CANADA BUSINESS CORPORATIONS ACT

DISCUSSION PAPER

DIRECTORS' LIABILITY

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EXECUTIVE SUMMARY

DIRECTORS' LIABILITY

Directors' liability raises an issue that strikes at the heart of corporate governance in Canada. The competitiveness of Canadian corporations will be negatively affected if excessive or unmanageable liabilities cause highly-qualified directors to resign and outstanding people to refuse to serve on boards. Talented board members are essential to Canadian prosperity to permit Canadian corporations to thrive in the competitive domestic and international markets. On the other hand, there is a need for adequate corporate accountability. Inadequate accountability can lead to harm to other parties and the environment, result in a serious misallocation of resources and impact negatively on Canadian prosperity. Corporate liability, including directors' liability, is an important and effective compliance and risk-allocation mechanism.

The following issues are examined with respect to improving the fairness and predictability of directors' liabilities under the CBCA:

- liabilities;
- defence mechanisms;
- indemnification;
- directors' and officers' liability insurance;
- cap on the liability of directors; and
- duties of the board of directors.

With respect to **liabilities**, two areas of concern, wages and fiduciary duties, have been identified. The first issue considered with respect to the directors' liability for employees' wages is whether the CBCA should be amended to remove the provision on wage liability (s. 119). There are now overlapping directors' wage liability provisions under most provincial and federal labour standards laws. Also, the CBCA generally does not deal with the fair disposition of debt. On the other hand, directors have been liable for unpaid wages since the enactment of the first federal corporate law in 1869 and the current CBCA rules ensure that precedence is given to the payment of wages. Two alternative options are set out: 1) repeal the CBCA directors' wage liability provision (s. 119), and 2) maintain the provision. Another issue is whether s. 119, if maintained in the CBCA, should be amended to clarify that directors' liability for debts of employees does not include liability arising out of a contract or collective agreement for severance or termination pay.

With respect to fiduciary duties, directors must act honestly and in good faith with a view to the best interests of the corporation. There appears to be some uncertainty as to 1) the persons to whom these fiduciary duties are owed, 2) the content and object of the duties involved, and 3) the specific role of the nominee directors.

One issue is whether the CBCA should be amended to define the term "best interests of the corporation" (par. 122(1)(a)) by specifying the stakeholders to whom the fiduciary duties are

owed. Two further issues are whether the CBCA should be amended to narrow the content and object of fiduciary duties and whether to allow nominee directors to give special but not exclusive attention to the interests of those who elected or appointed them. The recommendation of the paper is that no legislative changes be made in this area and that the courts be left to develop fiduciary duties and the limits on their applicability.

Concerning **defence mechanisms** available to directors, the issue is whether the CBCA should be amended to provide for a due diligence defence. Currently, under subs. 123(4) of the CBCA, a director is not liable for improper share issuances or payments (s. 118), unpaid wages (s. 119) or breach of fiduciary duty and the duty of care (s. 122) if he/she relies in good faith upon:

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

The good faith reliance defence appears to be deficient in the limited nature of the circumstances in which it can be used to exonerate a director. The paper recommends that the CBCA be amended to include a due diligence defence for directors because this defence seems to be fairer for directors than the good faith reliance defence.

Indemnification provisions should be flexible, not require excessive conditions and protect adequately the directors. On the other hand, indemnification should be prohibited where it might encourage wrongful or improper conduct. With these goals in mind, the paper examines several issues related to indemnification of directors under s. 124 of the CBCA. One issue is that legal expenses in complex proceedings can be staggering and a director may be unable to finance his/her own defence. The current section 124 does not provide for the advancement of defence costs. The paper recommends permitting the corporation to advance defence costs to its directors so long as the directors produce a written undertaking to repay the advance if the court determines that the general fiduciary standards are not met.

A number of other issues are canvassed including whether the CBCA indemnification provision should be amended concerning the decision to indemnify and whether the CBCA should be amended to permit indemnification in investigative proceedings.

Directors' and officers' liability insurance provides protection to directors and officers in addition to the rights of indemnification created by s. 124 of the CBCA. Subsection 124(4) of the CBCA specifically authorizes the purchase of insurance. However, no insurance is permitted for liabilities relating to the "failure to act honestly and in good faith with a view to the best interests of the corporation," which is similar to the restrictions placed on indemnification. Some feel that the decision regarding the scope of insurance coverage should be left to the market place. The recommendation of the paper is that subs. 124(4) be amended to permit a corporation

to insure its directors and officers against any liability incurred by reason of these individuals being or having been a director or officer of the corporation or the body corporate, whether or not the corporation would have the power to indemnify them against such liability under the provisions of the CBCA.

The paper discusses whether it is appropriate to introduce a **cap on the liability** of directors. During preliminary consultations, it was suggested that a cap be placed on the total liability faced by directors of CBCA corporations. However, several objections can be made to a liability cap. Limiting the liability faced by directors essentially transfers that liability, and the risk, from them, their corporations, and their insurers back to the injured party. That party could be the corporation's employees, creditors, the government, or other third parties. Another argument is that it is inappropriate for corporate legislation to attempt to affect compliance regimes established by other legislation. This could be seen as an unfair imposition of corporate policy goals upon goals enacted by other legislation. On the other hand, one complaint about directors' liability is that there is no overall coordination of the many liabilities imposed by statute on directors. A liability cap could serve as that coordination. The paper recommends against a liability cap.

Finally, on the **duties of the board of directors**, subsection 102(1) of the CBCA provides that ". . . the directors shall manage the business and affairs of a corporation." The appropriateness of this definition has been questioned. The TSE report on corporate governance in Canada recommends the elimination of any possible interpretation of the directors' responsibilities as being to manage the business day-to-day and to describe the responsibility as being to supervise the management of the business. The Business Corporations Act (Ontario) defines the general duty of the board as being to "manage or supervise the management of the business and affairs of a corporation." The paper recommends adopting this definition.

The recommendations and options outlined in the paper are not in any sense the final word on the subject. They are ideas that have come about largely through discussions with stakeholders across the country. As such, they are not government or even departmental policy.

There may be strong objections to the recommendations and options contained in this discussion paper. There may be alternatives that we have not yet been made aware of. There may even be entirely different ways of looking at the issue of directors' liabilities. This paper is intended to solicit from those who use the CBCA and others new ideas on how the directors' liability provisions of the CBCA can be made more fair and predictable for directors and otherwise improved.

CANADA BUSINESS CORPORATIONS ACT

DIRECTORS' LIABILITY

I. INTRODUCTION

[1] Resignations by directors of Westar Mining, Canadian Airlines and Peoples Jewellers during the summer of 1992 brought media attention to the issue of directors' liability. The resignations were prompted by fears of these directors that they would be held personally liable for millions of dollars of unpaid corporate debt should their corporations become bankrupt. Because of these incidents, the media raised questions as to whether Canadian legal standards on directors' liability have become too severe.

[2] This raised an issue that strikes at the heart of corporate governance in Canada. The competitiveness of Canadian corporations will be negatively affected if excessive or unmanageable liabilities cause highly-qualified directors to resign and outstanding people to refuse to serve on boards. Talented board members are essential to Canadian prosperity to permit Canadian corporations to thrive in the competitive domestic and international markets.

[3] On the other hand, there is a need for adequate corporate accountability. Inadequate accountability can lead to harm to other parties and the environment, result in a serious misallocation of resources and impact negatively on Canadian prosperity. Corporate liability, including directors' liability, is an important and effective compliance and risk-allocation mechanism.

[4] In October 1992, the federal government established an interdepartmental working group to examine the issue of directors' liabilities. The working group found that statutory liability faced by directors has expanded during the last 20 years, particularly with respect to source deductions, taxes, unpaid wages, severance and termination pay, and environmental and corporate law. Stronger enforcement and broader court interpretations have increased the exposure of directors to liability. Also, there is significant uncertainty surrounding the potential interpretation of certain statutes. The working group did not, however, find sufficient evidence to conclude that directors' liability has become so severe that it could not be handled by the market but suggested steps might be taking to increase the fairness and predictability of directors' liability.

[5] As part of the goal of encouraging fairness and predictability, Industry Canada contracted out a study to develop criteria for determining where, if at all, it is appropriate to impose absolute liability on directors.[1] This study will be referred to below as the "Directors Absolute Civil Liability Report." A second study, relating particularly to corporate law and the

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[1] The Regulatory Consulting Group Inc., Directors' Absolute Civil Liability under Federal Legislation, Final Report, August 10, 1994, 87 pages.

Canada Business Corporations Act[2] (CBCA), examined how to provide greater certainty for directors where the risk of liability arises not from government action, but from private rights of action created by federal legislation.[3] This study will be referred to below as the "Directors' Liability from Private Rights of Action Report." The implications of these studies as they relate to CBCA are discussed below.

[6] Preliminary consultations were carried out across Canada in early 1994 regarding Phase II amendments to the CBCA. A number of comments were made concerning directors' liability and its impact on CBCA corporations and management. These comments are summarized below where relevant.

[7] The December 1994 Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada[4] (TSE report) reviewed the issue of directors' liability. The TSE report accepts "in general terms the principle that imposing personal liability on directors is an acceptable and effective technique for influencing corporate conduct."[5] However, the TSE report expresses concerns about the impact of directors' liability as well as the "collective impact" of various kinds of statutory liability imposed incrementally without a global view being taken.

[8] The TSE report recommends therefore a review of directors' liabilities in each jurisdiction to determine if such liability is effective in influencing the corporate conduct in question. It notes that:

> We recommend that following the review described above all legislatures should repeal legislation imposing personal liability on directors which no longer serves the purpose for which it was enacted and that legislation not so repealed be amended, if necessary, to ensure directors are provided a due diligence defence.[6]

[9] In light of the work of the interdepartmental working group, the resulting studies, the preliminary consultations by Industry Canada, and the TSE report, the following issues have been identified with respect to improving the fairness and predictability of directors' liabilities under the CBCA:

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[2] R.S.C., 1985, c. C-44, as amended.

[3] Mindy Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action, Final Report, May 25, 1994, 166 pages.

[4] Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, Where Were the Directors? Guidelines for Improved Corporate Governance in Canada, Toronto, December 1994, paragraphs 5.53 to 5.67.

[5] Ibid., par. 5.53.

[6] Ibid., par. 5.62.

- liabilities (unpaid wages, fiduciary duties);
- defence mechanisms;
- indemnification of directors and officers;
- directors' and officers' insurance;
- imposition of a liability cap; and
- clarification of the duties of the board of directors.

[10] Certain preferred positions or recommendations are made simply to help focus discussion. No final determination of the most appropriate options will be made by Industry Canada until after consultations are held.

II. LIABILITIES

[11] Legal articles and recently-held seminars and conferences have indicated that directors' liability in the corporate law context is an area of concern. There has been a gradual expansion of directors' liabilities in the corporate law area during the past 20 years. Some of this expansion reflects changes to corporate legislation (e.g., the derivative and oppression remedies). Other factors, including court decisions, have been important. Finally, the Directors' Liability from Private Rights of Action Report notes two areas -- the fiduciary duties and directors' duties owed to third parties -- where there may be uncertainty under the CBCA.[7]

[12] Under the CBCA, directors can be liable:

- for authorizing the issuance of shares for a consideration other than money and the consideration received is less than the fair equivalent of the money the corporation should have received (subs. 118(1));

[7] The Directors' Liability from Private Rights of Action Report also mentions oppression remedy as a third area of concern for directors. Directors' liability arising under the oppression remedy provision will be reviewed as part of a third phase of reform of the CBCA. It is foreseen that Phase III will look generally at CBCA remedies.

- for certain amounts paid by the corporation, for example financial assistance or dividends, when the corporation is not solvent, etc. (subs. 118(2));[8]
- for unpaid debts owed to employees (accrued wages and vacation pay, s. 119);
- for insider trading (s. 131); and
- under the oppression remedy (s. 241).[9]

[13] In addition to these liabilities, directors can be liable to the corporation for the breach of their fiduciary and care duties. At common law and under the Civil Code of Québec, numerous fiduciary duties are imposed on directors. The primary fiduciary duty of the director is to disclose and/or avoid conflict of interest situations. A prime situation for conflict of interest between directors' duties to the corporation (including the shareholders' interests) and their self-interest is the take-over bid setting. Other common law and civil law fiduciary duties include the prohibition on the use of a position in the business to make a personal profit or a profit for third parties and the duty to account (for the profit the directors had made on the shares which they sold, for example).

[14] The common law[10] also imposed a duty on directors to act carefully, but the standard for that duty is subjective to the director (that is, the skill to be expected of a person having the particular director's knowledge and experience) and can therefore be a very low standard.

[15] Since 1975, the fiduciary and care duties have been defined by the CBCA. In order to fulfil their fiduciary duties, directors must "act honestly and in good faith with a view to the best interests of the corporation" (par. 122(1)(a)). This wording presumably incorporates all aspects of the common law fiduciary duty. The statutory duty of care obliges the directors to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances" in managing the corporation and exercising their powers (par. 122(1)(b)). The

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[8] The fairness and predictability of liability imposed on directors under subs. 118(2) will be examined in the discussion paper on financial assistance, one of the other nine areas being reviewed for CBCA Phase II reform. Because the solvency and assets tests imposed under the CBCA financial assistance provision (s. 44) and parallel provisions (for share purchase, dividends, etc.) are vague and uncertain, there is a strong argument that there is an unfair level of liability imposed on directors. The problems arising under s. 44 for directors and others and options for addressing these problems will be canvassed in this discussion paper on financial assistance.

[9] Directors can also be penally liable for certain actions they take or they authorize or permit the corporation to take. For example, see CBCA subs. 127(9), subs. 250(2) and s. 251.

[10] In re City Equitable Fire Insurance Co. Ltd., [1925] Ch. 419.

standard of care was increased by the CBCA in 1975 from the common law subjective standard to an objective, reasonable person standard.

[16] Many of the directors' duties referred to above are owed only to the corporation.[11] Therefore, it is the corporation that must take legal proceedings against the directors. However, the CBCA provides a statutory derivative action which allows shareholders and others to sue directors on behalf of the corporation for liabilities that directors may owe to the corporation (ss. 239-240).[12]

[17] A major development during the last 20 years has been the expansion by the courts of the persons to whom fiduciary duties and/or duties of care are owed. Traditionally, in Canada, directors have owed fiduciary duties only to the corporation and not to shareholders. However, recent cases have held that directors may be responsible in some circumstances to shareholders, other investors, and, even in some cases, the government for breaches of either duties of care or loyalty and good faith. There seems to be an increasing tendency to name directors in suits between corporations for breaches of contract. Most of these cases, though, relate to the private company setting where the director is also an owner-manager.

[18] Wage liability was identified in the preliminary consultations. Fiduciary duties were identified in the Directors' Liability from Private Rights of Action Report. These two issues are reviewed in detail below.

A. Liability for Employee Wages

General Background

[19] Pre-confederation corporate statutes imposed liability for employee wages on shareholders, but Canadian corporate legislation soon transferred this liability to directors.[13] In

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[11] The first two listed liabilities are owed to the corporation. Liability for wages is in favour of the employees. Insider trading liability is to persons who suffer a direct loss and to the corporation for any benefit received by the director from insider trading (as defined by s. 131). The liability the directors face under the oppression remedy is not strictly defined but could include liability to shareholders, other directors, officers, creditors and others (CBCA, ss. 238 and 241).

[12] The derivative action recognizes the inherent conflict in a corporation with respect to the decision of the board to sue one or more directors, especially where there has been no change in board membership.

[13] T. Hadden, R. Forbes, L. Simmonds, Canadian Business Organizations Law, Toronto, Butterworths, 1984, pp. 111, 142 and 232.

fact, at the federal level, directors have been held liable for employee wages under corporate legislation since 1869. Under the CBCA, subs. 119(1) currently provides:

> Directors of a corporation are jointly and severally liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.

[20] The corporate law wage liability provisions appear to have been originally considered as an exception to the "special privilege" of corporate limited liability. Under this view, principals (investors and managers) acting through the corporate form would be liable for the debts and responsibilities of the corporation except that statute and/or common law provides them with certain protections of limited liability. This limited liability was seen as an exception to their usual responsibility. Therefore, the wage liability provisions did not create or impose liability on directors; the provisions simply created an exception to the limit of liability for directors.[14]

[21] More recently, a different perspective has been applied. In the 1993 Supreme Court of Canada decision in Barrette v. Heirs of the late H. Roy Crabtree, Madam Justice L'Heureux-Dubé notes:

> Section 114(1) [now CBCA subs. 119(1)] is located within a specific legal framework. In terms of the general principles governing company law, the provision is exceptional in at least three respects. First, the rule departs from the fundamental principle that a corporation's legal personality remains distinct from that of its members. In doing so, s. [119(1)] creates an exception to the more general principle that no one is responsible for the debts of another. Further, unlike other statutory rules which may impose personal liability on directors, s. [119(1)] does not contain an exculpatory clause.[15]

[22] The purpose of the liability is to protect employees in the event of insolvency of the corporation. Madam Justice L'Heureux-Dubé in Barrette comments upon the purpose and context of the remedy against directors:

> For lack of any other reason it occurs to me that what must have been had in view, was to protect to a limited extent those who were employed by such companies in positions which do not enable them to judge with any special intelligence what is the company's real financial position. The directors have personally this knowledge or should have it, and if, aware of the company's embarrassed affairs, and specially of the danger of a

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[14] Schumacher v. Moore, [1934] 4 D.L.R. 585, 586-7 (Man. C.A.) applying Reference re s. 110 Dominion Companies Act, [1934] S.C.R. 653 and following the opinion expressed by Richards, J.A. in Macdonald v. Drake (1906), 16 Man. R. 220.

[15] Barrette v. Heirs of the late H. Roy Crabtree, [1993] 1 S.C.R. 1027, at page 1043.

> speedy collapse and insolvency, they continue to utilize the services of employees who have no means of securing this knowledge and who give their time and labour upon their sole reliance, often, on the good faith and respectability of the company's directors, it is not inequitable that such directors should be personally liable, within reasonable limits, for arrears of wages, thus given to their service.[16]

[23] Today, all provinces except the Atlantic provinces impose liability on directors for wages. Directors' liability for wages is found in corporate legislation or in employment standards legislation, or in some cases in both.[17] In the 1991 Labour Canada report, Employment Standards Legislation in Canada, the present law was summarized as follows:

> All jurisdictions (with the exception of the Atlantic provinces) provide, generally in an act respecting corporations or in their employment standards legislation, that directors and officers of a corporation are liable for the employees' wages. This type of provision enables employees to "pierce the corporate veil," since the corporation is in itself a separate and distinct legal entity from that of the directors and officers. Without such a provision, the employees' only recourse would be against the corporation.[18]

[24] Recently, the Canada Labour Code was amended to include directors' liability for wages.[19]

[25] There are now overlapping requirements. Corporate law liability provisions apply to corporations constituted under that incorporation law at the federal or provincial levels. These corporations may also be subject to employment standards legislation, again either at the federal or provincial levels. Directors of corporations incorporated under the laws of the Atlantic provinces and subject to neither federal employment standards provisions nor the employment standards laws of another province are not subject to liability for unpaid wages.

[26] As a director is usually liable only where the corporation cannot pay and is insolvent, directors' wage liability provisions could also be found in federal bankruptcy legislation. In fact,

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[16] Ibid., p. 1042.

[17] Saskatchewan for instance provides for this lability in both its Business Corporations Act, R.S.S. 1978, c. B-10, s. 114 and its Labour Standards Act, R.S.S. 1978, c. L-1, s. 63.

[18] Minister of Supply and Services Canada, Employment Standards Legislation in Canada, Ottawa, 1991, p. 117.

[19] An Act to amend the Canada Labour Code and the Public Service Staff Relations Act, S.C. 1993, c. 42, s. 37, adding s. 251.18 to the Canada Labour Code, R.S.C. 1985, c. L-2.

during the 1970s, the federal government proposed amendments to federal bankruptcy legislation to impose directors' liability for wages.[20]

Consultations

[27] Preliminary consultations regarding Phase II amendments to the CBCA produced the following comments:

- Directors should not be held liable for unpaid wages. Even if the risk is manageable, the liability should be on the officers, not the directors.

- Liability for wages should be removed from corporate law. It could be dealt with exclusively under labour law statutes or the Bankruptcy and Insolvency Act[21] (BIA).

- The first corporate law exercise should be a harmonization exercise. Overlap of different statutes has created uncertainty. The business community needs uniformity and consistency.

[28] It should be added that these consultations were not intended to be exhaustive and that all points of view may not have been expressed.

Issue 1: Whether the CBCA should be amended to remove the provision on wage liability (s. 119).

a) Background

[29] Employment standards legislation imposes liability on directors for wages as part of an overall scheme of employee protection. These protections are the result of consultations between labour and business groups in the employment standards law forum. A larger, overall view of worker protection is therefore taken. Similarly, bankruptcy legislation could place wage liability within the overall scheme of corporate reorganization, bankruptcy and insolvency. Bankruptcy priorities and other mechanisms can also be adjusted within this overall scheme to balance rights and protections. This bolsters the view that s. 119 should be removed from federal corporate law to allow for a more holistic approach to employee protection on corporate insolvency. Moreover,

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[20] See, for example, Bill S-11, clause 189, introduced into Parliament in 1978 (first reading March 21, 1978) but never adopted.

[21] R.S.C. 1985, c. B-3, as amended.

wages are essentially debt. Beyond the oppression remedy, the CBCA does not really deal with the fair disposition of debt. It is not a typical element of corporate regulation.

[30] In contrast, the corporate law view of wage liability is narrower in some respects. While its goal is employee protection, wage liability is also imposed from a traditional fear about abuse of the corporate form. There have always been concerns that the limited liability vehicle will be used to the disadvantage of those who contract with or are injured by the corporation. This is particularly so in the case of contracting parties who have unequal bargaining powers (such as employees). By addressing the concerns of one of the major contracting groups, the employees, it can be argued that directors' liability for wages has helped increase the acceptance of the corporate form.

[31] It could also be argued that corporate law is better placed to balance the corporate law concerns of ensuring that fair liabilities are placed on directors so that boards of directors attract talented people. Good corporate governance may be negatively affected by excessive directors' liability. Wage liability under corporate law, imposed since the first corporate law statutes, has not been a problem. In two of the high profile cases of resignation of directors,[22] the problem arose under provincial legislation that imposes absolute liability on directors for payments due to employees on termination of their employment. As shown below, under subs. 119(1) of the CBCA, directors' liability for unpaid wages does not extend to statutory based termination pay and absolute liability is not imposed on directors.

[32] Another issue is that the federal bankruptcy law does not include a provision on directors' wage liability and the patchwork of federal and provincial corporate and employment standards legislation. The Atlantic provinces have no liability at all and some provinces impose liability only in their corporate laws, which are not applicable to directors of CBCA corporations. Therefore, the existence of wage liability in federal corporate law at least provides some form of consistency for CBCA corporations and more generally across the country. However, the argument that s. 119 of the CBCA ensures national consistency is weakened by the fact that CBCA corporations represent only about 12% of Canadian corporations.

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[22] The directors of Westar Mining Ltd. were primarily concerned about upcoming liabilities for severance pay to their employees. Under B.C. law, the directors are liable for severance pay unless the company is in receivership or bankruptcy. What prompted the potential liability was the fact that Westar's employees were on strike and under such conditions B.C. law holds that severance pay becomes due after 13 weeks.

In Alberta, the resignation of the directors of Canadian Airlines International Ltd. appears to have been a reaction to the Westar situation. Canadian Airlines had a large number of employees who could have been entitled to back wages, vacation pay and possibly severance pay (in British Columbia). The company carried only $10 million in insurance for its directors and officers, which would not have been sufficient to cover these and other payments that would have been due.

b) Options

[33] There are two options:

A) The first option would be to repeal s. 119 of the CBCA.

B) The second option would be to maintain s. 119 of the CBCA.

Issue 2: Whether s. 119, if maintained in the CBCA, should be amended to clarify that directors' liability for debts of employees does not include liability under contract, including collective agreement, for severance or termination pay.

a) Background

[34] The two major problems for directors in the high profile cases mentioned above were that the liability was absolute and that the liability potentially included huge sums due to employees on termination of their employment.[23] The first issue, absolute liability, is considered below under the heading "Defence Mechanisms." The second issue, liability for severance and termination pay, is a complex one. On the one hand, these sums are contractually or statutorily provided to employees to protect them on termination of their employment. As unsecured creditors of the corporation for these amounts, employees are very unlikely to recover the unpaid amounts from the insolvent corporation, even if the BIA provides a priority for claims by employees. It can be argued that at least the statutory minimums for severance and termination pay are predictable costs of doing business in Canada and directors should plan for such corporate liabilities.

[35] On the other hand, the amounts due to employees for severance and termination are potentially huge. It appears fair to require directors to ensure that the corporation's finances are such that amounts already earned by employees (wages and accrued vacation pay) have been set aside and are not used to pay other creditors to keep the company running. But it appears less fair to require directors to set aside huge sums for future contingencies for severance and termination pay. It may not be economically viable to do so and could breach their obligation to the corporation to endeavour to keep it running as a going concern through difficult times.

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[23] Referred to hereafter as severance and termination pay. Generally, the payments due to employees could include statutory and/or contractual employee rights for termination and severance pay, pay in lieu of notice and damages for wrongful dismissal (breach of the contract of employment). These sums can often be very large and may be indeterminate in nature (for example, damages as determined by a court).

Indeed, it is likely impossible for directors to set aside large sums once the corporation is in difficulty.

[36] Section 119 of the CBCA imposes wage liability on directors only in respect of "all debts not exceeding six months wages payable to each such employee for services performed for the corporation" [emphasis added]. This provision has been judicially interpreted to exclude damages for wrongful dismissal and statutory-based termination and severance pay which are considered to be benefits arising from the termination of employment, not debts for services performed for the corporation.[24]

[37] However, the courts have commented that severance pay arising out of a contract or a collective agreement may fall within section 119 if it is interpreted to be compensation for past services and thus forms part of the employees' remuneration.[25] This distinction between statutory and contractual obligations appears artificial, at least from the perspective of directors facing huge amount of liability.

[38] In the recent Supreme Court of Canada decision in Barrette v. Heirs of the late H. Roy Crabtree, Madam Justice L'Heureux-Dubé in giving the judgment for the court comments:

> Section 114(1) [now subs. 119(1)] is ambiguous. This ambiguity is evidenced, first, in the diametrically opposite conclusions arrived at by the [Superior] Court of Quebec and the Court of Appeal. It is also reflected in the rules of interpretation put forward by each party, which lead to opposite results.
>
> According to the appellants, the rules of statutory interpretation generally give a broad meaning to the word "debts" in s. [119(1)]. Thus, by reason of the remedial nature of that provision, a broad and liberal interpretation should be adopted so as to include the amounts awarded by the Superior Court as pay in lieu of notice. The respondents, on the other hand, point out that s. [119(1)] imposes a liability on them that goes beyond what the law ordinarily prescribes, being an exception to the general rule that directors are not liable for a company's debts. The respondents accordingly submit that, given the

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[24] Barrette v. Heirs of the late H. Roy Crabtree, note 15, affirming [1991] R.J.Q. 1193, at 1196 (Quebec C.A.). See also Mesheau v. Campbell (1982), 39 O.R. (2d) 702 (C.A.); Mills-Hughes v. Raynor (1988), 63 O.R. 343 (Ont. C.A.); and Turcot v. Conso Graber Inc., (1990) R.D.J. 166 (Que. C.A.). Compare Meyers v. Walters Cycle Co. et al. (1990), 85 Sask. R. 222 (C.A.) wherein the Saskatchewan Court of Appeal concluded that damages for wrongful dismissal (termination) did fall within directors' liability provisions in the Saskatchewan Business Corporations Act and Labour Standards Act. Until the decision in Barrette which expressly distinguished Meyers on the basis of some different wording under the Saskatchewan provision, there was concern that the interpretation made by the Saskatchewan court might be applied to the CBCA provision.

[25] Schwartz v. Scott (1985), 32 B.L.R. 1, at page 3 (Que C.A.); and Mills-Hughes v. Raynor, note 24.

exceptional nature of directors' personal liability, s. [119(1)] requires instead a strict interpretation.[26]

[39] Madam Justice L'Heureux-Dubé concludes:

> However much sympathy one may feel for the appellants, who have been deprived of certain benefits resulting from the contract of employment with their employer, that does not give a court of law the authority to confer on them rights which Parliament did not intend them to have. In the absence of the provision here at issue, the employees would have suffered the same fate as any creditor dealing with an insolvent debtor, in this case the bankrupt employer. The Act provides a remedy, giving them recourse against the directors of the corporation, but it has limited that remedy both in quantity and in duration. Only Parliament is in a position, if it so wishes, to extend these benefits after weighing the consequences of so doing. This, in the final analysis, remains a political choice and cannot be a function of the courts.[27]

b) Recommendation

[40] We recommend that s. 119, if maintained in the CBCA, be amended to confirm and clarify that directors' liability does not extend to statutory or contractual (including by collective agreement) termination or severance pay.

Issue 3: Whether s. 119, if maintained in the CBCA, should be amended to impose liability on officers or shareholders instead of directors in case of unpaid wages.

a) Background

[41] As noted above, pre-confederation Canadian corporate laws imposed liability on shareholders. In Barrette v. Heirs of the late H. Roy Crabtree, Madam Justice L'Heureux-Dubé notes that the corporate law of the state of New York has imposed liability for wages on the shareholders since 1848. The liability is imposed on the ten largest shareholders. In comparing this with s. 119 of the CBCA, Madam Justice L'Heureux-Dubé points out that:

> By specifying that the sums paid by one director could be recovered from other directors, the federal statute avoided reproducing one of the flaws inherent in the

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[26] Barrette v. Heirs of the Late H. Roy Crabtree, note 15, pp. 1034-5.

[27] Ibid., pp. 1051-2.

> American provision. Similarly, by placing this liability on the shoulders of directors rather than shareholders, the federal provision avoided the problem of the potential liability of shareholders with small holdings who had no part in the administration of the company.[28]

[42] Imposing liability on shareholders in place of directors is problematic from a corporate governance perspective. It is the directors, not the shareholders, that manage or supervise the management of the corporation. Moreover, imposing liability on shareholders would conflict with one of the principal benefits of the corporate form, namely limited liability for shareholders.

[43] Officers are also in a different position than directors. Under the corporate governance framework established by the CBCA, it is the directors' right and obligation to manage or supervise the management of the corporation. The officers under this framework are subject to the control of the board of directors. Also, officers' liability makes some employees, namely the officers, liable for unpaid wages of other employees.

[44] When the Employment Standards Act (Ontario) was amended[29] in 1991, the amending legislation, Bill 70, originally proposed placing liability on officers as well as directors. However, after consultations, the proposal for officers' liability was removed.

b) Recommendation

[45] We do not recommend that s. 119, if maintained in the CBCA, be amended to impose liability on officers or shareholders instead of directors.

B. Fiduciary Duties

General Background

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[28] Ibid., p. 1040.

[29] An Act to amend the Employment Standards Act to provide for an Employee Wage Protection Program and to make certain other amendments, S.O. 1991, c. 16, s. 40r and following.

[46] Under s. 122 of the CBCA, directors[30] must act honestly and in good faith with a view to the best interests of the corporation. However, there is still uncertainty as 1) to whom these fiduciary duties are owed, 2) the content and object of the duties involved, and 3) the specific role of the nominee directors.

Issue 4: Whether the CBCA should be amended to define the term "best interests of the corporation" (par. 122(1)(a)).

a) Background

[47] The Directors' Liability from Private Rights of Action Report concludes:

> The concept of "best interest of the company" is far from clear: does this merely mean maximizing value to shareholders or should the directors be considering other stakeholders? When the director himself or herself is another stakeholder (or has other interests), at what point are his or her decisions thereby tainted?
>
> The above issue could be left to be dealt with at common law.[31] On the other hand, specific legislation could be developed as has been done in the U.S. with stakeholder legislation. Obviously, such legislation could be reproduced in Canada to permit directors to consider other elements besides shareholder values or alternatively could be brought in an amended form to oblige directors to consider other such issues. On the other hand, if the legislature wished to make a different policy choice, opposite results could be achieved by statutory direction requiring that the director's main preoccupation be the maximization of shareholder values. This would then leave the directors to consider the interests of other stakeholders (employees, the environment, creditors, etc.) through indirect pressure resulting from other legislation.[32] [Emphasis added]

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[30] Section 122 of the CBCA deals with both directors and officers. Although the discussion below focuses on directors, it applies equally to officers and any given recommendations or options also apply to officers.

[31] "The concept of fiduciary obligations was developed over the centuries by courts of Equity." B. Welling, Corporate Law in Canada [:] The Governing Principles, 2d ed., Toronto, Butterworths, 1991, p. 380. Of course, in Canada, the common law and equity courts have long been merged and the distinctions between the two bodies of laws have become less distinct. We will therefore continue to refer to common law development which should be taken to include the development under the law of equity.

[32] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action Report, note 3, p. 159.

[48] In the leading Canadian case on the subject, Canadian Aero Service Limited v. O'Malley,[33] the Supreme Court of Canada states that directors and senior officers of corporations stand "in a fiduciary relationship to [the corporation], which in its generality betokens loyalty, good faith and avoidance of a conflict of duty and self-interest."[34] Also, that "strict application against directors and senior management officials is simply a recognition of the degree of control which their positions give them in corporate operations."[35]

[49] The court also notes:

> 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.[36]

[50] A key area raising conflict of interest concerns for directors has been the hostile take-over bid setting. The directors have a wide array of defensive measures they may adopt or implement including poison pills and the issuance of shares to friendly persons. It is not always clear, however, what action is in the best interests of the corporation.

[51] The Directors' Liability from Private Rights of Action Report surveys the cases in this area[37] and reports:

> . . . that where directors can demonstrate that the issues they considered, which might at first glance appear not to involve the immediate best interests of the shareholders as a whole, were justified on a longer-term or broader-based view of the shareholders interests, their conduct will be appropriate under current law. Where this relationship between the short-term and longer-term or broader-based interests is incapable of

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[33] [1974] S.C.R. 592.

[34] Ibid., p. 606.

[35] Ibid., p. 610.

[36] Ibid., p. 620.

[37] The following cases were reviewed: Re Olympia & York Enterprises Ltd. and Hiram Walker (1986), 59 O.R. (2d) 254 (Div. Ct.); Teck Corporation Ltd. v. Millar, [1973] 2 W.W.R. 385 (B.C.S.C.); Howard Smith Ltd. v. Ampol Petroleum Ltd., [1974] 1 All E.R. 1126 (P.C.); Exco Corporation v. Nova Scotia Savings & Loan Company (1987), 35 B.L.R. 149 (N.S.S.C. - T.D.); Re 347883 Alberta Ltd. and Producers Pipeline Inc., [1991] 4 W.W.R. 577 (Sask. C.A.); 820099 Ontario Inc. v. Harold E. Ballard Ltd. (1991), 3 B.L.R. (2d) 113 (Ont. C.A.); and Benson v. Third Canadian General Investment Trust Ltd. (1993), 14 O.R. (3d) 493 (Gen. Div.).

> precise definition and/or where the balance between what would be considered proper and improper motives is close, Canadian directors have few guidelines.[38]

[52] However, these circumstances are not prevalent, and thus, the absence of guidelines in these cases is not a major issue.

[53] We remain concerned that, while the term "the best interests of the corporation" may be sufficiently defined, the proper purpose doctrine, as set out in Canadian Aero Service Limited v. O'Malley, remains subject to conflicting judgments. Some cases have interpreted proper purpose strictly. In Exco Corporation v. Nova Scotia Savings & Loan Company, Mr. Justice Richard of the Nova Scotia Supreme Court writes:

> When exercising their power to issue shares from treasury the directors must be able to show that the considerations upon which the decision to issue was based are consistent only with the best interest of the company and inconsistent with any other interests. This burden ought to be on the directors once a treasury share issue has been challenged. I am of the view that such a test is consistent with the fiduciary nature of the director's duty, in fact it may be just another way of stating that duty. . . .
>
> The . . . directors used their rather substantial power for a wrong purpose, i.e., a purpose which was not demonstrably in the best interests of the company. They used their power to support one group in a take-over, a group which the directors had sought out and which was "not unfriendly" to those directors. What the directors did was more consistent with a finding of self-interest than with bona fide company best interest. Or, to put it more in the context of the test which I previously set out, what the directors did was not inconsistent with self-interest. In so doing they breached their fiduciary duty to the general body of shareholders.[39] [Emphasis added]

[54] This strict test would mean that directors could never take any defensive measures because any defensive measure is consistent with self-interest of the directors. It is in the directors' self-interest to oppose many take-over bids because they may lose their job as directors.

[55] Other cases have looked for the dominant or primary purpose, placing the burden on directors to show that the dominant purpose was proper. In Teck Corporation Ltd. v. Millar, Mr. Justice Berger of the British Columbia Supreme Court states:

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[38] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action Report, note 3, p. 60.

[39] Exco Corporation v. Nova Scotia Savings & Loan Company, note 37, pp. 261-2. Other cases applying a strict proper purpose doctrine include Hogg v. Cramphorn, [1967] 1 Ch. 254 and Howard Smith Ltd. v. Ampol Petroleum Ltd., note 37.

> How can the court go about determining whether the directors have abused their powers in a given case? How are the courts to know, in an appropriate case, that the directors were genuinely concerned about the company and not merely pursuing their own selfish interests? Well, a similar task has been attempted in cases of conspiracy to injure. There the question is whether the primary object of those alleged to have acted in combination is to promote their own interests or to damage the interests of others. . . .
>
> I think the courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interest, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose.[40] [Emphasis added]

[56] In Re 347883 Alberta Ltd. and Producers Pipeline Inc., the Saskatchewan Court of Appeal reconciles these two lines of cases:

> The tests adopted by Berger J. in Teck and by Richard J. in Exco, while stated in a different way, do not conflict with the business judgment rule developed in the United States. . . . It recognizes that, in a take-over situation, the directors will often be in a conflict of interest situation, and, in implementing a poison pill defence strategy, the directors must be able to establish that (a) in good faith they perceived a threat to the corporation, (b) they acted after proper investigation, and (c) the means adopted to oppose the take-over were reasonable in relationship to the threat posed . . .
>
> The tests developed in Teck and Exco, and in the American authorities above referred to, contain relevant considerations. They also extend considerable deference to bona fide business judgments of the directors. However, they do not go far enough to determine this case. They give no principles for determining whether or not the defensive strategy was reasonable in relationship to the threat posed. They do not deal with the principle that shareholders have the right to determine to whom and at what price they will sell their shares . . . They fail to consider the effect of the take-over provisions in the provincial securities legislation.[41]

[57] The Saskatchewan Court of Appeal goes on to consider National Policy No. 38 of the Canadian Security Administrators and the Saskatchewan securities legislation and continues:

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[40] Teck Corporation Ltd. v. Millar, note 37, pp. 413-4. Another case applying a less stringent proper purpose test is Re Olympia & York Enterprises Ltd and Hiram Walker, note 37.

[41] Re 347883 Alberta Ltd. and Producers Pipeline Inc., note 37, p. 594.

> In applying the above criteria to the facts of this case, the most important issue is whether the directors, in adopting the defensive tactics culminating in the issuer bid, met the onus upon them to show that they acted in the best interests of the corporation as a whole, and whether their actions were reasonable in relation to the threat posed.[42]

[58] The "best interests of the corporation" have been interpreted strictly in Exco Corporation (proper purpose doctrine). The Teck Corporation Ltd. (primary purpose doctrine) and Re 347883 Alberta Ltd. and Producers Pipeline Inc. (business judgment doctrine) cases have defined the directors' duties in a way that they can take more initiatives in a takeover situation. We have now three different interpretations of what constitutes "acting in the best interests of the corporation."

b) Recommendation

[59] We recommend that no legislative changes be made in this area and that the courts be left to develop the concept of the "best interest of the corporation."

c) Options

[60] A) An option would be to amend the CBCA to provide that the directors be held to have acted honestly and in good faith with a view to the best interests of the corporation under par. 122(1)(a) where the directors discharge the onus of proving that the dominant or primary purpose of their actions was the best interest of the corporation, even though the directors may have directly or indirectly benefited.[43]

[61] B) Another option would be to amend the CBCA to adopt, in respect of actions taken by directors in response to a take-over bid, the American business judgment rule.[44]

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[42] Ibid., p. 595.

[43] This option follows the rule set out in Teck Corporation Ltd., note 37. This rule is discussed at pages 16-17 of the document.

[44] This option follows the rule set out in Re 347883 Alberta Ltd. and Producers Pipeline Inc., note 37. This rule is discussed at pages 17-18 of the document.

Issue 5: Whether the CBCA should be amended to narrow the content and object of fiduciary duties (par. 122(1)(a)).

a) Background

[62] The range of people to whom directors owe a fiduciary duty and the bases for such a fiduciary relationship have been expanding with time. This has led not only to increased directors' liabilities but also to increased uncertainty.

[63] If the courts intend to expand the fiduciary duties of directors owed to shareholders, investors, creditors and others, this would be a very serious development for directors. The expansion of fiduciary duties seems to be a very severe way of imposing liability because these duties are strictly enforced. Fiduciary duties of loyalty and good faith can be breached even where directors may have otherwise exercised reasonable care in their dealings. The existence of both statutory and co-existing common law fiduciary duties may create confusion and therefore uncertainty.

[64] On the other hand, fiduciary duties have been developed by the courts. It is true that Canadian corporate law statutes and the Civil Code of Québec have generally codified fiduciary and care duties but this codification does not appear to have affected or been intended to affect their development. If Canadian courts expand the category of persons to whom directors owe fiduciary duties (as other common law jurisdictions have done),[45] they are presumably responding to a concern about corporate governance of corporations.

[65] This trend of expanding liability is also reflected in the broader use of the oppression remedy and in the general expansion of tort/fault liability of all professionals. Restricting fiduciary duties may simply lead the courts to use other mechanisms to impose liability on directors.

[66] It is not clear what direction the courts in Canada will take. Most pronouncements by the courts have been on preliminary matters and there have yet to be any definitive rulings on these issues.

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[45] Canadian authorities, following the New Zealand decision Coleman v. Myers, [1977] 2 N.Z.L.R. 225 (C.A.), have already suggested that the directors may owe parallel fiduciary duties to shareholders in some circumstances: see in particular Dusik v. Newton (1985), 62 B.C.L.R. 1 (C.A.), Vladi Private Islands Ltd. v. Haase (1990), 96 N.S.R. (2d) 323 (S.C.) and Tongue v. Vencap Equities Alberta Ltd (1994), 14 B.L.R. (2d) 50 (Alta. Q.B.). In Tongue, at page 85, the Court held: "There is no general fiduciary duty that arises between a director and shareholders simply because of that relationship: something more must be present before a fiduciary duty arises."

b) Recommendation

[67] We recommend that no legislative changes be made in this area and that the courts be left to develop fiduciary duties and the limits on their applicability.

Issue 6: Whether to allow nominee directors to give special but not exclusive attention to the interests of those who elected or appointed them (s. 122).

a) Background

[68] The Directors' Liability from Private Rights of Action Report notes:

> From a practical viewpoint, shareholders and creditors appoint their nominees to the board of directors precisely because they want their special interests to be looked after. On the other hand, once appointed, if the nominee director is to look to the best interests of the corporation, even when those interests differ from those of the appointing shareholder or creditor, he or she is almost certainly going to disappoint his "appointer."[46]

[69] The Report concludes:

> The degree to which a nominee director is permitted to owe his primary allegiance to, and be directed in his decisions by, his "appointer" is . . . unclear, especially since unthinking adherence to the "appointer's" wishes appears to be a frequent phenomenon, particularly where the "appointer" is a parent or affiliate company.
>
> In this instance, the Alberta statute provides a possible legislative alternative. This legislation expressly permits directors to give special consideration to their patrons. Of course, the courts will still be left to determine how much special consideration is "too much."[47]

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[46] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action Report, note 3, p. 74.

[47] Ibid., p. 160.

[70] While the phenomenon referred to was certainly recognizable in the past,[48] it has been suggested that the directors consider their role now in a different manner and are more conscious of their responsibility as directors. Therefore, they may be looking at their presumed adherence to the appointer's wishes in a different light.

[71] The Alberta provision referred above is subs. 117(4) of the Business Corporations Act[49] (Alberta) which reads:

> In determining whether a particular transaction or course of action is in the best interests of the corporation, a director if he is elected or appointed by the holders of a class or series of shares or by employees or creditors or a class of employees or creditors, may give special, but not exclusive, consideration to the interests of those who elected or appointed him.

[72] The 1980 Report of the Alberta Institute of Law Research and Reform that led to the enactment of the Business Corporations Act (Alberta) in 1981 makes the following comments about this provision:

> There is the further question, and one which we are inclined to deal with, arising from the fact that the constitution of some companies allows the election of a director of a company by a special constituency of creditors or [employees] . . . or preferred shareholders. If such a director is elected, the CBCA, and probably the present Alberta law, imposes on him the same duty to advance the company's interests as is imposed upon the other directors. It may well be argued that the director's fiduciary duty prevents him from reporting to his constituency and from taking its interests into account, so that the purpose for which he is appointed is stultified. Our inclination is to adapt a suggestion made by Professor Gower in connection with another subject and to recommend that the proposed Act provide that, in considering whether a transaction or course of action is in the interests of the corporation, such a director "may give special but not exclusive consideration" to the interests of the special constituency, and s. 117(4) of the draft Act would so provide. We do not think that the Act should go much further in the direction of allowing the director to act against the interests of the

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[48] In the following cases, the courts have canvassed the issue as to whether the influence exerted by the appointing creditor or shareholder has been undue: PWA Corporation v. The Gemini Group Automated Distribution Systems Inc. et al. (1993), 15 O.R. (3d) 730 (C.A.), Deluce Holdings Inc. v. Air Canada (1992), 12 O.R. (3d) 131 (Ct. Gen. Div.) and Balestreri v. Robert (1992) J.E. 92-533 (Que. C.A.).

[49] S.A. 1981, c. B-15.

corporation, and we think that this provision, despite its vagueness, will be of some assistance.[50]

[73] The Directors' Liability from Private Rights of Action Report also indicates that:

> Other available options include a statutory direction to the effect that directors shall not give special consideration to the private interests of their patrons, if such were the policy choice. This alternative would at least provide nominees with external support [statutory support] when they felt obliged to adopt a tough stance.[51]

b) Recommendation

[74] No change is recommended because we are concerned about "diluting" the directors' duty to act "with a view to the best interests of the corporation."

c) Options

[75] A) One option would be to adopt the Alberta provision that nominee directors may give special, but not exclusive, consideration to the interests of those who elected or appointed them. It can be argued that the Alberta provision reflects corporate realities.

[76] B) Another option would be to adopt the Alberta provision with the further proviso that nominee directors may give special, but not exclusive, consideration to the interests of those who elected or appointed them so long as the consideration is not contrary to the best interests of the corporation.

III. DEFENCE MECHANISMS

Consultations

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[50] Alberta Institute of Law Research and Reform, Proposals for a new Alberta Business Corporations Act, Report No. 36, Edmonton, 1980, p. 66.

[51] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action Report, note 3, p. 161.

[77] During the preliminary consultations, the following comments were made concerning directors' defence mechanisms:

- Absolute liability is a serious problem. Directors should not be held liable for problems beyond their control, regardless of how they performed.

- The good faith reliance defence found in the CBCA (subs. 123(4)) is an adequate defence. But there is a need for a tighter "good faith reliance" definition to reduce uncertainty or, at least, a clarification of the expression "good faith."

- The CBCA should include a due diligence defence. Directors understand better what this standard means, and thus, it would reduce uncertainty in the market place.

- The problem with a due diligence defence is that it can vary considerably from decision to decision.

- The burden of proof should not be on the directors. Instead a regulatory agency or the Crown should prove the directors were not diligent.

Issue 7: Whether the CBCA should be amended to provide for a due diligence defence (subs. 123(4)).

a) Background

[78] Under subs. 123(4) of the CBCA, a director is not liable for improper share issuances or payments (s. 118), unpaid wages (s. 119) or breach of fiduciary duty and the duty of care (s. 122) if he/she relies in good faith upon:

i) financial statements represented to him/her by an officer or the auditor to present fairly the financial position of the corporation; or

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

[79] The good faith reliance defence permits a director to bring forward a very specific kind of argument in response to a suit. If relying on financial statements in the particular circumstances is unreasonable, then the reliance would not be in good faith.

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

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

[82] The good faith reliance defence does not always fulfil this goal. It does not encourage directors to be proactive in their corporate behaviour.

[83] The TSE report on corporate governance in Canada recommends that corporate laws should be amended to ensure directors are provided with an effective due diligence defence. According to the TSE report:

> The existence of a due diligence defence will motivate a board to establish a system within a corporation to ensure that the corporate conduct which is the concern of the relevant law does not occur. The existence of the system is no guarantee that the conduct will not occur but the system should substantially reduce the risk.[52]

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

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[52] Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, Where were the Directors?, note 4, par. 5.62.

[53] The Queen v. Sault Ste. Marie, [1978] 2 S.C.R. 1299, at page 1326, has led to an interpretation of most statutory penal offences as including a defence of due diligence. This defence

> leaves open to the accused to avoid liability by proving [on the balance of probabilities] that he took all reasonable care. This involves consideration of what a reasonable man would have done in the circumstances. The defence will be available if the accused . . . took all reasonable steps to avoid the particular event.

[85] The due diligence defence provides more fairness to directors than does the good faith reliance defence. With a due diligence defence, the directors may act reasonably prudently by relying on financial statements represented to them by an officer of the corporation or by relying on their own assessment of the financial health of the corporation. However, the due diligence defence also recognizes that the nature and extent of the expected precautions will vary under each circumstance. These precautions can include such things as putting in place appropriate controls and systems to monitor and ensure that policies are being implemented, requiring a proper review of periodic reports and taking appropriate action when a problem is brought to the directors' attention.

b) Recommendation

[86] We recommend that subsection 123(4) of the CBCA be amended to permit directors to avoid liability for wrongful payments by the corporation (s. 118), unpaid wages (s. 119) and breaches of duty (s. 122) where he/she exercised the degree of care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances to prevent the wrongful act.[54]

c) Options

[87] A) The due diligence defence could be partially defined. The definition could give a court some guidance as to what constitutes "acting reasonably in the circumstances," including reliance in good faith on financial statements, on expert reports, on information presented by officers and other employees, or reliance on industry standards. If the definition is not exhaustive, the courts would be able to add other components to the definition but the certainty for directors would be less than a fully-defined definition.

[88] B) The due diligence defence could be entirely defined. The authors of the Directors' Absolute Civil Liability Report conclude:

> The best overall substitute for directors' absolute civil liability would be reliance on strict liability, with limited defences. This approach has the advantage of providing certainty to directors, consistency with developments in corporate governance, amelioration of directors' chill,

[54] What constitutes acting with due diligence would still include relying in good faith on financial statements, on expert reports, or on information presented by officers.

enhanced compliance, and fairness, and would provide satisfactory compensation.[55]

[89] A list of restrictive components of due diligence would provide greater certainty for directors about the circumstances under which liability might be imposed. However, such definition might have the same limitation as the current subs. 123(4) of the CBCA.

IV. INDEMNIFICATION

General Background

[90] Indemnification provides financial protection by the corporation for its directors.[56] Indemnification protects directors against exposure to legal expenses and liabilities that may be incurred by them in connection with legal proceedings based on an alleged breach of duty in their service to or on behalf of the corporation. Today, with the increased volume and cost of litigation, it would be difficult to persuade responsible persons to serve as directors if they were compelled to personally bear the cost of vindicating the appropriateness of their conduct in every instance in which it might be challenged. Thus, indemnification is permitted by s. 124 of the CBCA[57] and provides an important protection for directors.

[91] Despite this, if permitted too broadly, indemnification may violate tenets of public policy. It may be inappropriate to permit directors to use corporate funds to avoid personal consequences of improper conduct. For example, a director who intentionally inflicts harm on the corporation should not expect to receive assistance from the corporation for legal or other expenses. That director should also be required to satisfy from his or her personal assets not only any adverse judgment but also legal expenses incurred in connection with the proceeding. Any other rule could encourage socially undesirable conduct.

[92] Another policy issue concerns indemnification against liabilities or sanctions imposed under provincial or federal civil or criminal statutes. A shift of the economic cost of these

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[55] The Regulatory Consulting Group Inc., Directors' Absolute Civil Liability under Federal Legislation, note 1, p. 87. By "strict liability with limited defences," the authors mean "the recognition of a plenary due diligence with statutory criteria for determining due diligence" (p. 71).

[56] The CBCA provisions on indemnification deal with both directors and officers. Although the discussion below focuses on directors, it applies equally to officers and any given recommendations or options also apply to officers.

[57] For the text of s. 124 see Appendix I.

liabilities from the individual director to the corporation by way of indemnification may in some instances frustrate the purpose of those statutes.[58]

[93] The fundamental issue that must be addressed by indemnification provisions is the establishment of policies consistent with broad principles to ensure that: (1) indemnification is permitted where it will be consistent with corporate policies, and (2) indemnification is prohibited where it might protect or encourage wrongful or improper conduct.[59]

Consultations

[94] During the preliminary consultations, a number of comments were made about the lack of clarity in the CBCA regarding indemnification rules. Some of the comments were:

- it is not clear whether a corporation can finance a director's defence before it is determined by the court whether he or she is entitled to indemnification. A corporation should be allowed to assist with the defence costs of a director. But if guilty, the director should be forced to pay the costs back.

- the funding of litigation costs by the board of directors presents a certain risk for those directors. They could be jointly and severally liable to the corporation under par. 118(2)(e) of the CBCA if the money cannot be recovered from the recipient. As a result of such risk, there may be reluctance on the part of the directors to authorize funding a defendant director's or officer's litigation.

Issue 8: Whether the CBCA indemnification provision should be amended to allow for the advancement of defence costs (s. 124).

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[58] In R. v. Bata Industries Ltd et al. (1992), 9 O.R. (3d) 329, the Ontario Court (Provincial Division) had ruled that two Bata directors were required to pay fines of $12,000 because they had failed to take "all reasonable care" to prevent the company from allowing the discharge of used solvents. The court had also prohibited any indemnification of the two Bata directors by the corporation. The appeal judge reduced the fines to $6,000 but upheld the trial court's prohibition concerning the indemnification ((1993), 14 O.R. (3d) 354). On September 20, 1995, the Court of Appeal overturned the appeal judge's decision on the basis that the probation order was imposed on the company and not on its directors. If Bata was to be prohibited from paying the fines for the two directors, it would have to be done under the Business Corporations Act (Ontario), not by virtue of a probation order under the Provincial Offences Act ([1995] O.J. no. 2691, unreported).

[59] Committee on Corporate Laws, "Changes in the Model Business Corporation Act - Amendments Pertaining to Indemnification and Advance for Expenses", (1994) 49 The Business Lawyer 749-50.

a) Background

[95] The current indemnification provision (s. 124) do not provide for the advancement of defence costs to directors. At least one court decision[60] supports the ability of the corporation, with board approval, to indemnify a director's costs before the action or proceedings are concluded or decided (except in case of a derivative action[61]). However, there is still considerable uncertainty in this area.

[96] Several years may pass from the start of proceedings against a director until a final adjudication. In the interim, the director may have the burden of financing his or her defence. Legal expenses in complex proceedings can be staggering. If the corporation will not provide advance funding, directors may find themselves unable to finance their own defence. However, during the early stages of legal proceedings, neither the corporation nor the court is likely to be in a position to determine the ultimate propriety of indemnification.

[97] American legislation[62] has provided for the payment of defence expenses in advance. For example, the Delaware General Corporation Law[63] (DGCL) permits advances on receipt of a written undertaking by the director to repay the amount if it is ultimately determined (by the court) that he or she is not entitled to be indemnified by the corporation.

[98] In addition to this requirement, the Model Business Corporation Act[64] (MBCA) requires that an affirmative determination be made by the director that he or she meets the requisite standard of conduct. Furthermore, an authorization for payment must be given by the board of directors or the shareholders.

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[60] Chromex Nickel Mines Ltd v. British Columbia (Securities Commission) (1991), 4 B.L.R. (2d) 189 (B.C.S.C.).

[61] Canada Deposit Insurance Corporation v. Canadian Commercial Bank (1989), 68 Alta L.R. (2d) 194 (Alta C.A.).

[62] We have reviewed the Delaware General Corporation Law (Appendix II) and the Model Business Corporation Act (Appendix III). The Committee on Corporate Laws of the American Bar Association developed, and from time to time proposes changes, to the Model Business Corporation Act. In 1994, the Committee approved proposed amendments to subchapter E entitled "Indemnification and Advance for Expenses". Both the statute and the model offer procedures to enable the corporation to authorize advances for expenses.

[63] § 145(e) of the General Corporation Law, DEL. CODE ANN. tit.8 (1993).

[64] § 8.53.

[99] If the corporation advances expenses to a director in connection with a derivative action, the MBCA[65] provides that the corporation must report that fact to the shareholders prior to their next meeting.

[100] Neither of these two American models holds other directors liable when the money advanced is not recovered.

b) Recommendation

[101] We recommend that a new subsection be added to section 124 to permit the corporation to advance defence costs to its directors (as well as directors of a grandchild corporation[66]) so long as the directors produce a written undertaking to repay the advance if the court determines that the general fiduciary standards are not met.[67]

[102] In the case of a derivative action,[68] directors have to defend themselves in the same manner as in an action by a third party. Directors should also have access to advances for defence costs. However, minority shareholders' rights have to be adequately protected. To ensure this, besides requiring a director's written undertaking to repay if the general fiduciary duties are not met, any advancement of costs would have to be approved by the court under subs. 124(2) of the CBCA. The court would examine each application and decide if the advancement of defence costs are appropriate under the circumstances. The corporation would have to send a notice to the shareholders advising them of its intention to advance defence costs in connection with a derivative action.[69] Informed in advance, minority shareholders would have the opportunity to

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[65] § 16.21(a).

[66] See Issue 11 on Extension of Indemnification.

[67] In Blair v. Consolidated Enfield Corp. (1993), 15 O.R. (3d) 783 (Ont. C.A.), the corporation refused to grant indemnity because Mr. Blair had not acted in the best interests of the corporation. The Ontario Court of Appeal states that Mr. Blair acted in the best interests of the corporation by acting in accordance with the legal advice of the corporation's solicitors as to the validity of the ballots cast by proxy. On March 21, 1995, the Supreme Court of Canada affirmed the decision of the Court of Appeal but the court has not yet released the written reasons for judgment ([1995] S.C.J. No. 29).

[68] The derivative action (s. 239) is invoked where the corporation has a grievance against management or a third party. The action is taken by a "complainant" (who can be a shareholder, a director, an officer, the CBCA Director or any other person who, in the discretion of a court, is a proper person to make an application (s. 238)) in the name and on behalf of the corporation. If the case is decided in favour of the complainant, the corporation, and not the complainant personally, will benefit by the decision.

[69] It might be appropriate to require prior notice of the court application as opposed to notice of the advancement of defence costs.

dispute the advanced defence costs before the court. One question is whether the same rule should be adopted for publicly-traded and privately-held corporations. Requiring notice to be sent to all shareholders of a publicly-traded corporation seems to be burdensome.

[103] The liability under par. 118(2)(e) of the CBCA[70] would not arise because funds can be advanced so long as there is a written undertaking by the directors or officers to repay the amount advanced.

Issue 9: Whether the CBCA indemnification provision should be amended concerning the decision to indemnify (s. 124).

a) Background

[104] A CBCA corporation can grant an indemnity to directors in the same manner as it exercises other corporate powers, that is by way of resolution of its directors (s. 103). In contrast, the DGCL[71] permits a corporation to indemnify its directors only if an appropriate committee determines that the required statutory standard of conduct has been met. The committee makes this determination by (i) a majority vote of a quorum consisting of directors who are not parties to the action, or (ii) where such a quorum is not obtainable, by (a) independent legal counsel in a written opinion, or (b) shareholders.

[105] The MBCA[72] also provides a method for determining whether a corporation should indemnify a director. It makes a distinction between a "determination" and an "authorization." After a favourable "determination" has been made by a committee formed by directors who are not parties to the action (whether the director meets the relevant standard of conduct), the decision is taken by the committee whether to "authorize" indemnification.[73] This decision includes a review of the reasonableness of the expenses and the financial ability of the corporation to make the payment.

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[70] Under par. 118(2)(e), a director who vote for or consent to a resolution authorizing a payment of an indemnity contrary to section 124, is jointly and severally liable to restore to the corporation any amounts paid and not otherwise recovered by the corporation.

[71] § 145(d).

[72] § 8.55.

[73] Except if the corporation, by a provision in its articles, bylaws or in a resolution adopted or a contract approved by its board of directors or shareholders, obligate itself in advance to provide indemnification (§ 8.58(a)).

b) Recommendation

[106] We do not recommend that the corporation be required to establish a committee to determine whether the required statutory standard of conduct has been met in order to indemnify the directors. The current provision has not presented any obvious problems.

c) Options

[107] A) The CBCA could be amended to adopt a procedure similar to the DGCL. A committee, formed by directors who are not parties to the action (or, if impossible, by an independent counsel or shareholders) could be in a better position than the board to judge the reasonableness of the expenses, the financial ability of the corporation to make the payment, and whether limited financial resources should be devoted to this or some other use by the corporation.

[108] B) In order to ensure that directors are not resolving to indemnify themselves, section 124 could require that a corporation can grant an indemnity only if shareholders have approved it by special resolution. Many other important issues require special shareholders' approval in the CBCA (e.g., addition to/reduction of the stated capital account (ss. 26 and 38), amendment of articles (s. 173)).

Issue 10: Whether the CBCA should be amended to permit indemnification in investigative proceedings (subs. 124(1)).

a) Background

[109] Subsection 124(1) of the CBCA does not mention investigative proceedings and it is not clear under the present rules whether indemnification is permissible in respect of them.[74] Such proceedings, for example hearings before a securities commission, can be costly and lengthy. Some have argued that where an investigation is made into a director's conduct by or on behalf of the corporation, or by a third-party (such as a regulator), all expenses incurred by the said director

[74] There is at least one case which deals specifically with indemnification in investigative proceedings. In Denton v. Equus Petroleum Corporation (1986), 33 B.L.R. 314 (B.C.S.C.), the Court held that the costs incurred by the director were paid to defend criminal and administrative "investigations" and not criminal or administrative "actions or proceedings" as required by subs. 152(1) of the Company Act of British Columbia [subs. 124(1) of the CBCA].

should be subject to indemnification irrespective of the fact that the investigation does not result in a legal action.[75]

[110] We have been advised that, generally, insurers will not pay defence costs for investigative proceedings except as a loss prevention matter (as they could adversely affect concurrent civil proceedings or result in the same). Insurance contracts often reflect the breadth of the corporation's obligation to indemnify and a broadening of indemnification rules could lead to the insurance market having to cover this field. The result might be increased insurance premiums to ensure the proper spread of risk.

b) Recommendation

[111] We recommend that the CBCA be amended to adopt a broad definition of "proceedings" which allows indemnification to be made available to directors in all types of litigation or other adversarial matters, whether civil, criminal, administrative, or investigative and whether anticipated, threatened, pending, commenced, continuing or completed.

Issue 11: Whether the CBCA should extend indemnification to a broader group of persons (subs. 124(1)).

a) Background

[112] Subsection 124(1) of the CBCA permits indemnification by the corporation of

> . . . a director or officer of the corporation, a former director or officer of a corporation or a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor . . . (emphasis added)

[113] First, the CBCA indemnification provision applies not only to officers and directors of the corporation but also to officers and directors of a body corporate who act at the corporation's request. As such, it does not apply where a person acts at the corporation's request as a director or officer (or in a similar capacity) of a partnership, a trust or other unincorporated entity. Broadening the definition would enable directors to obtain benefits of protection of indemnification while they are or were serving at the corporation's request as a director (or in a

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[75] L. H. Richard, "La protection des administrateurs de compagnies: l'indemnisation statutaire et les mesures complémentaires de protection", (1989) 35 McGill Law Journal 117, 138 and D.A. Altro, "Must the Company Indemnify the Director for Expenses Arising Out of Legal Actions Incurred by Him", (1980) 40 Revue du Barreau 241, 269.

similar capacity) of a partnership, a trust, a joint venture or other unincorporated entity (e.g., a mutual fund managed by the corporation, a trade association or a nonprofit entity).

[114] Second, one condition for indemnification (subs. 124(1)) is that the corporation has a shareholding or other financial interest in the body corporate. Consequently, a corporation cannot offer an indemnity to individuals who sit on the boards of subsidiaries of subsidiary corporations ("grandchildren") or on outside boards at the request of subsidiaries. In both cases, the indemnity must come from the subsidiary itself as the direct shareholder. However, from a financial viewpoint (particularly in case of insolvency of the subsidiary), only indemnity from the parent will be of use to the directors and officers.[76]

[115] The elimination of the shareholding or other financial interest in the body corporate would permit indemnification by the parent corporation of a director of a grandchild corporation or of a director sitting on an outside board at the request of the subsidiary.

[116] The DGCL[77] allows indemnification of a broader group of individuals. In addition to current and former agents and employees of the corporation, the DGCL includes persons who hold these offices with any other "corporation, partnership, joint venture, trust or other enterprise" where so serving at the request of the corporation. There is no requirement that the corporation be a shareholder or creditor of the other entity to which the party being indemnified is associated. The MBCA is essentially the same.

b) Recommendations

[117] We recommend that in subs. 124(1) of the CBCA:

- the reference to a shareholding or other financial interest in the other entity ("which the corporation is or was a shareholder or creditor") be eliminated;

- the phrase "as a director or officer of a body corporate . . ." be amended to read as "as a director or officer of a body corporate, partnership, a trust, a joint venture or other unincorporated entity . . ."

Issue 12: Whether paragraph 124(1)(a) should be amended to refer to "the corporation or body corporate."

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[76] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action, note 3, p. 148.

[77] § 145(a).

a) Background

[118] To be indemnified, subs. 124(1) requires an individual acting as a director of another body corporate at the request of the corporation to act honestly and in good faith with a view to the best interests of the corporation. Consequently, in order to be indemnified by the corporation at whose request he/she acts, this director has to act in the best interest of the corporation. He/she can be put in the position of having to breach his/her duty to the body corporate.

[119] There also is an inconsistency between subs. 124(1) and par. 124(4)(b). In subs. 124(1), the director, even of a body corporate, must act in the best interests of the corporation in order to be indemnified. In par. 124(4)(b), the director of a body corporate should not fail to act in the best interests of the body corporate in order to be insured by the corporation. The two requirements do not appear to be consistent.

[120] The discussion paper prepared on the reform of the Company Act[78] (British Columbia) provides that if an individual acts as director of another body corporate,[79] at the request of the corporation, he/she can be indemnified if he/she acts honestly and in good faith with a view to the best interests of the body corporate of which he/she is a director.

[121] The MBCA "permissible indemnifications provision" provides that:

> § 8.51 (a) Except as otherwise provided in this section, a corporation may indemnify an individual who is a party to a proceeding because he is a director against liability incurred in the proceeding if:
>
> (1) (i) he conducted himself in good faith; and
> (ii) he reasonably believed:
> (A) in the case of conduct in his official capacity, that his conduct was in the best interests of the corporation; and
> (B) in all other cases, that his conduct was at least not opposed to the best interests of the corporation; and
> . . .
> [Emphasis added]

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[78] Ministry of Finance and Corporate Relations, Company Act (:) Discussion Paper, Province of British Columbia, January 1991, p. 89.

[79] In the context of the Company Act (British Columbia), a company is the equivalent of a "corporation" in the CBCA; and a corporation in the context of the B.C. is a "body corporate" in the CBCA.

[122] Our understanding of this provision is that the director would no longer be required to act in the best interests of the corporation (as long as the conduct was "at least not opposed" to the best interests of the corporation) and still retain his/her right to indemnification. This test is less onerous than what is now in the CBCA.

b) Recommendation

[123] We recommend that par. 124(1)(a) be broadened to allow directors to be indemnified by the corporation where they act honestly and in good faith with a view to the best interests of body corporate (and they serve as directors of that body corporate at the corporation's request).[80]

[124] This amendment would allow a director to act in the best interests of the body corporate, even if he/she was nominated and indemnified by the corporation.

c) Option

[125] When an individual is serving as a director of a body corporate, etc. at the request of the corporation, an option to the above could be to require that his/her action should be "at least not opposed" to the corporation's best interest.

Issue 13: Whether the CBCA should provide for a "non-exclusivity" clause (s. 124).

a) Background

[126] Section 124 of the CBCA does not expressly provide whether indemnification is permitted in circumstances not provided for in the section. For example, while apparently permitted at common law, the CBCA does not expressly permit indemnification of corporate advisors.

[127] The Dickerson Report stated that

> In addition to being far more detailed than English and Canadian law, they [the provisions of the New York Business Corporation Law] create an exclusive regime that applies to every New York business corporation irrespective of any other provisions contained in the corporation's articles or by-laws. Although much

[80] In order to be consistent with recommendation #11, the proposed reference in par. 124(1)(a) should also include a partnership, a trust, a joint venture or other unincorporated entity.

> influenced by the New York model, s. 9.20 [of the model act] does not adopt its policy of setting up an exclusive statutory regime.[81]

[128] Although the issue does not appear to have been judicially considered, most commentators have argued that the intention of the legislator in spite of the silence of the law is that CBCA indemnification provision is not exclusive.[82] This would mean that a corporation may provide for indemnification of its directors and others through contracts, articles, by-laws, directors resolutions, etc. in situations which are not covered in s. 124, but are not contrary to public policy nor prohibited by the statute.

[129] In the wake of the directors' liability insurance crisis, several American states have gone further and adopted non-exclusivity clauses in their corporate laws which override the limitation in other provisions in order to expanded the corporation's indemnification powers.[83] These clauses apparently permit indemnification even in cases not permitted by other provisions of the statute (for example, where the directors have breached their fiduciary duties). Therefore corporate by-laws or contracts can override the statutory rules limiting indemnification.

[130] American commentators have criticized these non-exclusivity clauses as being too liberal. The commentators have expressed concern that public policy could be subverted if, for instance, a director is indemnified according to a by-law in spite of a finding in a derivative suit that he/she had breached his/her fiduciary duty to the corporation.[84] Although there is no case law on point, it is probable that United States courts would not allow indemnification under a by-law

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[81] R.W. Dickerson, J.L. Howard and L. Getz, Proposals for a New Business Corporations Law for Canada, vol. 1, Information Canada, Ottawa, 1971, par. 244.

[82] L. H. Richard, "La protection des administrateurs de compagnies: l'indemnisation statutaire et les mesures complémentaires de protection", note 75, pp. 144-6; J. Nicholl, "Directors' and Officers' Liability Insurance", vol. 4 of Corporate Structure, Finance and Operations, ed. L. Sarna, Toronto, Carswell, 1986, p. 10 and D.A. Altro, "Must the Company Indemnify the Director for Expenses Arising Out of Legal Actions Incurred by Him", note 75, p. 269. One commentator holds opposite views, at least concerning the indemnification provisions of the British Columbia Company Act: H.S. Wineberg, "Proposals for the Reform of Provisions of the British Columbia Company Act that Indemnify Directors", (1992) 50 The Advocate 523, 532.

[83] For example, § 145(f) of the DGCL provides that

> The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any by-law, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

[84] E. N. Veasey, J.A. Finkelstein, C.S. Bigler, "Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance", (1987) 42 Bus. Law. 399, 414.

or pursuant to a contract when the proposed indemnification is prohibited by law or public policy.[85]

b) Recommendation

[131] We do not recommend any amendment in this area.

Issue 14: Whether the CBCA should be amended regarding mandatory indemnification in the case of a derivative action (subs. 124(3)).

a) Background

[132] This subsection provides for mandatory indemnification of directors and officers by the corporation in specific situations. Some commentators have suggested that it is unclear whether subs. 124(3) can be read with subs. 124(2) to make indemnity mandatory for a substantially successful defence of a derivative action. This uncertainty comes from the first sentence of subs. 124(3), which specifies: "Notwithstanding anything in this section."

[133] Subsection 124(2) requires court approval of any indemnification paid by the corporation to a director who has been sued by or on behalf of the corporation. We believe this implies that in a derivative action situation a director has no right of indemnification in accordance with subs. 124(3).

b) Recommendation

[134] We propose that subs. 124(3) be amended to make it clear that the mandatory indemnification does not apply in case of a derivative action.

V. DIRECTORS' AND OFFICERS' INSURANCE

Issue 15: Whether the CBCA insurance provision should be amended to cover situations where the corporation cannot indemnify its directors (subs. 124(4)).

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[85] Ibid.

a) Background

[135] It appears that larger Canadian corporations generally have insurance coverage for their directors and officers.[86] This D&O liability insurance provides protection to directors and officers in addition to the rights of indemnification created by s. 124 of the CBCA. Subsection 124(4) of the CBCA specifically authorizes the purchase of insurance for the same category of persons named in subsection (1). However, no insurance is permitted for liabilities relating to the "failure to act honestly and in good faith with a view to the best interests of the corporation."

[136] In 1971, the Dickerson Report[87] recommended that a corporation be allowed to insure its directors and officers to cover situations where the corporation could not indemnify them in respect of an obligation they incur in connection with some breach of fiduciary duty. This recommendation, however, was not adopted when the CBCA was passed in 1975.

[137] The Directors' Liability from Private Rights of Action Report notes:

> . . . most directors' and officers' liability insurance policies exclude coverage in cases of dishonesty and in respect of acts committed for an illegal purpose or personal gain. However, . . . given that a director may well have acted honestly and in good faith but not in the best interests of the corporation, it would appear that these insurance policies are significantly broader than the legal ability of the corporation to indemnify. Hence, it would appear that the corporation is not entitled to buy the insurance product with this broader coverage for its directors under Section 124(4) of the CBCA, . . .
>
> In addition, all liability policies in the Province of Quebec are "defence" policies by law. In other words, the insurer is required to take up the defence of its assured as long as there is a possibility that an adverse judgment against the latter would be covered by the policy. Thus, where there are allegations in the claim that the director breached his or her obligation under Section 122(1)(a) of the CBCA, the insurer would normally be obliged to defend the director and pay for all defence costs as they are incurred. While this principle is not enshrined as a statutory requirement in the other provinces, . . . the [existing] case law dictates that most insurance policies will be read to reach the same results, absent very clear wording to the contrary. If, however, the company is not entitled to indemnify the director for the acts or omissions in question and if the other

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[86] According to a recent Conference Board survey, eighty-five per cent of the corporations surveyed carried liability insurance for their directors (N. Borris Carlyle, Canadian Directorship Practices (:) Compensation of Boards of Directors, by the Conference Board of Canada, May 1995, p. 15).

[87] R.W. Dickerson, J.L. Howard and L. Getz, Proposals for a New Business Corporations Law for Canada, note 81, par. 249.

> directors would be taking a risk in providing an indemnity before final judgment in circumstances where such a breach of fiduciary duty is alleged, does the mere purchase of the insurance policy technically constitute a breach of Section 118(2)(e)? We doubt that this was the intention of the legislator when these provisions were enacted.[88]

[138] Both the DGCL[89] and the MBCA[90] authorize a corporation to "purchase and maintain insurance on behalf of its directors, officers, . . . against any liability asserted against him . . . , whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section."

[139] The discussion paper prepared on the reform of the Company Act (British Columbia) recommends allowing the company to "purchase and maintain insurance for the benefit of an eligible party [as defined] against any liability incurred by reason of the eligible party being or having been a director or officer of the company or a corporation."[91]

[140] Generally, insurance companies do not provide policies against matters involving wrongdoing, intentional actions, bad faith, self-dealing, etc., although some policies will pay defence costs for certain criminal charges. Presently, in Canada, such coverage is not allowed under the CBCA and other provincial corporate laws. It is not clear that this restriction is of value to either the corporation or its stakeholders. Some feel that the decision regarding the scope of insurance coverage should be left to the market place.[92]

b) Recommendation

[141] We recommend that subs. 124(4) be amended to permit a corporation to insure its directors and officers against any liability incurred by reason of these individuals being or having been a director or officer of the corporation or the body corporate, whether or not the

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[88] M. Paskell-Mede, John Nicholl, Directors' Liability from Private Rights of Action, note 3, pp. 155-56.

[89] § 145(g).

[90] § 8.57.

[91] Ministry of Finance and Corporate Relations, Company Act: Discussion Paper, note 78, p. 90.

[92] Commenting on the fact that no insurance is permissible for liabilities relating to "failure to act honestly and in good faith with a view to the best interests of the corporation," Bruce Welling notes that "It is not immediately apparent whether insurance companies would be willing to sell such policies at any rate, but there seems little reason why the statute should prohibit the practice if insurers wanted to do so." (Corporate Law in Canada, note 31, p. 314).

corporation would have the power to indemnify them against such liability under the provisions of the CBCA.

VI. LIABILITY CAP

Consultations

[142] Some persons suggested during the preliminary consultations that we insert in the CBCA an overriding clause that would limit directors' liability for civil matters. It was suggested that:

- a cap be placed on the total liability faced by directors of CBCA corporations.
- a legal mechanism be provided to override potential liabilities from other statutes.

[143] Other stakeholders have indicated that a liability cap is not a good proposal. They submitted that:

- if directors have a liability cap, then accountants or other parties would be accountable for amounts owing.
- the CBCA is not the place for a liability cap; other statutes, e.g., environmental statutes/regulations would be a more appropriate place in which to put a cap.

Issue 16: Whether it is appropriate to cap the liability of directors.

a) Background

[144] In the United States, one of the principal themes of corporate governance in the late 1980s has been protection of corporate directors and officers from personal liability for money damages. Until that time, directors and officers were relatively protected by the business judgment doctrine[93] which upholds the decisions of board of directors provided that directors are

[93] The rule has been characterized as having five elements: the decision must be a business decision, the board should be disinterested, have acted with due care, in good faith and even if it satisfies all the other elements, must still not have abused its discretion. (R.R. Seuradge, "Note: The Personal Liability of Directors in Florida: Whose Corporation is it Anyway?", (1991) 15 Nova Law Review 1396).

exercising their best business judgment and protects the directors themselves from personal liability for money damages. The standard of liability for recovery of money damages against directors was at least gross negligence, and sometimes an even more rigorous standard was imposed.

[145] However, in the 1980s, United States courts appeared to become more willing to involve themselves into corporate decision-making through both equitable and monetary relief. The well-known case of Smith v. Van Gorkom[94] was the culmination of the courts' "activism." In this 1985 case, the Supreme Court of Delaware held that the directors of Trans Union Corporation could be liable for damages approaching $50 million in approving a negotiated merger without sufficient information and deliberation, even though the price was nearly fifty percent higher than the recent market price for Trans Union's shares.

[146] The Trans Union decision clearly created in the United States a corporate and insurance crisis that led to a legislative solution. Legislative initiatives have generally followed one of three approaches: 1) the "charter option", 2) the "cap on money damages", or 3) the "self-executing" approach.

[147] The "charter option" statute is the most popular; it was first enacted by Delaware in 1986.[95] The 1986 amendments to the DGCL added section 102(b)(7) to permit a corporation in its articles, through shareholders approval, to eliminate or limit personal liability of its directors to the corporation and its shareholders for breach of fiduciary duty.[96] The Delaware legislature rejected providing a statutory cap for the personal liability of directors because this approach would fix the remedy for liability in an arbitrary amount unrelated to the facts of each case. Under section 102(b)(7), shareholders may choose to fix any amount they want as a cap on liability and they may determine each particular cap according to the particular transaction at issue.[97]

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[94] 488 A.2d 858 (Del. 1985).

[95] As of mid 1993, thirty-eight states have enacted provisions similar to the DGCL "charter option". (D. Block, N. Barton and S. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors, 4th ed. Englewood Cliffs, New Jersey, Prentice Hall, 1993, at page 1099.)

[96] However, liability will not be excused for wrongful conduct in the form of:
(i) a breach of duty of loyalty;
(ii) acts not in good faith or involving intentional misconduct;
(iii) declaration of unlawful dividends, stock repurchases or redemptions; and
(iv) transactions where a director or another person receives an improper benefit.

[97] James B. Behrens, "Delaware Section 102(b)(7): A Statutory Response to the Director and Officer Liability Insurance Crisis", (1987) 65 Washington University Law Quarterly 481, 484.

[148] The "cap on money damages" approach, enacted by the state of Virginia, limits the damages that may be assessed against an officer or director in a suit by or in the right of the corporation or by the stockholders directly to the greater of $100,000 or the amount of cash compensation received by the directors from the corporation during the last year. In addition, the provision permits the stockholders to reduce or eliminate (but not increase) this limit to the "monetary amount specified" in either the articles or by-law provision.[98]

[149] The "self-executing" approach, as the name implies, means that the standard of liability is determined by the statute itself. Shareholders have no input into whether liability for monetary damages should attach to their directors in circumstances other than those prescribed by the statute. For example, under the Florida statute,[99] a director is not personally liable for monetary damages to the corporation or any other person except in five defined circumstances.[100]

[150] Several objections can be made to a liability cap. First, limiting the liability faced by directors essentially transfers that liability, and the risk, from them, their corporations, and their insurers back to the injured party. That party could be the corporation's employees, creditors, the government, or other third parties.

[151] Second, a cap imposed on both large and small corporations could never be optimal; it would reflect a considerable trade-off and might be neither efficient nor effective. In the case of large corporations, even a very large liability cap might not even come close to approaching the potential liabilities faced by directors and, as such, it might negate the effectiveness of directors' liability as a deterrence mechanism. In the case of small corporations, a large cap probably would always be larger than any liability that directors of these small corporations face.

[152] Third, the TSE report on corporate governance in Canada recommends against capping directors' liability. The report states that:

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[98] The Virginia statute also provides:

> The liability of an officer or director shall not be limited ... if the officer or director engaged in wilful misconduct or a knowing violation of the criminal law or of any federal or state securities law, including, without limitation, any claim of unlawful insider trading or manipulation of the market for any security. (VA. CODE ANN. § 13.1-692.1 (Supp. 1987)).

[99] Florida Business Corporation Act, FLA. STAT. § 607 (1989 & Supp. 1990), section 607.0831.

[100] These exceptions are: 1) a violation of criminal law, 2) direct or indirect improper personal benefits, 3) payment of an improper dividend or distribution, 4) in a derivative action, "conscious disregard for the best interests of the corporation, or wilful misconduct", or 5) in a suit by a third party, "recklessness or an act or omission ... committed in bad faith or with malicious purpose or in a manner exhibiting wanton and wilful disregard of human rights, safety or property".

> We do not think a cap could be effectively implemented simply through amendments to a corporation's governing statute. A cap would require coordination amongst the jurisdictions imposing personal liability on directors of a particular corporation - a practical impossibility.[101]

[153] Fourth, the liability capping laws in the United States were adopted in response to a concern about excessive levels of directors' liability to shareholders, arising particularly through class actions. The main areas of concern in Canada have arisen largely in respect of statutory liabilities. It could be argued that it is inappropriate for corporate legislation to attempt to affect compliance regimes established by other legislation. This could be seen as an unfair imposition of corporate policy goals upon goals enacted by other legislation. On the other hand, one complaint about directors' liability is that there is no overall coordination of the many liabilities imposed by statute on directors. A liability cap could serve as that coordination.

b) Recommendation

[154] We do not recommend a cap on directors' liabilities.

c) Options

[155] A) Introduce in the CBCA a cap of a specific sum fixed by statute or in the regulations (e.g., $10 million) on civil liability for monetary damages or amounts that directors face (as directors) under **the CBCA**. Alternatively, the amount could be fixed by a formula, such as the annual income earned by the director from the corporation (including dividends, bonus, benefits and any salary earned as an officer or employee).

[156] The amount of $10 million might be large enough to deter directors from unacceptable practices. It is also large enough to ensure that relatively few stakeholders would not be able to obtain amounts owed them. Furthermore, it would remove some of the risks of enormous, uninsurable and unforseen liabilities that have been a deterrent to qualified Canadians accepting positions as directors. It would also enable most corporations to cover their directors by way of insurance. We understand that the current D&O insurance market enables directors to purchase insurance in the range of $10 million, but insurance amounts in range of $100 million are difficult if not impossible to arrange.

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[101] Toronto Stock Exchange Committee on Corporate Governance in Canada, Where were the Directors?, note 4, par. 5.63.

[157] One problem is that such a cap would provide little protection to directors of small corporations, particularly for those that do not have or cannot get insurance. A cap probably would always be larger than any liability that directors of small corporations may face.

[158] B) Permit the limitation of directors' liability for breaches of their duty of care.

[159] Under this option, the shareholders of a corporation would be allowed to include in the articles of incorporation, either as originally filed or by amendment, a provision limiting the liability of directors to the corporation or its shareholders for monetary damages for breaches of their duty of care. A minimum level of responsibility could be imposed through a provision prohibiting the limitation of liability of any director to an amount less than: the greater of (1) $100,000, or (2) the director's annual compensation as director and as officer or employee, if applicable.[102]

[160] This option is similar to section 102(b)(7) of the DGCL[103] but contains some differences. Unlike the Delaware approach, the option sets a floor on the limitation that may be adopted by shareholders. The complete elimination of directors' liability is prohibited.

[161] The option also distinguishes between inside and outside directors by mandating a different liability floor for each group and by subjecting inside directors to greater

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[102] This option comes from: R.L. Newcomb, "The limitation of Directors' Liability: A proposal for legislative Reform", (1987) 66 Texas Law Review 411.

[103] § 102(b)(7) of the DGCL:

> (b) ... the certificate of incorporation may also contain any or all of the following matters--
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> ...
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this subsection to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

liability in general. This arises because directors, on average,[104] earn substantially less than the $100,000 minimum limit while officers of large corporations generally earn more than that. This different treatment could be justified on the basis that inside directors are generally not subject to the limitations of many outside directors who receive information only at the discretion of management.

VII. DUTIES OF BOARD OF DIRECTORS

Issue 17: Whether the definition of the duties of the board of directors should be modified (subs. 102(1)).

a) Background

[162] Subsection 102(1) of the CBCA provides that:

> Subject to any unanimous shareholders agreement, the directors shall manage the business and affairs of a corporation.

[163] The appropriateness of this definition has been questioned. In the case of a small corporation, the board of directors is often composed of the officers/owners of the corporation. In this situation, the board really manages the corporation on a day-to-day basis. However, in the case of a large corporation, "the board can supervise, direct or oversee but it cannot manage, at least not in the day-to-day sense."[105]

[164] The TSE report on corporate governance in Canada recommends the elimination of any possible interpretation of the directors' responsibilities as being to manage the business day-to-day and to describe the responsibility as being to supervise the management of the business.[106] The Business Corporations Act[107] (Ontario) defines the general duty of the board as being to "manage or supervise the management of the business and affairs of a corporation."

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[104] The "average annual potential compensation" to outside directors of corporations in Canada was $14,685 in 1994 (N. Borris Carlyle, Canadian Directorship Practices (:) Compensation of Boards of Directors, note 86, p. 7).

[105] Toronto Stock Exchange Committee on Corporate Governance in Canada, Where were the Directors?, note 4, par. 4.10.

[106] Ibid.

[107] R.S.O. 1990, c. B.16, subs. 115(1).

b) Recommendation

[165] We recommend that subs. 102(1) be amended to read ". . . the directors shall manage or supervise the management of the business and affairs of a corporation."

c) Option

[166] The directors' responsibility could be described as only being to supervise the management of the corporation (that is, eliminate the reference to directors managing the corporation).

VIII. CONCLUSION

[167] The purpose of this discussion paper, along with eight others dealing with CBCA reform,[108] is two-fold:

1) to address problems with the existing legislation that have been brought to the attention of Industry Canada, and

2) to provide, where possible, new approaches to advance the field of corporate law in Canada.

[168] The recommendations and options outlined in the paper are not in any sense the final word on the subject. They are ideas that have come about largely through discussions with stakeholders across the country. As such, they are not government or even departmental policy.

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[108] The other eight discussion papers deal with:

- Financial Assistance to Directors, Officers and Shareholders;
- Shareholder Communications and Proxy Solicitation Rules;
- Takeover Bids;
- Insider Trading;
- Directors' and others Residency Requirements;
- Going-Private Transactions;
- Unanimous Shareholder Agreements; and
- Technical Amendments.

[169] There may be strong objections to the recommendations and options contained in this discussion paper. There may be alternatives that we have not yet been made aware of. There may even be entirely different ways of looking at the issue of directors' liabilities. This paper is intended to solicit from those who use the CBCA and others new ideas on how the directors' liability provisions of the CBCA can be made more fair and predictable for directors and otherwise improved.

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APPENDIX I

CANADA BUSINESS CORPORATIONS ACT

R.S.C., 1985, c. C-44

2.(1) [**"director" "directors" and "board of directors"**] "director" means a person occupying the position of director by whatever name called and "directors" and "board of directors" includes a single director;

118.(2) [**Further directors' liabilities**] Directors of a corporation who vote for or consent to a resolution authorizing . . .

. . . . . .

(e) a payment of an indemnity contrary to section 124, . . .

. . . . . .

are jointly and severally liable to restore to the corporation any amounts so distributed or paid and not otherwise recovered by the corporation.

122.(1) [**Duty of care of directors and officers**] Every director and officer of a corporation in exercising his powers and discharging his duties shall

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

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

123.(4) [**Reliance on statements**] A director is not liable under section 118, 119 or 122 if he relies in good faith on

(a) financial statements of the corporation represented to him by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or

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

124.(1) [**Indemnification**] Except in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, a corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation, or a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor, and his heirs and legal representatives, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by him in respect or any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of such corporation or body corporate, if

(a) he acted honestly and in good faith with a view to the best interests of the corporation; and

(b) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, he had reasonable grounds for believing that his conduct was lawful.

(2) [**Indemnification in derivative actions**] A corporation may with the approval of a court indemnify a person referred to in subsection (1) in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, to which he is made a party by reason of being or having been a director or an officer of the corporation or body corporate, against all costs, charges and expenses reasonably incurred by him in connection with such action if he fulfils the conditions set out in paragraphs (1)(a) and (b).

(3) [**Indemnity as of right**] Notwithstanding anything in this section, a person referred to in subsection (1) is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by him in connection with the defence of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of the corporation or body corporate, if the person seeking indemnity

(a) was substantially successful on the merits in his defence of the action or proceeding; and

(b) fulfils the conditions set out in paragraphs (1) (a) and (b).

(4) [**Directors' and officers' insurance**] A corporation may purchase and maintain insurance for the benefit of any person referred to in subsection (1) against any liability incurred by him

(a) in his capacity as a director or officer of the corporation, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the corporation; or

(b) in his capacity as a director or officer of another body corporate where he acts or acted in that capacity at the corporation's request, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the body corporate.

(5) [**Application to court**] A corporation or a person referred to in subsection (1) may apply to a court for an order approving an indemnity under this section and the court may so order and make any further order it thinks fit.

(6) [**Notice to Director**] An applicant under subsection (5) shall give the Director notice of the application and the Director is entitled to appear and be heard in person or by counsel.

(7) [**Other notice**] On an application under subsection (5), the court may order notice to be given to any interested person and such person is entitled to appear and be heard in person or by counsel.

APPENDIX II

DELAWARE GENERAL CORPORATION LAW

DEL. CODE ANN. tit. 8 (1993)

§145. INDEMNIFICATION OF OFFICERS, DIRECTORS, EMPLOYEES AND AGENTS; INSURANCE

(a) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that his conduct was unlawful.

(b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favour by reason of the fact that he is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by him in connection with the defense or settlement of such action or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

(c) To the extent that a director, officer, employee or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b), or in defense of any claim, issue or matter therein, he shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by him in connection therewith.

(d) Any indemnification under subsections (a) and (b) (unless ordered by a court) shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the director, officer, employee or agent is proper in the circumstances because he has met the applicable standard of conduct set forth in subsections (a) and (b). Such determination shall be made (l) by the board of directors by a majority vote of a quorum consisting of directors who were not parties to such action, suit or proceeding, or (2) if such a quorum is not obtainable, or, even if obtainable a quorum of disinterested directors so directs, by independent legal counsel in a written opinion, or (3) by the stockholders.

(e) Expenses (including attorneys' fees) incurred by an officer or director in defending any civil, criminal, administrative or investigative action, suit or proceeding may be paid by the corporation in advance of the final disposition of such action, suit or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the corporation as authorized in this Section. Such expenses (including attorneys' fees) incurred by other employees and agents may be so paid upon such terms and conditions, if any, as the board of directors deems appropriate.

(f) The indemnification and advancement of expenses provided by, or granted pursuant to, the other subsections of this section shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under any by-law, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

(g) A corporation shall have power to purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against him and incurred by him in any such capacity, or arising out of his status as such, whether or not the corporation would have the power to indemnify him against such liability under the provisions of this section.

(h) For purposes of this Section, references to "the corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, and employees or agents, so that any person who is or was a director, officer, employee or agent of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Section with respect to the resulting or surviving corporation as he would have with respect to such constituent corporation if its separate existence had continued.

(i) For purposes of this Section, references to "other enterprises" shall include employee benefit plans; references to "fines" shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to "serving at the request of the corporation" shall include any service as a director, officer, employee or agent of the corporation which imposes duties on, or involves services by, such director, officer, employee, or agent with respect to an employee benefit plan, its participants, or beneficiaries; and a person who acted in good faith and in a manner he reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner "not opposed to the best interests of the corporation" as referred to in this Section.

(j) The indemnification and advancement of expenses provided by, or granted pursuant to, this section shall, unless otherwise provided when authorized or ratified, continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

(As amended by Ch. 186, Laws of 1967, Ch. 421, Laws of 197O, Ch. 437, Laws of 1974, Ch. 25, Laws of 1981, Ch. 112, Laws of 1983, Ch. 289, Laws of 1986 and Ch. 376, Laws of l99O.)

APPENDIX III

MODEL BUSINESS CORPORATION ACT

Chapter 8 Subchapter E
Indemnification and Advance for Expenses

§ 8.51. PERMISSIBLE INDEMNIFICATION

(a) Except as otherwise provided in this section, a corporation may indemnify an individual who is a party to a proceeding because he is a director against liability incurred in the proceeding if:

(1) (i) he conducted himself in good faith; and

(ii) he reasonably believed:

(A) in the case of conduct in his official capacity, that his conduct was in the best interests of the corporation; and

(B) in all other cases, that his conduct was at least not opposed to the best interests of the corporation; and

(iii) in the case of any criminal proceeding, he had no reasonable cause to believe his conduct was unlawful; or

(2) he engaged in conduct for which broader indemnification has been made permissible or obligatory under a provision of the articles of incorporation (as authorized by section 2.02(b)(5)).

(b) A director's conduct with respect to an employee benefit plan for a purpose he reasonably believed to be in the interests of the participants in, and the beneficiaries of, the plan is conduct that satisfies the requirement of subsection (a)(l)(ii)(B).

(c) The termination of a proceeding by judgment, order, settlement, or conviction, or upon a plea of nolo contendere or its equivalent, is not, of itself, determinative that the director did not meet the relevant standard of conduct described in this section.

(d) Unless ordered by a court under section 8.54(a)(3), a corporation may not indemnify a director:

(1) in connection with a proceeding by or in the right of the corporation, except for reasonable expenses incurred in connection with the proceeding if it is determined that the director has met the relevant standard of conduct under subsection (a); or

(2) in connection with any proceeding with respect to conduct for which he was adjudged liable on the basis that he received a financial benefit to which he was not entitled, whether or not involving action in his official capacity.

§ 8.52. MANDATORY INDEMNIFICATION

A corporation shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding.

§ 8.53. ADVANCE FOR EXPENSES

(a) A corporation may, before final disposition of a proceeding, advance funds to pay for or reimburse the reasonable expenses incurred by a director who is a party to a proceeding because he is a director if he delivers to the corporation:

(1) a written affirmation of his good faith belief that he has met the relevant standard of conduct described in section 8.51 or that the proceeding involves conduct for which liability has been eliminated under a provision of the articles of incorporation as authorized by section 2.02(b)(4); and

(2) his written undertaking to repay any funds advanced if he is not entitled to mandatory indemnification under section 8.52 and it is ultimately determined under section 8.54 or section 8.55 that he has not met the relevant standard of conduct described in section 8.51.

(b) The undertaking required by subsection (a)(2) must be an unlimited general obligation of the director but need not be secured and may be accepted without reference to the financial ability of the director to make repayment.

(c) Authorizations under this section shall be made:

(1) by the board of directors:

(i) if there are two or more disinterested directors, by a majority vote of all the disinterested directors (a majority of whom shall for such purpose constitute a quorum) or by a majority of the members of a committee of two or more disinterested directors appointed by such a vote; or

(ii) if there are fewer than two disinterested directors, by the vote necessary for action by the board in accordance with section 8.24(c), in which authorization directors who do not qualify as disinterested directors may participate; or

(2) by the shareholders, but shares owned by or voted under the control of a director who at the time does not qualify as a disinterested director may not be voted on the authorization.

§ 8.54. COURT-ORDERED INDEMNIFICATION AND ADVANCE FOR EXPENSES

(a) A director who is a party to a proceeding because he is a director may apply for indemnification or an advance for expenses to the court conducting the proceeding or to another court of competent jurisdiction. After receipt of an application and after giving any notice it considers necessary, the court shall:

(1) order indemnification if the court determines that the director is entitled to mandatory indemnification under section 8.52;

(2) order indemnification or advance for expenses if the court determines that the director is entitled to indemnification or advance for expenses pursuant to a provision authorized by section 8.58(a); or

(3) order indemnification or advance for expenses if the court determines, in view of all the relevant circumstances, that it is fair and reasonable

(i) to indemnify the director, or

(ii) to advance expenses to the director, even if he has not met the relevant standard of conduct set forth in section 8.51(a), failed to comply with section 8.53 or was adjudged liable in a proceeding referred to in subsection 8.51(d)(1) or (d)(2), but if he was adjudged so liable his indemnification shall be limited to reasonable expenses incurred in connection with the proceeding.

(b) If the court determines that the director is entitled to indemnification under subsection (a)(l) or to indemnification or advance for expenses under subsection (a)(2), it shall also order the corporation to pay the director's reasonable expenses incurred in connection with obtaining court-ordered indemnification or advance for expenses. If the court determines that the director is entitled to indemnification or advance for expenses under subsection (a)(3), it may also order the corporation to pay the director's reasonable expenses to obtain court-ordered indemnification or advance for expenses.

§ 8.55. DETERMINATION AND AUTHORIZATION OF INDEMNIFICATION

(a) A corporation may not indemnify a director under section 8.51 unless authorized for a specific proceeding after a determination has been made that indemnification of the director is permissible because he has met the relevant standard of conduct set forth in section 8.51.

(b) The determination shall be made:

(1) if there are two or more disinterested directors, by the board of directors by a majority vote of all the disinterested directors (a majority of whom shall for such purpose constitute a quorum), or by a majority of the members of a committee of two or more disinterested directors appointed by such a vote;

(2) by special legal counsel:

(i) selected in the manner prescribed in subdivision (1); or

(ii) if there are fewer than two disinterested directors, selected by the board of directors (in which selection directors who do not qualify as disinterested directors may participate); or

(3) by the shareholders, but shares owned by or voted under the control of a director who at the time does not qualify as a disinterested director may not be voted on the determination.

(c) Authorization of indemnification shall be made in the same manner as the determination that indemnification is permissible, except that if there are fewer than two disinterested directors, authorization of indemnification shall be made by those entitled under subsection (b)(2)(ii) to select special legal counsel.

§ 8.56. OFFICERS

(a) A corporation may indemnify and advance expenses under this subchapter to an officer of the corporation who is a party to a proceeding because he is an officer of the corporation

(1) to the same extent as a director; and

(2) if he is an officer but not a director, to such further extent as may be provided by the articles of incorporation, the bylaws, a resolution of the board of directors, or

contract except for (A) liability in connection with a proceeding by or in the right of the corporation other than for reasonable expenses incurred in connection with the proceeding or (B) liability arising out of conduct that constitutes (i) receipt by him of a financial benefit to which he is not entitled, (ii) an intentional infliction of harm on the corporation or the shareholders, or (iii) an intentional violation of criminal law.

(b) The provisions of subsection (a)(2) shall apply to an officer who is also a director if the basis on which he is made a party to the proceeding is an act or omission solely as an officer.

(c) An officer of a corporation who is not a director is entitled to mandatory indemnification under section 8.52, and may apply to a court under section 8.54 for indemnification or an advance for expenses, in each case to the same extent to which a director may be entitled to indemnification or advance for expenses under those provisions.

§8.57. INSURANCE

A corporation may purchase and maintain insurance on behalf of an individual who is a director or officer of the corporation, or who, while a director or officer of the corporation, serves at the corporation's request as a director, officer, partner, trustee, employee, or agent of another domestic or foreign corporation, partnership, joint venture, trust, employee benefit plan, or other entity, against liability asserted against or incurred by him in that capacity or arising from his status as a director or officer, whether or not the corporation would have power to indemnify or advance expenses to him against the same liability under this subchapter.

§ 8.58. VARIATION BY CORPORATE ACTION; APPLICATION OF SUBCHAPTER

(a) A corporation may, by a provision in its articles of incorporation or bylaws or in a resolution adopted or a contract approved by its board of directors or shareholders, obligate itself in advance of the act or omission giving rise to a proceeding to provide indemnification in accordance with section 8.51 or advance funds to pay for or reimburse expenses in accordance with section 8.53. Any such provision that obligates the corporation to provide indemnification to the fullest extent permitted by law shall be deemed to obligate the corporation to advance funds to pay for or reimburse expenses in accordance with section 8.53 to the fullest extent permitted by law, unless the provision specifically provides otherwise.

(b) Any provision pursuant to subsection (a) shall not obligate the corporation to indemnify or advance expenses to a director of a predecessor of the corporation, pertaining to conduct with respect to the predecessor, unless otherwise specifically provided. Any provision for indemnification or advance for expenses in the articles of incorporation, bylaws, or a resolution of the board of directors or shareholders of a predecessor of the corporation in a merger or in a contract to which the predecessor is a party, existing at the time the merger takes effect, shall be governed by section 11.06(a)(3).

(c) A corporation may, by a provision in its articles of incorporation, limit any of the rights to indemnification or advance for expenses created by or pursuant to this subchapter.

(d) This subchapter does not limit a corporation's power to pay or reimburse expenses incurred by a director or an officer in connection with his appearance as a witness in a proceeding at a time when he is not a party.

(e) This subchapter does not limit a corporation's power to indemnify, advance expenses to or provide or maintain insurance on behalf of an employee or agent.

§ 8.59. EXCLUSIVITY OF SUBCHAPTER

A corporation may provide indemnification or advance expenses to a director or an officer only as permitted by this subchapter. . . .

. . . . . .

§ 16.21. OTHER REPORTS TO SHAREHOLDERS

(a) If a corporation indemnifies or advances expenses to a director under section 8.51, 8.52, 8.53, or 8.54 in connection with a proceeding by or in the right of the corporation, the corporation shall report the indemnification or advance in writing to the shareholders with or before the notice of the next shareholders' meeting.

(b) If a corporation issues or authorizes the issuance of shares for promissory notes or for promises to render services in the future, the corporation shall report in writing to the shareholders the number of shares authorized or issued, and the consideration received by the corporation, with or before the notice of the next shareholders' meeting.

APPENDIX IV

COMPANY ACT OF BRITISH COLUMBIA
(R.S.B.C. 1979, ch. 59, as amended)

Discussion Paper
January 1991
Province of
British Columbia
Ministry of Finance and Corporate Relations

Appendix "A"

Division X--Indemnification of Directors and Payment of Expenses

1. (1) In this Division

"eligible company", in relation to a company, means an individual who:

(a) is a director, former director, officer or former officer of the company,

(b) is a director, former director, officer or former officer of a corporation who acts or acted as such at the request of the company, or

(c) is a director, former director, officer or former officer of a corporation with which the company is, or was, affiliated,

[and includes the heirs and personal or other legal representatives of the individual to whom the context can apply according to law.]

"expenses" include costs, charges and expenses (including, legal and other fees), but does not include judgements, penalties, fines or amounts paid in settlement of a proceeding;

"proceeding" includes any civil, criminal, administrative, regulatory or investigative action or proceeding, whether threatened, pending or completed.

(2) [This Division only applies to and in respect of the indemnification or payment of expenses to an eligible party or his heirs and personal or other legal representatives.]

(3) Sections 126 and 127(1)(c) do not apply to an indemnification or payment of expenses made [permitted] [authorized] under this Division.

2. [**Indemnification and Payment of Expenses Permitted**] Subject to section 5, and unless the articles or memorandum otherwise provide, if authorized by the directors of the company [by resolution of its directors] or by ordinary resolution, a company may

(a) indemnify an eligible party [and his heirs and personal or other legal representatives] against [liability to pay] all judgements, penalties, fines and amounts paid in settlement, and

(b) upon final disposition of the proceeding, pay the expenses actually and reasonably incurred by an eligible party [or his heirs and personal or other legal representatives]

in respect of any proceeding in which the eligible party is implicated or to which the eligible party is made a party by reason of being or having been a director or officer of the company or a corporation.

3. [**Mandatory Payment of Expenses**] Subject to section 5 and unless the articles or memorandum otherwise provide, upon the final disposition of a proceeding

(a) in which an eligible party [or his heirs and personal or other legal representatives] are implicated, other than as a complainant, or

(b) to which the eligible party [or his heirs and personal or other legal representatives] are made a party

by reason of the eligible party being or having been a director or officer of the company or a corporation, a company shall pay the expenses actually and reasonably incurred by the eligible party [or his heirs and personal or other legal representatives] in respect of the proceeding and for which he has not been reimbursed, if the eligible party [or his heirs and personal or other legal representatives] are

(c) wholly successful, on the merits or otherwise, in the outcome of the proceeding, or

(d) substantially successful on the merits in the outcome of the proceeding.

4. [**Authority to Advance Expenses**] Unless the articles or memorandum otherwise provide, if authorized by the directors of the company [by resolution of its directors] or by ordinary resolution, a company may pay, as they are incurred in advance of the final disposition of the proceeding, the expenses actually and reasonably incurred by an

eligible party [or his heirs and personal or other legal representatives] in respect of any proceeding

(a) in which the eligible party [or his heirs and personal or other legal representatives] are implicated, or

(b) to which the eligible party [or his heirs and personal or other legal representatives] are made a party

by reason of the eligible party being or having been a director or officer of the company or a corporation, but only if the company first receives from the eligible party [or his heirs and personal or other legal representatives], a written undertaking to repay the amounts advanced if it is ultimately determined that indemnification or payment of expenses is prohibited by section 5 [that there is no entitlement to payment by reason of section 5].

5. [**Indemnification Prohibited**] A company shall not indemnify an eligible party [or his heirs and personal or other legal representatives] under section 2 or pay the expenses of an eligible party [or his heirs and personal or other legal representatives] under sections 2 or 3 if

(a) the eligible party did not act honestly and in good faith with a view to the best interests of the company or corporation of which he is or was a director or officer,

(b) in the case of a proceeding other than a civil proceeding, the eligible party did not have reasonable grounds for believing that his conduct was lawful, and

(c) in respect of any proceeding against the eligible party [or his heirs and personal or other legal representatives] by or on behalf of the company or corporation of which he is or was a director or officer, the approval of the court has not first been obtained.

6. [**Agreements to Indemnify**] (1) Nothing in this Division precludes a company, whether before or after the commencement of a proceeding, from entering into a written agreement with a person [an eligible party] under which the company undertakes to indemnify and pay or advance the expenses actually and reasonably incurred by that person by reason of that person being or having been a director or officer of the company or a corporation.

(2) Every agreement referred to in subsection (1) is subject to this Division.

7. [**Court Ordered Indemnification**] Notwithstanding any other provision of this Division and whether or not payment of expenses or indemnification has been sought, authorized or declined under this Division, on application by the company or an eligible party [or his heirs and personal or other legal representatives], the court may

(a) order a company to indemnify an eligible party [or his heirs and personal or other legal representatives] against any liability incurred by the eligible party [or his heirs and personal or other legal representatives] in respect of a proceeding,

(b) order payment by a company of the expenses incurred by an eligible party [or his heirs and personal or other legal representatives] in respect of a proceeding,

(c) order the enforcement of, or any payment under, an agreement of indemnification entered into by the company,

(d) order a company to pay the expenses actually and reasonably incurred by any person in obtaining an order under this section, or

(e) make any further or additional order it considers appropriate.

8. [**Insurance**] A company may purchase and maintain insurance for the benefit of an eligible party [or his heirs and personal or other legal representatives] against any liability incurred by reason of the eligible party being or having been a director or officer of the company or a corporation.