

COMPANY LAW

CONTENTS

GOVERNANCE

[§5.01]	Introduction	32
[§5.02]	Management of the Company	32
	1. Control of the Corporation	32
	2. Directors	32
	(a) Election or appointment of directors	32
	(b) Number	33
	(c) Residency requirements	33
	(d) Qualification of directors	33
	(e) Improper election or appointment	33
	(f) Term of office	33
	(g) Resignation	33
	(h) Removal	33
	(i) Alternate Directors	33
	(j) Register of Directors	34
	3. The Powers of Directors	34
	4. Officers	34
	5. Insiders	35
	6. Residual Powers of Shareholders	35
	7. Directors' Meetings	36
[§5.03]	Duties and Liabilities of Directors and Officers	37
	1. What Are the Duties?	37
	2. To Whom Are the Duties Owed?	39
	3. Avoiding the Duties	41
	4. Prohibited Resolutions	42
[§5.04]	Conflict of Interest	42
	1. General	42
	2. Disclosure and Ratification	43
[§5.05]	Protection from Liability	46
	1. Due Diligence	46
	2. Indemnification	46
	3. Insurance	47
	4. Resignation	48
	5. Trust Funds	48
	6. Relief by Court	48
[§5.06]	The Lawyer as a Director	48
	1. Duties	48
	2. Conflicts	49
	3. Loyalty	50
	4. Use of Confidential Information	50
	5. Privilege	50

Chapter 5

Governance¹

For further discussion of this subject please see the *British Columbia Company Law Practice Manual* (Vancouver: CLE), Chapter 6.

All legislative sections cited in this chapter and all references to the “Act” are to the *Business Corporations Act*, S.B.C. 2002, c. 57, as amended unless otherwise stated. All references to the Regulation (“Reg.”) are to section of the *Business Corporations Regulation* (B.C. Reg. 65/2004), as amended.

[§5.01] Introduction

This chapter deals with how companies are run and the duties and responsibilities of the people who run them.

Federal companies differ in some respects and are not dealt with comprehensively in this chapter; however, comparative provisions of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (*CBCA*) are mentioned in some sections.

[§5.02] Management of the Company

1. Control of the Corporation

While the articles may grant shareholders of a company, or any other person, extensive authority in connection with the management of the business of the company, the general practice is to entrust a board of directors with the exclusive power to manage the company and to grant that power free from interference from the shareholders (derived from s. 136(1)). Usually, the shareholders are left only with the power to change the directors at the annual general meeting or to remove them by special resolution (s. 128(3)(a)), or some other method or resolution as specified in the articles (s. 128(3)(b)).

2. Directors

(a) Election or appointment of directors

Under the *Business Corporations Act*, the person or persons designated as directors in the notice of articles are the first directors. After that, the Act and the articles govern elections and appointments (s. 122(1) and see *Western Mines Ltd. v. The Shield Development Co. Ltd.*, [1976] 2 W.W.R. 300 (B.C.S.C.)).

Often the articles provide that the directors retire at each annual general meeting and the incoming directors are elected or appointed at that meeting, although this is not mandatory. Directors may appoint additional directors between annual general meetings, if authorized by the articles, and provided that the number of directors added does not exceed 1/3 of the number of first directors (if any of them are still in their first term), or in any other case, 1/3 of the then current number of directors (s. 122(2) and (3)).

Subject to the articles, the remaining directors may fill a casual vacancy on the board (s. 131(b)) unless the articles provide otherwise (s. 130). Sections 131 to 135 set out the rules for filling vacancies and they apply unless the articles provide otherwise.

To be a valid election or appointment, certain procedures must be followed. First a director must consent or acquiesce at the meeting at which the director is elected or appointed (s. 122(4)). Consent can take the form of

- (a) written consent (before or after the appointment)(ss. 122(4) and 123 (1) (a)), or
- (b) performing functions of, or realizing benefits that are available to, a director of the company after that person knew or ought to have known of the election, appointment or designation (s. 123 (1) (b)).

The consent lasts until revoked, the director’s term ends and that director is not immediately re-appointed, or the director resigns or is removed (s. 123(3)).

The shareholders of private companies may elect directors by a resolution in writing instead of by actually holding a meeting.

¹ Based on an article prepared by **Geoffrey Bird** for the CLE publication, *Company Law* (November 1987). Reviewed and revised in March 1994 with the assistance of Harris S. Wineberg, Ladner Downs, Vancouver. Geoffrey Bird of Aydin Bird, Vancouver has kindly reviewed and revised this chapter annually since February 1995. Current to January 2006.

A company must file a notice of change of directors with the registrar within 15 days of the change in its directors or the address of a director (s. 127(1)). This will change the company's notice of articles (s. 127(2) and (3)).

(b) Number

Private companies must have at least one director and public companies must have at least three directors (s. 120).

Commonly, the articles give the shareholders the power to change or fix the number of directors. Always review the company's articles for the proper procedures and authorities.

(c) Residency requirements

There are no residency or citizenship requirements for directors under the *Business Corporations Act* (unlike under the former *Company Act*).

(d) Qualification of directors

Under s. 124(2), those who are not qualified to become or act as directors include: people under the age of 18; people found to be incapable of managing their own affairs; undischarged bankrupts; and people who have been convicted of an offence in the past five years concerning the promotion, formation or management of a corporation or unincorporated business, or an offence involving fraud.

If a director ceases to meet the qualifications of s. 124 or articles of the company, the director does not automatically cease to hold office but is required to resign immediately (s. 124(3)).

(e) Improper election or appointment

Every act of a director will not be invalid merely because of a defect or irregularity that may *later* be discovered in his or her appointment, election or qualification (s. 143). Be aware that the language of s. 143 may not be as broad as it seems.

(f) Term of office

The articles govern the length of a director's term of office and typically provide that the term will extend only to the next annual general meeting (s. 128(1)(a)).

(g) Resignation

The resignation of a director must be in writing and delivered to the company or a lawyer for the company. It is only effective at the time the resignation is received, or at the time, date or event specified in the resignation, if that time is later (s. 128(2)). The resignation no longer needs to be received at the company's registered office as was required under the former *Company Act*.

(h) Removal

Directors generally retire at each annual general meeting and if others are elected in their place, the term of the retiring directors ceases (if the articles so provide). Otherwise, a director may only be removed as specified in the articles, or by special resolution of the shareholders (s. 128(3)).

If the holders of a class or series of shares have the exclusive right to elect or appoint one or more directors, then only those shareholders may remove those directors (s. 128(4)).

(i) Alternate Directors

Although it is common to appoint alternate directors in British Columbia (and most standard form articles provide a procedure for doing so), there still is no statutory authority for this practice. Section 137 of the *Business Corporations Act* (which authorizes the transfer of powers of a director to another person if authorized by the articles), seems to contemplate the complete transfer of authority away from the directors, which is not normally what a director intends to have happen when the director appoints an alternate. Section 137 does provide that an alternate director would be subject to the same duties, liabilities and protections as any director of the company, to the extent that the alternate exercised the functions of a director, unless the functions were exercised only under the direction and control of another director, shareholder or senior officer.

Provisions in articles permitting the appointment of alternate directors vary; some provide that the alternate director can only attend directors' meetings in the place of his or her appointer, while others purport to appoint alternate directors for all purposes. An example is a provision permitting alternate directors to sign directors' written resolutions in the place of their appointers, although some practitioners have serious doubts about how valid this practice is.

(j) Register of Directors

A company must maintain a register of its directors (s. 126). This register must contain the full names and prescribed addresses of the directors, the date on which each director was elected or appointed, and the date on which each former director became a director and ceased to hold office as a director.

A director may avoid disclosing his or her home address if the director also has an office address where the director usually can be served.

The “prescribed address” for a director or officer is the delivery address of the office the director normally occupies during business hours (including, if different, its mailing address) or the address of their residence (Regulation, s. 2(2)).

3. The Powers of Directors

Section 136(1) of the *Business Corporations Act* states that:

The directors of a company must, subject to this Act, the regulations and the memorandum and articles of the company, manage or supervise the management of the business and affairs of the company.

When a person who is not a director (except those mentioned in s. 138(2)) performs the functions of a director, certain liabilities and obligations of directors will apply to that person (s. 138(1)).

No limitation or restriction on the powers or functions of the directors is effective against a person who does not have knowledge of these limitations or restrictions (s. 136(2)).

The standard form articles of British Columbia companies normally contain provisions similar to the Act.

In practice, the directors provide for the establishment of sound business policies of the company and it is the officers of the company (appointed by the directors) who actually carry out those business policies on a daily basis. Because there is an active duty imposed on directors to manage the company, no distinction may be drawn between active and passive (or nominee) directors and their exposure to liability.

When the appropriate provisions are placed in the company’s articles, the directors may transfer their powers to manage or supervise the management of the business, in whole or part, to others (who need not be shareholders or directors) (s. 137(1)).

Consequently, some or all of the shareholders of a company (or other persons) can act as directors of the company if the shareholders want them to. To transfer powers effectively, the articles must clearly indicate (by referring to s. 137 or otherwise) the intention that such powers be transferred (s. 137(1.1)(b)).

When the powers are transferred, the persons to whom these powers are transferred are subject to the same duties and liabilities as any director who exercises these powers (s. 137(2)(a)). And the “regular” directors are relieved from liabilities to the extent that other parties exercise these powers (s. 137(2)(b)). See also *Practice Material: Company*, §18.02.4.

Section 146(1) of the *CBCA* provides similarly. If all the shareholders (or all of the shareholders and a third person) enter into a unanimous shareholder agreement, they may restrict in whole or in part the powers of the directors to manage, or supervise the management of the business and affairs of the corporation, as long as it is otherwise a lawful agreement (s. 146(1)). The shareholders who are party to a unanimous shareholder agreement are subject to the same duties and liabilities as any director who exercises these powers. Like under the *Business Corporations Act*, the “regular” directors of the company are relieved from their duties and liabilities to the extent that other parties exercise powers under the unanimous shareholder agreement.

When a receiver-manager is appointed for a company, the powers of the directors and the officers cease to the extent of the appointment and during the period of appointment (s. 105). The powers and duties of the directors and officers continue with respect to other corporate matters and assets not covered by the appointment of the receiver-manager. If the company is still viable after the receiver-manager has completed his or her job, the powers of the directors and officers then resume. If a liquidator is appointed, the powers of the directors and officers cease, except in so far as the liquidator allows them to continue (s. 334(1)(a)).

4. Officers

The term “officer” is not defined in the *Business Corporations Act*, although “senior officer” is defined in s. 1(1).

A company doesn’t need to have any particular officers, nor is any office with the company required to be filled by a director, unless the articles provide otherwise (ss. 141(1) and (2)).

The qualification criteria for officers are the same as those for directors under s. 124 (s. 141(3)). However, it is an offence for an unqualified person to act as an officer of a company (s. 426(4)). The election and appointment of officers is within the power of the directors, unless the articles specify otherwise (s. 141(1)). Even though there may be an irregularity or a defect in the election or appointment of an officer, his or her acts may still be valid (s. 143). If an officer is removed from office without cause, his or her contractual rights as an employee, if any, still survive, but the appointment as an officer does not of itself create any contractual rights (s. 141(5)).

Only “senior” officers must disclose possible conflicts of interest arising from offices or property held (ss. 147 to 153). The same rules for indemnification and insurance that apply to directors also apply to officers (ss. 159 to 160).

The duties of the officers are directed by the articles and by the directors. Officers must also comply with the *Business Corporations Act*, the articles (s. 142(1)(c) and (d)). Sections 142(1)(a) and (b) impose a duty on an officer to act honestly, in good faith and in the best interests of the company, as well as a duty of care equivalent to a reasonable person standard.

5. Insiders

“Insider” in respect of a “private company” means (s. 192(1)):

- (a) a director or senior officer of the private company,
- (b) a person who beneficially owns shares of the private company that carry, in aggregate, more than the prescribed fraction of the votes [presently set at 1/10th (Reg. s. 19)], that may be cast in an election or appointment of directors at a general meeting,
- (c) an associate of a person referred to in paragraph (a) or (b),
- (d) the private company itself,
- (e) an affiliate of the private company,
- (f) a person who is employed by the private company or who is retained by it on a professional or consulting basis, or
- (g) a director or senior officer of another corporation if that other corporation is itself an insider of the private company.

Insider reports that disclose trading in shares are required for reporting issuers only; see Part 12 of the *Securities Act* and Part 12, Division 3 of the *Securities Act Rules*.

Every insider of a private company is liable if he or she uses specific confidential information in any transaction relating to any security of the private company (which term includes more than just shares of a company), if it is for the benefit or advantage of the insider or any associate or affiliate of the insider and if such information, if generally known, might reasonably be expected to materially affect the value of the security (s. 192(2)). The insider may be required to compensate any person who suffers a direct loss as a result of the insider’s forbidden conduct, and may also be accountable to the corporation (s. 192(3)).

When insiders and others who are in a “special relationship” to the corporation misuse confidential information, the *Securities Act* may also impose significant liabilities and penalties on them.

6. Residual Powers of Shareholders

Although for the most part the directors have the exclusive right to manage the business of the company, the shareholders are permitted a role in corporate governance in some areas:

(a) Pre-emptive rights on allotment of shares

Section 41 of the former *Company Act* granted mandatory pre-emptive rights to existing shareholders of non-reporting companies for later allotments of shares. Each of the existing shareholders of a particular class had a right of first refusal to maintain his or her rateable interest in the company. These rights of first refusal continue to apply under the *Business Corporations Act* to companies that are subject to the Pre-existing Company Provisions, (Table 3, Part 3 to the Regulation), although the shareholders of a pre-existing company may remove them by altering its notice of articles by special resolution (*Business Corporations Reg. s. 45*)

In the case of companies incorporated under the *Business Corporations Act*, such pre-emptive rights are *not* mandatory. They apply only if they are provided for in the company’s articles.

(b) Disposition of the company’s undertaking

Section 301(1) of the *Business Corporations Act* provides that a company must not sell, lease or otherwise dispose of all or substantially all of its undertaking unless

- it has been authorized to do so by special resolution, or
- the sale is in the ordinary course of its business.

The ordinary course of business exception would apply when a company, in the course of carrying on its business, sells most of its assets all at once (such as an apartment building or a large machine) but is replacing it with similar asset and continuing the business. This prohibition does not apply to a disposition of the undertaking by way of security, or by a short-term (less than three years) lease, or to parent, subsidiary or sister corporations (in the wholly owned context), or to the sole shareholder of the company (s. 301(6)).

Although it appears directors of a company can avoid the effect of s. 301 by first transferring the undertaking to a wholly owned subsidiary of the company with the intent that the wholly owned subsidiary would then transfer it to a third party, such action may well expose the directors who participated in such a scheme to liability for breach of their duty of good faith. There also is a risk that a court may determine that the “undertaking” of a parent company includes the assets of a subsidiary.

Case law indicates that the meaning of the words “all or substantially all of its undertaking” must be interpreted in a qualitative (how important) as well as a quantitative (what proportion) manner. In particular, a court will examine whether the disposition in question was an unusual transaction or one made in the regular course of business (*Lindzon v. International Sterling Holdings Inc.* (1989), 45 B.L.R. 57 (B.C.S.C.)).

When a company asks the shareholders to approve the disposition, a shareholder is then entitled to file a notice of dissent and the company may be required to purchase the dissenter’s shares (s. 301(5)).

Section 301(5) provides that any shareholder of a company may send (see s. 7) a notice of dissent to the company in respect of a special resolution to approve or ratify a disposition of substantially all of the company’s undertaking. If a shareholder does, Division 2 of Part 8 (ss. 237 to 247) applies, meaning that the shareholder can have the shares that are the subject of the notice of dissent purchased by the company at their fair value.

If a shareholder intends to dissent, the shareholder should not vote the subject shares in favour of the resolution approving the disposition or sign any consent resolution in writing approving the disposition.

When the special resolution is to approve a

proposed disposition, the company should observe the timing requirements in Division 2 of Part 8. The company should ensure that it complies with ss. 240(1) and (2) regarding the sending of material advising all shareholders (voting and non-voting) of their dissent rights (whether or not there is an actual meeting), as the company may not want to continue with the disposition if there are too many dissents.

7. Directors’ Meetings

In order to act, the directors must act together as a board. This does not mean that the directors must always hold a formal meeting, although they cannot be too casual about it either.

A resolution of the directors may be passed without a meeting if each of the directors “entitled to vote on the resolution” consents to the resolution in writing, or in any other way permitted under the Act or by the company’s articles (s. 140(3)). A director who is not entitled to vote on a particular resolution (for example, due to a conflict) does not need to sign the resolution for it to be valid.

A single director may constitute a meeting, but only if the company has one director (s. 140(4)).

Unless the articles specifically forbid it, directors can hold a meeting by telephone or by any other device that allows the participants to communicate with each other at the same time (s. 140(1)(b)).

It is quite proper for a quorum of directors of a company to meet and settle the principles of the subject upon which they are making a decision and to prepare the formal minutes later. However, the courts in British Columbia (more so than elsewhere in Canada) require certain formalities to be observed. In *Re Associated Color Laboratories Ltd.* (1970), 12 D.L.R. (3d) 338 at 351 (B.C.S.C.), the court approved the statement of F.W. Wegenast in *The Law of Canadian Companies* (1931) at page 215 in which he said:

...So long as those in attendance are satisfied, the formalities may be reduced to a minimum. The only essentials are that the proper persons should be in attendance and that the minutes should represent their intention.

There must be a real meeting at which a quorum is present. A meeting cannot be held by polling the directors one by one unless the articles specifically permit this as a way of holding directors’ meetings (s. 140(3)(a)(ii)).

All directors must receive prior notice of the meeting unless they are all present at the meeting. The period of notice need only be what is reasonable in the circumstances, it may be given verbally, and it need not specify the nature of the business to be transacted, unless the articles provide otherwise. It is proper to hold a meeting and later obtain a waiver of notice of that meeting from any directors who did not receive due notice. If a director then refused to give his or her waiver, the meeting would not have been validly held and any resolutions purporting to be passed, of no effect.

As a result of the wording of s. 140(3)(a)(i), resolutions in writing are only effective on the date the last director signs. Even though directors may properly ratify and confirm prior actions and therefore validate them, a resolution of the directors (whether in writing or passed at a meeting) speaks only from the date it is actually passed. Take, for example, the declaration of a dividend. One cannot really say that for the purposes of the *Income Tax Act* a dividend was declared last December 31 if all of the action relating to it took place the following June when the company's tax return was being prepared. However, if it could be said that the directors at least considered the matter on December 31 at a "meeting" where a quorum was present and if all directors are prepared to waive notice of the meeting, then it would be proper to prepare minutes of that meeting to reflect the actions that actually took place on December 31.

(a) Honesty

This duty includes being truthful, open and above-board with fellow directors. In particular, it prohibits any secret profits or any non-approved conflict of interest.

(b) Good faith and in the best interests of the company

This duty could more broadly be called the duty of loyalty or the fiduciary duty. The director must exercise his or her powers in the best interests of the company as a whole and not for any improper or collateral purpose, especially one that involves the director personally. The Supreme Court of Canada commented on the fiduciary duty in *Peoples Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68.

In determining whether or not there has been a breach of this duty, there is no general rule to apply. As Chief Justice Laskin said in *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592 at 620:

The general standards of loyalty, good faith and avoidance of a conflict of duty and self-interest to which the conduct of a director or senior officer must conform, must be tested in each case by many factors which it would be reckless to attempt to enumerate exhaustively.

And at 607:

An examination of the case law . . . shows the persuasiveness of a strict ethic in this area of the law. In my opinion this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing.

A director must be especially careful if he or she has been appointed to the board to represent the interest of a third party such as a shareholder or creditor. A director has a fiduciary duty to disclose information to the company if it affects the company in an important way, even if such disclosure would harm the interests of the party who appointed him or her (*PWA Corp. v. Gemini Group Automated Distribution System Inc.* (1993), 103 D.L.R. (4th) 609 (Ont. C. A.), leave to appeal refused (1993), 104 D.L.R. (4th) vii (note) (S.C.C.)).

[§5.03] Duties and Liabilities of Directors and Officers

1. What are the Duties?

The statutory duties of directors and officers are outlined in s. 142 of the *Business Corporations Act*. Every director and officer must (s. 142(1))

- (a) act honestly and in good faith with a view to the best interests of the company,
- (b) must exercise the care, diligence and skill that a reasonably prudent individual would exercise in comparable circumstances,
- (c) act in accordance with the Act and the regulations, and
- (d) subject to paragraphs (a) to (c), act in accordance with the memorandum and articles of the company.

(c) Care, diligence and skill of a reasonably prudent person

(i) Care

The duty of care requires prudence based on common sense. A director must act deliberately and cautiously and try to foresee the probable consequences of a proposed course of action.

(ii) Diligence

The duty of diligence is the making of those inquiries that a person of ordinary care in that position or in managing his or her own affairs would make. Some examples of the requisite standard of diligence are as follows:

A. attending meetings

A director does not have to attend all directors' meetings but should try to do so since he or she may be held liable for prohibited matters that happened while he or she was absent. If a director is not present at a meeting at which certain prohibited matters were approved (that is, carrying on restricted businesses, purchasing, redeeming or acquiring shares or paying dividends when the company is insolvent, paying improper indemnities, authorizing improper commissions or discounts or issuing shares without proper consideration), he or she must formally dissent within seven days of hearing about it or be deemed to have approved (s. 154(7)).

Section 123(3) of the *CBCA* is broader in that it does not restrict the application of the rule to certain kinds of resolutions. The director of a federal company must dissent with respect to any resolutions with which he or she does not want to be associated.

B. relying on other directors

Subject to the duty of care mentioned earlier, the general rule is that a director is not liable for the misdeeds of his or her co-directors if he or she has not participated in the acts resulting in the damage and is not negligent. However, in some American cases, all of the directors of a company have been held equally liable for misinformation in a

prospectus, even though all were not active participants in the misstatements.

C. relying on officers and professionals

In being diligent, a director may rely on the officers of the company, although he or she should still be cautious in accepting information from them and should ensure that the officers and professionals have the requisite expertise and credentials.

Section 157(1) of the *Business Corporations Act* permits a director (but not an officer) to rely in good faith on

- (a) financial statements of the company represented to the director by an officer of the corporation or in a written report of the auditor of the company to fairly reflect the financial condition of the company,
- (b) a written report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by that person,
- (c) a statement of fact represented to the director by an officer of the company to be correct, or
- (d) any record, information or representation that the court considers provides reasonable grounds for the actions of the director, whether or not that record was forged, fraudulently made or inaccurate.

The group referred to in s. 157(1)(b) is limited to true "professionals" and does not necessarily include experienced but non-professional officers of the company (see *People's Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68, at paras. 73-78).

Section 157(2) provides that:

A director of a company is not liable under section 154 if the director did not know

and could not reasonably have known that the act done by the director or authorized by the resolution voted for or consented to by the director was contrary to this Act.

Note that s. 157(2) applies only to a director, not to an officer. In practice, it would be difficult for a director to avoid liability by relying on s. 157(2).

A director should, as a minimum, examine the financial statements and review the general business activities of the company with the executive officers. However, a director is not required to go behind the financial statements to examine entries in the company's books.

The directors must be cognizant of the business as a whole. Directors have been found negligent where the actions by an officer of the company resulted in losses, which could have been detected and prevented by proper supervision.

D. relying on outside experts

Directors are not expected to be experts in all fields and frequently must rely on the advice of specialists. They should obtain outside advice when circumstances require, but they must be reasonably assured that the outsider is truly qualified to give the advice sought. Directors may rely on the advice and opinions of an outside expert if the outsider is independent and appears qualified to give the advice and the directors continue to exercise their own judgement.

(iii) Skill

The inclusion in the statutes of the reference to a "reasonably prudent person" requires an ignorant or inexperienced director to rise to the level of a reasonably prudent person in the circumstances, and holds a director with some special skill and knowledge (such as a lawyer) to the standard of a reasonably prudent person with that special skill and knowledge.

It is probable that in interpreting the meaning of "skill", no allowance will be made by the courts for any shortcoming such as lack of skill, knowledge or intelligence. In applying this test, the courts will probably also consider such factors as:

- the director's own qualifications;
- the significance of the action;
- the information available to him or her;
- the time available to make the decision;
- the alternatives that were open at the time;
- whether he or she represents a special interest group; and
- whether he or she is an advisor to the company (lawyer, accountant, engineer, etc.).

2. To Whom Are the Duties Owed?

It has long been a principle of common law that directors owe a fiduciary duty only to the company and not to the creditors or anyone else (*Percival v. Wright*, [1902] 2 Ch. 421). However, subsequent case law has eroded this position to the extent that now the directors may be held responsible to many different groups.

(a) Shareholders

The directors of a company may be liable to the shareholders for remedies sought under the oppression remedy or to the company under the derivative action remedy. The latter actions are commenced in order to right a wrong done to the company. The wrongdoers will normally be the directors and officers whose action has resulted in damage to the company. The directors could also be liable to the company for improper use of corporate assets that exist for the benefit of all shareholders or for favouring one group of shareholders over another in a takeover battle.

In *Redekop v. Robco Construction Ltd.* (1978), 7 B.C.L.R. 268 (S.C.), a director failed to disclose his interest in one of the company's contracts. It was held that the company could recover the secret profits and a minority shareholder was entitled to an order that his shares be purchased either by the company or by the errant director.

In *Malcolm v. Trustee Holdings Ltd.*, 2001 BCCA 161, the Court affirmed that, other than in exceptional circumstances (such as a family relationship or a special relationship of trust and dependency between the parties), the fiduciary duty of the directors is to the company and not to the individual shareholders.

Essentially, if there has been a “corporate mistake” in the conduct of the business or affairs of the company, any interested person may apply to court, under s. 229 of the *Business Corporations Act (CBCA, s. 247)*, for an order to remedy that omission, defect, error or irregularity, and it is the directors and officers of the company who must provide the remedy.

(b) Creditors

Generally, directors owe no fiduciary obligation to creditors (*Western Finance Company Ltd. v. Tasker Enterprises Ltd.*, [1980] 1 W.W.R. 323 (Man. C.A.)). Some courts, however, have lifted the corporate veil in order to benefit creditors who have been the victims of unscrupulous conduct. In such cases directors and officers, as agents of the corporation, could be deprived of their immunity and held liable if their actions are tortious.

Under s. 301(2) of the *Business Corporations Act*, if the appropriate requirements for the disposition of an undertaking of the company are not observed, a creditor may apply to the court to enjoin the proposed disposition or set aside the disposition or make any other order the court considers appropriate.

When funds administered by the company are impressed with trust conditions (even those contractually imposed, such as by an agreement with a creditor that funds received under certain conditions are to be held in trust for the creditor), directors have been held personally liable for participating in the breach of trust by the company when the subject funds were intermingled with those of the company (*Air Canada v. M & L Travel Ltd.*, [1993] 3 S.C.R. 787).

The Supreme Court of Canada clarified the nature of the duty of care owed by directors of a company to its creditors in *People’s Department Stores Inc. (Trustee of) v. Wise*, 2004 SCC 68. The trustee in bankruptcy of People’s Department Stores had claimed that in attempting to remedy the financial difficulties of a parent company and its

subsidiary, the directors had favoured the interests of one company over the other to the detriment of the creditors and had, therefore, breached their duty of care to the creditors.

The court held that although the directors of a company do owe a duty of care to a company’s creditors (and other parties), such a duty is in the nature of a negligence standard of care (that is, to exercise the care, diligence and skill of a reasonably prudent individual) and is not comparable to the fiduciary duty that is owed by the directors to the company itself (that is, to act honestly and in good faith with a view to the best interests of the company). The court stated (at paragraph 67) that directors and officers will not be held to be in breach of their duty of care if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. Directors are not expected to be perfect and the courts will not second-guess their decisions, but the court will determine whether the directors in reaching their decision exercised an appropriate degree of prudence and diligence.

(c) Employees

Each of the directors and officers of a company may be liable for up to two months’ wages and salaries of certain employees under s. 96(1) of the British Columbia *Employment Standards Act*. This liability includes unpaid commissions of employees. Despite s. 96(1), directors and officers are not personally liable for vacation pay accruing after the director or officer ceased to hold office, or for severance pay or termination pay payable under the *Employment Standards Act*, if the company is in receivership, or is subject to action under the *Bank Act (Canada)* or to a proceeding under an insolvency act.

Directors and officers may also be liable under occupational health laws for injuries caused to employees by unsafe working conditions. Directors and officers should be especially careful if their company deals in toxic substances.

In one instance, the Ontario Court of Appeal allowed an employee to recover damages from the directors personally for breach of his employment contract by holding them liable for the tort of inducing the breach of the contract by the company (*Kepic v. Tecumseh Road Builders, supra*).

(d) Government

At least 135 provincial and federal statutes provide for liability of directors and officers in certain circumstances.

Many statutes (including the *Criminal Code*) provide that if the company has committed an offence under that act, every director and officer who authorized, directed, condoned or participated in the offence is liable to the same penalties as if they had personally committed the offence. Fines for such offences range from \$50 to \$25,000 with the possibility of up to one year of imprisonment.

Some examples of the statutes follow.

(i) Corporate statutes

Section 427(2) of the *Business Corporations Act* provides for a fine of up to \$10,000 for directors and officers who authorize or condone the making of false or misleading statements.

Under the *CBCA*, failure to provide information to the Director under the *CBCA* relating to ownership and control, improper use of shareholder lists, failure to comply with proxy requirements, false reporting, and so on, all give rise to fines and/or imprisonment.

(ii) Securities Act

Directors, officers and employees who participate in insider trading activities by buying and selling securities of their company with knowledge of material facts or changes that have not been generally disclosed to the public are liable to very large fines and long terms of imprisonment. Such people are also liable if they advise other persons of inside information or do not provide full, true and plain disclosure in prospectuses and other disclosure documents.

(iii) Criminal Code

A person may become a party to the offence of conspiracy (as opposed to being an actual participant) if he or she encouraged the conspirators to pursue their ends (*Criminal Code* ss. 463, 464 and 465).

(e) Environmental Management Act

The *Environmental Management Act*, S.B.C. 2003, c. 53 imposes liability on corporations but also on individuals, including directors, officers, agents and employees, for offences committed under that Act (s. 121). Further, a “person” is defined to include directors and officers for the purposes of responsibilities under the remediation provisions.

3. Avoiding the Duties

(a) Nominee director

This term is used to describe a director who serves on the understanding that he or she is merely to obey orders given by someone else. Being a nominee, dummy, honorary, accommodation, or part-time director does not lessen a director’s responsibility or duty unless (and only) where the powers to be exercised by the director have been transferred to another person.

There is no distinction between the duties and responsibilities of inside (active) directors or of nominee or accommodation directors or of outside or part-time directors.

A person may not avoid the responsibilities of a corporate director by accepting the office as an accommodation with the understanding that he or she will not exercise any duties of a director.

(b) Doing nothing

Even if a director has not participated in an illegal act, the director is not necessarily excused. A director must actively dissent within seven days of learning of certain prohibited acts taken by the other directors, or else he or she will be deemed to have consented to such acts (s. 154(8)).

While a director may not be liable for any improper act of which he or she is ignorant or which occurred before he or she became a director, upon learning of such a wrongful act, a director must take immediate and effective steps to absolve himself or herself and satisfy the duty to protect the company. If a causal connection can be shown between a director’s inaction and a loss suffered by the company, the director may be held liable for the consequences of his or her inaction (*Bishopsgate Investment Management Ltd. v. Maxwell*, [1993] B.C.L.C. 814 (Ch. D.)).

American courts have also held that a director should take corrective action if he or she becomes aware of suspicious circumstances involving co-directors (*Newton v. Hornblower Inc.*, 585 P.2d 1136 (Kan. 1978)).

(c) Agreement

No provision in a contract or articles relieves a director from the duty to act in accordance with the *Business Corporations Act*, nor from liability for breaches of duty, negligence, default or breach of trust (s. 142(3)). Any provision in the articles or a contract that would amount to such an exemption would be struck down by the courts, although articles that merely modify the scope of a director's duty to an extent that does not amount to relief from the duty will be permitted (*Rhyolite Resources Inc. v. CanQuest Resource Corp.* (1990), 50 B.L.R. 275 (B.C.S.C.)).

4. Prohibited Resolutions

Under s. 154, directors become liable for losses and damages suffered by the company if they vote for or consent to certain resolutions. These resolutions relate to:

- an act contravening the restrictions on any business or power if the company pays compensation to a person (s. 154(1)(a));
- paying an unreasonable commission or discount on the issue of shares (s. 154(1)(b));
- paying certain (non-stock) dividends if the company is insolvent or if the payment renders the company insolvent (s. 154(1)(c));
- purchasing, redeeming, or otherwise acquiring shares for consideration where the company is or is rendered insolvent (s. 154(1)(d));
- making a payment or giving an indemnity to a director, officer or other eligible party contrary to s. 163 (s. 154(1)(e)); and
- issuing shares for less than their par value or that are not fully paid (s. 154(2)).

Some of these prohibited resolutions involve a question of whether a company is insolvent or would be rendered insolvent by the action, so a director can apply to court to determine if a company is insolvent or would be rendered insolvent by the proposed action (s. 70(3)). This application would likely only be useful in extreme cases.

A director who attended a meeting but did not vote for the resolution or who did not attend the meeting may avoid liability when a prohibited resolution is passed by actively dissenting as set out in ss. 154(5) or 154(8). Since a director is deemed to have given consent unless a dissent is made, it is important to follow the procedures set out in these subsections.

A director may avoid liability for a prohibited resolution that has been passed by entering a dissent in the minutes, or by delivering a dissent in writing to the secretary during the meeting, or, more practically, by sending it by registered mail to the registered office promptly after the meeting (s. 154(5)). The company and the secretary of the subject meeting must certify the date and time the dissent is received (s. 155) and must place a copy with the company's records at its records office (s. 42(1)(o)).

A director cannot dissent if he or she voted for the resolution (s. 154(6)).

The joint and several liability under ss. 154(1) and (2) is in addition to, and not in derogation of, any liability imposed on a director by the *Business Corporations Act* or any other act or rule of law (s. 154(3)). Anyone else who benefited from the resolution may also be joined (s. 154(2)(b)).

[§5.04] Conflict of Interest

Conflict of interest is the one area where directors and officers are most likely to get into trouble. Although the basic principles that relate to conflicts of interest are clear and although conflicts should be avoided where possible, applying those principles in practice permits a director some latitude. If the director moves carefully, the law may still permit a measure of conflict to co-exist between a director's own interest and that of the company.

The following is a discussion of how a director could run into conflict, a consideration of what conflicts are permissible, and if those conflicts are not permissible, what forms of protection are available to the director.

1. General

The basic principle was set out in *Aberdeen Railway Co. v. Blaikie Brothers*, [1854] All E.R. Rep. 249 at 252 (H.L.). It states that no fiduciary

shall be allowed to enter engagements in which he has, or can have, a personal interest conflicting, or which possibly may conflict with the interest of those he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or

unfairness of a contract so entered into.

The meaning of these words was narrowed and clarified by the House of Lords in *Phipps v. Boardman*, [1967] 2 A.C. 46 (H.L.). The words “possibly may conflict” were interpreted to mean what the reasonable person, in looking at the situation, would think gives rise to a real, sensible possibility of conflict, not what one could imagine might arise out of a situation.

If there is an improper conflict (as opposed to a permissible conflict as discussed later), the errant director must account to the company for his or her profits (*Redekop v. Robco Construction Ltd.* (1978), 7 B.C.L.R. 268 (S.C.)). This obligation does not depend on bad faith or bad intent, or whether the profit would or should otherwise have gone to the company, or whether the opportunity may not even have been open to the company to take advantage of, or whether the company was in fact damaged, or whether the director had a duty to obtain the source of the profit for the company. The mere existence of the conflict gives rise to the obligation to account.

For a director, a conflict may arise in many situations, including when the director:

- personally contracts with or competes with the company or he or she is a director of two companies that contract with each other.
- does something that is motivated by considerations other than the “best interests of the company” or when he or she does something ostensibly for one reason but also has an important collateral purpose. This is referred to as the “collateral purpose” doctrine. The leading cases relating to this doctrine are *Teck Corp. Ltd. v. Millar* (1972), 33 D.L.R. (3d) 288 (B.C.S.C.), and *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254, in which the directors used their power to issue shares to themselves and others in order to try to extinguish a contract and defeat a takeover bid.
- learns of or appropriates for himself or herself an opportunity for profit that should have gone to the company. This is called the “corporate opportunity” doctrine. The Supreme Court of Canada set out the principle that a director or officer cannot take a maturing corporate opportunity for himself or herself (*Canadian Aero Service v. O’Malley*, [1974] S.C.R. 592; see also *3464920 Canada Inc. v. Strother*, 2005 BCCA 35)).

Things such as secret benefits, secret commissions and bribes are forbidden and will render the director or officer who took them liable to account, even if they were not gained at the expense of the company and even if the opportunity was not open to the company. A director who takes a bribe in any form, even if it appears to be a gift, is liable to account for it. A director must not accept any gift or remuneration from someone dealing with the company.

2. Disclosure and Ratification

At common law a person in a position of trust (such as a director or an officer of a company), could not benefit in any way from his or her position. About 100 years ago the courts began to relax this rule, provided that the shareholders ratified the action. If the interested director held shares, he or she was entitled to vote in ratification proceedings (*North-West Transportation Co. v. Beatty* (1887), 12 A.C. 589 (P.C.)). Most jurisdictions have now codified these rules in their corporate statutes so that directors or officers may not be held accountable for profits or gains realized from a contract or transaction with the company in which he or she has a personal interest, provided that the director takes certain steps. These steps are set out in ss. 147 to 153 of the *Business Corporations Act* and in s. 120 of the *CBCA*.

Generally, all directors but only “senior” officers (defined in s. 1(1)) must disclose their personal interests in a contract or other transaction (s. 148(1)).

Directors and senior officers need only disclose the contract or transaction when it is material to the company and if the director or senior officer has a material interest in the contract or transaction, or is a director or senior officer of, or has a material interest in a person that has a material interest in the contract or transaction (s. 147(1)). Additional exemptions are provided for in situations that were not required to be disclosed under the *Company Act*, or for when the only parties to the transaction are the company and various wholly-owned subsidiaries or when the interested directors or senior officers are the sole shareholders of the relevant company (s. 147(2) and (3)).

Unless the director or senior officer properly discloses his or her interest and has the transaction properly approved, they must account to the company for any profit they make as a result of the transaction (s. 148(1)). If they do not take these steps, the director or senior officer may still be relieved of the obligation to account for profits by the court if the court finds that the transaction was fair and reasonable to the company (s. 150(1)).

A director or senior officer is not liable to account for any profits from the contract or transaction which he or she was required to disclose provided that

1. the disclosable interest was disclosed under the relevant *Companies Act* and the contract or transaction is approved under s. 149, other than s. 149(3) (s. 148(2)(a)), or
2. the directors who have no conflict approve the contract or transaction after the nature and extent of the interest have been disclosed to them (s. 148(2)(b)); or
3. the shareholders approve the contract or transaction by a special resolution after the nature and extent of the interest have been disclosed to them (s. 148(2)(c)); or
4. even if the contract or transaction is not approved in accordance with s. 149, if the contract or transaction was entered into before the person became a director or senior officer, the interest is disclosed to the directors or the shareholders, and the interested director or senior officer does not participate in any decisions or resolutions relating to the matter (s. 148(2)(d)).

There is no time specified for when the disclosure must be made, so the necessary approval may be given after the transaction has taken place.

No particular form is specified for the disclosure but it must be in writing. "Written" may be by being included in the consent resolution, or in the minutes of the meeting that approved the transaction, or in a written disclosure delivered to the company's records office (s. 148(3)). Copies of disclosures must be retained at the company's records office (s. 42(1)(n)(ii)) and shareholders may inspect the relevant portions of the minutes of meetings of directors or directors resolutions or other records that contain the disclosures (s. 148(5) to (7)).

If the company has entered or proposes to enter a material transaction or contract with a company or firm of, or in which, a director or senior officer of the company is a director or senior officer or holds a material interest, it is sufficient disclosure if a written statement is delivered to the company declaring that the interested party has such an interest or holds such a position in the target company or firm (s. 148(4)).

Once the interested director or officer makes the appropriate disclosure, the transaction must be approved by a directors' resolution or a special resolution of the shareholders (s. 149(1)). An interested director is not entitled to vote on the directors' resolution (but can vote his or her shares on a shareholders' resolution) to approve the matters (s. 149(2)) and is entitled to be counted in the quorum for the directors meeting, unless the articles provide otherwise (s. 149(4)).

When all the directors are interested in a transaction, they are authorized by s. 149(3) to vote to approve it on behalf of the company and thereby put it into effect (for example, in the case of the issue of shares to all of the directors). However, this does not mean that if all the directors are interested in the same transaction they may approve it and not be liable to account to the company for any profit. Section 148(2)(b) says that a director does not have to account for profits if the transaction is disclosed and approved by the directors, but the approval is only effective in situations other than those in s. 149(3). Consequently, if all the directors are interested, then they must properly disclose and have the transaction approved by special resolution of the shareholders under s. 148(2)(c), or else they may be liable to account for any profits.

There is no requirement that the transaction be reasonable and fair to the company before the directors and shareholders can approve it. However, if the contract or transaction was not properly approved under s. 148(2), the court may, if it determines that the contract or transaction is not reasonable and fair to the company, enjoin the company from entering the transaction, and/or order that the interested director or senior officer account for their profits, and/or make any other order that the court considers appropriate (s. 150(2)).

A resolution in writing of the directors may still be used when a director is unable to vote because that director has a disclosable interest (s. 149(2)) since only those directors entitled to vote need sign a resolution in writing for it to be valid (s. 140(3)(a)(i)).

A director or senior officer is not required to disclose his or her interest in a contract or transaction merely because (s. 147(4)):

1. the contract or transaction relates to security granted by the company for loans to or obligations undertaken by the director or senior officer or a person in whom the director or senior officer has a material interest for the benefit of the company or its affiliate;
2. it relates to an indemnity or insurance for

- the director or senior officer under ss. 159 to 165; or
3. it relates to the remuneration of a director or senior officer in his or her capacity as a director, officer, agent or employee of the company or its affiliate; or
 4. it relates to a loan to the company, and he or she (or a particular corporation or firm in which he or she has a material interest) has guaranteed or will guarantee the repayment of the loan; or
 5. it is with or for the benefit of an affiliated corporation (see s. 2(1) to (4)), and he or she is a director or senior officer of that affiliated corporation (although if the director has some other interest in the affiliated corporation, such as being a shareholder, then the exception does not apply).

Sometimes additional exceptions are included in the articles of a company. It is important to ensure that any provisions in the articles that make exceptions to the conflict provisions are not broader than those in s. 147(4) so as not to mislead the directors and officers. The provisions of the *Business Corporations Act* take precedence in this area and must be observed (ss. 142(2) and (3)).

Although a director or senior officer may be liable to account for profits if the disclosures and approvals referred to in ss. 148 and 149 are not obtained, the fact that the director or senior officer was interested in the matter does not render the contract or transaction invalid (s. 151). In that event, the court, on the application of the company or any director, senior officer or shareholder may enjoin the company from entering into the proposed contract or transaction, order that the director or senior officer must account for any profit, or make any other order that the court considers appropriate, but only if the court determines that the contract or transaction was not fair and reasonable to the company (s. 150(2)). A court will only set aside a contract or transaction if it is equitable to do so (*Ronbar Holdings Inc. v. Realcash Services Inc.*, [1991] B.C.W.L.D. 1875 (S.C.)).

Keep in mind that the courts impose a high standard of compliance on directors in situations where there is a conflict. Mere disclosure may not be sufficient in all cases. In *Levy-Russell v. Tecmotiv Inc.* (1994), 13 B.L.R. (2d) (Ont. Ct. (Gen. Div.)) the court stated that even if the director has made full disclosure, the director must continue to place the interests of the company ahead of his own. If the conflict is serious and the stakes are high, resignation by the director may be the only proper

way to deal with it.

The directors should always go through the process of disclosure and ratification (that is, comply technically with the statutory rules) even if it may seem unnecessary at the time. If the company has only two or three directors who are the sole shareholders and are aware of the circumstances, one might say, "Who is to complain?"

Any director, senior officer, registered or beneficial shareholder, as well as the company, can complain if the proper steps of disclosure and ratification are not observed (s. 150(2)). In addition, the shareholders may change and the new group, upon discovering the profit formerly made by the directors, may claim for repayment. This is what happened in the case of *Abby Glen Property Corporation v. Stumborg* (1978), 85 D.L.R. (3d) 35 (Alta. C.A.). The previous directors sold their shares and later had to account for their former, undisclosed profits, even though this profit now amounted to a windfall for the new shareholders since the purchase price of the shares was negotiated without knowledge on either side of this potential claim. Similarly, in the case of *Redekop v. Robco Construction Ltd.* (1978), 7 B.C.L.R. 268 (S.C.), the court held that because a director did not properly disclose his interest and obtain the necessary approvals, he had to account, even though the director may have been acting in good faith or the business opportunity which the interested director took for himself was not open to the company.

Section 153 states that a director or senior officer who holds any office or possesses any property, right or interest by which, directly or indirectly, a duty or interest might be created in material conflict with his or her duty or interest as a director or senior officer of the company, must disclose the nature and extent of the conflict. The disclosure must be made to the directors promptly after he or she becomes a director or senior officer, or if he or she is already a director or senior officer, promptly after he or she began to possess the property, right or interest or hold the office. However, this section seems to stand alone: sections 147 to 150 do not seem to apply to it. Consequently, even if disclosure has been made under s. 153, when a specific transaction or contract comes along in which a director or senior officer has an interest, that director or senior officer must still comply with ss. 148 and 149.

The *Canadian Aero Service* case, [1974] S.C.R. 592, expanded the potential liability of directors and officers in situations where they might be inclined to take a maturing business opportunity for themselves.

If a director or officer wishes to take a “business opportunity” that the company does not wish to pursue, he or she may be able to reduce (though probably not eliminate) exposure to liability by taking the following steps:

- disclose promptly his or her intent;
- resign from the board upon seeing the opportunity emerge;
- offer the opportunity to the company before leaving;
- delay making any profit from the venture for as long as possible;
- avoid taking any of the company’s clients, at least not directly. Any clients who wish to remain with the director should approach him or her, not vice versa;
- avoid luring away any officers or employees of the company, and
- receive from the board and the shareholders their blessing in the form of resolutions, which turn down the profitable opportunity and ratify his or her action.

These steps will not guarantee immunity, but they may help if the director or officer remains adamant in taking advantage of what might be a corporate opportunity.

It is also useful to obtain the unanimous ratification of the action by the shareholders. The case of *Canada Safeway Ltd. v. Thompson*, [1951] 3 D.L.R. 295 (B.C.S.C.) indicated that the conduct of the director may have been acceptable if the shareholders of the company had unanimously approved his actions after receiving full disclosure.

[\$5.05] Protection from Liability

What can a director do to protect himself or herself against liability in a conflict of interest situation, and if found liable, to what extent may he or she be insured or indemnified?

1. Due Diligence

For directors to be able to properly defend themselves if their conduct is called into question, they must be able to show that they were duly diligent (that is, they took all reasonable care) in their conduct as a director. This requirement is particularly important in avoiding responsibility for the conduct of employees who may have caused the company to commit an offence. If directors are able to show on a balance of probabilities that they took all reasonable care, they may avoid liability (*R. v. Bata Industries Limited* (1992), 9 O.R. (3d) 329 at 362 (Prov. Ct.)).

Bata has been cited with approval and adopted in many subsequent cases, although none so far has reconsidered or reviewed the underlying principles.

The due diligence exercised by directors and officers of a corporation is one of the factors taken into account when assessing who is to be ordered to undertake or contribute to remediation under the *Environmental Management Act* (s. 46(1)).

2. Indemnification

At common law, a company was permitted to indemnify directors in certain circumstances. Most jurisdictions have now codified this ability in their corporate statutes, but it is still only applicable in limited circumstances.

Under the *Business Corporations Act* a company may indemnify a director, officer or other parties, except regarding certain matters (see ss. 164(a) and (b) and s. 163(2)).

A company may indemnify a past or present director or officer or other persons who acted as a director or officer of affiliates or, at the request of the company, acted as a director or officer or equivalent of a partnership, trust, joint venture or other unincorporated entity (defined as an “eligible party”) against “eligible penalties” (defined in s. 159) relating to their actions as directors and officers of the company (s. 160).

Subject to the prohibitions referred to below, a company must pay the net expenses of an eligible party, after the final disposition of the matter, if the party was substantially successful on the merits, or if he or she was wholly successful on the merits or otherwise (s. 161).

A company may also pay the expenses of an eligible party in advance, provided that the party undertakes to repay the advances if it is later determined that the company is prohibited from paying such expenses (s. 162).

A company cannot pay an indemnity if

- the indemnity or payment is made under an earlier indemnity and at the time the agreement was made the company was prohibited from paying an indemnity by its memorandum or articles (ss. 163(1)(a) and (b));
- the party did not act honestly and in good faith with a view to the best interests of the company (s. 163(1)(c));
- the proceeding was not a civil proceeding and the party did not have reasonable grounds for believing that his or her conduct was lawful (s. 163(1)(d)); and
- the proceeding is brought against the party by the company or an associated corporation (s. 163(2)).

Notwithstanding any of the above limitations, the company or a director or officer may apply to court for an order that the company must indemnify the director or officer for any liability or expenses incurred by the party or for any other related obligations of the company (s. 164).

Although a company may enter into an agreement to indemnify a director or officer, because of the prohibitions the agreement cannot indemnify him or her in all circumstances. A director or officer would be wise to obtain an agreement of indemnity from the company requiring it to indemnify him or her when it is permissible to do so. Also, it is permissible and wise to obtain an agreement from a principal shareholder of the company or from some other outside party to protect against the other circumstances.

3. Insurance

Most company acts allow the company to purchase insurance for directors and officers (*Business Corporations Act* s. 165 and *BCBA* s. 124(4)). The *Business Corporations Act* allows the company to take out insurance on behalf of a director or officer against any liabilities, even those against which the company is not entitled to indemnify him or her.

Although this option is very helpful for directors, it does not solve all their problems. Frequently there are restrictions contained in the insurance policies, which exclude claims for wilful or dishonest acts. Some policies also provide for a large deductible, which in effect prevents a complete avoidance of

liability. Although policies used to be issued for up to three years, most now have a term of one year only.

Canadian companies are becoming increasingly interested in obtaining liability insurance for their directors and officers. There are basically two kinds of policies that follow the nature of the liabilities described above. The first type covers directors and officers for personal liability when the corporation either chooses not to or is not permitted to indemnify them or does not have the ability to do so. The second type insures the company itself so that it may be reimbursed for the costs and expenditures it incurs in indemnifying its own directors and officers.

Whether or not insurance is available and how much it costs depends on the individual case. However, because of recent high profile scandals and legal actions against directors and officers, the cost of this type of insurance has increased substantially in recent years and insurance companies have implemented tougher underwriting guidelines. Some of the factors that the insurance companies consider when reviewing a potential client are as follows:

- the scope of the indemnification provisions;
- the amount of coverage desired;
- whether the company shares are widely or closely held;
- the profitability of the company;
- the type of business conducted by the company;
- the degree of control exercised by its parent if the company is a subsidiary;
- the type of products manufactured by the company;
- whether the company frequently offers securities to the public;
- whether the company is involved in acquisitions or mergers or corporate changes; and
- the company's past loss history.

The policies also have some broad exclusions. They generally do not apply to the following:

- fines and penalties imposed by statutes;
- libel or slander;
- personal gains which are found to be illegal;

- claims made by the company itself against the director;
- punitive damages;
- claims brought about or contributed to by the dishonesty of the director or officer; or
- liability for obtaining a secret profit or gaining a corporate opportunity.

In addition, some policies will totally or partially exclude environmental or pollution claims.

It is also possible to obtain policies for senior management personnel who are not otherwise directors or officers of the company but who play a major role in its corporate decisions.

4. Resignation

Although a director is probably wise to resign from the company as soon as he or she sees that things are beginning to go wrong, resignation will not shield the director from liability for matters that have already occurred. Remember the previous comments about a director's duty to be diligent and the fact that some American cases have held that if a director discovers wrongdoing, he or she has an active duty to do something about it.

5. Trust Funds

Many statutes impose personal responsibility on the directors of companies that fail to observe the statutory rules. Recently, some companies have attempted to protect their directors from personal liability for unpaid wages, taxes, assessments, and so on, by establishing a fund to ensure that such obligations are actually paid by the company. This tactic has met with some limited success in British Columbia; see *Re Westar Mining Ltd.* (1992), 70 B.C.L.R. (2d) 6, in which the Supreme Court approved the establishment of a trust fund to pay the vacation pay of employees, although the court denied the use of such a fund to secure the unpaid severance pay of the employees.

The directors of an Ontario company tried to protect themselves by establishing a trust fund to pay statutory liens shortly before their company went bankrupt. The court set aside the fund as a preference and allowed a secured creditor to collect the money instead (*Central Guaranty Trust Co. v. 775843 Ontario Ltd.* (1993), 6 P.P.S.A.C. (2d) 121 (Ont. Ct. (Gen. Div.)). It has been suggested that if the directors establish such a fund far enough in advance of the company's insolvency, then they may be successful in retaining the fund to pay obligations for which they might otherwise be personally responsible.

6. Relief by Court

Where it appears to the court that in a proceeding against a director, officer, receiver, receiver-manager or liquidator of a company where it appears to the court that the director (or such other person) is or may be liable for negligence, default, breach of duty or breach of trust, but he or she has acted honestly and reasonably and ought fairly to be excused, the court, after taking into consideration all the circumstances of the case, may relieve the director (or such other person), either wholly or partly, from liability, on the terms the court considers necessary (s. 234).

To be entitled to the relief a director must pass three tests, that is, he or she must have acted both honestly and reasonably and also ought fairly to be excused; see *Doncaster v. Smith* (1987), 15 B.C.L.R. (2d) 58 (C.A.) (a case involving a receiver manager) and *Island Realty Investments Ltd. v. Douglas* (1985), 19 E.T.R. 56 (B.C.S.C.) (a case involving a director). In general, a director should be excused if his or her default arises from a mere technical defect that would not ordinarily have caused any loss to the company (*Doncaster v. Smith*).

[§5.06] The Lawyer as a Director

Generally, lawyers make good directors. Their training equips them to articulate their position well, to marshal facts required in making business decisions, and to explain the legal impact of the company's decisions. They have extensive experience because of their work with many business-related problems. Many lawyers participate in their own businesses separately from their legal practice. For these reasons, they are frequently asked to serve on the board of directors of companies, especially those of their clients.

Problems

For the lawyer who serves as director, serious problems may arise which are different from, and in addition to, all of the other problems that relate to directors in general.

1. Duties

In satisfying the duty of care, a director must exercise that degree of skill that may be reasonably expected of a person of his or her knowledge and experience. In matters in which a lawyer is deemed to have a higher degree of skill than a layperson, the lawyer has a greater burden and responsibility. He or she must therefore take a greater interest in the affairs of the corporation and make more inquiries about its operations.

A leading case illustrating this situation is *Escott et al. v. BarChris Construction Corporation* (1968), 283 F. Supp. 643, a decision of the U.S. District Court of New York. This case involved a class action for damages sustained as a result of false statements and material omissions in a prospectus contained in a registration statement. One of the directors was a lawyer who was also counsel for the company. Even though there was an express finding that he honestly believed that the registration statement was true and complete, his “unique position” as the director most directly concerned with the statement could not be disregarded. The court said at 687:

As a lawyer, he should have known his obligations under the statute. He should have known that he was required to make a reasonable investigation of the truth of all of the statements in the unexpertised portion of the document, which he signed. Having failed to make such an investigation, he did not have reasonable grounds to believe that all these statements were true . . . As the director most directly concerned with the registration statement and assuring its accuracy, more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work.

2. Conflicts

This problem concerns the situation where a person acts as the lawyer for the company at the same time as he or she acts as one of its directors. One of the functions of the board of directors is to monitor the management. It is not always practical for any person to be loyal to the board (as a director is bound to be) and, at the same time, to be loyal to management (as a lawyer is bound to be) since it is from the management that the lawyer receives instructions and the retainer. In general, it is almost impossible for a lawyer to be free from conflict in this situation.

On the question of conflicts of interest, refer to and become familiar with Chapters V, VI and VII of the *Code of Professional Conduct*, as well as Chapters 6 and 7 of the *Professional Conduct Handbook*.

Chapter 7 of the *Handbook* provides several principles to guide a lawyer’s conduct when the lawyer is invited to act as legal advisor and investor, or as legal advisor and in some other role. Note that a lawyer may not act for a client when the lawyer has a direct or indirect financial interest in a matter, or a financial or membership interest in or

with the client that would reasonably be expected to affect the lawyer’s professional judgement. Also, a lawyer will be barred from acting if a relative or associate has a financial or membership interest, which would reasonably be expected to affect the lawyer’s judgement (Rules 7(1) and (2)).

The provisions in the *Code* and *Handbook* do not forbid a lawyer from acting both as lawyer for a company and as one of its directors, although they do point to the dual role as a likely source of problems. Normally, if two clients have mutual dealings, a lawyer is able to decline to act for either or both clients should a problem develop. However, if the lawyer is a director of one of those clients, he or she also faces the difficult decision of having to resign as director.

In securities practice, there is a very high standard of care and diligence expected of lawyers when the prospectus is being prepared. A lawyer may have to act in an adversarial role when conducting examinations and certifications. This adversarial approach is jeopardized when he or she is also a director of the company. This conflict would be particularly pronounced if the company’s chief executives refused to follow his or her advice with respect to disclosure or some other matter. In that case, the lawyer/director may become a party to the decision by the board not to follow his or her own advice.

A lawyer/director is also unable to give an opinion that is free from his or her professional training. If he or she is asked (as every director is) for his or her view on the course of action proposed by the board, the reply will be taken as if it were a legal opinion, whether or not he or she is retained as the board’s lawyer.

At common law, lawyers have been shielded from liability to parties other than clients by the doctrine of privity, but the trend now is to repudiate the doctrine of privity and permit non-clients to recover damages when the injured party had cause to rely on the lawyer who acted as director or officer of the company in which the injured party had some investment (see *Hedley, Byrne & Co. v. Heller & Partners Ltd.*, [1964] A.C. 465 (H.L.), and Chapter 6 of the *Practice Material: Professional Responsibility*).

3. Loyalty

Lawyers acting as corporate counsel are employees of the company. As employees they owe their loyalty to management. They should try to anticipate problems before they actually materialize and must be cautious and conservative.

Directors owe their loyalty not only to management, but also to all the shareholders and employees. Their goal is to create profits for the corporation, even at a risk.

For a discussion of a lawyer's duty of loyalty to his or her client, see *3465920 Canada Inc. v. Strother*, 2005 BCCA 35.

4. Use of Confidential Information

A director must not use confidential or sensitive information to benefit himself or herself or others. This principle applies with even greater force to a lawyer (whether a director or not) because he or she often has access to more sensitive, confidential information about clients than may be the case with other directors. If the lawyer/director should also happen to be a shareholder, he or she may be tempted to buy or sell, or not to sell, shares in the client's company according to the nature of the information.

5. Privilege

How can the lawyer/director determine whether the information he or she receives is privileged? If the information is received in the lawyer's capacity as director, it is not privileged; if it is received in the lawyer's capacity as lawyer, it is privileged.

The best advice is that a lawyer should not serve on the board of a company for which he or she or any member of his or her firm acts as lawyer. Everything a lawyer is expected to do on the board can be done better if he or she is an independent legal consultant.

However, what if a lawyer has to (or wants to) serve on the board of directors of a client company? W.R. Miles suggested the following policy at the 1980 Canadian Bar Association mid-winter meeting, pages F-47 to F-50:

- (1) there should be a process to screen the companies for which lawyers in the firm may act as directors;
- (2) the lawyer must be kept well informed of corporate affairs and insist upon financial information and regular meetings;
- (3) the lawyer should insist on an indemnity from the shareholders of the company;
- (4) the lawyer should always be sensitive to potential conflict situations;
- (5) the lawyer should establish a close relationship with the auditor; and
- (6) in the case of public companies, the lawyer should only purchase or sell shares after publication of the financial statements.