Joint Council/PUC Education Meeting

On January 17, 2013, City Council met in closed session with representatives from the PUC for the purpose of receiving an education/training session on Council's role as the sole shareholder of PUC Inc. and PUC Distribution, and the topics of conflict of interest and corporate fiduciary duties.

Lawyers George Rust d'Eye and Michael Foderick, from the Toronto law firm of WeirFoulds^{LLP}, made oral presentations.

At the close of the meeting, Council directed staff to make available to the public the material that was provided by the presenters. Scroll down page to view material.

Malcolm White
City Clerk

MEMORANDUM

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TO	Members of Council of the City of Sault Ste. Marie Appointed as Directors of a PUC Corporation	
FROM	George H. Rust-D'Eye	
DATE	January 17, 2013	
FILE	09500.00002	
RE	(1) Duties as a Director of a PUC Corporation (the "Corporation"); and (2) Duties as a Councillor for the City of Sault Ste. Marie and, in particular, issues of potential Conflict of Interest arising out of Council decisions involving the Corporation	

The City Solicitor has asked us to provide information in connection with your duties and responsibilities as a director of the Corporation. In particular, she has asked us to advise you on what you can consider and how you should be guided in discharging your duties and obligations as a director of the Corporation in making a determination on specific issues before the Board. She has also asked us to consider potential conflict of interest issues regarding certain matters that will come before Council involving the Corporation.

Particular concern arises out of the tensions between (1) your position as a nominee to the Board of Directors by the City of Sault Ste. Marie, your capacity as a resident of Sault Ste. Marie, and your direct and indirect potential interests as a Councillor for any affected area of the City, on the one hand, and (2) your position as a member of the Board of Directors of the Corporation, on the other hand, as these tensions are reflected in decisions as a Board member of the Corporation.

The following is based on an opinion letter, based on substantial research, provided by my colleague, Dan Ferguson, to another client of the firm who had similar questions to your own. Please note that we have not updated the research or case authorities from the original opinion, in view of this being general guidance and discussion in a workshop and not a formal opinion on any specific issue.

Duties of Directors

Directors of a Corporation are subject to two important duties which were first developed by the courts and embodied in the Common Law and which are now embodied in corporate statutes (in the case of the Corporation, section 134(1) of the *Business Corporations Act* (Ontario) (the "**OBCA**"). These duties are:

(i) to act honestly and in good faith with a view to the best interests of the Corporation; and

(ii) to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The first duty is commonly referred to as the "duty of loyalty". The second duty is commonly referred to as the "duty of care".

Section 132(1) of the OBCA deals with specific types of conflict of interest and a director's duties to disclose such types of conflict of interest and refrain from voting on matters related to the same. This section provides for specific requirements to be adhered to by a director and provides that if such requirements are not complied with, a contract or transaction entered into by the Corporation can be voided and the director can be held to account for profits and revenues generated by the contract or transaction. It also provides for a mechanism by which a director in such a conflict of interest can still remain a director of a corporation and by which a corporation can enter into such a business opportunity notwithstanding a conflicted director. We have received no information suggesting grounds upon which section 132 is applicable to the position of Members of City Council as members of the Corporation, with respect to any particular matter.

While the definition of a material interest is broadly defined to include an indirect interest by virtue of affiliation with a corporation or family members, section 132 applies only to a director who is a "party to a material contract or transaction or proposed material contract or transaction with the Corporation" or who has a "material interest in a person who is a party to a material contract or transaction or proposed material contract or proposed transaction with the Corporation". If you are not a party to such a contemplated contract or transaction and do not have a material interest in a party to the contemplated contract or transaction, your interest in the transaction as a resident of Sault Ste. Marie, nominee of the City of Sault Ste. Marie or Councillor for an affected constituency, would not fall within the purview of section 132 of the OBCA.

Nevertheless, even for decisions which are not under the purview of section 132, a director's overriding fiduciary duty of loyalty may preclude participation in a decision, require the disclosure of an interest or require other actions of a director in a matter involving a conflict of interest in a much broader sense than covered by section 132. Section 134 requires a director to address conflicts of interest in the broader sense. We will, therefore, continue to focus on the duty of loyalty under section 134.

The duty of loyalty embodied in section 134 involves the duty always to act within the scope of the "best interests of the Corporation". This involves adherence to, among other things, a number of related rules and duties:

(a) the duty to avoid conflicts of interest;

(b) the duty not to use your position for personal gain;

(c) the duty to serve the Corporation selflessly, honestly and loyally; and

(d) the duty to exercise independent judgment.

There are number of clear directions that these rules provide:

It is clear that you cannot act simply in the interests of the City of Sault Ste. Marie just because you are its nominee on the Board of Directors.

You also cannot simply act to further your own interests as a resident of the City of Sault Ste. Marie or a Councillor representing an affected area, or simply consider the political ramifications to you as a Councillor of any decision that you may make.

In addressing your decisions, you must ensure that your decisions are not based on, or improperly swayed by, the tensions that arise from your capacity as a nominee of the City of Sault Ste. Marie as sole shareholder, a resident of Sault Ste. Marie, Councillor for an affected area, or political pressures that may be imposed upon you directly or indirectly.

Each Councillor on the Board may become subjected to the tension arising out of (i) their capacity as a member of the Board, on the one hand, and (ii) their capacity as nominee of the City, a resident of Sault Ste. Marie and Councillor, on the other. We do not believe that this tension, itself, requires a declaration of interest or a disqualification from voting on issues or other action concerning a conflict of interest in connection with your considerations and decisions at the Board. If this were the case, Councillors could not act on behalf of the Corporation in many important decisions. The tensions give rise to an irreconcilable conflict and the requirement of a declaration of interest, disqualification and/or other actions at the Corporation's Board level only if they impede your ability to make decisions in the best interests of the Corporation.

The practice of appointing Members of Council to the Board of Directors of the Corporation is designed to ensure that board members have a certain viewpoint and experience to bring to their decision-making powers at the Board and that the tensions arising out of their capacity do not, in and of themselves, disqualify them from making determinations on behalf of the Corporation that impact the community, as long as they are still able to act in the best interests of the Corporation notwithstanding these tensions.

Within the context of the "best interests of the Corporation", directors may consider issues that go beyond the short term, narrow economic impact upon the Corporation of a decision and include broader issues, such as community interests, interests of employees, suppliers or consumers, governmental issues and environmental issues.

For example, the B.C. Supreme Court stated in the leading case of *Teck v. Millar*:

> "If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting *bona fide* in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of a policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered *bona fide* the interests of the shareholders."

We quote from a leading text on this matter, *Directors' Duties in Canada*, 3rd edition, by Barry Reiter, at pages 60 and 61:

> "[the corporate statutes] require directors to act in 'the best interests of the corporation' but do not define that phrase. With respect to the interests of shareholders, while it is true that directors owe their fiduciary duties to the corporation and not to its shareholders, the practical reality is that in most situations, it will be appropriate for the directors to equate the 'best interests of the corporation' with the best interests of 'all of the shareholders, taking no one sectional interest to prevail over the others'.
>
> This does not mean that it will never be appropriate for directors to have regard to the interest of non-shareholder constituencies. In *Peoples*, the Supreme Court of Canada held that directors, in appropriate circumstances, may consider broader community interests, such as those of employees, suppliers, consumers, governments and the environment:
>
> > We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all of the circumstances of the given case, for the Board of Directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.

> However, to the extent that the directors do take non-shareholder interest into consideration, they should only do so with an eye to the 'best interests of the Corporation' in the sense that they believe that a 'better Corporation' will thereby be created. In other words, directors are not required to focus exclusively on short-term profit and shareholder value maximization, but they may chart a course that they honestly and reasonably believe will result in the Corporation, and ultimately its shareholders, growing and prospering in the long term, having regard for the social, political, and economic environment in which the Corporation operates."

The last paragraph of the above-referenced quote sets out succinctly the nature of what should guide you as a director in participating in making decisions of the Board. Firstly, you may look at a broad range of matters in assessing what you believe is in the best interests of the Corporation. Your decision has to be guided by the lens of what is in the best interests of the Corporation, and must be made by you honestly and in good faith, but can take into account a broad range of issues in making this honest determination. Your determination of what is in the best interests of the Corporation must also satisfy the second prong of the director's duties, namely, the "duty of care" test. This means that you must be able to establish that your determination of what was in the best interests of the Corporation was also made with the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. In other words, your determination of what is in the best interests of the Corporation must be supportable as being reasonable. This is an objective test and not a subjective test.

All relevant criteria may be referred to, as appropriate, in making your honest and reasonable determination as to the best interests of the Corporation on any issue. In ascribing the weight to be given each of these issues in making your determination, you must be guided by your honest assessment of the best interests of the Corporation and your determination must be reasonable.

In short, you can look at a broad range of issues in determining what is in the best interests of the Corporation and your determination must be guided by the best interests of the Corporation and arrived at honestly and in good faith. It must also be reasonable and bear the scrutiny of an objective test of reasonableness.

It may be helpful in providing some guidance for the determination of whether or not your decision is based on the right criteria, satisfies your director's obligations and was made without undue influence from the tensions referred to above, if you can answer the following

question in the affirmative. Would you vote the same way as a director of the Corporation even if you were not subject to the tensions arising out of being a board nominee of the City, a resident of Sault Ste. Marie or a Councillor for an affected area, and irrespective of your direct or indirect political interests? In your consideration you can draw a distinction between resorting to your perspective and experience as a Councillor and resident of the City (which is appropriate to draw upon) and succumbing to the tensions arising from your status and capacity in these respects (which is inappropriate). If the answer to the preceding question is honestly and reasonably determined by you to be in the affirmative and if you have made your board decision honestly and reasonably, then our view is that you have satisfied your obligations as a director in the decision you have made. If you cannot honestly and reasonably answer in the affirmative or if your board decision can be questioned when measured against the two duties, then you have to vote another way, declare an interest and refrain from voting or take other actions to further assess and address these tensions and the conflict posed by them.

Other Matters

A director is absolved from duties and obligations to which he or she would otherwise be subject to the extent that a director's powers are restricted by a unanimous shareholders' agreement.

The *Municipal Conflict of Interest Act* does not apply to your determinations as a director of the Corporation by virtue of section 142(6) of the *Electricity Act, 1998*. It is extremely important to note that section 142(6) only addresses your decision as a Board member of the Corporation and your decisions at the Corporation's Board level must be distinguished from your decisions on matters involving the Corporation and its activities at Council and your duties as a Councillor on Council deliberation involving the Corporation or its activities. The *Municipal Conflict of Interest Act* is relevant to any determination concerning the Corporation or its activities that may go before Council. This issue is addressed below.

Conflict of Interest Issues on Council Deliberations involving the Corporation and its Activities

Section 2 of the *Municipal Conflict of Interest Act* provides that membership of a Councillor on a board of a private corporation that has an interest in a matter before Council does constitute an indirect pecuniary interest on the part of such Councillor in such matter in respect of which Council is concerned. However, section 4 of the Act provides that the provisions contained in section 5, which require a Councillor to disclose an indirect pecuniary interest and to refrain from deliberating and voting in connection with matters

involving such indirect pecuniary interests of a Councillor, do not apply in certain circumstances. One such exception is section 4(h):

> "Section 5 does not apply to a pecuniary interest in any matter that a member may have ...
>
> (h) by reason only of the member being a director or senior officer of a corporation incorporated for the purpose of carrying on business for and on behalf of the municipality or local board or by reason only of the member being a member of a board, commission or other body as an appointee of a council or a local board."

The Corporation was incorporated under the OBCA pursuant to section 142 of the *Electricity Act*, 1998. The title to section 142 is "Incorporation of Municipal Electricity Businesses". Section 142 of the *Electricity Act*, 1998 makes it clear that corporations incorporated pursuant to this section are to be incorporated for the purposes of generating, transmitting, distributing and retailing electricity and that the Corporation and a holding company for such types of corporations is also considered to be in such business. **Accordingly, your capacity as a member of the Board of the Corporation as provided for and described above does not itself require you to declare an interest and to refrain from deliberations or voting on a proposal at Council.** Obviously, if there were other factors constituting an indirect or direct pecuniary interest so as to put you within the ambit of section 5 or outside of the exceptions contained in section 4 (or if other issues arise which do constitute such conflicts or which are not covered by exceptions), then compliance with section 5 would be required. Also, it is trite and likely goes without saying that in your deliberations and vote on the proposal at Council you have to comply with your general obligations of good faith, honesty and other statutory and legal requirements in discharging your duties, that you are subject to in all your deliberations and votes as a Councillor for the City of Sault Ste. Marie. These other duties remain in place, even though you are not obligated to disclose your interest and to refrain from deliberations and voting on any matters involving the Corporation or its activities simply because of your capacity as a member of the Board of Directors of the Corporation.

It may be advisable for you to make a statement at the outset of Council deliberations on such a matter that will provide a record of your consideration of this issue and your obligations in this regard and your due diligence in recognizing a potential issue and in

representing and obtaining in good faith a legal opinion on it. You could make the following statement on the record:

> "I am a member of the Board of Directors of the Corporation and hereby declare my interests in this respect. I have sought legal advice in connection with my obligations under the *Municipal Conflict of Interest Act* at Council deliberations and votes on matters involving the Corporation and its activities given these circumstances. I have been advised that pursuant to subsection 4(h) of the Act, the section 5 obligations of disclosure and refraining from deliberating or voting on matters do not apply by reason only of me being a director of a corporation incorporated for the purpose of carrying on business for and on behalf of the municipality or by reason only of me being a member of a board as an appointee of council."

GHR/jnb

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WeirFoulds LLP

MEMORANDUM

	INTERNAL COMMUNICATION	Page 1
TO	Robert Warren	
FROM	Natalia Vandervoort	
DATE	January 14, 2013	
FILE	09500.00002	
RE	Obligations and Liabilities of Directors and Officers of a Corporation Incorporated under the *Ontario Business Corporations Act*	

This memorandum[1] sets out general information regarding the obligations and liabilities of directors and officers of a corporation incorporated under the *Ontario Business Corporations Act* ("**OBCA**")[2], as well as some of the ways in which directors and officers can manage and limit their personal liability. As such, this memo is not meant to be a comprehensive analysis of the law. If you would like me to explore any of the issues discussed in this memo in more detail, please let me know.

In our case, city councillors sit on the board of directors of a public utilities commission incorporated under the OBCA. Apart from general liabilities and duties, we are particularly concerned with any conflict of interest issues that may arise in the city councillors' roles as both members of the board of directors and members of council.

DUTIES, RESPONSIBILITIES AND POTENTIAL LIABILITIES OF DIRECTORS AND OFFICERS UNDER THE OBCA

STATUTORY DUTIES

The two main duties under the OBCA that inform and direct the conduct of officers and directors are:

1. **Fiduciary Duty:** Directors have a duty to act honestly and in good faith with a view to the best interests of the corporation [s. 134(1)(a)].

[1] This memo is an update of Dan Ferguson's memo dated February 5, 2004 re Directors' and Officers' Liabilities and Obligations in the CBCA context (408257.1). I also heavily relied on Ryan Filson's precedent memo re Directors' Duties and Liabilities in the OBCA context (1096786.1), particularly in the "Practice Advice" section.
[2] RSO 1990, Ch. B. 16.

2. **Duty of Care:** Directors have a duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances [s. 134(1)(b)].

Additionally, the Act imposes the following duties:

3. **Duty to Comply with OBCA, etc.:** Every director and officer of a corporation shall comply with the Act, the regulations, articles, by-laws and any unanimous shareholder agreement [s. 134(2)]. Except for a unanimous shareholder agreement, directors or officers cannot contract out from this duty or from liability as a result of a breach [s. 134(3)]. This duty is guided by the fiduciary duty.

4. **Duty to Manage or Supervise Management**: Subject to any unanimous shareholder agreement, the directors shall manage or supervise the management of the business and affairs of a corporation [s. 115(1)]. This duty must be exercised in accordance with the duty of care under s. 134(1)(b).

Fiduciary Duty: The fiduciary duty has three interrelated components: (1) to act honestly, (2) to act in good faith, and (3) to act in the best interests of the corporation.

In arriving at a decision, even though the fiduciary duty is owed solely to the corporation, directors and officers must have regard to all relevant considerations, including the need to treat stakeholders equitably and fairly.[3] On this basis, the best interests of the corporation include the interests of shareholders, employees, creditors, consumers, governments, the environment, and others to inform their decision.[4] In this determination, conflicting interests may arise. The business judgment rule applies to the directors' decision as to what the relevant stakeholders' interests are.

The courts have been prepared to sanction directors who have not acted honestly where the directors were self-dealing or acting in their own self-interest.[5] Inherent in the directors' and

[3] *BCE Inc. v. 1976 Debentureholders, Re*, 2008 SCC 69 at p 4 (Summary) ["*BCE*"].
[4] *Ibid* at para 39, referencing *Peoples Department Stores* (see citation below).
[5] *Ibid* at p 4; Carol Hansell, *Directors and Officers in Canada: Law and Practice*, loose-leaf, (consulted on January 11, 2013), vol 2 (Carswell: 1999+), at 9-9 ["*Hansel* 2"].

officers' fiduciary duty is the obligation to refrain from acting in a conflict of interest with the corporation, unless properly dealt with, and from taking away an opportunity belonging to the corporation.[6] The general rule is that a director or officer must avoid putting himself/herself in a situation where his/her duty to act in the best interests of the corporation may be compromised by a competing personal interest.

Minimally, to satisfy their fiduciary duties to the corporation, directors must ensure that the corporation meets its statutory obligations.[7] This is expressed by the duty to comply with the Act in subsection 134(3).

Duty of Care: Unlike the fiduciary duty, the identity of the beneficiary of the duty of care is open-ended. As such, the duty of care may be the basis of civil liability to a variety of stakeholders. The Supreme Court of Canada has made it clear that this duty is owed to creditors.[8] However, the statutory duty of care does not provide for an independent basis for a claim. Instead, courts may take this provision into account in determining the standard of behaviour to be reasonably expected from directors facing a civil claim in tort, for example.

In *Peoples*, the standard was raised from that of the "reasonable person" to an "objective contextual standard".[9] One way for directors and officers to satisfy their duty of care is through process based activity such as recorded meetings. A more detailed discussion of this is included below, under "Practical Advice".

Duty to Comply with the Act - Reasonable Diligence Defence [s. 135(4)]: A director is not liable under section 130 (authorizing issuance of a share for consideration other than money) and has complied with his/her obligation under subsection 134(2) (duty to comply with the Act) if the director exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances, including reliance in good faith on financial statements or reports presented or on advice of an officer or employee of the corporation or on a report of a lawyer, accountant, engineer or appraiser, among other information set out in the provision.

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[6] *Hansel 2, supra* at 10-86.
[7] *BCE, supra* at para 38.
[8] *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68 at para 57 ["*Peoples*"].
[9] *Ibid* at para 62.

REMEDIES FOR BREACH OF STATUTORY DUTIES

Derivative Action (s. 246): This remedy allows a complainant (as defined in s. 245), with leave, to enforce directors' duties to the corporation by bringing an action in the name of and on behalf of the corporation. The court is able to grant various orders as set out in s. 247.

Oppression Remedy (s. 248): Unlike the derivative action, which is aimed at enforcing a right of the corporation itself, the oppression remedy is broader by focusing on the harm to the legal and equitable interests of complainants affected by oppressive acts of a corporation or its directors. This remedy is available to a wide range of complainants such as creditors and security holders.[10] The prescribed orders that the court can grant are set out in s. 248(3) and are broader than those under the derivative action.

In assessing a claim for oppression, the court must answer two questions:

(1) Does the evidence support the reasonable expectation asserted by the claimant?

(2) Does the evidence establish that the reasonable expectation was violated by conduct falling within the terms "oppression", "unfair prejudice" or "unfair disregard"?

With respect to the first factor, in determining a reasonable expectation, the court may look at, among others, the commercial practice, the nature of the corporation, the relationship between the parties, and past practices.[11]

Unless the directors have committed misconduct, or authorized or actively participated in the oppressive conduct in such a way that would permit a court to identify the directors' conduct as the cause of the damages, directors are generally not personally liable.

The circumstances in which personal orders against directors have been found to be appropriate are:

- where directors obtain a personal financial benefit from their conduct;
- where directors have increased their control of the corporation by the oppressive conduct;

[10] *BCE, supra* at para 45.
[11] *Ibid* at p 4 (Summary).

- where directors have breached a personal duty they have as directors;
- where directors have misused a corporate power; and
- where a remedy against the corporation would prejudice other security holders.

Common Law: Directors may be held liable under fiduciary duty principles or under the law of negligence for damages caused by the conduct of the corporation. However, directors will generally be held liable for negligence only if they have full knowledge of the wrongdoing and their conduct is unusually deliberate and reckless, such that the damage is attributable to the conduct of the directors distinct from the conduct of the corporation. In such circumstances, the directors may be liable notwithstanding that they purport to have acted on behalf of the corporation.

RESPONSIBILITIES AND LIABILITIES UNDER THE OBCA

The provisions reviewed in this section are important for directors and officers (where applicable) when exercising their duties under the Act, as in some circumstances, the directors and officers can be held personally liable or may even face a jail term.

It is important to note that pursuant to s. 261, no civil remedy for an act or omission is suspended or affected by reason that the act or omission is an offence under this Act.

Authorizing Issuance of Shares for Consideration other than Money (s. 130): Where directors vote for or consent to a resolution authorizing the issue of a share for a consideration other than money contrary to s. 23, the directors will be jointly and severally liable to the corporation to make good any amount by which the consideration received was less than the fair equivalent of the money [s. 130(1)]. Similarly, where directors vote for or consent to a resolution authorizing various purchases of shares, commissions, and/or payments contrary to the Act, directors will also be jointly and severally liable to the corporation [s. 130(2)].

To avoid liability under subsection 130(1), directors must prove that they did not know and could not have reasonably known that the shares were issued for a consideration less than the fair equivalent of the money that the corporation would have received [s. 130(6)].

Liability to Employees for Wages (s. 131): 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 [s. 131(1)].

However, directors are only liable under this section if execution against the corporation is returned unsatisfied or if the corporation goes into liquidation or faces other prescribed solvency issues [s. 131(2)].

Conflict of Interest (s. 132): A director or officer who is a party to a material contract or transaction or to a proposed material contract or transaction or who has a material interest in same shall disclose in writing to the corporation or request to have entered in the minutes of meeting of directors the nature and extent of his/her interest(s) [s. 132(1)].

In particular, directors must disclose their interests in the following circumstances [s. 132(2)]:

(a) at the meeting at which a proposed contract or transaction is first considered;
(b) if the director was not then interested in a proposed contract or transaction, at the first meeting after he or she becomes so interested;
(c) if the director becomes interested after a contract is made or a transaction is entered into, at the first meeting after he or she becomes so interested; or
(d) if a person who is interested in a contract or transaction later becomes a director, at the first meeting after he or she becomes a director.

Whereas, officers (who are not directors) must disclose their interests in the following circumstances [s. 132(3)]:

(a) forthwith after the officer becomes aware that the contract or transaction or proposed contract or transaction is to be considered or has been considered at a meeting of directors;
(b) if the officer becomes interested after a contract is made or a transaction is entered into, forthwith after he or she becomes so interested; or
(c) if a person who is interested in a contract or transaction later becomes an officer, forthwith after he or she becomes an officer.

If in the ordinary course of business the material (proposed) contract or transaction would not require approval by the directors or shareholders, the director or officer shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors

the nature and extent of his or her interest forthwith after the director or officer becomes aware of the contract or transaction or proposed contract or transaction [s. 132(4)].

The case law suggests that where there is "full and frank" disclosure to all interested parties and those parties approve, there is no need to comply with the requirement of written notice.[12] It is important to note that directors are not free to act as they please after they disclose their interest in the proposed transaction. Instead, the directors (or officers) must continue to place the interests of the corporation first.

Directors with a potential or an actual conflict of interest (see s. 132(1)) are not to attend any part of a meeting during which the contract or transaction is discussed and are not to vote any resolution to approve the contract or transaction unless the contract or transaction is [s. 132(5)]:

(a) one relating primarily to his or her remuneration as a director of the corporation or an affiliate;
(b) one for indemnity or insurance under section 136; or
(c) one with an affiliate.

The effects of the statutory disclosure of the potential or actual conflict of interest are (1) the director or officer is not accountable to the corporation or its shareholders for any profit or gain realized from the contract or transaction, and (2) the contract or transaction is neither void nor voidable [s. 132(7)]. Additionally, failure to disclose may result in the director or officer accounting to the corporation for any profit or gain realized [s. 132(9)].

The director or officer is not liable (provided they acted honestly and in good faith) and the contract or transaction is not void or voidable (provided that it was fair and reasonable to the corporation) where [s. 132(8)]:

(a) the contract or transaction is confirmed or approved by special resolution at a meeting of the shareholders duly called for that purpose; and
(b) the nature and extent of the director's or officer's interest in the contract or transaction are disclosed in reasonable detail in the notice calling the meeting or in the information circular required by section 112.

[12] *Reeves v. Russell* (2009), 82 RPR (4th) 137 (Ont Sup Ct) at para 90.

It is important to add that even if the director or officer does not have a financial interest in the particular transaction or contract, a conflict may be found if there is some personal connection with the party doing business with the company.[13] Directors and officers must be cognizant of this possibility and declare all possible conflicts/interests to avoid the possibility that the transaction will be subsequently set aside by the court.

Insider Liability (s. 138): If the director or officer (an insider) makes use of any specific confidential information for his/her own benefit or advantage that might reasonably be expected to affect materially the value of the security, that director or officer will be liable to compensate for the loss and would be accountable to the corporation for any direct benefit or advantage received [s. 138(5)].

Misrepresentation Offence (s. 256): Every person who makes a misrepresentation to the Director or to the Commission (or other persons) or who fails to file or comply with directions given by the Directors or the Commission (or other related parties) will be guilty of an offence and on conviction, liable to a fine or to imprisonment, or to both [s. 256(1)]. No person is guilty under this provision if that person did not know and in the exercise of reasonable diligence could not have known that the statement was a misrepresentation [s. 256(4)].

If a body corporate is guilty of an offence, every director or officer of this body corporate who, without reasonable cause, authorized, permitted or acquiesced in the offence is also guilty of an offence and on conviction is liable to a fine of more than $2,000 or to imprisonment for a term of not more than one year, or to both [s. 256(3)].

Offences in Failing to Comply with Provisions under the Act (s. 258): Every person who fails to comply with or contravenes, without reasonable cause, the following subsections (as they relate to directors and/or officers) is guilty of an offence and on conviction liable to a fine of not more than $2,000 or to imprisonment for a term of not more than one year, or to both, or if such person is a body corporate, to a fine of more than $25,000 [s. 258(1)].

- s. 29(5): a corporation shall not transfer shares under (4) to any person unless the corporation is satisfied, on reasonable grounds, that the ownership

[13] *Hansell 2, supra* at 10-33.

of the shares as a result of the transfer would assist the corporation or any of its affiliate or associate to achieve the purpose set out in (4) (subsection dealing with the exception relating to Canadian ownership);

- s. 52(5): No person shall use a list obtained (of debt obligation holders) except for the purposes set out in this subsection;
- s. 146(8): No person shall use a list obtained (of shareholders) except for the purposes set out in this subsection;
- s. 111: Fails to send a prescribed form of proxy to each shareholder of an offering corporation with notice of a meeting of shareholders;
- s. 112(1): Fails to send an information circular in connection with a proxy solicitation;
- s. 149(1): A director failing to appoint an auditor or auditors pursuant to this section at the first annual or special meeting of shareholders, if the shareholders fail to do so;
- s. 154(1): Fails to place certain information to shareholders at the annual meeting of shareholders; or,
- Fails to comply with any provision of the Act or the regulations.

If a body corporate is guilty of an offence, every director or officer of this body corporate who, without reasonable cause, authorized, permitted or acquiesced in the offence is also guilty of an offence and on conviction is liable to a fine of more than $2,000 or to imprisonment for a term of not more than one year, or to both [s. 258(2)].

POTENTIAL LIABILITIES OF DIRECTORS UNDER OTHER STATUTES

Directors may face personal liabilities under a number of statutes. However, the reasonable diligence defence acts to shield directors from liability, just like it does under the OBCA above.

Bankruptcy and Insolvency Act: Directors may be held liable if the corporation commits fraudulent acts when facing insolvency. Under the BIA, a variety of transactions are deemed

to be fraudulent when a corporation is facing insolvency (e.g. transactions with parties related to the corporation or fraudulent dispositions of property). If a corporation is deemed to have entered such transactions, the directors and officers who approve of or consent to the transactions may be personally liable with the corporation [s. 204], and for any losses or damages that are caused by the transactions [s. 204.3].

Income Tax Act (Federal): Directors may be held personally liable where the corporation fails to deduct or remit certain payments, notably source deductions in respect of salaries, wages, pension benefits, retiring allowances as well as payments of deferred profit-sharing plans, RRSPs and similar amounts [e.g. s. 227.1]. However, directors will not be liable unless the corporation has failed to pay such amount or is insolvent [s. 227.1(2)], and there is a limitation period of two years for claims against directors. Additionally, directors' liability for required remittances is subject to the due diligence defence [s. 227.1(3)] and to rely on this defence, directors must take positive steps to ensure that the corporation complies with its remittance requirements, including the introduction of adequate policies, and receiving regular reports on remittances including standard confirmations that the required remittances have been made.

Directors may also be liable and subject to penalties for offences committed by the corporation [ss. 238-239, 242]. However, directors will generally be held responsible for offences, however, only if they directed, authorized, assented to, acquiesced in or participated in the offences [s. 242].

Income Tax Act (Ontario): Directors may also face personal liabilities for the corporation's failure to withhold and remit source deductions [s. 38(1)].

Employment Standards Act, 2000 (Ontario): Directors are jointly and severally liable to the employees of the corporation for, among others, all debts not exceeding 6 months' wages that become payable while they are directors for services performed for the corporation, etc. [s. 81]. However, directors are only liable where the corporation did not pay the employees as prescribed by the Act or where the corporation becomes insolvent, among others set out in ss. 81(1) and 100(1)-(5) of the Act.

Canada Pension Plan Act: Where a corporation fails to deduct or remit CPP contributions from employee wages, the directors of such corporation at the time of the failure are jointly and severally liable together with the corporation to pay the unpaid amounts plus any interest on the amounts [s. 21.1]. Directors may avoid liability for such unpaid amounts if the

directors have applied reasonable care to ensure that the amounts are paid appropriately, and the directors are not liable for any claims that arise more than two years after the directors cease to act as directors [s. 21.1(2)].

Ontario Pension Benefits Act: Under the *Ontario Pension Benefits Act*, directors and officers may also face liability [ss. 109 and 110(2)] if they do not for example take reasonable care in the circumstances to prevent the corporation from contravening the PBA or its regulations.

Occupational Health and Safety Act: Directors may be held liable to fines of up to $25,000 and possible prison terms [s. 66]. Directors and officers have a positive duty to take all reasonable care to ensure that the corporation complies with the OHSA and its regulations. The level of care that is reasonable will be determined by the nature of the corporation's operations, the risks to employees, the alternative measures that may be available to reduce risks, and standards established by other companies in the industry. Generally, but not always, liability can be minimized or avoided by implementing a health and safety management service, as appropriate in light of the specific risks of injury to employees.

Environmental Statutes: The environmental statutes in Canada generally establish the following kinds of offences: (a) causing pollution in excess of prescribed standards or having unacceptable impact; (b) failing to report pollution to authorities; (c) failing to comply with licences, certificates or governmental orders; and (d) failing to clean-up pollution that has already occurred.

Enforcement of these offences is in large measure implemented by statutes, which impose liability for offences committed by a corporation upon directors in their general personal capacities. A typical example is subsection 280(1) of the Canadian Environmental Protection Act, 1999 which renders liable a director who "directed, authorized, assented to, acquiesced in or participated in" the commission of an offence, regardless of whether the corporation has been prosecuted or convicted. This effectively means that the director is not subject to liability unless he/she had knowledge of the activities which constituted the offence.

However, certain environmental statutes extend the scope of director liability such that a director is under a duty to act pro-actively to prevent a corporate offence. Section 194 of the Environmental Protection Act (Ontario), for example, requires a director to take "all reasonable care" to prevent a corporation from unlawfully discharging a contaminant. Failure to do so will render the director liable to penalties irrespective of whether the

corporation itself is charged with or convicted of an offence. A director who is found liable for a corporate environmental offence may be subject to substantial penalties, including fines or even jail, or both.

PRACTICAL ADVICE

While the potential liabilities of directors and officers can be very intimidating, there are many practical things that can be done to assist directors in satisfying their obligations and liabilities and to defend against any claim for breach of these duties. Here are a few practical suggestions that can be implemented without significant impact to the current structure of corporate governance and which involve merely a heightened awareness of, and concentration on, some issues and procedures and a little more formality in certain areas.

(a) The duty to act honestly and in good faith and with integrity and in the best interests of the corporation.

The honesty and bona fides of directors and officers, obviously, is a given. There are, however, various pitfalls that a director or officer can become unwittingly subject to.

Maintain Confidentiality: For example, included in the duty of good faith is a duty to at all times maintain information that the director becomes aware of by virtue of his or her office strictly confidential. Directors can unwittingly breach confidence through careless comments or the use of e-mail or memoranda which is not marked privileged and which is not conveyed and kept in a confidential manner. Directors and officers should always be mindful that their conversations, e-mails and memoranda must be kept confidential and act accordingly. Also, we should review, and amend where appropriate, the basis upon which director and management communications and records are transmitted and stored so that their confidentiality is maintained in a meaningful way.

Address Real or Potential Conflicts of Interest: Another common trouble area is when a director is unaware of a real or potential conflict of interest and therefore does not deal with it appropriately at law. For example, from time to time, directors and senior managers will have to negotiate and accept contracts on behalf of the corporation. If, for example, contracts are with an entity that the director could have some interest in (for example, shares owned by them in a public company) or with professional service providers that are somehow connected to a director or officer, it is important for that director to be aware of

such conflict, disclose his or her interest and then ensure that he or she does not vote or take part in any meaningful way in the negotiations of such contract. Directors can easily avoid being caught in a conflict of interest if they are educated by legal counsel as to the nature of this duty and how it can become an issue, as well as the simple procedure of declaring a potential conflict and refraining from voting on issues relevant to such conflict.

In particular, the courts have been found to accept the creation of a special committee of independent directors as a mechanism to minimize conflicts of interest when considering non-arm's length transactions.[14]

Recognize Opportunities: Directors must be mindful that it is their duty to be able to recognize "corporate opportunities" and to bring them to the attention of the board and the company so that these "corporate opportunities" can be properly assessed and acted on, if appropriate.

Business Judgment Rule: If the court is scrutinizing a particular decision of the board of directors, the directors may be able to invoke the business judgment rule to protect that decision. However, directors must demonstrate to the court that they exercised "sound business judgment". This again goes back to demonstrating to the court that an adequate process was followed to arrive that the particular decision (see below).[15] For example, the directors making the decision must be independent and disinterested and they must have exercised reasonable diligence in informing themselves of all the available material information (10-11).

While the duty of good faith, honesty and integrity to act in the best interests of the corporation is very seldom breached intentionally, directors must be cognizant of this duty at all times and always question whether or not a real or potential problem can exist. Being actively aware of this duty and measuring your actions against the duty at all times will assist in ensuring that this duty is not unknowingly breached.

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[14] *Greenlight Capital Inc. v. Stronach* (2006), 22 BLR (4th) 11 (Ont Sup Ct) at para 33.
[15] Fraser McDonald, "Public versus Private Standards of Responsibility", *Business Law Directors' and Officers' Liability in the Current Marketplace* (OBA Institute 2010 of Continuing Legal Education: February 16, 2010).

(b) A duty to manage the business of the corporation in a competent manner.

In general, the directors of a corporation are expected to carry on the overall management and direction of the corporation and to make decisions that determine the strategic direction of the corporation. In the role as directors, they need not deal with day to day management issues, as these decisions fall within the purview of senior management.

Avoid Unauthorized Delegations: Nonetheless, directors are fiduciaries and have to be careful to not abdicate their responsibility and not to make unauthorized delegations of their duties as fiduciary. In short, it is often a difficult line to draw between appropriate delegation and inappropriate delegation of directors' duties. While Section 115 of the OBCA provides that the director shall manage the business and affairs of the corporation, Section 127 allows the directors of the corporation to appoint from among their number, a managing director or committee of directors and delegate to such managing director or committee any power of the directors. Further, Section 133 provides that subject to the articles, by-laws or any unanimous shareholders' agreement, the directors may designate the offices of the corporation, appoint as officers persons of full capacity, specify their duties and delegate to them powers to manage the business and affairs of the corporation. Both Section 133 and Section 127 delegations are subject to limits and prohibitions on delegation as more particularly specified in Section 127 of the OBCA namely: submitting questions requiring approval of the shareholders, filling a vacancy among the directors or in the officer of auditor, issuance of securities, declarations of dividends, purchases, redemptions or other acquisition of shares and other like matters.

The issue for directors to address is how to ensure that notwithstanding the significant delegation of management to various committees, the directors are still discharging their duty of managing the affairs of the corporation and discharging their duties. Since there is no "safe harbour" or "bright line test" on this issue, the directors should institute processes and procedures that are designed to accomplish three goals: (i) institute tools and processes so that they are informed as to all relevant circumstances and management issues facing the corporation; (ii) institute tools and processes to ensure that they are able to make and implement management decisions or ratify the decision made by committees that can fall within the ambit of director management issues; and (iii) institute processes that give evidence that the directors are aware of the circumstances of the corporation and have made and implemented management decisions.

This can be achieved with some relative ease and will not only give evidence of appropriate management, but also of satisfaction of the standard of care required of directors and may provide an adequate defence to some of the specific statutory liabilities to which directors are subject. The following are some of the bases upon which to accomplish the foregoing:

(i) establish regular information and reporting systems from each of the management committees that are implementing management initiatives;

(ii) set up board of directors' meetings to review this information and comment on it; and

(iii) establish methods of communicating the board's decisions and comments back to the management groups.

These procedures need not be overly cumbersome or formal. For example, management decisions could be minuted by the management teams and then incorporated into, say for example, quarterly agendas for quarterly board of directors' meetings where they could be reviewed and commented on, which review would be forwarded back to the various committees for review, action and subsequent reporting.

Record Keeping: While board of directors' meetings and management committee meetings need not be overly formal, there should be a record of the following:

(i) adequate information being available;

(ii) agendas and background documents to be provided prior to meetings;

(iii) attendance at meetings by directors and committee members so that they ask questions with independent minds;

(iv) each director and committee member making notes and documenting their participation; and

(v) directors' and committee discussions and resolutions being properly minuted and then conveyed to and from the various committee levels and board level.

Directors should ensure that particulars, including the financial and business implications of any contemplated transactions be provided to them in sufficient time prior to a meeting of the board to allow an active discussion of the proposal and the making of an informed judgment.

(c) Due diligence and avoiding or defending statutory liabilities.

It is really only a refinement of the above procedures that can afford the best possibility of avoiding or defending against statutory liabilities imposed on directors.

Due Diligence Defence: The best way for directors to avoid or defend any allegations of non-compliance with various statutory duties is to put forward the "due diligence" defence. A "due diligence" defence is based on being able to prove that in certain sensitive areas the Corporation has through Board direction and oversight established the following:

(i) identifying areas that the company has to keep in compliance with;
(ii) putting into place systems for preventing non-compliance;
(iii) training employees with respect to compliance;
(iv) documenting compliance and breaches;
(v) monitoring and adjusting prevention systems;
(vi) ensuring that adequate authority is given to appropriate employees; and
(vii) plan remedial action in case the system fails.

In other words, the corporation must show that a system was in place to prevent the prohibited act from occurring and that reasonable steps were taken to ensure the effective operation of the system. On that basis, directors should work with management to establish corporate policies and systems that are appropriate to the particular risks arising from the operations of the corporation, and they should review and update the policies and systems regularly. Appropriate policies and systems may concern matters such as financial systems and accounting, risk management (including communication strategy that provides an opportunity for a reasonable investigation of the accuracy and completeness of all statements before they are issued to the public), contracting practices, workplace policies, corporate governance and early warning systems to provide alerts regarding financial problems and other unusual challenges that the corporation encounters.

Again, if the board is delegating tasks in this area, as it most surely will, it must ensure that committees provide detailed reports and that the directors approve overall policies and important decisions. The due diligence defence is best understood when reviewed in the context of a specific example, such as, for example, the areas of environmental compliance and employee health and safety measures. It may be warranted for us to review our performance in all of the seven subparagraphs above (and in our record keeping in respect of them) in connection with certain identified areas which should include environmental compliance and health and safety measures, as well as any other areas that the Board approves after consultation with our legal department.

Dealing with Statutory Requirements: With respect to the various statutory requirements that directors of corporations are to adhere to, the following is a suggested guideline for reducing risk: (a) ensure that directors are aware of the various statutory liabilities that may be relevant to them; (b) ensure that the directors are aware of the factual circumstances of the corporation which are relevant to the statutory requirements; (c) ensure that there is a record of the directors adequately addressing these legal and factual considerations at the appropriate time.

The following is a suggestion as to how to achieve this. Prior to the suggested quarterly board or committee meetings (or at any time that an action by directors or a committee is required), in-house counsel could review agendas of meetings with a view to identifying potential areas of concern and suggest what factual and legal issues would have to be addressed by the appropriate body and how best to record the directors' or committee members' due diligence in this regard. For example:

(i) if dividends were being declared, it would be suggested that proof that the directors had reviewed the financial statement of the corporation to ensure the required financial threshold was satisfied in connection with the dividend;

(ii) at regular quarterly meetings employee remittances would be reported to the appropriate committee or directors;

(iii) at regular quarterly meetings counsel could suggest what environmental or employee or health and safety issues should come before the appropriate board or committee.

(d) Some Miscellaneous Suggestions

In addition, there are other matters that the board of directors can consider in order to mitigate risks to directors and officers which include the following: (a) the by-laws of the corporation or its parent can provide for indemnifications of directors; (b) there can be specific contractual indemnifications given to directors and officers by the corporation or the parent corporation; (c) appropriately drafted directors' and officers' liability insurance can be obtained; not only should it be obtained, but it should be periodically reviewed and the directors and officers should be aware of the coverages given as well as the exclusions of liability.

In particular, under section 136(1) of the OBCA, a corporation can indemnify its directors provided that they have satisfied their statutory duties (duty of care and fiduciary duty).

A director should ensure that when he or she is resigning from a position as director or officer, a formal written resignation is given to the corporation and that the internal corporate and public registers are amended appropriately, as such a resignation will terminate director and officer liability for matters arising after the date of resignation. It is obviously important to keep factual evidence of the resignation in the records of both the corporation and the person resigning.