

Liability of Directors in Canada – An Excerpt

by Ellyn Law LLP, Toronto, Canada - www.ellynlaw.com

Igor Ellyn, QC, FCI Arb., Lauren Lackie, Orié Niedzviecki, Belinda Schubert and Evelyn Perez Youssoufian

This article is an excerpt of the Canada Chapter of *International Liability of Corporate Directors*, 2nd edition, published by Juris Publishing in February 2013.¹ This excerpt excludes numerous aspects of the full chapter, particularly in reference to offering corporations, national corporate reporting, the supervisory role of the securities commissions, insider trading, prospectus violations, director loans and directors and officers' liability insurance and indemnification of officers and directors. Further, some sections have been abridged. The full article should be consulted for the omitted aspects and for a more complete analysis of the applicable law. This article is not legal advice and is intended solely as information. Further information can be obtained from the authors.

In Canada, there is a large body of statutory and common law which provides guidance about the standards of conduct expected from directors and attaches personal liability for failing to meet those standards. Directors now owe expanded duties to shareholders, employees, creditors, and other stakeholders and are increasingly being held personally responsible for the corporation's conduct. Liability attaches under the *Canada Business Corporations Act* (CBCA),² and under provincial corporations acts, most of which are similar to the *Ontario Business Corporations Act* (OBCA).³ This article deals only with liabilities under business corporations.

Sources of Liability

Liability of corporate directors in Canada, with the exception of the Province of Quebec, arises through both the common law and statutes. Each relevant statute governs corporations incorporated under it. For instance, if incorporation was made pursuant to the CBCA, this statute will govern to the exclusion of provincial Corporations Acts. The CBCA governs corporations incorporated under it, wherever in Canada they are situated.

Regardless of the statute under which incorporation occurs, many provincial and federal statutes dealing with specific areas of the law, such as the employment relationship, environmental protection, and taxation will give rise to the potential for liability of directors and officers.

¹ Available for purchase online at http://www.jurispub.com/cart.php?m=product_detail&p=12449

² RSC 1985, c C-44.

³ RSO 1990, c B.16.

Liability against directors flows primarily from the CBCA, OBCA, the Securities Acts,⁴ and historical actions under common law, some of which have not been codified. The remedies against directors arise from the following circumstances:

- Breach of responsibilities to the corporation or shareholders;
- Breach of the duty of loyalty to the corporation;
- Breach of the duty to act with skill and care;
- Breach of fiduciary duty (which may overlap with the statutory duty);
- Misrepresentation and fraud;
- Breach of specific duties under securities, taxation, environmental, employment, and other statutes;
- Circumstances which justify lifting the corporate veil; and
- Criminal and quasi-criminal acts.

Federal and provincial statutes also impose liability on directors and officers. The number of statutes in Canada that impose such liabilities has been estimated at more than 200.⁵

Lifting the Corporate Veil

The corporation is a legal entity separate from its shareholders and employees. As far back as 1897, in the oft-cited case of *Salomon vs. Salomon & Company Ltd.*,⁶ and more recently in the various Corporations Acts, it has been recognized that the corporation is akin to a natural person, with its own set of rights and liabilities. This separation between a corporation and its owners is commonly referred to as the “corporate veil”. The historic benefits of this division in terms of financing entrepreneurial activities and the creation of capital markets are undeniable.⁷

The evolution of the common law has increasingly held those responsible for corporate action accountable for any tortious conduct by them or the corporation. Courts have confirmed that there is no principled basis for protecting directors, officers, and employees from liability for their own tortious conduct on the basis that such conduct was in pursuit of the interests of the corporation.⁸ However, the doctrine of the corporate veil has not been abolished.

Directors, officers, and employees of limited companies remain protected from personal liability unless it can be shown that their actions are tortious or exhibit an identity separate from that of the company so as to make the act or conduct complained of their own.⁹ It is not yet clear

⁴ There are Securities Acts in each province and territory but in this chapter, reference will be made to the Ontario Securities Act, RSO 1990, c S.5 (OSA).

⁵ As noted by W. Horton et al. Canada chapter, *Liabilities of Corporate Directors*, 1st ed. Juris Publishing.

⁶ (1897) AC 22.

⁷ W. Horton et al., *supra.*

⁸ *ADGA Systems International Ltd. vs. Valcom Ltd.*, 43 OR (3d) 101 (CA) (1999).

⁹ *Scotia McLeod Inc. vs. Peoples Jewellers Ltd.*, 26 OR 481 (CA) (1995), leave to appeal to SCC refused 183 DCR (4th) vi; *Meditrust Healthcare Inc. vs. Shoppers Drug Mart*, 124 OAC 137 (CA) (1999) leave to appeal to SCC refused 134 OAC 399; *Immocreek Corp. vs. Pretiosa Enterprises Ltd.*, 186 DLR. (4th) 36 (2000); Sarra, “The Corporate Veil Lifted: Directors and Officer Liability to Third Parties”, 35 CBLJ (2001), at pp. 55-72.

whether a director or officer could be held liable for an unintentional tort.¹⁰ The legal standard appears to change where the conduct complained of goes beyond mere tort and becomes criminal or near criminal. In this case, the courts do not generally require the actions to exhibit a separate identity or interest of the corporation.

There are four circumstances in which liability will be imposed on directors for criminal or near criminal acts of the corporation: 1) Where the corporation was formed for the express purpose of doing a wrongful or unlawful act; 2) When the director expressly or impliedly directed that a wrongful thing be done; 3) Where the corporation is being used as a cloak to cover fraud or improper conduct; and 4) Where it would be “flagrantly opposed to justice” not to lift the corporate veil.¹¹ Similarly, the corporate veil cannot be used to protect directors against liability for crimes committed by the corporation.¹²

Criminal and Near-Criminal Acts

Just as there is no corporate veil protecting directors and officers from personal liability for negligent acts committed in office, directors and officers have personal criminal liability for criminal acts done in the course of their duties.¹³ Liability can be imposed individually or where it is proven that there was a common intention among two or more directors and/or officers to commit an unlawful act.¹⁴

It is not a bar to personal conviction that the acts were committed on behalf of a corporation and that the corporation itself is liable. The director and/or officer can still be held liable, either as the principal or as an aider or abettor, as the facts may prove.¹⁵

Threats and Retaliation against Employees for Disclosing Unlawful Conduct

A new offence designed to prohibit threats or retaliation against employees for disclosing unlawful conduct was introduced into the Criminal Code in 2004.¹⁶ The new provision has been criticized as a measure likely to have little effect, given that whistleblowers will take little comfort in the protections afforded by the provision.¹⁷ Nonetheless, its inclusion in the Criminal Code sends a strong signal to the business community that a corporate code of silence cannot be enforced to protect wrongdoing.¹⁸

¹⁰ Sugitan vs. *McLeod*, OJ No. 878 (SCJ) (2002), in which the issue was raised but not determined.

¹¹ McNally and Cotton, “A Thesis Regarding the Civil Liability of Directors for Criminally or Near Criminally Culpable Acts”, 30 *The Advocates’ Quarterly* (2005), at p. 194.

¹² *R vs. United Keno Hill Mines*, 1 YR 299 (Terr Ct) (1980), Paragraph 39.

¹³ Criminal Code, RSC 1985, c C-46, Section 21(1).

¹⁴ Criminal Code, Section 21(2).

¹⁵ *R. vs. Fell*, 64 CCC (2d) 456 (Ont CA) (1981).

¹⁶ Criminal Code, Section 425.1.

¹⁷ Hutchison and Henein, “Life After Martha, It’s Not a Good Thing: Corporate Crime and Criminal Corporations,” republished in *Crime & Corporations* (2006), at p. 9.

¹⁸ W. Horton *et al* Canada chapter, *Liabilities of Corporate Directors*, 1st ed. Juris Publishing.

Directors and Officers

Federal and provincial corporate statutes define the role and attendant duties and responsibilities of a director. Section 2(1) of the CBCA defines a director as “a person occupying the position of director by whatever name called and “*directors*” and “*board of directors*” includes a single director”. Where liability falls on a director, the determination of who is a director is not limited to examining the actual titles held.

On the other hand, Section 2(1) of the CBCA defines an officer as “an individual appointed as an officer under Section 121, the chairperson of the board of directors, the president, a vice-president, the secretary, the treasurer, the comptroller, the general counsel, the general manager, a managing director, of a corporation, or any other individual who performs functions for a corporation similar to those normally performed by an individual occupying any of those offices.”

Who is a director?

Any person who exercises a function that is directorial in nature may be found to be acting in the capacity of a director. Where a statute sets out the duties of directors without distinguishing between a director and an officer, such duties will generally be held to apply to both.

The role of a director includes the management of or supervision of the management of the business affairs of a corporation, subject to the provisions of any unanimous shareholder agreement.¹⁹ This role is further defined by various statutory and common law limits on directorial power, including rights reserved to shareholders and duties owed to the corporation and others.²⁰

Where directors are employees of the corporation (“inside directors”), employment agreements may stipulate on indemnification and other aspects of the liabilities of the employees as directors. While inside directors typically insist on entering into indemnification agreements as a term of employment, boards of directors are not legally obliged to indemnify them.²¹ Directors may appoint officers and determine their duties. They also may delegate their powers to manage the business affairs of the corporation to the officers.²²

Residency Requirements

At least 25 per cent of the directors of a Canadian corporation should be resident Canadians but, if a corporation has less than four directors, at least one director should be a resident Canadian. Under Section 2 of the CBCA, a resident Canadian refers to a Canadian citizen who

¹⁹ CBCA, Section 102(1).

²⁰ Reiter, *Directors' Duties in Canada* (2006), at pp. 18-153.

²¹ CBCA, Section 124(1).

²² CBCA, Section 121.

has his usual place of residence in Canada, a Canadian citizen who is not ordinarily resident in Canada but is a member of a prescribed class of persons,²³ or a permanent resident of Canada who is applying for refugee protection.²⁴

If the corporation has only one or two directors, one of them should be a resident Canadian. However, if a corporation engages in an activity in a prescribed business sector in Canada that has other rules under a federal statute or regulation, a majority of the directors should be resident Canadian.²⁵

In the case of a holding corporation that is a subsidiary of another body corporate, not more than thirty-three per cent of the directors should be resident Canadians if the holding corporation earns less than five per cent of its gross revenues in Canada in its most recent fiscal year.²⁶ For corporations incorporated under the OBCA (other than a non-resident corporation), at least 25 per cent of the directors should be resident Canadians, but where a corporation has less than four directors, at least one director should be a resident Canadian.²⁷

Inside and Outside Directors

Directors may be officers or employees of the corporation of which they are a director or its affiliates, or they may be considered “outside directors” who have no such additional ties to the corporation. Public corporations should have at least three directors, two of whom should be outside directors.²⁸

Outside directors are seen as less likely than inside directors to find themselves in situations that give rise to a conflict of interest, and more likely to act objectively in making management decisions for the corporation. In terms of assessing potential liability, outside directors also may be seen as having less knowledge of the workings of a corporation and less influence in its day-to-day activities.²⁹

This reduced degree of involvement and control has resulted in outside directors facing less exposure to liability where they are found to be truly acting independently. Although the CBCA does not distinguish between outside and inside directors when imposing duties, the case law shows that outside directors are less likely to be held personally liable for the acts of the corporation than inside directors.³⁰

²³ As prescribed by Section 13 of the CBCA.

²⁴ Within the meaning of Section 2(1) of the Immigration and Refugee Protection Act (SC 2001, c 27).

²⁵ CBCA, Sections 105(3)-(3.1). For example, corporations engaged in telecommunications, broadcasting, and banking should have a majority of Canadian ownership.

²⁶ CBCA, Sections 105(3.3)-(4).

²⁷ OBCA, Sections 2 and 118(3); Income Tax Act, Section 250(4).

²⁸ CBCA, Section 102(2).

²⁹ Anderson, *Directors' Personal Liability for Corporate Fault: A Comparative Analysis* (2008), at p. 89.

³⁰ *Ibid.*, at p. 114.

Under Section 237.3(1) of the CBCA, each defendant who has been found liable for financial loss is responsible for the portion of the damages that corresponds to his degree of fault. Thus, outside directors may be liable for a smaller portion of any damages awarded against their inside director counterparts.

In determining whether a director has acted in a way that is free of corporate influence, the courts have considered factors such as holdings in the company, business or personal relationships to major shareholders, former working relationships, affiliations with other companies, and past or present financial transactions.³¹

The distinction between inside and outside directors frequently arises in respect of the director's liability for the corporation's failure to pay a tax, which is imposed on the directors by statute. This includes the corporation's failure to remit employee payroll deductions to the Canada Revenue Agency under the Income Tax Act and the failure to remit to Goods and Services Tax (GST) or Harmonized Sales Tax (HST) collected on sales by the corporation. For example, the Federal Court of Appeal distinguished between inside and outside directors for liability under the Income Tax Act for failure to deduct or withhold remittances at source in the following terms:

'The outside director who gets involved to the extent of his role in the business and his abilities meets the standard of care in principle. If he ensures that the business is viable before investing money in it, if he surrounds himself with reliable and competent people who undertake the day-to-day management of the business, if he stays generally informed about what is happening, if nothing happens which should arouse suspicion about the payment of the corporation's liabilities, if he acts quickly when problems arise, he should not as a general rule be held liable.'³² This emphasizes the ability of an external director to rely on management, except when something occurs that should arouse his suspicion so that he should personally take action.³³

The Tax Court of Canada recently affirmed³⁴ the principle that inside and outside directors are subject to different tests and that it is wrong to automatically uphold liability of directors where a company fails to pay government taxes. The Court observed that the personal knowledge and background of the director, as well as his corporate circumstances in the form of the company's organization, resources, customs, and conduct are taken into account.³⁵

However, even an outside director has to demonstrate that he acted reasonably to obtain the necessary information to form a reasonable judgment. Willful blindness to the circumstances of the business will not exonerate an outside director from liability.³⁶

³¹ *Brant Investments Ltd. vs. KeepRite Inc.*, 60 OR (2d) 737 (HC) (1987), at p. 756, affirmed by *Brant Investments Ltd. vs. KeepRite Inc.*, CanLII 2705 (ON CA) (1991).

³² *Silver vs. Imax Corporation*, CanLII 72342 (ON SC) (2009), referring to *Cadrin vs. Canada*, FCJ No 1926 (FCA) (1998), Paragraph 5.

³³ *Silver vs. Imax Corporation*, CanLII 72342 (ON SC) (2009), Paragraph 404.

³⁴ *Thomas vs. The Queen*, TCC 421 (CanLII) (2011), Paragraphs 17-18, referring to *Soper vs. Canada*, 1 FC 124 (CA) (1998), Paragraphs 29-30.

³⁵ *Soper vs. Canada*, 1 FC 124 (CA) (1998), Paragraph 29.

³⁶ *Dipede vs. R.*, TCC 100 (2004), Paragraph 236.

The Supreme Court of Canada has stated that directors and officers will not be held to be in breach of the duty of care under Section 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The business decisions they make should be reasonable in light of all the circumstances about which they knew or ought to have known.

In determining whether directors have acted in a manner that breached the duty of care, perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations involved in corporate decision-making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.³⁷

Duties of Directors and Officers

In carrying out their responsibilities, directors and officers are subject to the duty to act honestly and in good faith to the best interests of the corporation, and the duty to exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.³⁸

Directors also are obligated to comply with the CBCA, its regulations, articles, by-laws, and any unanimous shareholder agreement.³⁹ Where a unanimous shareholder agreement restricts the powers of directors to manage or supervise the management of corporate business and affairs, parties to the agreement who are given such powers have all the rights, powers, duties, and liabilities of a director, and the directors are relieved of their rights, powers, duties, and liabilities to the same extent.⁴⁰

No other provision in a contract, the articles of incorporation, by-laws, or a resolution serves to relieve a director or officers from the duty to act in accordance with the CBCA or relieves them from liability for any breach. Directors also have specific functions set out by statute that should be fulfilled. These include approval of financial statements, appointment of auditors and new board members, and approval of directors' expenses.

The duty to act honestly and in good faith to the best interests of the corporation puts directors in the role of fiduciary of the corporation. This gives rise to additional obligations, including avoidance of conflicts of interest, not using one's position for personal gain or seizing corporate opportunity, and maintaining the confidentiality of corporate information.

³⁷ *Peoples Department Stores vs. Wise*, as cited by W. Horton et al Canada chapter, *Liabilities of Corporate Directors*, 1st ed. Juris Publishing.

³⁸ CBCA, Section 122(1).

³⁹ CBCA, Section 122(2).

⁴⁰ CBCA, Section 146(5).

Monitoring of Management

In the absence of a unanimous shareholder agreement with terms that shift management functions to persons other than the directors, the management of corporate business and affairs is carried out by directors, not by shareholders. Apart from specific duties that they should perform themselves, directors are entitled to delegate some of their functions to officers. The exigencies of business and the company's articles of association determine whether it is appropriate to delegate a duty.⁴¹

Where directors have delegated the management of corporate business and affairs, they have a duty to supervise those who are carrying out management functions.⁴² By virtue of Sections 122(3) and 146(5) of the CBCA, directors continue to be liable for their actions regardless of any delegation on their part. The only instance where liability may shift occurs as a result of the terms of a unanimous shareholder agreement.

In the absence of grounds for suspicion, a director may rely on officers to honestly perform duties that have been properly delegated to them. However, directors should review statements or reports given to them by those who are performing a delegated function, to determine whether there are reasonable grounds to question the content of the statement or document or the interpretation thereof.

Where the propriety of the supervision of those to whom tasks have been delegated becomes an issue, the "business judgment rule" (i.e., directors are presumed to have acted properly so long as they have exercised sound business judgment) and due diligence serve as potential defences.

While inside directors are generally expected to have a greater knowledge of corporate affairs and to be in a better position to evaluate whether delegation of certain management functions is reasonable, the distinction between inside and outside directors is not determinative. Nevertheless, there has been some suggestion that inside directors will have more difficulty relying on a due diligence defence in view of their close involvement with the corporation's day-to-day operations.

Outside directors should act prudently by asking questions to meet the duty of actively overseeing the company's operations, particularly when there are grounds for caution, such as the possibility of financial problems. All directors who wish to delegate authority should:

- Ensure that the function to be delegated is not excluded from delegation by Section 115 of the CBCA, a unanimous shareholders agreement, and the articles and by-laws of the corporation;

⁴¹ *Soper vs. Canada*, 1 FC 124 (CA) (1998), Paragraph 16, citing *City Equitable Fire Insurance Co., Re*, 1 Ch 407 (Eng CA) (1925), at pp. 426-428.

⁴² CBCA, Section 102(1).

- Carefully select the relevant officers and other advisors by considering their qualifications and areas of expertise;
- Review any report or piece of information provided by the individuals to whom authority has been delegated to ensure that it does not raise red flags, and diligently ask questions where clarification is needed;
- Actively monitor the performance of officers and advisors;
- Ensure that officers and advisors are not exceeding the bounds of delegated authority;
- Review the status of the corporation's business affairs with officers and directors;
- Depending on the importance of a transaction or event, actively obtain independent confirmation of the contents and conclusions reached in reports, and obtain advice from outside experts where appropriate;
- If there are grounds to believe that problems have arisen or may arise in the future, investigate the situation as soon as suspicions arise; and
- Establish safety mechanisms to identify and deter conduct by officers or advisors that may harm the corporation.

Fraudulent Transactions

Fiduciaries are not permitted to enter into engagements in which they have or can have a conflict of personal interest and duty,⁴³ as the fiduciary obligations of directors were such that no personal interest could be allowed to conflict with the carrying out of their obligations. Today, conflict rules with respect to directors are fully addressed in Section 120 of the CBCA,⁴⁴ thus:

- Directors who have an interest in a material contract or transaction with the corporation should disclose the nature and extent of their interest in writing or request to have the conflict entered in the minutes of the board;
- Disclosure should be made at the meeting when a proposed contract or transaction is first considered or, if board approval is not required for the contract, as soon as the director becomes aware of the conflict;
- A conflicted director should not vote on any resolution to approve the contract or transaction;
- Directors may make a general notice declaring an ongoing conflict; and

⁴³ *Aberdeen Railway Co. vs. Blaikie Bros.* (1854) [1843-60] All ER 249 (Scot HL), at p. 252.

⁴⁴ See also OSC Rule 61-501 (2000), 23 OSCB 971, Part 5, which impose reporting and procedural requirements on directors for transactions between a corporation and one or more of its directors or senior officers; and Part 7 of Companion Policy 61-501CP (2000) 23 OSCB 2719, sets out the role of directors in reviewing related-party transactions. Among other requirements, directors should disclose their reasonable beliefs as to the desirability or fairness of the proposed transaction, and the material factors on which their beliefs are based.

- If a director fails to disclose his interest in a material contract or transaction, a court may set aside the contract or transaction upon application of the corporation or its shareholder.

The CBCA also requires (although the OBCA does not) director or shareholder approval of the contract or transaction to avoid accountability for the directors or a finding that the contract or transaction is void or voidable. Section 132 of the OBCA contains other provisions not present in the CBCA, thus:

- A conflicted director is not accountable to the corporation for any profit or gain realized from a contract or transaction if the conflict was properly declared and the contract was reasonable and fair to the corporation;
- A material contract or transaction in which a director has a material interest is not void or voidable for the sole reason of the conflict or that the director voted for the contract, as long as the conflict was properly declared and the contract was reasonable and fair to the corporation; and
- Shareholders may approve of conflicted contracts by special resolution that will, under certain conditions, protect the contract or transaction from challenge and the director from accounting for the profits from the interested contract. Any shareholder approval requires that the director act honestly and in good faith and that the contract or transaction be reasonable and fair to the corporation.

The mere possibility that a director will be placed in a conflicted position is not enough to disqualify him.⁴⁵ Fraudulent acts by a director also may give rise to criminal or quasi-criminal liability.

Although a corporation comes into existence only on the date shown in the certificate of incorporation, promoters (individuals who intend to or are in the process of incorporating the corporation) may want or need to contract with third parties on behalf of the corporation prior to the date of its incorporation.

A promoter who will be a director should be aware of the potential for liability for pre-incorporation contracts, or those contracts which the promoter has signed in his own name, not making it clear to the other party that he is acting as an agent of the corporation and has no personal liability. Section 14 of the CBCA provides that a promoter is liable on a pre-incorporation contract before the corporation is formed. The corporation will be liable under the contract once it adopts it, at which time the promoter is released from liability. The promoter may expressly opt out of liability and, subject to his express waiver of liability, the court can apportion liability between him and the corporation upon his application or by a third party. The CBCA

⁴⁵ *Stelco Inc. (Re)* (2005) OJ No. 730 (SCJ) rev'd by (2005) OJ No. 1171 (CA)

provisions apply only to written contracts,⁴⁶ while the OBCA provisions apply to both written and oral contracts.⁴⁷

Duty to Exercise Care

In exercising their powers and discharging their duties, directors should (a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.

Unlike fiduciary duties, directors' general duties of care can be owed to any third party stakeholder. While directors are not ordinarily liable to creditors for the debts of the corporation, they do have general duties to creditors. The importance of creditors' interests increases in relevancy as the corporation's financial position deteriorates. If the corporation is or almost insolvent, directors should carefully consider the impact of proposed corporate actions on creditors of the corporation.⁴⁸

Each director is assessed as an individual and will be held to an objective standard of care. The content of the standard will be determined in the context of his skill, training, and the circumstances surrounding his actions. The shareholders elect the director, and cannot then demand a level of training or abilities that he does not possess. However, a higher degree of skill will normally be expected from an experienced business person than a lay person.

The circumstances surrounding the actions of the director or officer, as opposed to his subjective motivations, are the key to assessing whether he has satisfied the applicable standard of care. It is not enough for a director to simply say that he "did his best." Rather, objective factors such as whether or not he is a member of management or a specific committee on the board, whether or not he was provided with information that should have objectively raised a particular concern, whether or not he was selected to serve on the board because of professional qualifications or skills, and so on, will be determinative.

Reliance on the Advice of Others

The common law principle known as the "business judgment rule" has been codified in Canada on the basis that a director cannot "micromanage" the corporation, watch the employees, or analyze the corporation finances by himself. He should be able to reasonably rely on the advice of a select group of others who have direct information – such as officers, certain employees, and professionals.

⁴⁶ CBCA, Section 14(1).

⁴⁷ OBCA, Section 21.

⁴⁸ Horton *et al*, *supra.*, citing *Peoples Department Stores vs. Wise*.

The availability of competing interests and different potential paths to take should not affect the working of the business judgment rule. The director may consider the interests of shareholders, employees, creditors, consumers, governments, and the environment.

So long as the ultimate decision of the director is in the realm of reasonableness that is within a “range of reasonable alternatives”, the decision will be protected by the business judgment rule as directors are usually much more suitable to determine what is in the best interests of the corporation.⁴⁹

To rely on the reasonable diligence defence under the CBCA, a director should show that he exercised the care, diligence, and skill that a reasonably prudent person would have exercised in comparable circumstances. This includes reliance in good faith on (a) financial statements of the corporation fairly represented to him by an officer of the corporation or in a written report of the auditor to reflect the financial condition of the corporation; or (b) a report of a person whose profession lends credibility to a statement made by such person.⁵⁰

However, courts will not support the application of the business judgment rule if it does not meet minimum levels of reasonableness, as what happened in *UPM-Kymmene Corp. vs. UPM-Kymmene Miramachi Inc.*⁵¹ While this decision pays lip service to the business judgment rule and the principle of deference, it does open the door to increased judicial inquiry into what steps the directors of a corporation took in exercising their judgment. This inquiry could go too far and defeat the purpose of the business judgment rule.

Usurpation of Corporate Opportunity

Directors are often asked to evaluate investment opportunities for the corporation. It is not difficult to see the potential conflict when directors independently invest in a project that could have been acquired by the corporation, as opportunities which may be valuable to the corporation can be diverted away from it to directors and officers acting in their own self-interest.

To address the abuses that can easily result from such conduct, the law imposes fiduciary duties on directors to control their ability to seize corporate opportunities. While the objective behind the doctrine is relatively clear, the way in which courts have applied the doctrine has varied significantly. Until 1974, the test as to a director usurping a corporate opportunity was strict and inflexible. The issue before the court was whether the director took advantage of the authority granted to him by the corporation’s shareholders to acquire some “unbargained for” personal benefit.

It did not matter whether the director was acting in good faith, that the company would or could not have taken advantage of the opportunity, or whether the company suffered harm as a result

⁴⁹ *BCE Inc. vs. 1976 Debentureholders*, (2008) SCC 69, Paragraph 40.

⁵⁰ CBCA, Sections 123(4), 118, and 119.

⁵¹ (2004) 183 OAC 310 (CA).

of the director's behavior. Even after a director's resignation or dismissal, he could not act on information that came to him while he served the corporation.⁵² In the leading case of *Can Aero Services Limited vs. O'Malley*,⁵³ the Supreme Court relaxed the test and held that the application of the rule should be responsive to the circumstances of the case. *Can Aero* has been referred to more than 200 times in jurisprudence. The test established by the Supreme Court has been modified to provide that a director's duties in relation to a corporate opportunity will be assessed in light of all relevant factors, including:

- The position or office held by the director or officer;
- The nature of the corporate opportunity;
- The "ripeness" of the opportunity (i.e., whether a transaction is a mere possibility or close to being finalized);
- The specificity of the opportunity;
- The director's or managerial officer's relation to the opportunity;
- The amount of knowledge possessed;
- The circumstances in which the information or knowledge was obtained and whether it was special or private;
- The timing of the alleged breach (i.e., whether it was after the termination of the director's relationship with the company); and
- The circumstances under which the relationship terminated (i.e., whether it was by retirement, resignation, or discharge).⁵⁴

To reduce the risk of liability for seizing a corporate opportunity, a director who wants to pursue an opportunity in his personal capacity should seek legal advice. He also should take the following precautions, subject to the lawyer's advice:

- Disclose the interest in the opportunity to the board of directors in writing;
- Refrain from taking part in the process by which the corporation evaluates the opportunity;
- If the corporation decides to reject the opportunity, confirm in writing that the corporation did so while informed of his interest and based on business considerations alone;
- Obtain written approval to pursue the opportunity from the directors who are not in a conflict of interest with the opportunity or request approval from the shareholders by special resolution; and
- Refrain from taking part in any meeting related to the subject of him pursuing the opportunity or voting on any related resolutions.⁵⁵

Competing with the Corporation

⁵² *Industrial Development Consultants Ltd. vs. Cooley*, (1972) 1 WLR 443 (HC).

⁵³ (1974) SCR 592, Paragraph 48.

⁵⁴ *RBC Dominion Securities Inc. v. Merrill Lynch Canada Inc.*, (2008) SCC 54 (CanLII).

⁵⁵ Juma, "Appropriation of Corporate Opportunities by Company Directors", VIII/2 *Corporate Governance* (2010), at p. 434.

A problem related to directors' self-interested contracts and transactions and corporate opportunities is that of competition with the corporation. Director competition may occur either directly by engaging in a business that competes with the corporation or indirectly by having an interest in such a business.

Early decisions in this area tended to support the right of a director to compete with the corporation. The old English case *London and Mashonaland Exploration Co. vs. New Mashonaland Exploration Co.*⁵⁶ stands for the proposition that it is acceptable for a director of a company to act as a director of a competing company absent a restriction in the articles of incorporation. Despite *Mashonaland* and subsequent cases,⁵⁷ Canadian law generally imposes a fiduciary duty on a director not to compete with his company or to serve as a director of a competing company.⁵⁸ Although the case has not been overturned, it is significant that the *Mashonaland* decision predated the evolution of much of the law relating to fiduciary duty.

The basic principle in Canada is that the prohibition that is placed on a former director, or any former senior employee, who owes a fiduciary duty to his former employer, precludes the individual from using any special knowledge he obtained during the course of his involvement with the business to directly solicit the customers of his former business.

However, it does not preclude the solicitation of those customers as part of the general solicitation of potential customers, nor does it preclude the individual from using his general body of knowledge and expertise from competing, either for himself or for someone who might employ him, for the business of such customers.⁵⁹ Canadian law attempts to strike a balance among three competing interests – the right of the corporation to maintain the confidentiality of its goodwill, client lists, processes, and trade secrets; the right of the departing director to establish a new business in the field in which he has long experience; and the right of the clients to choose with whom they prefer to do business.⁶⁰

The principles applicable to a former director opening a competing business are based on the law of fiduciary duty and the terms of any agreement between the parties as to non-solicitation of clients or non-competition. The scope of the fiduciary duty is fact-specific and partly depends on the reasonable expectations of the parties.⁶¹ To be enforceable, covenants that restrict the

⁵⁶ (1891) WN 165.

⁵⁷ *Mashonaland* was approved in *Bell vs. Lever Bros Ltd.*, (1932) AC 161 (HL) and was followed by *Waite's Auto Transfer Ltd. vs. Waite*, (1928) 3 WWR 649 (Man KB). *Waite* was rejected in *W.J. Christie & Co. vs. Greer*, (1981) 121 DLR (3d) 472 (Man CA), although the proposition that a director may compete with the corporation of which he is a director was not directly addressed by the court.

⁵⁸ Christie, "The Director's Fiduciary Duty not to Compete", 55/4 *Modern Law Review* (1992).

⁵⁹ *Zesta Engineering Ltd. vs. Cloutier*, (2010) ONSC 5810, Paragraph 227, referring to *Edac Inc. vs. Tullo*, (1999) CanLII 14868 (ON SC) and the seminal case of *Canadian Aero Service Ltd. vs. O'Malley*, (1974) SCR 592.

⁶⁰ *BMO Nesbitt Burns Inc. vs. Ord*, (2007) CanLII 24673 (ON SC).

⁶¹ *Audience Communication Inc. vs. Sguassero*, (2008) CanLII 17306 (ON SC), Paragraph 63, affirmed by (2010) ONCA 510 (CanLII), referring to *Hodgkinson vs. Simms*, (1994) 3 SCR 377, Paragraphs 35-36; Ng, *Fiduciary Duties: Obligations of Loyalty and Faithfulness* (2007), Section 7:30; *D'Elia Estate vs. D'Elia*, (2009) CanLII 3977

departing director from carrying on his business or profession should be reasonable as to geographic scope, the activity that is restricted, and the time period of the restriction.⁶²

Where a director resigns his office, has no non-competition or non-solicitation covenant with the business, and there are factors suggesting others in the business are preventing him from carrying on his profession or trade, an Ontario court may not find any breach of fiduciary duty. Such determination will depend on several factors, such as:

- The former director sold his shares and resigned his directorship and office;
- The director had no intention of establishing a competing business before leaving;
- There was no evidence that he had solicited his former customers to follow him;
- The director received no secret benefits, property, or business advantage belonging to the corporation for which it had been negotiating while he held his office, employment, or directorship;
- He did not use secret or confidential information to gain an advantage; or
- Any damages incurred by the former employer were not caused by the director.⁶³

Statutory Limitations on Directors' Liability

There is no federal limitations legislation affecting civil claims related to the liability of corporate directors. While the Ontario Limitations Act of 2002 (OLA)⁶⁴ does not specifically provide for its application to federal causes of actions, neither does it exclude the same from its application.⁶⁵ While no Ontario Court has definitively ruled on the matter, the OLA generally “applies to claims pursued in court proceedings”, which is certainly wide enough to encompass a CBCA oppression claim brought in Commercial Court.⁶⁶ As a matter of strict interpretation, it is likely that the OLA applies.

Because of this uncertainty, where a corporation is incorporated under the CBCA, it might be best to adhere to the OLA two-year limitation period⁶⁷ instead of taking the risk that the six-year limitation period under the Federal Courts Act⁶⁸ applies. Section 39 of the Federal Courts Act clearly states that provincial limitation legislation applies to an oppression claim under the CBCA that is brought in Federal Court, in the absence of more specific federal legislation. In federal

(ON SCJ), additional reasons at (2009) 48 ETR (3d) 239 (ON SCJ); *Cohen vs. Kechichian*, (2003) CanLII 16606 (ON CA).

⁶² *Elsley vs. J.G. Collins Ins. Agencies*, (1978) 2 SCR 916; *Mason vs. Chem-Trend Limited Partnership*, (2011) ONCA 344 (CanLII), Paragraph 10; *KJA Consultants Inc. vs. Soberman*, (2003) CanLII 13546 (ON SC); *KRG Insurance Brokers (Western) Inc. vs. Shafron*, (2009) SCC 6, Paragraphs 23-28.

⁶³ *OEB International Ltd. vs. Leyden*, (1995) CanLII 7332 (ON SCJ), Paragraphs 63-64, referring to *Intertech Model Fixtures Inc. vs. Rusch*, (1992) 8 BLR (2d) 150 (ON Gen. Div.).

⁶⁴ SO 2002, c 24, Schedule B, Section 16.

⁶⁵ Chapman, “Eight (unanswered) questions on the new Limitations Act”, 34 Adv Q 285 (July 2008), at p. 307.

⁶⁶ Chapman, “Eight (unanswered) questions on the new Limitations Act”, 34 Adv Q 285 (July 2008), at p. 307.

⁶⁷ OLA 2002 SO, c 24, Schedule B, Section 4.

⁶⁸ RSC 1985, c F-7.

courts, the provincial limitations acts apply as federal law.⁶⁹ In Ontario, it is now clear that the limitation period for claims under the OBCA, OSA, and likely, for claims under CBCA, is two years after the oppression claim was discovered.⁷⁰

Director's Statutory Liabilities Limitations under the Canada Business Corporations Act

Under Section 251 of the CBCA, every person who, without reasonable cause, contravenes a provision of the CBCA or its regulations for which no punishment is provided is guilty of an offence punishable on summary conviction. A prosecution for an offence under the CBCA may be instituted at any time within two years after the time when the subject matter of the complaint arose. Under Section 251(3), the CBCA does not suspend or affect civil remedies for an act or omission by reason that it is an offence under the CBCA.

Section 118(7) of the CBCA states that an action to enforce a liability imposed by Section 118(1) (i.e., voting for or consenting to a resolution to issue shares for consideration other than money) or 118(2) (i.e., voting for or consenting to resolutions contrary to various sections of the CBCA) may not be commenced after two years from the date of the resolution. A director who violates the following provisions of the CBCA without reasonable cause is liable on summary conviction to a fine not exceeding \$5,000, imprisonment for a term not exceeding six months, or to both:

- Section 21 (access to corporate records);
- Section 22 (preparation, maintenance of, and form of corporate records);
- Section 85(5) (use of the list of security holders);
- Section 149 (send out proxies along with notice of meeting); and
- Section 225 (production of documents and records of a dissolved corporation by a person to whom they have been entrusted for six years after its dissolution or until the expiration of such other shorter period as may be ordered).

In contrast, a director who violates the following provisions is similarly liable:

- Section 150(1) and Section 150(2) (soliciting proxies and sending copies of management proxy circular or dissident's proxy circular);
- Section 171(6) and Section 176(8) (failure to notify the audit committee and the auditor of any error or misstatement of which the director becomes aware in a financial statement reported on; if the auditor or former auditor informs the directors of an error or misstatement in a financial statement, the directors should prepare and issue revised financial statements or inform the shareholders);
- Section 235 (failure to require reporting of information on ownership and control, constructive interest in securities, and publication of information); and
- Section 250 (offences with respect to records).

⁶⁹ *Wewaykum Indian Band vs. Canada*, (2002) SCC 79 (CanLII).

⁷⁰ *Fracassi v. Cascioli*, (2011) ONSC 178 (CanLII), Paragraphs 272-273.

Director's Statutory Liabilities Limitations under the Ontario Business Corporations Act

The OBCA has a general two-year limitation period on proceedings for offences under it or its regulations. Under Section 259(1) of the OBCA, no proceeding under Section 256 or under Section 258(1)(j)⁷¹ for a contravention of Section 144⁷² should be commenced more than two years after the facts upon which the proceedings are based first came to the knowledge of the Director as certified by him.⁷³

If a director be found guilty of misrepresentation as defined by Section 256(2) of the OBCA or of an offence listed in Section 258(1), he will be liable to a fine of not more than \$2,000, imprisonment for not more than one year, or to both, or, if such person is a body corporate, to a fine of not more than \$25,000. Where the corporation is guilty of any of the offences under Section 256(2) and Section 258(1) of the OBCA, a director who, without reasonable cause, authorized, permitted, or acquiesced in the offence also will be liable to a fine of not more than \$2,000, imprisonment for not more than one year, or to both.

Liability of Directors for Employee Wages

Corporate and employment standards legislation in many provinces make directors liable to employees for unpaid wages. For example, the Ontario Employment Standards Act of 2000 (ESA)⁷⁴ renders directors jointly liable to employees for all debts not exceeding six months' wages payable to each employee for services performed for the corporation while they are directors. Under Section 119(1) of the CBCA, a director is liable for up to six months of debt for services performed for the corporation while the director is in office.

It is an offence under both the CBCA and Section 136 of the ESA for a corporation to fail to pay unpaid wages. Any director who authorizes, permits, or acquiesces in a contravention of the ESA becomes a party to the offence, regardless of whether the corporation is prosecuted or convicted. Upon conviction, a director is liable to a fine of up to \$50,000, imprisonment for up to 12 months, or both, and may be ordered to pay the amount unpaid by the corporation.

Liability under the Occupational Health and Safety Act

Directors also can be held liable under the Ontario Occupational Health and Safety Act (OHSA).⁷⁵ Section 32 of the OHSA imposes a positive duty on directors and officers to take all reasonable care to ensure that the corporation complies with the OHSA and the regulations,

⁷¹ Section 258(1)(j) of the OBCA is the catch all provision to Section 258(1) stating that a person who "otherwise without reasonable cause commits an act contrary to or fails or neglects to comply with any provision of this Act or the regulations" is guilty of an offence.

⁷² Section 144 of the OBCA deals with the corporate records that are to be open to examination by directors.

⁷³ In Ontario, pursuant to Section 4 of the OLA, a proceeding should not be commenced more than two years after the claim was discovered. Discoverability by due diligence should be proved if the claim is commenced more than two years after the event occurred.

⁷⁴ SO 2000, C 41.

⁷⁵ RSO 1990, C O1.

orders and requirements of inspectors and Directors, and orders of the Minister. Under Section 66(1) of the OHSA, directors may receive a term of imprisonment (of not more than 12 months), a fine (of not more than \$25,000), or both for failing to comply with Section 32 of the OHSA.

Liability under Environmental Law

Directors and officers can be held directly responsible for failure to implement proper pollution control measures under federal and provincial statutes, primary of which is the Canadian Environmental Protection Act of 1999 (CEPA).⁷⁶

Section 280.1 of the CEPA imposes on directors the duty to take all reasonable care to comply with the CEPA and its regulations. If a corporation commits an offence under the CEPA or its regulations, any officer or director who directed, authorized, assented to, acquiesced in, or participated in the commission of the offence is liable to the penalty provided, whether or not the corporation has been prosecuted or convicted.

The CEPA contains a wide range of indictable and summary conviction offences for which a corporation and a director may be held liable. They include failing to provide required information or notices; failing to do proper testing; failing to comply with transportation of dangerous goods requirements; the manufacture and import of unapproved substances; improper use of sewer systems; failing to comply with occupational health and safety requirements or any orders issued under CEPA; and any form of pollution involving air, land, or water.

The CEPA offences are strict liability offences subject to the due diligence defence. A director may be held liable if he fails to prevent what he should have foreseen, and the standard used is that which a reasonable man would have foreseen in comparable circumstances. Under Section 186(1) of Ontario's Environmental Protection Act (EPA),⁷⁷ every person who violates the EPA or its regulations is liable for a breach of the statutory duty whether or not the corporation has been prosecuted or convicted.

Under Section 187(5) of the EPA, the maximum penalty for noncompliance by an individual is a maximum fine of \$4-million per day on a first conviction (\$6-million per day on subsequent conviction), imprisonment for up to five years less a day, or both. Once charged with an offence for failing to carry out a statutory duty, the director bears the burden of proving on a balance of probabilities that he carried out the duty that is the subject of the charge.

The Ontario Water Resources Act⁷⁸ includes provisions similar to those in the EPA regarding liability for directors, and those in the Dangerous Goods Transportation Act, including an onus on the director or officer to prove due diligence and penalties. The due diligence defence is

⁷⁶ SC 1999, c 33. Statutes which deal with federal environmental issues include the Transportation of Dangerous Goods Act of 1992, SC 1992, c 34; the Fisheries Act, RSC 1985, c F-14; and the Hazardous Materials Information Review Act, RSC 1985, c 24 (3rd Supp), Part III.

⁷⁷ RSO 1990, c E19.

⁷⁸ RSO 1990, c O40.

available under all Canadian environmental statutes. When assessing the due diligence defence, courts have considered the following factors:

- The extent of the injury caused to the environment, business, or individuals;
- The existence of an adequate pollution prevention system;
- The supervision of this system;
- The timely reporting of any infraction;
- The directors' responses to the situation;
- The existence of emergency plans;
- The accepted practices in the industry;
- The existence of alternatives to the steps that were taken;
- The economic feasibility of these alternatives;
- The foreseeability of a potential source of danger;
- The ability to control the damage; and
- The novelty of the technology involved.

Liability under the Dangerous Goods Transportation Act

Directors who are found to have directed, authorized, assented to, acquiesced in, or participated in the commission of an offence under the Dangerous Goods Transportation Act can be subjected to criminal liability, whether or not the corporation has been convicted. Section 4(1) holds that every person found guilty of contravening the prohibition on transporting dangerous goods without adhering to the prescribed safety requirements is liable on first conviction to a fine of not more than \$50,000, and on each subsequent conviction to a fine of not more than \$100,000, or to imprisonment for up to two years.

Liability under the Consumer Protection Act

Section 116(3) of the Consumer Protection Act of 2002⁷⁹ provides for the liability of every director who fails to take reasonable care to prevent the corporation from committing an offence under Section 116. Directors are liable on conviction to a fine of not more than \$50,000 or imprisonment for up to two years less a day.

Liabilities under the Competition Act

Directors and officers can be charged criminally for conspiracy or bid-rigging under the Competition Act.⁸⁰ In both cases, the individual director has to be directly involved in the impugned agreement or arrangement. Conviction for other offences is punishable by imprisonment for a term not exceeding five years or to a fine (in the discretion of the court for bid-rigging and not exceeding \$10-million for conspiracy).

⁷⁹ SO 2002, c 30, Schedule A.

⁸⁰ RSC 1985, c C-34, Section 45.

Liability for Corporate Income Taxes

When a corporation fails to comply with federal and provincial laws regulating tax matters and other source deductions, a director may be exposed to both civil and criminal liability. Directors are most often subject to liability for unfulfilled withholding obligations of a corporation under the Income Tax Act. The full chapter deals with these topics in more detail in respect of civil and criminal liability under the Income Tax Act and other tax statutes. The full chapter also refers to defences to tax liability.

The instances of liability of directors and officers of Canadian corporations referred to in this article are an overview of the applicable law. For a deeper analysis of these issues, including duties relating to offering corporations, national corporate reporting, the supervisory role of the securities commissions, insider trading, prospectus violations, director loans and directors and officers' liability insurance and indemnification of officers and directors, please consult the full chapter referred to the first page.