informed.*[188]
>
> *... with respect to any going-private transaction, ... it should be legislated that valuations must be produced. We think the law should specify that they must be performed by qualified people.*[189]

The Committee notes that improvements are being made with respect to going-private disclosure. These improvements, along with recently proposed valuation and fairness opinion disclosure standards, are likely to bolster standards in this area.

25. The Committee recommends that there be no changes to the *Canada Business Corporations Act* in relation to going-private transactions.

(186) *Proceedings of the Task Force on Corporate Governance*, Issue No. 1, 14 February 1996, 1:53, (Mr. William Hess).

(187) *Ibid.*, Issue No. 6, 22 February 1996, 6:29, (Mr. Claude Lamoureux).

(188) *Ibid.*, Issue No. 5, 21 February, 1996. 5:8, (Mr. Dale Richmond).

(189) *Ibid.*, 5:14.

CHAPTER 7

CORPORATE GOVERNANCE AND INSTITUTIONAL INVESTORS

INSTITUTIONAL INVESTORS

A. Background

The role of institutional investors in corporate governance has become a subject of increasing interest to students of corporate governance and to policymakers. This is due to the growing importance of institutional investors in securities markets as well as to their more active stance with respect to questions of corporate governance.

> *Corporate and Public Pension Funds, mutual funds, banks and near banks, insurance companies, and public and private endowments are institutional investors. In the United States, at the end of 1990, these investors held over US$ 6 trillion, or 45%, of all financial assets. Comparing this figure with their 21% share in 1950 illustrates their indisputable rise. In the equity market, which is of particular importance to us, the share held by institutional investors rose from 23% in 1955 to 53% in 1992. American institutional investors own over US$ 1 trillion of the equity in the United States and 90% of this is held by corporate, public, and union pension funds. This means that pension funds control 47% of all U.S. equity and explains why pension funds have been at the forefront of the movement toward institutional activism.*
>
> *The position of Canadian institutional investors is similar. For instance, at the end of 1993, the book value of financial assets under the control of trustee-administered pension funds, mutual funds, insurance companies, banks and near banks had swollen to $1,283 billion, of which $142 billion was equity. Canadian public and private pension funds together controlled book value assets of nearly $250 billion and book value stocks of $70 billion. Note that in Canada the share of institutional investors in total equity is only 35%, compared to 53% in the United States. Nevertheless, these institutional holdings are substantial.*
>
> *This last figure appears more impressive, in fact, when the relative lack of liquidity of the Canadian equity market is taken into account. [It has been] estimated that a mere 5.3% of the stocks traded on the Toronto Stock Exchange can be said to be widely traded. Most stocks (59.4%) on the TSE are traded in thin markets, which increases the price of exit. [It is also estimated] the 50% to 60% of*

the shares of widely held companies that are traded in deep markets are held by institutional investors. Here, the size and power of institutional investors in the United States as well as in Canada have increased substantially over the past 30 years.

In the United States this increase has been accompanied by a call for a more active role for institutional investors in corporate governance issues. As in the United States, the growing importance of institutional investors in the equity market has been accompanied in Canada by an awareness of corporate governance problems and the potential benefits shareholders could derive from a louder institutional "voice." The wave of mergers and takeovers that swept Canada in the 1980s, and the ensuing attempts of corporate managers to adopt poison pill strategies, prompted an interest in corporate governance and in the protection of minority shareholders.[190]

Jeffrey MacIntosh, who has dealt extensively with the role of institutional investors in Canada, has summarized the influence of institutional investors in a number of ways:

- Voting against management (often in conjunction with other institutional investors).
- Threatening to exercise dissent rights.
- Suing to enjoin a transaction.
- Enlisting the support of securities regulators to stop a transaction.
- Publicly expressing dissatisfaction with management, or a particular course of action recommended by management.
- Mounting or participating in a proxy battle to unseat management (in rare cases).

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(190) Michel Patry and Michel Poitevin, "Why Institutional Investors Are Not Better Shareholders" in Ronald J. Daniels and Randall Morck eds. *Corporate Decision-Making in Canada*, University of Calgary Press, 1995, p. 351. In fact, the number one stock market investor and the leading manager of public funds in Canada is the Caisse de dépôt et placement du Québec with $12 billion invested in Canadian equities; its equity portfolio accounts for approximately 4% of the securities traded on the TSE. (Jean-Claude Delorme, *Corporate Governance in the Year 2000*, in Daniels and Morck (1995), p. 652.)

The relative importance of the Teachers' Pension Plan Board was revealed in the testimony:

At December 31, 1995 the capitalization of the TSE was $423 billion. Of this amount, the free float was $319 billion. Our portfolio of stocks at year end was $11.5 billion representing approximately 3.6 percent of the free float on the TSE. For comparison, the California Public Employees' Retirement System, the largest pension fund in the U.S. and a widely known force in American corporate governance, owns substantially less than 1% of the total equity capitalization of the largest American public companies.

Finally, the teachers' plan ownership position in some public companies is significantly larger still than our relative market position. Teachers' holds an ownership position in excess of 10 per cent of shares outstanding in eight companies and we own more than five per cent in over 40 companies. (*Proceedings of the Task Force on Corporate Governance*, Issue No. 6, 22 February 1996, 6:22, Mr. Claude Lamoureux).

- Supporting institutional organizations (such as the Pension Investment Association of Canada) and soft dollar brokers (like Fairvest Securities) which actively support institutional causes.
- Creating proxy voting guidelines, either individually or through representative organizations, dealing with matters like poison pills, executive compensation, blank cheque preferred, etc.
- Meeting with management, either individually or collectively, to discuss matters of concern.[191]

He also dealt with the problems that tend to blunt institutional incentives, including:

- Institutional investors are not exempt from free-rider problems (increasing corporate value will benefit other, non-contributing shareholders, and in particular may benefit the institutions' rivals).
- Institutions may be co-opted by management (e.g., a bank might vote with management in the fear that if it does not, the bank will lose the corporation's deposit and/or loan business).
- Pension fund managers may follow a "golden rule" - a mutual back-scratching arrangement under which fund managers appointed by management from one corporation will refrain from engaging in activism in return for similar behaviour from other fund managers.
- Political pressures brought to bear on public pension funds.
- Limited monitoring capabilities, given large portfolios, limited staff, and limited ability to engage in active management activities.
- The need or desire to maintain liquid portfolios, which results in the acquisition of small blocks without significant voting power.
- Legal restraints on institutional monitoring activities.
- Agency conflicts within institutional investors.
- An institutional culture of "passivity."
- Fear of political reprisals for too direct involvement in corporate activities.
- Fear that approaching other shareholders with concerns about management, will trigger a "race to the exit" which will cause the share price to fall.
- Potential fiduciary conflicts between maximizing fund value and corporate value when fund managers become corporate directors.
- The proliferation of non-voting shares in Canada.
- Difficulties in identifying other shareholders.
- Poison pills.[192]

MacIntosh and Schwartz conclude that, on balance, both the theoretical and empirical evidence in the U.S. support the view that institutional shareholders increase corporate value. Their research for Canada offers support for the hypothesis that institutional investors increase firm value in Canada as well. "There is also some support for the hypothesis that

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(191) Jeffrey G. MacIntosh and Lawrence P. Schwartz, "Do Institutional and Controlling Shareholders Increase Corporate Value"? In Daniels and Morck (1995), p. 311.

(192) *Ibid.*, p. 312, 313.

institutional monitoring acts to reduce the danger of redistributive transactions engineered by controlling interests."(193)

Finally, Patry and Poitevin, in their research, conclude:

> *Clearly, the potential for institutional activism is much lower in Canada than in the United States. Fewer companies are widely held in Canada, which makes for fewer pivotal institutional investors. For most investors, most of the time, a passive attitude is rational. We also believe that common sense points towards public and private pension funds as the most promising would-be activists, monitors and influence seekers.*
>
> *We argue that the weaknesses in the governance of pension funds must be dealt with before any significant improvement will be seen in the internal organization of those funds and, consequently, before any dividend that might accrue from the improved governance of Canadian firms can be reaped.*
>
> *Given that pension funds may play a more prominent role in the governance of Canadian firms in the near future, we believe that generic issues, of the process and procedural types, are most likely to emerge. We also conjecture that pension funds will prefer informal modes of intervention to formal modes, and conciliatory approaches to corporate governance issues to adversarial approaches. Progress could be made quickly if the largest funds developed ways and means to coordinate their behaviour. A detailed analysis of the equity portfolios of the 20 largest pension funds, for example, could shed light on this question.*(194)

B. Views Presented to the Committee

One witness argued that:

> *... institutional investors could be much more active in their criticism of underperforming companies. ... Shareholders should express their dissatisfaction privately. Once they have done that, they must go public with it too.*(195)

(193) *Ibid.*, p. 330.

(194) Patry and Poitevin (1995), p. 373.

(195) *Proceedings of the Task Force on Corporate* Governance, Issue No. 1, 13 February 1996, 1:33, (Mr. J.P. Bryan).

In fact, one witness said:

> *... the thing that has always irritated me and continues to irritate me is the fact a lot of them will not even complete the proxy statement. I have heard all kinds of answers, none of which I find acceptable. If I am an institution and I am holding shares on behalf of all of you, then I am your surrogate and I have to treat those shares as a form of "trust", and I must vote them for the slate of directors or withhold them in respect to any one of them, or whatever the case may be, and it really irritates me that it is investment without involvement or responsibility in a corporate sense.*(196)

Canada is lagging behind the U.S. in this area.

One witness cited the case of CalPERS (the California Public Employees' Retirement System).

> *CalPERS of California is probably a pioneer in the field of corporate performance. They were very firm in their positions and very consistent in leur démarche with corporations, the result being that some corporations had to go as far as replacing their chief executive officer. Had they not been that aggressive, I am not sure that corporate governance would have progressed in other countries as it has in the past few years.*(197)

Witnesses indicated that institutional investors have started to play a new and expanded role in Canadian corporations. The CEO of BCE, for example, stated that:

> *Our largest shareholder in our company recently visited us with a very structured list of questions, many of which related to governance of the company. They were very interested in the kinds of things that are reviewed by the board and the board's role in terms of actually making determinations on strategy issues which would affect the future of the company. That is becoming a trend with institutional investors.*(198)

Other witnesses confirmed this view.

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(196) *Ibid.*, Issue No. 6, 22 February 1996, 6:90-91, (Sir Graham Day).

(197) *Ibid.*, Issue No. 4, 20 February 1996, 4:15, (Mr. Jean-Claude Delorme).

(198) *Ibid.*, 4:74, (Mr. L.R. Wilson).

They are trying to do more of that. I do not know how effectively or how wisely they are doing it because they are subject to their own limitations. Some institutional investors -- the Caisse may be one and OMERs another -- prepare a list of the things they do not like. For instance, they do not like A and B shares. They do not like someone with more clout than someone else, or different classes of shareholders electing different classes of directors.(199)

This witness argued in fact that the most significant force affecting the Canadian equity market is increasing institutionalization - including such organizations as the Caisses de Dépôt, the pension funds and the mutual fund industry. (See Appendix 4 for a list of the largest pools of funds in Canada.)

The institutionalization of equity ownership has already had a profound effect on the Canadian public equity market and the corporate governance process. Indeed, it is the institutionalization of ownership that has prompted many, if not most, of the significant developments that we have observed in corporate governance, director behaviour, and corporate law in the past few years.(200)

Witnesses representing institutional investors argued that institutions invest for the long term and hold substantial stakes in Canadian companies. They have the incentive and the means to monitor the quality and effectiveness of corporate management and boards of directors. This is not a task for shorter term and smaller investors. In theory then, the large shareholders are undertaking activity that is in the interests of the smaller shareholder.

One witness cited a case in which a controlling shareholder

thought they could sell out their control for 10 times what a minority shareholder would get when the shares were equal, and there was even a piggyback agreement in the agreement. At that time, the pension funds decided to take a public stand, and we had a one-page advertisement in the Globe & Mail which said that it was a matter of fairness, and we won the case. However, that is the exception.(201)

In this case, the witness argued that the little investor could have done absolutely nothing. The small shareholder benefited from the actions of the institutional investors. He added:

(199) *Ibid.*, Issue No. 3, 19 February 1996, 3:23, (Mr. J. William E. Mingo).

(200) *Ibid.*, Issue No. 4, 20 February 1996, 4:23, (Mr. Claude Lamoureux).

(201) *Ibid.*, 4:51, (Mr. Tullio Cedraschi).

I believe that the interest of the large shareholder is parallel to the interest of the small shareholder, and that the idea that somehow the big shareholder has a secret strategy that is different from the interests of the small shareholder is nearly never the case. When it is, it is perfectly illegal.[202]

Another witness took a different point of view however.

I do not think that institutional investors should be assigned the responsibility of being the watchdog of the corporate world or "Canada Inc.", but there is no doubt that, because they are more articulate and have more resources, they will be able to take positions that will benefit other shareholders. If institutional investors are the watchdogs of anyone, they should be the watchdogs of the investments that they, themselves, make in specific corporations, because the investment policy objectives and the asset allocation policies of one investor may not coincide with the interests or the policies of another investor. Therefore, I do not see how one institutional investor or the collectivity of institutional investors could act on behalf of investors in general.[203]

In the past this was not always the case, as many large shareholders were interested in running the company for their own interests only. They had a vested stake in a corporate process that benefited them. The new institutional investors are independent, however, and focus on long-term wealth goals.

Pension funds, which are by law prohibited from owning more than 30% of the voting shares of any corporation, argue that they have no interest in controlling the company. In most cases they do not even want representation on the board. Clearly, however, in some cases ownership of only 5% of the shares of a company gives the shareholder considerable power over the company.

There is an alternative to assuming an active role in the corporate governance process.

In most cases, the very first approach is to sell, which by the way, gives an excellent signal to the market. We had one Canadian company, which again shall remain unnamed, that had excessive options. We decided to sell. It did not change the president's mind that day, but I am sure that a few weeks later when he was driving to the office he was thinking that a responsible shareholder thought that

(202) *Ibid.*, 4:53.

(203) *Ibid.*, 4:18, (Mr. Jean-Claude Delorme).

what he had done was excessive, and it was excessive. If I would give you the figures, you would be surprised.

Selling passes a message on to management. They are constantly in need of additional equity capital. They must go to the bond market, and they need the support of the capital markets, so if mutual funds and insurance companies and pension funds and rich individuals and even small individuals start selling, it passes a message to management. They are not happy about it. It depresses their stock and gives them less access to capital, so they are quite eager to ensure that these irritants are removed.[204]

Others argue, however, that this cannot always be done. When one witness asked some institutional investors why they do not simply sell when they are unhappy, he received the following response

The answer to that was two-fold. First, that is not good enough. We think that we have a duty to those who have entrusted their money to us not simply to place a massive sell order, even assuming that we could do so without affecting the market. The reality is that we are investing in such size that we cannot place a massive sell order without depreciating the value, and it might be in conflict with our duty to do so.

Second, we have foreign property rules in this country which oblige us to keep a certain percentage of our funds invested in Canadian securities. The universe of securities which qualify for those investments is so small compared to our funds which are so large that whether or not we have taken a fiduciary duty pill, we are forced to act in an active way. We cannot, as a practical matter, respond to the dilemma by selling.[205]

It appears, then, that a growing role for institutional investors, in corporate governance, is inevitable. One witness said:

As institutions continue to assume an important role in the corporate governance process, holding managers, directors and large, active shareholders accountable, the need for a regulatory approach to corporate governance decreases.[206]

(204) *Ibid.*, 4:50, (Mr. Tullio Cedraschi).

(205) *Ibid.*, Issue No. 5, 21 February 1996, 5:94, (Mr. Tom Allen).

(206) *Ibid.*, Issue No. 6; 22 February 1996, 6:24, (Mr. Claude Lamoureux).

. . .

There have been many occasions in the past few years when the teachers' plan has been concerned about corporate performance, or opposed to a corporate action, or interested in providing input on a voting or other issue of corporate policy. In those circumstances, Teachers' staff has conducted rigorous research and often offered quiet advice to management and boards.(207)

Teachers indicated that it had talked to a number of boards asking them to consider making changes in management. This action was only taken after extensive research was done.

Witnesses for OMERS and the CN Investments indicated that this was the approach they preferred to follow as well, acting quietly behind the scenes. Mr. Sillcox of OMERS stated:

We have been mostly reactive in the field of governance. If there is any failure, we feel that we have not been more proactive. In being more proactive, we would do so behind closed doors. There were questions about one industry before us here, and I have a fair amount of detail about how this will unfold. It will be done quietly. It will take years to change because these changes will not be embraced overnight. I think that things will improve. The spotlight is being turned on all of us a little bit more. It is unpleasant, but it is something that we simply must do. I do not think we will be going public on things when we do not have to do so. If we have to and all negotiations break down, then, as a means of last resort, you go to the public to try to correct the situation. Either you are right or the target is wrong. That is something which has not been prevalent in the Canadian market. Perhaps it is because we are so small and know one another fairly well.(208)

Mr. Cedraschi of CN Investments expressed similar views.

If I own a large percentage of a company, and that is usually in Canada, then in addition to considering selling, which is still my number one choice, I do have the opportunity to pick up the phone and call the president and CEO and say, "Could I have a half hour meeting with you and express my concerns?" If I do that, I am sure there are some other investors that will as well. Sometimes you know a director on that board and you can talk to that director and

(207) *Ibid.*, 6:27.

(208) *Ibid.*, Issue No. 5, 21 February 1996, 5:23, (Mr. Robert Sillcox).

> *say, "Are you concerned about what is going on in this or that situation?"*
>
> *In general, that approach is more effective than the approach that brings them to the notice of the New York Times and gets them a lot of publicity. In effect, after a phone call by a major shareholder representing a major pension fund with 55,000 pensioners and 20-some thousand employees, there is no CEO that will not at least listen and say, "This is my explanation for what is going on." It is much stronger to take the more discreet approach, if you want.*
>
> *It is not very good to have shareholders and management fighting in the press all the time. It creates an image out that the capitalistic system does not work. It is sometimes better to handle things on a more discreet basis.*(209)

The generally accepted view was then that

> *In Canada ... institutional investors are less vocal and less visible. My own experience tells me that those institutional investors who practise a policy of active portfolio management of their assets have regular meetings with the management of corporations in which they have a position. Usually, those meetings are rather firm because the analysts working for the institutional investors normally have a very good knowledge, not only of that company, but of the industry in which that company operates. However, very few make a splash in the media about the position or the observations they have with respect to corporations. Institutional investors in Canada -- and I am referring to those practising an active portfolio management process -- are just as persistent as in other countries but perhaps more discreet.*(210)

What Teachers' has been unable to do, but what it wants to do, is to have discussions with other shareholders about corporate policy. Under current law, in order to do this it must first prepare a dissident proxy circular. In the United States this is no longer necessary. The law was changed in 1992 to permit freer communication among shareholders. The verdict is that this has been a beneficial change. This issue is dealt with in chapter 5.

Given the considerable resources of the institutional investor, and its access to senior management of a company, the question arose as to whether the institutional investor is privy to "inside" information. Both the institutional investors and the companies that appeared

(209) *Ibid.*, Issue No. 4, 20 February 1996, 4:51, (Mr. Tullio Cedraschi).

(210) *Ibid.*, 4:15, (Mr. Jean-Claude Delorme).

before the Committee emphatically stated that this was not the case - that each side went out of its way to ensure that there was no exchange of inside information.

Witnesses for the institutional investors agreed that there could be some level of disclosure when large institutional investors talk to each other or to a company. Implementing this would not be straightforward however.

> *I do not know where it would stop if a regime was put into place where you had to announce in some fashion that you were going across the street to talk to someone or report that you bumped into someone at a luncheon gathering or at Senate hearing. I think we would grind ourselves into a problem.*[211]

They felt that there should not be monitoring that will inhibit investment activity or that would have a negative impact on the returns of the beneficiaries of the funds.

The views expressed before the Committee are then, in general accord with the research findings discussed earlier in this paper. Institutional investors are a growing influence in corporate governance in Canada. It will be particularly interesting to observe what the effect of the pressure placed by institutional investors on publicly traded corporations in the area of corporate governance, will be on the state of corporate governance of the large institutional investors.

One witness stated:

> *I think the principles of good governance are generic. It would be very easy to take some of the principles that we spell out in this report and adapt them to other agencies. I know that not-for-profit organizations have looked at these principles. I know that Crown corporations are looking at these principles. I do not think it would be that difficult for pension funds to come up with a set of guidelines to be used for their internal governance.*
>
> *There is a bit of a void here. It is almost déjà vu. It is an opportunity for that sector of the investment community to lead in looking at its governance and to get control of the agenda, but it must do so in a constructive way to address some of the concerns you have identified.*[212]

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(211) *Ibid.*, Issue No. 5, 21 February 1995, 5:28, (Mr. Robert Sillcox).

(212) *Ibid.*, 5:95, (Mr. Peter Dey).

Finally, in response to the question as to whether guidelines with respect to institutional investors could have the same kind of beneficial impact [as the TSE governance rules], one witness replied:

> *I do not think so right now ... It is all right as it sits today. I would not suggest guidelines, but in the continuing work of your committee, as you close your report, you should put literally a red flag on that, because I think the nature of the structure of investment in Canada is significantly different than in other countries. Up to this point, I am not alarmed or concerned, but I see the potential for something to happen. ... I do not feel you need to deal with it now, but I have a sort of an uneasy feeling that it might change.*(213)

C. Views of the Committee

The Committee notes with interest the expanding role of institutional investors, notably the pension funds and mutual funds, in the economy in general, and in matters of corporate governance, in particular. Such institutions are growing rapidly and their economic impact is increasing along with their assets. There is, further, a perception that large institutional investors have preferred access to information. Questions have also been raised about the rules of corporate governance that apply to institutional investors.

> **26. The Committee recommends that the government assemble a database that will permit analysis of the role of institutional investors in markets in general, and in matters of corporate governance, in particular, within the next few years.**

CANADA'S FOREIGN PROPERTY RULE

A. Background

One regulation that significantly affects the investment policies of Canadian pension funds, and consequently that may have a significant impact on issues of corporate governance, is the Foreign Property Rule (FPR). The FPR limits to 20% the foreign component held in RRSPs and pension plans of Canadians. (This limit was increased from 10% to 20% during the last six years.)

The FPR was initially established to direct resources to Canada's stock and bond issuers and possibly Canada's financial services community. Underlying such a policy is an assumption that, without such a rule, Canadian issuers of securities, underwriters and distributors would be unable to attract investors at an "acceptable" price.

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(213) *Ibid.*, Issue No. 6, 22 February 1996, 6:105, (Hon. Peter Lougheed).

The author of a paper commissioned by the Pension Investment Association of Canada and the Investment Funds Institute of Canada states that he will not address the validity of this rule 25 years ago, but argues that it has none today. Further, he estimates that there is "a material long term potential cost of 20 basis points per annum ($700 million, when applied to 1994 pension and RRSP assets)."[(214)] The basic argument for relaxing this rule is that diversification is essential to investors.

The Pension Investment Association of Canada recommends that:

> *the federal government should gradually raise Canada's Foreign Property Rule to 30 per cent on investments that can be held in Canadian pension plans and RRSPs, after which it should be eliminated completely ...* [(215)]

B. Views of Witnesses Before the Committee

The witnesses who addressed the FPR issue were not in favour of such a tight restriction.

> *... we must invest 80 per cent of our funds in the Canadian market and can only invest 20 per cent in the rest of the world. The Canadian market is only 3 per cent of the capitalized markets of the world and we have a fiduciary and trustee requirement to produce returns, however we are limited to investing in a small part of the investible capital of the world.*
>
> ...
>
> *The foreign property content rule really skews our investment process away from the objectives that we have mandated by trust and fiduciary law and the statutory rules under which we operate, and it does it for reasons that are totally unrelated to the issues of prudence or safety in pension management.*[(216)]

Another fund manager commented:

> *... for a larger fund this [rule] is not too constraining; but for a smaller fund it may be constraining if they want to increase their investment outside Canada. The Canadian market represents only three per cent of the world market. We are already a fairly large*

(214) Keith P. Ambachtsheer, Canada's 20% Foreign Property Rule: Why And How It Should Be Eliminated, Toronto, September 1995.

(215) Press Release, Pension Investment Association of Canada, February 22, 1996.

(216) *Proceedings of the Task Force on Corporate Governance,* Issue No. 5, 21 February 1996, 5:9, (Mr. Dale Richmond).

institution so it is hard for us to move rapidly in the Canadian market. Consequently, we are forced to invest truly for the long term.(217)

Finally, the Chairman of the Ontario Securities Commission stated:

> *The difficulty is that once you put that rule in, very few people agree that you should get it out. The difficulty is that getting it out causes certain dislocations. The longer you leave it in, the harder it is to take out.*
>
> *Canada is not a major market. If you look at the Morgan Stanley index today, Canadian equities represent under 2 per cent of global equity capitalization. There are a number of major Canadian issuers, but Canada has no special meaning to them from a capital market perspective. As some of the emerging markets mature over the next little while – India, China, Russia - Canada will go down. At a certain point, unless we can keep our regulatory infrastructure current, we will go right off the screen for global institutional investors because it is just not a big enough market to worry about.*
>
> *The foreign property rule is the kind of thing that leaves people outside our markets to take the Canadian market place less seriously. It is completely out of step with global standards.*(218)

Relaxing, or eliminating the FPR, will also add an additional measure of market discipline on public sector issuers of securities. Their currently "captive" markets will be able to consider other investment opportunities to a greater degree.

C. Views of the Committee

It is the view of the Committee that, over the long-run, the foreign property rule should be phased out. The Committee is, however, aware that the process of modifying this rule may have unforeseen impacts on Canadian capital markets. It is important therefore that

(217) *Ibid.*, Issue No. 6, 22 February 1996, 6:30, (Mr. Claude Lamoureux). Teachers' is able to derive roughly 30% of its return from outside Canada, even with the FPR, through the use of derivatives. The fund swaps the return on non-marketable Ontario debentures for a return of another kind, one that would be based on the Standard and Poors Index, for example.

(218) *Ibid.*, 6:69, (Mr. Edward Waitzer).

policymakers carefully study the implications of phasing out the foreign property rule on Canadian capital markets.

> **27. The Committee recommends that the government undertake a study of the foreign property rule on Canadian capital markets, with a view to phasing out this restriction in the near term.**

APPENDICES

APPENDIX 1

News Release

MANLEY RELEASES DISCUSSION PAPERS ON CHANGES TO THE CANADA BUSINESS CORPORATIONS ACT

OTTAWA, August 29, 1995 — Industry Minister John Manley announced today the release of the first three in a series of nine discussion papers on possible changes to reform and modernize the *Canada Business Corporations Act (CBCA)*. Each paper deals with an area of the CBCA that business has identified as in need of reform. The papers will be used to focus public consultations which will begin later this year.

Modernizing the CBCA is one of several initiatives Industry Canada is undertaking to promote a healthier Canadian marketplace. Reform of the rules governing bankruptcy and insolvency, competition, and copyright is also underway. Helping the market to work efficiently allows businesses to prosper and is a vital ingredient in the federal government's jobs and growth strategy.

"The *Canada Business Corporations Act* is an important tool we can use to help ensure a sound marketplace and contribute to job creation and economic growth," said Mr. Manley. "While the Act has served business well, certain aspects of it need to be updated so that it can remain forward looking and help shape a more innovative economy in Canada."

Last year, Parliament reviewed and approved Bill C-12, the first phase of amendments to the Act. These technical amendments were directed towards improving service to federal corporations and enhancing the overall efficiency and effectiveness of the Act. Bill C-12 requires the Minister of Industry to submit recommendations on further more substantive changes to the law to Parliament by June 1997.

Business has identified nine general areas of the CBCA for review. The first three are the subjects of the discussion papers released today:

i) going-private transactions (those that result in termination of shareholder interests with compensation but without consent);
ii) directors' and other corporate residency requirements;
iii) shareholder communications and proxy solicitation.

The remaining six will each be the subject of a discussion paper to be released this Fall. They are: unanimous shareholder agreements; directors' liability; financial assistance to shareholders, directors and officers; insider trading; takeover bids, and miscellaneous technical amendments.

"Addressing these nine issues will add considerable flexibility to statutory rules, allowing Canadian corporations to react and adapt more quickly to a world economy full of opportunities", said the Minister.

For example, one of the papers to be released this fall will examine ways to improve the fairness and predictability of liability imposed on directors and officers of small and medium-sized CBCA corporations as well as of large enterprises.

Mr. Manley pointed out that the discussion papers in no way represent government, or even departmental policy. "Rather, they are intended to stimulate the widest possible range of discussion on how best to improve this important statute," he said.

As they are completed, all discussion papers will be circulated to interested stakeholders across the country. Later this year and early next year, departmental officers will conduct consultations on the recommendations and options presented in the papers.

Mr. Manley has directed the department to proceed with these consultations expeditiously so that recommendations leading to amendments to this statute can be given a high priority.

Copies of the discussion papers may be obtained by contacting:

Corporate Governance Branch,
Telephone: (613) 952-3678
Facsimile: (613) 952-2067

Copies will also be available electronically via the Internet:

1) World Wide Web (WWW)
http://info.ic.gc.ca/ic-data/ppd/ppd.html

2) Gopher
info.ic.gc.ca port 70/Industry Canada/Policy Papers and Documents

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For more information and backgrounder, please contact:

Bill Milliken, Minister's Office, (613) 995-9001
Jacques Hains, Director, Corporate Law Policy, Industry and Science Policy, (613) 952-0738

Release 7302

Backgrounder: Consultations on Changes to the *Canada Business Corporations Act*

Last year, Parliament reviewed and approved Bill C-12, the first phase of amendments to the *Canada Business Corporations Act* (CBCA). The legislation requires the Minister of Industry to submit by June 1997 a report to Parliament on recommendations for further changes to the law.

This second phase of CBCA reform is well under way. Industry Canada officials completed preliminary consultations last year. Business people and their advisors have indicated there are nine general areas of review required for Phase II of CBCA reform. Discussion papers, examining the current policy and reform principles and drafting policy recommendations for modernizing the CBCA in each of these areas are being prepared by Industry Canada officials. They include:

- directors' liability,
- directors' and other corporate residency requirements,
- shareholder communications and proxy solicitation,
- going-private transactions,
- unanimous shareholder agreements,
- financial assistance to shareholders, directors and officers,
- insider trading,
- take-over bids, and
- miscellaneous technical amendments.

Industry Canada officials will hold consultations with legal, accounting and business communities on these papers. To build on and complement this initiative and facilitate CBCA Phase II amendments, the Senate Banking, Trade and Commerce Committee will hold hearings this fall with senior business people and investors on a number of broader strategic policy considerations. These parallel consultations will address several questions related to each policy area:

CBCA Directors Residency Requirement

- The CBCA adopted a requirement in 1975 that a majority of directors must be resident Canadians. It was adopted primarily to promote Canadian input in decision-making in corporations located in Canada. Is this policy still valid today, in light of NAFTA, GATT and the globalization of markets?

- If not, are some resident directors, or at least one resident director, needed to ensure corporate accountability?

Globalization of markets and changes in the Canadian economy: directors' residency, Unanimous Shareholder Agreements and Going Private Transactions

- The parents of some Canadian subsidiaries appear to want to streamline their operations. One means would be to reduce or eliminate the Canadian subsidiary board. Repealing the Canadian directors' residency requirement might facilitate this, because the parent board could then also sit as the subsidiary board. What impact would this change have on Canadian interests?

- The CBCA provisions on Unanimous Shareholder Agreements (USAs) could also be amended to permit the elimination of the board altogether. Would these changes be appropriate in the context of Canadian subsidiaries?

- Similarly, some parents of Canadian subsidiaries want to buy out a Canadian minority shareholder position. The CBCA is currently unclear on the rules under which such going-private transactions (GPTs) may operate. Should the CBCA be amended to clarify the ground rules in order to facilitate GPTs and at the same time protect these minority shareholders?

Small CBCA businesses and USAs

- The CBCA regime applies to the largest and the smallest CBCA corporations in largely the same way. However, through a Unanimous Shareholder Agreement, some of the rigidity of the CBCA can be averted for smaller and medium sized CBCA corporations. Should the CBCA provisions on USAs be clarified and broadened?

- If so, should privately-held CBCA corporations be able to eliminate the board of directors and transfer all powers and responsibilities to the shareholders? What CBCA rules should shareholders be able/unable to contract out of by means of a USA?

Board of Directors and Committee Structures

- In 1993, the Toronto Stock Exchange (TSE) established a committee to conduct a comprehensive study of corporate governance in Canada. The December 1994 report of that committee proposed a set of guidelines which focus on restructuring Canada's boards of directors and recommend disclosure by listed companies of their system of corporate governance. The TSE implemented this flexible disclosure approach by requiring Canadian incorporated companies listed on that exchange to disclose their approach to corporate governance in their annual reports or information circulars. Implicit in the report's recommendations and explicit in comments made to the committee is that a legislated "one size fits all" approach is not appropriate. CBCA Phase II reform does <u>not</u> propose any rules in these areas. Is this approach correct?

- Or should the CBCA be amended to provide for matters such as independent board members, board committees and separation of CEO-Chairman?

Directors' Liability

- Directors' liability must address the balance between risk taking and responsibility. Excessive or unmanageable liabilities can cause highly-qualified directors to resign and outstanding people to refuse to serve on boards. At the same time, there is a need for adequate corporate accountability. Do current rules address this balance and are they sufficiently clear? Are current defence mechanisms, indemnification and insurance provisions adequate?

- In light of huge claims against directors, including the use of class actions, should the CBCA cap directors' liability? Or would a liability cap unfairly transfer risk from directors and their insurers back to injured parties, such as investors? Would a cap unreasonably impinge compliance under other statutory regimes?

Shareholder Communications

- There are barriers in the CBCA to both communication among shareholders and communication between issuers and the large number of beneficial shareholders. Following changes to SEC rules, should dissident proxy solicitation rules be relaxed to permit better communication among shareholders, particularly institutional investors?

- Should the CBCA be amended to require intermediaries to provide CBCA issuers with lists of beneficial shareholders and to allow issuers to use the lists for all purposes, including proxy solicitation?

Financial Assistance

- Directors of CBCA corporations must have reasonable grounds to believe that the corporation is solvent and can meet a difficult assets test before they approve the granting of financial assistance (by means of a loan, guarantee or otherwise) to shareholders, directors and officers for any purpose, or to any person for the purchase of the corporations shares. Otherwise, they may be personally liable. Is this fair?

- Many problems have been raised with this financial assistance provision, particularly the difficult and ambiguous assets test. Can these problems be solved by clarifying the provision? Or should it be repealed or replaced with a broader disclosure requirement or with a general duty to act in the best interests of the corporation? Would the elimination of this requirement be fair for minority shareholders and creditors?

Overlap of Corporate and Securities laws

- The CBCA regulates insider trading and take-over bids in relation to distributing (publicly-traded) CBCA corporations. Most of these corporations are subject to insider trading and take-over bid rules imposed by provincial securities laws. Do the CBCA provisions add extra value by ensuring a minimum level of investor protection or by regulating CBCA corporations not governed by any securities laws? Would repeal of the duplicative insider trading reporting requirements harm investor protection?

- Would CBCA rules, especially if updated, ensure that there is a minimum level of regulation and investor protection throughout Canada for federal business corporations?

Release 7302.bkg

APPENDIX 2

Minister of Industry   Ministre de l'Industrie

Ottawa. Canada K1A 0H5

The Honourable   L'honorable

John Manley P.C., M.P. c.p., député

aug 21/95

The Honourable Michael J.L. Kirby, Senator
Chairman
Standing Senate Committee on
Banking, Trade and Commerce
The Senate of Canada
Room 204 VB
Ottawa, Ontario
K1A 0A4

Dear ~~Senator Kirby~~ Michael:

Following up on our June 14, 1995 meeting, please find attached a copy of a news release and its backgrounder announcing the release of the first three CBCA Discussion Papers. Also attached, for your information, are copies of these papers.

As you will see, the backgrounder to the news release sets out a number of broad strategic questions related to the Phase II reform of the *Canada Business Corporations Act*. These broader questions, I hope, will assist you in deciding how you wish to proceed with and position your Committee hearings or they could even form the basis of your hearings this fall. It would be useful in making progress on this file if your Committee could focus on these issues.

As discussed at our meeting, and given your Committee's survey and strong interest in the issue of securities regulations, you could consider adding to the list of broad strategic questions, a question or two on the issue of national securities regulations. Should you agree, I would of course be most interested in what you hear, as I am sure would be our colleagues the Minister of Finance, the Honourable Paul Martin, and the President of the Queen's Privy Council, the Honourable Marcel Massé. Given this possibility, I have taken the liberty of copying this letter to both of them.

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Canada

As well, I understand that the Canadian Institute of Chartered Accountants (CICA) has approached you and suggested that your Committee look into the issue of auditors' liability. I think this would be useful particularly given that my officials have to focus on the nine issues identified by stakeholders last year.

Finally, I am also enclosing a list of senior business people and investors that my officials have prepared to assist you in your consideration of whom to invite to your fall hearings. You will note that we have not included the names of corporate law practitioners, as these experts will be consulted by my officials. I am sure that you will agree the final list of invitees should reflect some regional balance as well as the divergent views of stakeholders on any particular issue.

I want to thank you for our June 14, 1995 meeting which was very informative and useful. I look forward to your Committee's deliberations and conclusions/recommendations.

Yours very truly,

John Manley

Enclosures

c.c. The Honourable Paul Martin, P.C., M.P.
The Honourable Marcel Massé, P.C., M.P.

APPENDIX 3

DIRECTORS' LIABILITY UNDER SELECTED FEDERAL AND PROVINCIAL STATUTES

INTRODUCTION

Over the past two decades there has been a trend of imposing statutory personal liability upon directors for liabilities which would usually fall upon the corporation. Directors now face potential liability for environmental offences, wages of corporate employees, source deductions from payrolls, GST remittances and retail sales tax, among other things. These liabilities have been imposed under federal and provincial statutes.

These notes will provide a brief overview of the directors' liability provisions of a number of federal and provincial statutes.

FEDERAL STATUTES

Among the federal statutes that impose personal liability on directors are the *Atomic Energy Control Act* (AECA)[219] *Canadian Environmental Protection Act* (CEPA),[220] *Fisheries Act* (FA),[221] *Canada Business Corporations Act* (CBCA),[222] *Bankruptcy and Insolvency Act* (BIA),[223] *Excise Tax Act,* (ETA)[224] *Canada Labour Code*, (CLC)[225] *Competition Act*, (CA)[226] *Canada Pension Plan*, (CPP)[227] *Unemployment Insurance Act*, (UI Act),[228] the *Income Tax Act* (ITA), [229] *Hazardous Products Act* (HPA), [230] *Hazardous Materials Information Review Act* (HMIRA)[231] and *Transportation of Dangerous Goods Act, 1992* (TDGA).[232]

(219) R.S.C. 1985, Chap. A-16, as amended.

(220) R.S.C. 1985, Chap. 16 (4th Supp.), as amended.

(221) R.S.C. 1985, Chap. F-14, as amended.

(222) R.S.C. 1985, Chap. C-44, as amended.

(223) R.S.C. 1985, Chap. B-3, as amended.

(224) R.S.C. 1985, Chap. E-15, as amended.

(225) R.S.C. 1985, Chap. L-2, as amended.

(226) R.S.C. 1985, Chap. C-34, as amended.

(227) R.S.C. 1985, Chap. C-8 , as amended.

(228) R.S.C. 1985, Chap, U-1, as amended.

(229) R.S.C. 1985 (5th Supp.) C.1, as amended.

(230) R.S.C. 1985, Chap. H-3, as amended.

(231) R.S.C. 1985, c. 24, (3rd Supp.), as amended.

(232) S.C. 1992, C. 34, as amended.

A. *Atomic Energy Control Act*

Subsection 20(2) of the AECA imposes liability for an offence committed by a corporation on corporate officers and directors in situations where the officers or directors directed, authorized, assented to, acquiesced in or participated in the commission of the offence.

Penalties under the Act include fines of up to $5,000 and/or imprisonment for a maximum of two years for a summary conviction offence and fines of up to $10,000 and/or imprisonment for a maximum term of five years in proceedings by way of indictment.

B. *Canadian Environmental Protection Act*

Section 122 of CEPA imposes liability on corporate directors. It provides:

> Where a corporation commits an offence under this Act, any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is a party to and guilty of the offence, and is liable to the punishment provided for the offence, whether or not the corporation has been prosecuted or convicted.

CEPA provides for a wide range of offences including:

- failing to give inspectors assistance or information, making false or misleading statements or hindering an inspector (s.111);
- failing to provide samples or information or to conduct tests as required under certain sections of the Act (s.112); and
- contravening regulations made under the Act and manufacturing or importing substances in contravention of a condition or a prohibition issued under the Act (s. 113);

Penalties for these offences include fines and/or imprisonment. Offences under sections 111 and 112 are subject to a fine of up to $200,000 and/or imprisonment for up to six months. Offences under section 113 are subject to a maximum fine of $300,000 and/or imprisonment for a term of up to six months in summary conviction proceedings; proceedings by way of indictment carry a fine of up to $1,000,000 and/or imprisonment for a term of up to three years.

Fraudulent activities under CEPA such as providing false or misleading information, results or samples in connection with certain sections of the Act are subject to a fine of up to $300,000 and/or imprisonment for up to six months for a summary conviction offence or a fine of up to $1,000,000 and/or imprisonment for up to five years if found guilty of an indictable offence (s.114).

CEPA also makes it an offence, in contravention of the Act, to: (i) intentionally or recklessly cause a disaster that results in loss of the use of the environment; or (ii) show wanton or reckless disregard for the lives and safety of others thereby causing a risk of death or harm to others. These offences are subject to a fine without limitation and/or to imprisonment for up to five years (s.115).

CEPA provides for a "due diligence" defence in connection with most offences under the Act. A person will not be found guilty if it can be established that the person exercised "all due diligence" to prevent the commission of an offence (s. 125).

C. *Fisheries Act*

Under section 35 of the *Fisheries Act* it is an offence for any person to "carry on any work or undertaking that results in the harmful alteration, disruption or destruction of fish habitat." The Act also prohibits persons from depositing, or permitting the deposit, of deleterious substances into waters frequented by fish unless the deposits are authorized by regulation (s. 36(3)).

In the early 1990s, the FA was amended to increase the penalties for offences under the Act. First offenders are punishable on summary conviction by fines of up to $100,000. Subsequent offences are subject to fines of up to $100,000 and/or up to six months imprisonment. The maximum penalties for proceeding by way of indictment are fines of up to $500,000 for first offences, and $500,000 and/or up to two years' imprisonment for subsequent offences (s. 78).

Like CEPA, the FA imposes liability on corporate directors in connection with offences under the Act. Section 78.2 provides:

> Where a corporation commits an offence under this Act, any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of the offence is a party to and guilty of the offence and is liable on conviction to the punishment provided for the offence, whether of not the corporation has been prosecuted.

The FA provides for a due diligence defence in connection with offences under the Act. A conviction will not occur if the person charged with an offence establishes that he or she exercised "all due diligence" to prevent the commission of the offence, or reasonably and honestly believed in the existence of facts that, if true, would render the person's conduct innocent (s. 78.6).

D. *Canada Business Corporations Act*

Under the *Canada Business Corporation Act* directors can be liable:

- for authorizing the issue of shares for a consideration other than money and the consideration received is less than the fair equivalent of the money the corporation should have received (s. 118(1));

- for certain amounts paid by a corporation, for example, financial assistance, share redemptions, dividends, or commissions when the corporation is not solvent (s. 118(2));

- for unpaid debts owed to employees such as accrued wages and vacation pay (s. 119);

- for improper insider trading [(233)] (s. 131); and

- under the oppression remedy [(234)] (s. 241).

In addition to these statutory liabilities, directors can be liable to the corporation for the breach of their fiduciary and care duties. The main fiduciary duty of directors is to disclose and/or avoid conflict of interest situations. Section 122 of the CBCA defines these fiduciary and care duties in the following manner:

> Every director and officer of a corporation in exercising his powers and discharging his 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.

Some of the directors' liabilities referred to above, such as the first two, relate only to the corporation and the corporation must take legal proceedings against the directors. However, the CBCA provides a statutory derivative action which allows shareholders and others to sue directors on behalf of the corporation for liabilities that directors may owe to the corporation (ss. 239-240). [(235)]

In other situations, directors may be liable to persons other than the corporation: liability for wages is to the employees; insider trading liability is to persons who suffer a direct loss

(233) Improper insider trading involves corporate insiders such as directors who, in connection with transactions involving securities of the corporation, make use of confidential information for their own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of the securities.

(234) The oppression remedy allows a complainant to apply to the court for an order in respect of acts or omissions of a corporation or powers of corporate directors that are exercised in a manner that are oppressive or unfairly prejudicial to or that unfairly disregard the interests of any security holder, creditor, director or officer.

(235) Industry Canada, *Canada Business Corporations Act, Discussion Paper, Directors' Liability*, November 1995, p. 5.

and to the corporation for any benefit received by the director from insider trading; the liability the directors face under the oppression remedy is not strictly defined but could include liability to shareholders, other directors, officers, creditors and others. [236]

Some of the directors' liability provisions are subject to conditions and limitations. Under section 119 of the CBCA, directors are jointly and severally liable to corporate employees for all debts not exceeding six months' wages for services performed by employees for the corporation. A director, however, will not be liable for wages unless:

- the corporation has been sued for the debt within six months after it became due and the debt remains unsatisfied;

- the corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months after the proceedings were commenced; or

- the corporation has instituted bankruptcy proceedings and the claim for wages has been proved within six months after the proceedings began.

In addition, liability for wages will only ensue if the director is sued while he or she holds office or within two years after ceasing to be a director.

Under section 123(4) of the CBCA, a director is not liable for improper share issuances or payments (s. 118), unpaid wages (s.119) or breach of fiduciary duty and the duty of care (s. 122) if he or she relies in good faith upon:

> (i) financial statements represented to him or her by an officer or the auditor to reflect fairly the financial condition of the corporation; or
>
> (ii) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him or her.

E. *Bankruptcy And Insolvency Act*

The primary directors' liability provision of the *Bankruptcy and Insolvency Act* is section 204 which provides as follows:

> Where a corporation commits an offence under this Act, any officer, director or agent of the corporation, or any person who has or has had, directly or indirectly, control in fact of the corporation, who directed, authorized, assented to, acquiesced in or participated in the

(236) *Ibid.*, p. 5.

commission of the offence is a party to and guilty of the offence and is liable on conviction to the punishment provided for the offence, whether or not the corporation has been prosecuted or convicted.

Among the offences set out in the BIA are:

- making a fraudulent disposition of property;
- after or within twelve months before a bankruptcy, obtaining credit or property by false representations; and
- fraudulently concealing or removing property after or within twelve months before a bankruptcy (s. 198).

These offences are subject to a fine not exceeding $5,000 and/or imprisonment for a term of up to one year for a summary conviction offence; proceedings by way of indictment carry a maximum fine of $10,000 and/or imprisonment for a term not exceeding three years.

In addition, the BIA imposes strict liability on directors for the payment of dividends or the redemption of shares by an insolvent corporate debtor within one year before the corporation's bankruptcy. Where a dividend is paid or a share redemption takes place within twelve months before a bankruptcy, the onus is on the directors to show that the company was solvent when the transaction took place (s. 101).

Amendments to the *Bankruptcy and Insolvency Act* (Bill C-5) [237] tabled in the House of Commons in March 1996 would afford directors some protection from personal liability imposed by statute for corporate obligations. The bill would allow a reorganization proposal made pursuant to the Act to include provisions for compromising claims that arose by law against corporate directors. Claims against directors that related to contractual rights of creditors (such as personal guarantees) or that were based on allegations of misrepresentations made by directors to creditors or on wrongful or oppressive conduct by directors would not be included in a proposal.

Moreover, the bill would give directors a defence where they were liable for amounts paid out as dividends or for the redemption of shares by an insolvent corporation pursuant to section 101 of the BIA. Directors would be able to assert that they had reasonable grounds to believe that the corporation was not insolvent. To assist them in this regard, directors would be able to rely in good faith on reports or statements by auditors and officers of the corporation concerning the corporation's financial position, as well as information provided by professional advisors.

(237) Bill C-109, the predecessor to Bill C-5, was tabled in the House of Commons in November 1995. It died on the Order Paper with the prorogation of Parliament. Bill C-5 is virtually identical to Bill C-109.

F. *Excise Tax Act* (Goods And Services Tax)

Under section 323 of the *Excise Tax Act*, directors of a corporation which is required to remit the Goods and Services Tax (GST) to the federal government are jointly and severally liable, together with the corporation, to pay the tax as well as any interest and penalties relating to the tax. A director will not be liable, however, unless:

- a certificate for the amount of the liability of the corporation has been registered in the Federal Court and the execution for that amount has been returned unsatisfied in whole or in part;

- the corporation has been or is in the process of being liquidated or dissolved and the amount owing has been proved within the time limitations set out in the Act; or

- an assignment or receiving order has been made against the corporation under the *Bankruptcy and Insolvency Act*.

In addition, a director will not be liable where he or she exercised a degree of care, diligence and skill to prevent the failure to remit the tax that a reasonably prudent person would have exercised in comparable circumstances.

A director liable under section 323 cannot be assessed more than two years after he or she last ceased to be a director of the corporation.

G. *Canada Labour Code*

Under section 251.18 of the *Canada Labour Code* directors of a corporation are jointly and severally liable for up to six months' wages in respect of corporate employees where the wage entitlement arose when the directors in question held office and recovery from the corporation is impossible or unlikely.

Part II of the *Canada Labour Code* governs health and safety standards with respect to workers subject to federal jurisdiction. A violation of the health and safety provisions is a summary conviction offence subject to a fine of $15,000. Other offences, however, carry penalties specific to the offence.

Under Part II, a director, officer or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of an offence by a corporation is liable to the punishment provided for the offence (s. 149(2)).

H. *Competition Act*

Under section 65 of the *Competition Act*, it is an offence not to permit a person executing a warrant to search the premises referred to in the warrant and to examine, copy or seize records. It is also an offence to fail to supply information and to alter or destroy records.

Corporate directors can be liable in situations where they directed, authorized, assented to acquiesced in or participated in the commission of these offences (s. 65(4)).

I. *Canada Pension Plan*

The *Canada Pension Plan* requires employers to deduct CPP contributions from employees' salaries and to remit these contributions to the Receiver General. Where a corporate employer fails to deduct or to remit CPP contributions, persons who were directors of the corporation at the time when the failure occurred are jointly and severally liable to pay the contributions as well as any interest or penalties associated with the failure to remit (s. 21.1).

J. *Unemployment Insurance Act*

Like the *Canada Pension Plan*, the *Unemployment Insurance Act* contains directors' liability provisions. These relate to the failure of an employer to deduct or remit unemployment insurance premiums from the salaries of corporate employees. Section 54(1) of the UI Act provides:

> Where an employer who fails to deduct or remit an amount as and when required under subsection 53(1) is a corporation, the persons who were the directors of the corporation at the time when the failure occurred are jointly and severally liable, together with the corporation, to pay to Her Majesty that amount and any interest or penalties relating thereto.

K. *Income Tax Act*

The *Income Tax Act* imposes liability on directors of corporations under sections 159(3), 227.1 (1) and 242. The first two of these provisions impose civil liabilities while the last imposes criminal liability.

Section 159(3) provides as follows:

> Where a responsible representative distributes to one or more persons property over which the responsible representative has control in that capacity without obtaining a certificate under subsection (2) in respect of the amounts referred to in that subsection, the responsible representative is personally liable for the payment of those amounts to the extent of the value of the property distributed and the Minister may assess the responsible representative therefor in the same manner and with the same effect an as assessment made under section 152.

Personal liability for directors could arise under section 159(3) where the director acted as an assignee, liquidator, receiver, receiver-manager, administrator or other such person administering, winding up, controlling or otherwise dealing with the property, business or estate of another person.

Under section 227.1(1), directors are liable for the failure of the corporation to deduct, withhold or remit taxes under the Act. Where section 227.1(1) applies, a director is liable to pay the amount owing as well as any interest and penalties pertaining to those amounts. However, a director will not be liable under this section unless:

- a certificate for the amount of the corporation's liability referred to in section 227.1(1) has been registered in the Federal Court of Canada and execution for that amount has not been completely satisfied;
- the corporation has commenced liquidation or dissolution proceedings or has been dissolved and a claim for the amount of the corporation's liability has been proved within six months after the earlier of the date of the commencement of proceedings or the dissolution; or
- bankruptcy proceedings have been commenced against the corporation and a claim for the corporation's liability under section 227.1(1) has been proved within six months after the date of commencement of proceedings (s. 227.1(2).

No action or proceeding can be taken under this section of the ITA for the recovery of any amount payable by a director more than two years after the person ceased being a director of the corporation (s. 227.1(4)).

Section 227.1 contains a due diligence defence. A director will not be liable under section s. 227.1(1) where he or she "exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances (s. 227.1(3))." (238)

Section 242 of the ITA imposes criminal liability on corporate directors. The section provides that an officer, director or agent of a corporation may be punished for being a party to an offence under the Act where he or she directed, authorized, assented to, acquiesced or participated in the commission of the offence.

L. *Hazardous Products Act*

The *Hazardous Products Act* deals with the selling. importing and advertising of prohibited, restricted and controlled products. The Act prohibits the sale and importation of certain products and restricts the sale of other types of products in accordance with regulations made

(238) Provisions of section 227.1 with respect to due diligence and when a director is liable also apply to the directors' liability provisions of the *Canada Pension Plan* and the *Unemployment Insurance Act*.

pursuant to the Act. Controlled products destined for use in the workplace in Canada must meet the Act's information and labelling requirements.

It is an offence to contravene or fail to comply with the HPA or its regulations. Proceedings may be taken by way of summary conviction or indictment. Summary conviction offences are punishable by a fine of up to $100,000 and/or imprisonment for up to six months; indictable offences carry a maximum fine of $1,000,000 and/or imprisonment for up to two years. Directors or officers who directed, authorized, assented to, acquiesced or participated in the commission of an offence are considered parties to the offence and are liable to the punishment provided for the offence whether or not the corporation has been prosecuted or convicted (s. 28).

M. *Hazardous Materials Information Review Act*

Under the *Hazardous Materials Information Review Act* it is an offence to fail to provide the proper information when requesting an exemption. It is also an offence to fail to provide information when requested by a screening officer. Proceedings may be taken by way of summary conviction or indictment. Summary conviction offences are punishable by a maximum fine of $100,000 and/or imprisonment for up to six months; indictable offences carry a maximum fine of $1,000,000 and/or imprisonment for up to two years. Directors or officers who directed, authorized, assented to, acquiesced or participated in the commission of an offence are considered parties to the offence and are liable to the punishment provided for the offence whether or not the corporation has been prosecuted or convicted (s. 49).

N. *Transportation of Dangerous Goods Act, 1992*

Under the *Transportation of Dangerous Goods Act, 1992*, it is an offence to transport, handle or offer for transport any dangerous goods without following proper packaging or safety requirements as set out in the Act and the regulations.

Depending on the offence, a director or officer can be subject to a fine or imprisonment whether or not the corporation has been prosecuted for the offence (s. 39). Liability will not ensue, however, where it is established that the person took all reasonable measures to comply with the Act and to prevent the commission of the offence (s. 40).

PROVINCIAL STATUTES

Numerous provincial statutes impose liability on directors. Examples of some of these within the following categories are set out below:

- environmental laws;
- taxation statutes;

- occupational health and safety legislation;
- statutes imposing liability for wages; and
- corporate laws

A. Environmental Laws

Next to liability for wages and taxes, liability for environmental offences is one of the greatest concerns for corporate directors. There are a number of statutes at the federal and provincial level pertaining to the environment and many of these impose liability on directors in connection with actions taken by corporations.

1. *Ontario*

Under the *Environmental Protection Act*(239) of Ontario, directors and officers of a corporation may be held personally liable for corporate acts that produce environmental damage. Section 194 of the Act provides the following:

> (1) Every director or officer of a corporation that engages in an activity that may result in the discharge of a contaminant into the natural environment contrary to this Act or the regulations has a duty to take all reasonable care to prevent the corporation from causing or permitting such unlawful discharge.
>
> (2) Every person who has a duty under subsection (1) and who fails to carry out that duty is guilty of an offence.
>
> (3) A director or officer of a corporation is liable to conviction under this section whether or not the corporation has been prosecuted or convicted.

Penalties include fines, imprisonment and restoration orders.

The *Ontario Water Resources Act*(240) contains a provision similar to section 194 of the *Environmental Protection Act*.

2. *Alberta*

In Alberta, the *Environmental Protection and Enhancement Act*(241) provides that any officer, director or agent of the corporation who directed, authorized, assented to, acquiesced in or participated in the commission of an offence under the Act is guilty of an offence and liable to the punishment provided for the offence.

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(239) R.S.O. 1990, c. E.19.

(240) R.S.O. 1990, c. O.40, s. 116.

(241) Statutes of Alberta 1992, c. E-13.3, s. 218.

Penalties under the Act include fines of up to $100,000, and/or imprisonment for up to two years. Corporations are subject to fines of up to $1,000,000.

The Act goes on to provide that no one will be guilty of an offence if the person establishes on a balance of probabilities that he or she took all reasonable steps to prevent its commission (s. 215).

3. *Quebec*

Quebec's *Environment Quality Act*[242] provides that every director or officer of a corporation who by order, authorization or advice or encouragement leads the corporation to refuse or neglect to comply with an order to emit, deposit, release or discharge a contaminant into the environment in contravention of the Act or the regulations is guilty of an offence. The penalty for a first offence is a fine of between $2,000 and $20,000 and/or imprisonment for up to one year; for a subsequent offence the fine ranges from $4,000 to $40,000 and can be accompanied by imprisonment for up to one year (s. 106.1(a)).

4. *Nova Scotia*

The Nova Scotia *Environment Act*[243] imposes liability on corporate directors who direct, authorize, assent to, acquiesce or participate in a violation of the Act by a corporation. The Act also contains a due diligence defence (s. 160).

Penalties under the Act are quite severe. Depending upon the type of offence, fines to a maximum of $500,000 or $1,000,000 can be imposed.

B. Taxation Statutes

For the most part, provincial taxation statutes contain penalties and fines that mirror those found in federal taxation laws.

1. *Ontario*

Under the *Income Tax Act*[244] (Ontario), directors are liable for taxes that corporations are required to deduct and remit from salaries and wages. Directors will not be liable, however, where they exercise the degree of care, diligence and skill to prevent the failure to comply that a reasonably prudent person would have exercised under comparable circumstances (s. 38(3)).

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(242) R.S.Q. 1977, c. Q-2.

(243) Statutes of Nova Scotia, 1994-95, Chap.1, s. 164.

(244) R.S.O. 1990, c. I.2.

2. *Quebec*

Quebec legislation pertaining to the Ministère du Revenue[245] provides that where a corporation fails to remit, deduct, withhold or collect amounts required under the Act, directors are jointly and severally liable for the amounts in question plus interest and penalties. Directors will not be liable, however, where they act with reasonable care, dispatch and skill under the circumstances (s. 24.0.2).

C. Occupational Health and Safety Legislation

The purpose of occupational health and safety legislation is to ensure that the work environment for employees is safe and hazard-free.

1. *Ontario*

In Ontario, the *Occupational Health and Safety Act*[246] provides that directors and officers of a corporation are to take "all reasonable care" to ensure that the corporation complies with the Act and the regulations as well as any orders made pursuant to the Act.

Every person who contravenes or fails to comply with the Act, the regulations or an order is guilty of an offence and upon conviction liable to pay a fine of not more than $25,000 or to imprisonment for a term of not more than 12 months or to both (s. 66(1)). If a corporation is convicted of an offence, the maximum fine that may be imposed upon the corporation is $500,000 (s. 66(2)).

2. *Quebec*

Under Quebec's occupational health and safety legislation, corporate directors who prescribe or authorize an action or omission that constitutes an offence by a corporation or who consent to the offence are deemed to have participated in the offence. [247]

3. *New Brunswick*

The *Occupational Health and Safety Act*[248] of New Brunswick imposes liability on directors who knowingly direct, authorize, assent to, acquiesce or participate in the commission of an offence by a corporation. Penalties for violations of the Act include fines as well as imprisonment.

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(245) *An Act respecting the Ministère du Revenue*, R.S.Q. 1977, c. M-31, s. 24.0.1.

(246) R.S.O 1990, c. O.1, s. 32.

(247) *An Act Respecting Occupational Health and Safety*, R.S.Q. 1977, c. S-2.1, s. 241.

(248) S.N.B. 1983, C. O-0.2, s. 49, as amended.

4. *Manitoba*

Manitoba's *Workplace Safety and Health Act*,[249] provides that where a corporation commits an offence under the Act, any officer or director who directed, authorized, assented to, acquiesced in or participated in the commission of an offence is also guilty of the offence. Penalties for offences include fines as well as imprisonment. For first offences, fines cannot exceed $15,000, while subsequent offences carry a maximum fine of $30,000 (s. 55).

D. Statutes Imposing Liability For Wages

Directors may be liable for employee wages and vacation pay pursuant to corporate laws or employment standards legislation. Depending upon the type of business, these liabilities can be significant.

1. *Ontario*

The Ontario *Business Corporations Act* provides as follows:

> The directors of a corporation are jointly and severally liable to the employees of the corporation for all debts not exceeding six months' wages that become payable while they are directors for services performed for the corporation and for the vacation pay accrued while they are directors for not more than twelve months under the *Employment Standards Act*, and the regulations thereunder, or under any collective agreement made by the corporation.[250]

If a director is to be held liable for wages, the following conditions must be met:

- the director must be sued while he or she holds the position as a director or within six months of ceasing to be a director; and
- the action against the director must be commenced within six months after the debt became payable; and
  (i) the corporation is sued in the action against the director and execution against the corporation is returned unsatisfied in whole or in part; or

  (ii) before or after the action is commenced, the corporation goes into liquidation, is ordered to be wound up, or commences bankruptcy proceedings and the claim for the debt is proven. [251]

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(249) R.S.M. 1987, c. W210, s. 56.

(250) R.S.O. 1990, C. B.16, s. 131(1).

(251) *Ibid.*, s. 131(2)

2. *Alberta*

The *Business Corporations Act* of Alberta provides that directors are jointly and severally liable to employees of the corporation for all debts not exceeding six months' wages payable to each employee for services performed for the corporation while they were directors.[252] A director will not be liable for wages if he or she believes on reasonable grounds that the corporation can pay the debts as they become due; or if the debts are wages payable for services performed while the corporation is under the control of a receiver or a liquidator.[253]

Moreover, a director will not be liable for wages unless:

- the corporation has been sued for the debt within six months after it became due and execution has been returned unsatisfied in whole or in part;
- the corporation has commenced liquidation and dissolution proceedings or has been dissolved and a claim for the debt has been proved within six months after the proceedings have begun; or
- proceedings relating to the corporation have been commenced under the *Bankruptcy and Insolvency Act* and a claim for the debt has been proved within six months after the proceedings began. [254]

3. *Manitoba*

The *Corporations Act* of Manitoba provides that corporate directors are jointly and severally liable to employees for up to six months wages for services performed for the corporation while they are directors.[255] The conditions applicable to a director's liability for wages in Manitoba are virtually identical to those set out in the *Canada Business Corporations Act.*

4. *Quebec*

The *Companies Act* of Quebec makes directors jointly and severally liable for debts owing by a corporation to its employees to a maximum of six months' wages for services rendered to the corporation while they were directors. Directors will not be liable for unpaid wages, however, unless the company is sued within one year after the debt becomes due and the debt

(252) Statutes of Alberta 1981,c. B-15, s. 114(1).

(253) *Ibid.*, s. 114(2).

(254) *Ibid.*, s.114(3).

(255) R.S.M. 1987, c. C255, s. 114(1).

remains unpaid or the company is wound-up or becomes bankrupt and the claim for the debt remains unsatisfied.[256]

5. *British Columbia*

In British Columbia directors liability for unpaid wages is found in the province's employment standards legislation rather than in its corporations law.

The *Employment Standards Act* provides the following:

> 19. (1) A person who was a director or officer of a corporation at the time wages of an employee of the corporation should have been paid is personally liable for the unpaid wages in an amount not exceeding 2 months' wages for each employee affected, and this Act applies to the recovery of the unpaid wages from that person.

Liability will not extend to severance pay in cases where the corporation is in receivership or bankruptcy.[257]

The Act also provides that directors and officers of a corporation who direct, authorize, assent to, acquiesce in, or participate in the commission of an offence are liable for the offence.[258]

E. Corporate laws

1. *Ontario*

Under the *Business Corporations Act* directors can be liable, among other things, for:

- authorizing the issue of shares for a consideration other than money and the consideration received is less than the fair equivalent of the money the corporation should have received (s. 130(1));
- certain amounts paid by a corporation, for example, financial assistance, share redemptions, dividends, or commissions when the corporation is not solvent (s. 130(2)); and
- an indemnity paid contrary to the Act (s. 130(2)).

(256) R.S.Q. 1977, c-38, s. 96.

(257) S.B.C. 1980, c.10, s. 19, as amended.

(258) *Ibid.*, s. 103(6).

The Act provides that directors are jointly and severally liable to restore to the corporation the amounts paid and the value of the property distributed.

2. *Alberta*

The *Business Corporations Act* of Alberta provides that directors of a corporation who vote for or consent to a resolution authorizing the issue of shares for a consideration other than money are jointly and severally liable to the corporation to make good any amount by which the consideration received is less than the fair equivalent of the money that the corporation would have received if the shares had been issued for money on the date of the resolution. Directors can also be liable for a purchase, redemption or acquisition of shares contrary to the Act, a commission on the sale of shares not provided for in the Act, payment to a shareholder and financial assistance contrary to the Act, and the payment of a dividend contrary to the Act (s. 113).

The Act provides that directors are jointly and severally liable to restore to the corporation the amounts paid and the value of the property distributed (s. 113).

3. *New Brunswick*

The *Business Corporations Act* of New Brunswick contains directors' liability provisions that are virtually identical to those of the Ontario *Business Corporations Act*. Under the New Brunswick act, directors of a corporation who authorize the issue of shares for consideration other than money are jointly and severally liable to make good to the corporation an amount by which the consideration received is less than the fair equivalent of the money that the corporation would have received if the shares had been issued for the money on the date of the resolution. Moreover, directors will be liable if they authorize the purchase, redemption, or other acquisition of shares contrary to the Act, a commission or a dividend contrary to the Act, financial assistance contrary to the Act, payment of an indemnity contrary to the Act, or a payment to a shareholder contrary to the Act.[259]

The Act provides that directors are jointly and severally liable to restore to the corporation the amounts paid and the value of the property distributed.

4. *British Columbia*

The *Company Act* of British Columbia provides that directors who vote for, or consent to a resolution authorizing the purchase, redemption or acquisition of shares contrary to the Act, a commission or discount contrary to the Act, the payment of a dividend if the company is insolvent or would become insolvent, a loan, guarantee or financial assistance contrary to the Act, the payment of an indemnity to a director or former director without the approval of the court, or an act in respect of carrying on a business which the company is restricted from exercising and the company has paid compensation to any person in connection with the act, are jointly and severally liable to make good the loss suffered by the company as a result.[260]

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(259) S.N.B. 1981, c. B-9.1, s. 76, as amended.

(260) R.S.B.C. 1979, Chap. 59, s. 151.

LARGEST CANADIAN FUNDS/POOLS

1. Pension Funds (as of December 1995)

	Assets in $ Billions
Caisse de Dépôt	51.2
Teachers' Pension Plan Board	40.3
OMERS	24.0
Province of B.C.	23.3
Alberta Public Funds	10.7
Hospitals of Ontario	9.7
Ontario Pension Board	8.5
CN Rail Pension	8.3
Bell Canada and Northern Telecom.Pension(BIMCOR)	7.7
Ontario Hydro Pension	7.8
Workers' Comp.Board of Ontario	7.5
Hydro Quebec	6.0
OPSEU	5.8

Source: Pension Investment Association of Canada.

2. Mutual Fund Companies (as of March 1996)

	$(000)s
Investors Group	21,196,653
Trimark Investment Management Inc.	15,790,944
Royal Mutual Funds Inc.	14,561,981
Mackenzie Financial Corporation	12,835,112
AGF Management Limited	8,569,110
Templeton Management Limited	7,468,072
TD Asset Management	7,298,613
CIBC Securities Inc.	7,031,124
Fidelity Investments Canada Limited	6,767,559
Altamira Investment Services Inc.	6,018,772
Bank of Montreal Investment Management	5,441,837
C.I. Mutual Funds	5,165,829
MD Management Limited	5,131,549
CT Fund Services Inc.	4,876,342
Spectrum United Mutual Funds Inc.	4,325,493

Source: The Investment Funds Institute of Canada.

APPENDIX 5

WITNESSES

ISSUE NO.	DATE AND LOCATION	WITNESSES
1	Calgary, February 13, 1996	**From the Department of Industry:** David Tobin, Director General, Corporate Governance Branch; Mary Walsh, CBCA Director and Director General, Corporations Directorate; and Brian Dillon, A/Senior Project Leader, (CBCA Reform) Corporate Law Policy Directorate. **From the Canadian Institute of Chartered Accountants :** Michael H. Rayner, President; William Broadhurst, Chair, CICA Legal Liability Task Force; and The Honourable Willard Z. Estey, C.C., Q.C., Counsel. J.P. Bryan, President and Chief Executive Officer, Gulf Canada Resources Ltd. William L. Hess, Chairman, Alberta Securities Commission.
	Calgary, February 14, 1996	**From the Coalition for CBCA Reform:** John L. Howard, Senior Vice-President, Law and Corporate Affairs, MacMillan Bloedel Ltd; Dan Pekarsky, President, Corporate Advisory Group; and Rhondda Grant, Corporate Secretary and Associate General Counsel - Corporate, NOVA Corporation. George Watson, President and Chief Executive Officer, TransCanada PipeLines Ltd.

		Tom E. Kierans, President and CEO of C.D. Howe Institute and Director of several companies.
		Bob Blair, Director of several companies.
		Gordon Cummings, Chief Executive Officer, Alberta Wheat Pool.
2	Winnipeg, February 15, 1996	Lawrence O. Pollard, President and Chief Executive Officer, Pollard Banknote.
		The Honourable Doug Everett, Director of several companies.
		William Mackness, Corporate director and consultant.
		W.H. Loewen, President, CTI Comtel Inc.
		Bob Kozminski, Owner and President, Keystone Ford.
3	Halifax, February 19, 1996	J. William E. Mingo Q.C., Director of several companies.
		David J. Hennigar, Chairman, Annapolis Basin Pulp & Paper Co. Ltd.
		Louis R. Comeau, President and Chief Executive Officer, Nova Scotia Power Corporation.
4	Montreal, February 20, 1996	Jean-Claude Delorme, Advisor to the Chairman of the Board, *Caisse de Depôt et de Placement du Québec.*
		Jan Peeters, President, Fonorola inc.
		Tullio Cedraschi, President and Chief Executive Officer, CN Investments.
		From BCE Inc.: L.R. Wilson, Chairman, President and Chief Executive Officer;

Josef J. Fridman, Senior Vice-President, Law and Corporate Secretary; and
Monique Mercier, Assistant General Counsel - Corporate.

From Power Corporation of Canada:
Jim Burns, Deputy Chairman; and
Edward Johnson, Vice-President, General Counsel and Secretary.

David M. Culver, Chairman, CAI Capital Corp.

From the Montreal Exchange:
Gérald Lacoste, President and Chief Executive Officer; and
Louis-François Hogue, Director, Corporate Services Equity.

5 Toronto, February 21, 1996

From Ontario Municipal Employees Retirement Board:
Dale Richmond, President and Chief Executive Officer; and
Robert L. Sillcox, Senior Vice-President of Investments.

The Honourable Willard Z. Estey C.C., Q.C., Director of several companies.

William Dimma, Director of several companies.

Peter Widdrington, Chairman, Laidlaw Inc.

From the Toronto Stock Exchange:
Rowland Fleming, President and Chief Executive Officer, Toronto Stock Exchange;
Tom Allen, Director of several companies; and
Peter Dey, President and Managing Director, Morgan Stanley Canada Limited.

Adam H. Zimmerman, Director of several companies.

George J. Kosich, President and Chief Executive Officer, Hudson's Bay Co.

F.B. Ladly, Deputy Chairman and Chief Executive Officer, Extendicare Inc.

		John F. Fraser, Director of several companies. John D. McNeil, Chairman and Chief Executive Officer, Sun Life Assurance Company of Canada.
6	Toronto, February 22, 1996	The Honourable Donald S. Macdonald, Director of several companies. Claude Lamoureux, President and Chief Executive Officer, Ontario Teachers' Pension Plan Board. John T. Bart, President, Canadian Shareowners Association. Edward Waitzer, Chairman, Ontario Securities Commission Sir Graham R. Day, Director of several companies. The Honourable Peter Lougheed, Director of several companies. Maureen Kempston Darkes, President and General Manager, General Motors of Canada Ltd. **From the Coalition for CBCA Reform:** Purdy Crawford, Chairman, Imasco Ltd.; and P.K. Pal, Vice-President, Chief Legal Officer and Secretary, Alcan Aluminium Ltd. **From the Canadian Institute of Chartered Accountants:** Michael H. Rayner, President; Guylaine Saucier, Former Chair, Directors Advisory Group; and William H. Broadhurst, Chair, CICA Legal Liability Task Force.
2 *(Second Session)*	Ottawa, April 30, 1996	Bruce A. Malcolm, Director, Reed Stenhouse Ltd.