CORPORATE STRUCTURE, FINANCE AND OPERATIONS

VOLUME 4

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CORPORATE STRUCTURE, FINANCE AND OPERATIONS

Essays on the Law and Business Practice

VOLUME 4

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Preface

Many of the essays in the present volume deal to a large extent with the operations of a corporation. Notwithstanding the diverse range of topics covered, it may be said that a common thread is the corporate reaction to the taking of a risk.

In a narrow sense, a risk connotes an assault on an existing condition. In a larger sense, the taking of a risk is simply the exploration of and the setting of new boundaries of activity. In the corporate world risk may involve the establishment of a direction, the change of a direction or a reaction against movement. The establishment of a direction involves the setting of policy on financing arrangements, product lines, staff management and profit goals. On the other hand, a change of direction seeks to intensify, diminish or abandon existing strategies be they in identity, marketing or continuity of management. It should also be said that a reaction to movement or a resistance to normally acceptable risk-taking is in itself a risk, especially where the accepted market-place wisdom dictates a flow rather than a static position.

Several authors here represented concern themselves with the minimization of the impact of risk-taking by the use of insurance, planning and legislative umbrance. For example, banking institutions have created their own safety net by structuring their industry in a manner so pertinent to market needs as to be considered an economic partner. Manufacturers of hazardous products have come to rely almost too heavily on insurance coverage while insurers have sought new means and litigious positions to deny such coverage. Those corporations which are forced to submit to statutory restrictions on their ordinary operating methods such as internal language requirements do so with an efficiency-oriented reluctance or enthusiasm. When faced with an internal economic crisis, management ponders the potential benefits and losses from new investment efforts as opposed to the early and sometimes deserved demise of the enterprise.

I wish to thank the authors represented in this volume for their efforts in writing, revising and reviewing their texts and galleys and to colleagues and friends who have assisted in the creation of the anthology in its present form. The devotion and creative licence accorded to me by my wife and children, while fervently anticipated, has not been taken for granted throughout the process of assembling this and the previous volumes in the series.

Lazar Sarna
March 1986

Abbreviations

1. STATUTES

B.C.A. ..... Business Corporations Act

C.B.C.A. ..... Canada Business Corporations Act

C.B.I.C.A. ..... Canadian and Business Insurance Companies Act

C.c.B.C. ..... Code civil du Bas-Canada

C.E.R.C.L.A. ..... Comprehensive Environmental Response, Compensation and Liability Act

F.I.C.A. ..... Foreign Insurance Companies Act

G.W.E.C.A. ..... Gas, Water and Electricity Companies Act

I.T.A. ..... Income Tax Act

L.C.Q. ..... Loi sur les compagnies de la province de Quebec

L.S.A. ..... Labour Standards Act

L.S.C.C. ..... Loi sur les sociétés commerciales canadiennes

O.I.A. ..... Ontario Insurance Act

Q.C.A. ..... Quebec Companies Act

Q.I.A. ..... Quebec Insurance Act

Q.L.C. ..... Quebec Labour Code

R.C.R.A. ..... Resource Conservation and Recovery Act

2. OTHER ABBREVIATIONS

C.S.S. ..... Centre de services sociaux

D. & O. ..... Directors' and officers' liability insurance coverage

E.I.L. ..... Environmental Impairment Liability

E.P.A. ..... Environmental Protection Agency

O.T.C. ..... over the counter

Contents

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

*John I.S. Nicholl**

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Sommaire en français

L'auteur traite des nouvelles polices d'assurance responsabilité en vigeur, en Amérique du Nord et particulièrement en Ontario et au Québec, depuis les années 1970. Ces polices concernent des directeurs et officiers d'une compagnie.

Le risque couvert est celui de la poursuite dirigée contre des D. & O. d'une corporation assurée et qui entraînerait soit dans la corporation, soit à un individu qui se défend lui-même, des frais et déboursés et, possiblement une responsabilité civile.

Enfin, l'auteur analyse les polices et souligne les ambiguités et les incertitudes de certaines clauses telles que: objectifs corporatifs, durée de la police, acte illégal, degré de négligence et intention générale, acte malhonnête d'un directeur individuellement, l'indemnisation, l'obligation de l'assureur de défendre.

En conclusion l'auteur rappelle aux D. & O. qu'ils ont de grandes responsabilités et de bien étudier les polices pour être bien couverts mais il souligne qu'il n'y a pas d'assurance tous risques. A date les tribunaux ne semblent pas s'être prononcés sur l'interprétation de ces nouvelles polices.

Directors' and officers' liability insurance coverage (hereafter "D. & O. insurance") is a relatively recent phenomenon on this side of the Atlantic, having become fashionable in the United States during the 1970s, and eventually found its way north of the border. As a result, it has not yet acquired that patina of age which lends a comforting air of certainty to a policy wording, and a number of interesting questions arise when the form is reviewed from a legal standpoint.

This is not to say, of course, that the two principal varieties of policy

wording which we propose to review are not, in the main, perfectly straightforward and easily applied to most of the loss situations which may arise. However, the legal profession has a notorious weakness for the rough edges which may be found in any contract, and an insurance policy is no exception. What follows, therefore, is an attempt to map the treacherous areas of the most common D. & O. forms while ignoring the less interesting but more solid ground occupied, one hopes, by insurers and their assureds in most situations.

1. THE RISK

The risk underwritten by the D. & O. insurer, simply put, is that a director or officer (or, in some cases, an employee) of the corporation which has procured the coverage will be sued, and that either the assured corporation or the individual defendant himself will incur various costs and expenses, and possibly some civil liability, as a result.

The basic scheme of the D. & O. policy is thus that the insurer undertakes, upon certain terms and conditions, to indemnify the assured corporation for sums which it may choose or be obliged by law to expend as a result of a suit against one or more directors or officers, and, in addition, to indemnify the individual directors and officers for the pecuniary consequences of such a claim or suit where the assured corporation either *cannot* or *will not* take on this burden itself.

The liabilities to which directors and officers of Canadian corporations may be exposed are many and various, and we propose therefore to spend some time in defining the risk which is being underwritten, in order that the coverage which current D. & O. policies provide may be better understood.

2. STATUTORY LIABILITIES

The civil liability of an individual acting in his capacity as a director or officer of a corporation was at one time governed primarily by the common law, which remains the principal source of the doctrines and legal concepts by which that liability is measured. However, as is the case in many other fields, the common law has now been subsumed, though not necessarily supplanted, by statutory schemes for the regulation of companies generally, and it is therefore to the Companies Acts which govern every aspect of the life of the assured corporation that one must look for a codification of the duties and responsibilities of a director or officer.

We will deal here with the four statutes which are the principal sources of liability for directors and officers of corporations in Ontario and Quebec. It is essential to note, however, that this is not an exhaustive list of the statutes which may impose personal liability on directors or officers; in Quebec, for example, the Act respecting labour relations in the construction industry[1] creates a civil recourse against directors for back wages which substantially parallels the recourse available under the Quebec Companies Act ("Q.C.A.").[2] The Federal Canada Business Corporations Act ("C.B.C.A.")[3] and the Ontario Business Corporations Act ("B.C.A.")[4] are identical in many respects, and our comments on the C.B.C.A. may be applied to the corresponding provisions of the Ontario statute unless otherwise indicated. The Quebec Companies Act ("Q.C.A."), on the other hand, is substantially different in its terms, and accordingly it will be treated separately. Lastly, we will review the relatively recent amendments to the Federal Income Tax Act[5] regarding payment of taxes due by corporations.

(1) The Canada Business Corporations Act

The duties imposed on the directors and officers of corporations incorporated under the C.B.C.A. may be broadly segregated into two categories, to each of which different standards of conduct apply. These duties are owed *to the corporation*, and not to individual shareholders or third party creditors.[6]

(a) Fiduciary Duties

The first of these categories is that of *fiduciary* duties, expressed in general terms in section 117(1)(*a*) (section 134(1)(*a*) B.C.A.), which requires a director or officer to "act honestly and in good faith with a view to the best interests of the corporation." Specific fiduciary duties are also imposed in a series of provisions which amount in effect to prohibitions:

1 R.S.Q. 1977, c. R-20, s. 122.

2 R.S.Q. 1977, c. C-38, as amended; see pp. 16–17.

3 S.C. 1974–75, c. 33, as amended.

4 R.S.O. 1980, c. 54.

5 S.C. 1970–71–72, c. 63, as amended.

6 Bruce Welling, *Corporate Law in Canada; The Governing Principles* (Toronto: Butterworth & Co. (Canada) Ltd., 1984), p. 381. See, *e.g. Western Finance Co. v. Tasker Enterprises Ltd.*, [1980] 1 W.W.R. 323, 1 Man. R. (2d) 338, 106 D.L.R. (3d) 81 (Man. C.A.); *Roberts v. Pelling*, [1982] 2 W.W.R. 185, 16 B.L.R. 150 (*sub nom. Pelling v. Pelling*) 130 D.L.R. (3d) 761 (B.C.S.C.). In *Beamish v. Solnick* (1980), 10 B.L.R. 224 (Ont. H.C.); however, a director was held in exceptional circumstances to owe a duty *to a fellow director* to act in the best interests of the corporation.

1. Against the exercise of power to approve a contract where the financial interests or other duties of the individual director or officer conflict with those of the corporation (section 115 C.B.C.A.);
2. Against the exercise of power in the interests of the individual director or officer as distinct from the interests of the corporation (section 117(1)(*a*) C.B.C.A.);
3. Against the exploitation of "insider knowledge" in order to profit from securities transactions (section 125 C.B.C.A.);
4. Against the exploitation of "insider knowledge" to divert a corporate opportunity to the benefit of the individual director or officer (section 117(1)(*a*) C.B.C.A.);
5. Against the use of "insider knowledge" by an individual director or officer in competing against the corporation (section 117(1)(*a*) C.B.C.A.).

In fulfilling their fiduciary obligations the director and officer are obliged to act in good faith, as the terms of section 117(1)(*a*) imply, but their actions must also meet an objective standard in that they must be in the best interests of the corporation.[7]

> The court's jurisdiction to intervene is founded on the theory that if the directors' purpose is not to serve the interest of the company, but to serve their own interest or that of their friends or a particular group of shareholders, they can be said to have abused their power. The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose; it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers.[8]

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7 *Teck Corp. v. Millar,* [1973] 2 W.W.R. 385, 33 D.L.R (3d) 288 (B.C.S.C.); *Smith (Howard) Ltd. v. Ampol Petroleum Ltd.,* [1974] A.C. 821, [1974] 1 All E.R. 1126 (P.C.); *Beauchamp v. Contenants Sanitaires C.S. Inc.* (1979), 7 B.L.R. 200 (Que. S.C.). For recent insurance-related examples of conduct held to be a breach of fiduciary duty see *Alberts (Edgar T.) Ltd. v. Mountjoy* (1977), 16 O.R. (2d) 682, 2 B.L.R. 178, 36 C.P.R. (2d) 97, 79 D.L.R. (3d) 108 (Ont. H.C.); *Christie (W.J.) & Co. v. Greer,* 14 B.L.R. 146, [1981] 4 W.W.R. 34, 59 C.P.R. (2d) 27, 121 D.L.R. (3d) 472, 9 Man. R. (2d) 269 (Man. C.A.). See also, generally, *Regal (Hastings) Ltd. v. Gulliver,* [1942] 1 All E.R. 378 (H.L.); *Can. Aero Service Ltd. v. O'Malley,* [1974] S.C.R. 592, 40 D.L.R. (3d) 371, 11 C.P.R. (2d) 206 (S.C.C.); L.C.B. Gower, *Principles of Modern Company Law* (4th ed.) (London: Stevens & Sons, 1979), p. 571 *et seq.*; James A. Smith, *Corporate Executives in Quebec* (Montreal: Centre d'Edition Juridique, 1978), p. 164 *et seq.*; Welling, *supra,* note 6, at p. 341 *et seq.*

8 Teck Corp. v. Millar, *supra,* note 7, at p. 410–11; John L. Howard, "Directors and Officers in the Context of the Canada Business Corporation," in *Meredith Memorial Lectures* (Montreal: McGill University Law Faculty, 1975), p. 282.

It will be noted that sections 117(1) and (2) speak of both directors *and officers* in imposing the general fiduciary duty, among other things. Officers, unlike directors, are in any case agents of the corporation at common law, and are subject to the same standards of fiduciary care and duty as are all agents.[9] The terms of section 117 are thus redundant to this extent.

Section 118(4) of the C.B.C.A. (section 135(4) B.C.A.) provides a statutory defence *for directors only*[10] in respect of breaches of the duties imposed by certain provisions of the C.B.C.A., including section 117(1)(*a*) (section 134(1)(*a*) B.C.A.), where they have relied in good faith upon:

> *a*) financial statements of the corporation represented to [them] 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, or other person whose profession lends credibility to a statement made by him.

Both directors and officers, in their capacity as fiduciaries, have a duty to account to the corporation for moneys received, held or expended by them for the corporation. Welling[11] summarizes this duty with admirable brevity as follows:

> A fiduciary is liable to account *only* where
>
> (a) there is an actual conflict of interest or duty *or*
> (b) the opportunity [of personal gain] was obtained by virtue of his position.

A recent example of the application of the duty to account may be found in *Abbey Glen Property v. Stumborg*,[12] where a director was held liable to account to a successor corporation for secret profits; compare to *Misener v. H.L. Misener & Son Ltd.*,[13] where it was held that the director in question had no duty to account because her conflict of interest was *amorous* rather than commercial! See also *Lorenc v. Koteles*,[14] where the president

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9 See Howard, *supra*, note 8, at p. 291.

10 See Welling, *supra*, note 6, at p. 334 on this apparent oversight.

11 See *supra*, note 6, at p. 407.

12 [1978] 4 W.W.R. 28, 4 B.L.R. 113, 9 A.R. 234, 85 D.L.R. (3d) 35, affirming [1976] 2 W.W.R. 1, 65 D.L.R. (3d) 235 (Alta. C.A.).

13 (1977), 21 N.S.R. (2d) 92, 2 B.L.R. 106, 3 R.P.R. 265, 77 D.L.R. (3d) 428 (N.S.C.A.).

14 (1981), 14 Man. R. (2d) 427 (Man. Q.B.).

of the company was held liable to account for funds expended without the authority of the Board, and *D'Amore v. McDonald*.[15]

(b) Duty of Care

Section 117(1)(*b*) of the C.B.C.A. also imposes on directors and officers a duty " . . . to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." This is essentially the same as the common law standard, and, as with any other "reasonable man" standard, the question of what is "reasonable" varies considerably according to the qualifications and experience of the individual in question.[16] It is thus the case that conduct which might not be reasonable on the part of a director who is an experienced chartered accountant might nonetheless be perfectly acceptable on the part of a director who is a self-made man with a sixth grade education.

It may be said, generally, that the standard of care required of directors by the courts is not as stringent as the duties imposed on them as fiduciaries, and indeed this discrepancy seems to be justified by the exigencies and risks implicit in corporate decision-making. Moreover, the "good faith reliance" defence under section 118(4) is also available (again, it would appear, to directors only) in respect of breaches of the section 117(1)(*b*) duty of reasonable care. In other words, reliance *by a director* on financial statements or professional advice is *by definition* the reasonable care required by section 117(1)(*b*).

There is a dearth of case law on the issue of duty of care, and accordingly it is difficult to say precisely to what depths one must sink in order to be liable in negligence. Conduct unbecoming a director would seem to include deliberately ignoring the affairs of the corporation, and also transfer of control to persons whom one knows to be dishonest or irresponsible. Lesser sins are likely to be forgiven on the basis of the "business judgment" rule provided that the individual responsible can plausibly claim to have acted in good faith.[17] See *Revelstoke Credit Union v. Miller*,[18] where the directors of a credit union were held *not* to have been contributorily negligent in relying on the honesty of their manager; compare to *Stavert v. Lovitt*,[19] where the directors of a bank *were* held person-

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15 [1973] 1 O.R. 845, 32 D.L.R. (3d) 543 (Ont. H.C.); affirmed 1 O.R. (2d) 370, 40 D.L.R. (3d) 354 (Ont. C.A.).

16 See Welling, *supra*, note 6, at p. 332; Howard, *supra*, note 8, at p. 297.

17 See Howard, *supra*, note 8, at p. 285.

18 24 B.L.R. 271, 28 C.C.L.T. 17, [1984] 2 W.W.R. 297 (B.C.S.C.).

19 (1908), 42 N.S.R. 449 (N.S.C.A.).

ally liable for losses caused by an employee whom they knew to be suspect. However, as John L. Howard warned during the Meredith Memorial Lectures in 1975:

> To say that the duty of care standards are low and the available defences formidable to overcome is not to say that directors and officers are not exposed to substantial risk. According to Murphy's Law anything that can go wrong will go wrong. And the number of subjects that directors and officers deal with and the number of laws to which they are subject are numerous and complex, therefore the wise director scrutinizes carefully his rights to indemnity and his D. & O. liability insurance coverage.[20]

It is worth noting that in addition to the general duty of care established by section 117(1)(*b*) of the C.B.C.A., and the obligation to obey the law and the corporate constitution imposed by section 117(2) (section 134(2) B.C.A.), the C.B.C.A. in section 113 (section 130(1) B.C.A.) establishes specific duties of diligence for directors with respect to the issuance of shares for considerations other than money.

(c) Strict Liability

Under section 114 of the C.B.C.A. (section 131 B.C.A.) directors (*but not officers*) are also the guarantors of a maximum of six months back wages payable to the corporation's employees in respect of services performed for the corporation while they were directors. At first glance, this is a strict liability provision, and the director appears to be liable regardless of his diligence or good faith. Reference to section 118(4) reveals, however, that the "good faith reliance" defence is also available in respect of claims under section 114.

This application of section 118(4) is somewhat confusing, in that it is not clear how the reliance in good faith by the director on financial statements or professional reports relates to his liability for back wages. The best view appears to be that the intent of the statute is to exculpate directors who can reasonably claim to have been unaware of the corporation's insolvency (because they were relying on contrary statements or reports) at the time at which the employees' services were performed.

Section 113(2) (section 130(2) B.C.A.) also appears to impose on directors (*but not officers*) a strict liability where they have voted for or consented to resolutions authorizing various specific expenditures by the corporation. Again, however, section 118(4) comes to the rescue by providing a "good faith reliance" defence.

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20 See Howard, *supra*, note 8, at p. 300.

(d) Indemnification

The Dickerson Report, which was the foundation upon which the C.B.C.A. was drafted, noted that "[i]ndemnification [of corporate directors and officers] poses one of the most complex and controversial problems of modern corporation law."[21] Parliament did its best to meet this complexity head on with section 119 of the C.B.C.A. (section 136 B.C.A.), which is itself somewhat elaborate. Its provisions may be paraphrased briefly as follows:

1. Where the corporation is *not* the plaintiff, it has the option of indemnifying a director or officer against the pecuniary consequences of any proceeding in which he is implicated by reason of his status as a director or officer 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 criminal or penal proceedings, he had reasonable grounds for believing that his conduct was lawful;
2. Where the corporation *is* the plaintiff, it again has the option of indemnifying a director of officer implicated in any proceeding if *a*) he acted honestly and in good faith with a view to the best interests of the corporation; *b*) in the case of criminal or penal proceedings, he had reasonable grounds for believing that his conduct was lawful; *and c) the corporation obtains the approval of the court to indemnify*;
3. A director of officer has a *right* to be indemnified by the corporation *in respect of the costs of his defence only* in any proceeding in which he is implicated as a result of having been a director or officer, provided that *a*) his defence is substantially successful on the merits; *b*) he acted honestly and in good faith with a view to the best interests of the corporation; and *c*) where the proceeding is criminal or penal, he had reasonable grounds for believing that his conduct was lawful;
4. A corporation may obtain insurance for the benefit of a director or officer against liability incurred by him either a) as a director or officer of the corporation or b) as a director or officer of another corporation acting at the request of the corporation procuring the insurance *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 of which he is a director or officer.

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21 See R.M.V. Dickerson, *Proposals for a New Business Corporations Law for Canada* (Ottawa: Queen's Printer, 1971), p. 83.