Chartered Secretaries Qualifying Scheme – Level 1

Corporate Law Canada

Answers and Marking Scheme
November 2011

© ICSA, 2011

Questions

*(Answer **four** questions from this paper)*

1. Harry and Irma have just graduated from university and wish to start up a business designing web sites. They write a business plan indicating the need to buy equipment and software costing $10,000. Realistically, they also need three months' pay for each of them, to cover the period before the business generates any income. This is estimated at $10,000. They have sent their business plan with an application for a $20,000 loan to Needy Bank Inc.

Harry and Irma have student debts of approximately $25,000 each. They each received a graduation gift of $1,000 that they intend to invest to help to get the business up and running. They are also joint owners of a holiday cottage in Nova Scotia which is worth approximately $60,000. At the outset, to minimize costs, they intend to run the business from the cottage.

Harry has an aunt, Sally, who is rich and financially shrewd. He knows that any involvement she might be prepared to have with the business would have to be on a sound financial basis.

Required

(a) Identify the legal business structures *apart from* a registered corporation, available to Harry and Irma to adopt to run their business, briefly describe the key legal characteristics of each, and state in relation to each whether or not you consider it to be an appropriate structure for them from a legal perspective and why.

(8 marks)

(b) Advise Harry and Irma as to the key characteristics of the types of registered corporations available, the type most appropriate for them, and the legal attractions of this choice.

(5 marks)

(c) Assume that Needy Bank would be unwilling to lend Harry and Irma money, but Sally would be willing to make $20,000 available. Advise Harry and Irma as to how they might structure the funding of the corporation between equity and debt.

(8 marks)

(d) On a different assumption, assume that Needy Bank agrees to lend $20,000 but Sally does not want to provide any money. Advise Harry and Irma as to the protections the bank would be likely to seek, over and above a simple loan agreement with the corporation.

(4 marks)

(Total: 25 marks)

Marking scheme and suggested answers

(a) Identify the legal business structures *apart from* a registered corporation, available to Harry and Irma to adopt to run their business, briefly describe the key legal characteristics of each, and state in relation to each whether or not

© ICSA, 2011

you consider it to be an appropriate structure for them from a legal perspective and why.

(8 marks)

Partnership (Chapter 1, 1.2)

The common law definition, which is now found in relevant statutory provisions, of partnership is two or more persons carrying on business with a view to making a profit. The business does not legally exist but rather the partners together are the business. All assets and liabilities of the partnership are owned and owed by the partners. Subject to agreement, all profits of the business belong to the partners equally. Those profits are then subject to income tax at the individual tax rate of each partner but subject to reduction by the self- employment deductions available. There are currently three kinds of partnerships that exist in most Canadian provinces including Ontario: a) general partnership under the *Partnerships Act*, b) limited partnership under the *Limited Partnerships Act* and c) limited liability partnership. In Canada, partnerships are under provincial jurisdiction. See generally the case of *McKnight v. Hutchison*. Partnerships are unincorporated therefore the personal assets of Harry and Irma will be exposed should the business fail.

Technically, the partnership will be dissolved and a new partnership will need to be established if a new partner is added or a partner leaves.

The partnership assets will be available to the personal creditors of Harry or Irma.

The personal liability must be balanced against the administrative simplicity to determine the appropriateness of this structure. Their choice of legal structure will be heavily influenced by the tax implications.

General Partnership (Chapter 1, 1.2)

A general partnership does not have a separate legal existence and the partners have unlimited liability for the debts of the business. In addition, the partners are jointly and severally liable for the debts of the business. In other words, a creditor of the general partnership could sue all the partners together or could sue any one partner for the whole debt. Although, the one partner who paid the whole debt could ask for and even sue the other partners for reimbursement, several liability implies that any one partner might be required to pay the entire debt, at least initially. If the rest or even some of the rest of the partners do not have and in the future will not have assets, the right to reimbursement is a hollow right. The concept of agency applies in a general partnership as it does in a sole proprietorship. In a general partnership, the principal, i.e. the partners, give authority to their employees to enter into contracts with third parties that will bind the partners. In addition, in a general partnership, each partner is an agent for all the other partners. As a result, one partner can enter into a contract with a third party that will bind all the partners. Even if internally the partners agree that all partners must approve any contract, as long as the third party reasonably believes that the partner entering into a contract has the requisite authority, such apparent authority exists in the eyes of the law.

Vicarious liability also applies in basically the same way as in a sole proprietorship where the employer, here the partners, is responsible for the torts of its employees in the scope of the employee’s employment. In a general partnership, however, the partners are responsible for the torts committed by any one partner in the course of the partnership’s business. It is as a result of the concepts of unlimited liability, agency, and vicarious liability as expanded by general partnership that partners should choose wisely before adding a new partner to the partnership

Limited Partnership (Chapter 1, 1.2.2)

This is a partnership where there exists at least one general partner who makes all

© ICSA, 2011

decisions and who has unlimited liability for the debts of the partnership. Anyone who is not a limited partner is a general partner. Limited partnerships were created to address some of the liabilities that exist in general partnerships so as to enable easier equity financing. Unlike general partnerships, however, limited partnerships must be registered under the *Limited Partnerships Act*. Limited partnerships are also required to have at the end of the partnership name either 'limited partnership' or "LP" to give notice to any third party of the type of partnership. In an LP, there exists at least one general partner who makes all decisions and has unlimited liability for the debts of the partnership. Anyone who is not a general partner is a limited partner and as such has liability for debts limited to the amount paid for the limited partnership interest. The limited partner has no joint and several liability but is subject to the limitation that the limited partner cannot be involved in the management of the business. A limited partner is not an agent for the limited partnership; given that a third party would know that only the general partner is the agent. In other words, a limited partner is a silent investor analogous to a shareholder in a corporation. As a result, a limited partnership is sometimes referred to as a hybrid between a general partnership and a corporation.

A Limited Partnership would allow Aunt Sally to be a "sleeping partner" or limited partner, participating in profits, losses and capital but taking no part in management. Registration is required and the Director of Corporations Canadaissues a certificate of registration.
There seems no good reason to adopt this structure rather than a registered corporation.

Limited Liability Partnership (Chapter 1, 1.2.3)
This is a form of partnership where the partners are absolved of vicarious liability for the torts committed by their partners. Members or partners of a Limited Liability Partnership have limited liability and are taxed as self-employed partners for the profits of the partnership. Relatively recent legislative amendments have enabled general partnerships to carry on business in a profession e.g. lawyers, engineers, and architects, by way of a limited liability partnership. The limited liability partnership makes itself known to the public by inserting at the end of the partnership name 'limited liability partnership' or "LLP" thus giving anyone contracting with the business notice of the type of partnership. An LLP is similar to a general partnership in most ways except that in an LLP the partners' vicarious liability for the torts committed by anyone partner are limited. The partner committing the tort would be liable to the victim although the other partners in the LLP would have no vicarious liability. The limitation also applies to any deficiency which arises on liquidation of the LLP. All the other aspects of a general partnership would apply to an LLP.

Essentially, Limited Liability Partnerships (LLPs) are structures with the legal characteristics of private registered corporations that are taxed as general partnerships. An LLP is a corporation so is an artificial entity that owns property, contracts, sues and is sued and members are not liable for its debts. Members are required to contribute to the LLP any sum provided for in the LLP agreement and have no further statutory liability to contribute to the LLP assets, nor are LLP assets available to the personal creditors of members. The LLP survives changes in the membership.

This structure provides limited personal liability to Harry and Irma. The choice is likely to be driven by tax implications of establishing an LLP versus those of establishing a registered corporation. The uncertainties attaching to the rules and regulations may suggest that a registered corporation is a more familiar and therefore will be a less expensive choice.

© ICSA, 2011

Whilst no marks will be lost if students fail to mention it, students may be credited for mentioning, to dismiss it, sole proprietorship.
Sole proprietorship is inappropriate as there is nothing to suggest that either of Harry or Irma wishes to be the business owner and the other an employee/contractor, i.e., the facts imply Harry and Irma wish to share the profits and risks of the business equally.

[Marking guidance: 0.5 mark for each option identified (max 2 marks). 0.5 mark for each characteristic and 1 mark for each option's appropriateness assessment.
For pass mark: must identify both partnership and LLP (a pre-requisite to a pass)
For Merit: must address appropriateness of partnership and LLP]

(b) Advise Harry and Irma as to the key characteristics of the types of registered corporations available, the type most appropriate for them, and the legal attractions of this choice.

(5 marks)

Private and Public Corporations (Chapter 2, 3.1)

A "private corporation" (or "private issuer" as it is called under securities legislation) has three restrictions. They are as follows:
a. Fifty (50) shareholders or less,
b. Restriction on the transferability of all securities other than nonconvertible debt securities, and,
c. Securities may only be issued to certain classes of investors and generally not to the public.

The term "public corporation" is also well known and traditionally has the contrary elements to a private corporation. Specifically, a public corporation entails the following elements:
a. More than fifty (50) shareholders,
b. No restriction on the transferability of shares and
c. Invitation to the public to buy shares is allowed.

Neither the *CBCA* nor the *OBCA* contain the terms "Private Corporation" or "public corporation". The *CBCA* provides that a corporation can either be a "distributing corporation" (public) or not a distributing corporation (private). The *OBCA* provides that a corporation can either be an "offering corporation" (public) or not an offering corporation (private).

The terms private corporation (or private issuer) and public corporation, however, continue to be used partly because the terms are still used in securities legislation such as the *OSA*. The driving force behind the private corporation exemption from compliance with most securities law requirements is that shareholders of private corporations are likely to be insiders or savvy investors who need not be protected. In contrast, members of the public at large are protected in transactions with public corporations by regulation and timely disclosure. Complying with securities legislation is expensive and time consuming. Corporations, however, comply with the regulatory framework of securities legislation to access the stock market and raise equity financing.

In all the provinces, it is possible for private corporations to go public to raise more equity financing. Similarly, public corporations can convert to private corporations where the costs of compliance and disclosure override the benefits of access to the market.

Constrained Share Corporations (Chapter 2, 3.2)

The constrained share corporation is a method of incorporation used to preserve a percentage of Canadian ownership of a corporation. The existence of such “Canadian” corporations ties in with subsidies or cultural issues such as publishing, television etc. where public policy mandates that the money or heritage be Canadian. The current trend is toward less legislative push in this area although that could change at any time.

Accordingly, Harry and Irma should be advised that the most appropriate corporation for them to form is a registered private corporation limited by shares which provides shareholders with limited liability and a framework for raising capital by issuing new shares.

[Marking guidance: 0.5 mark for each type pair identified (limited/unlimited etc). Up to 3 for characteristics of the types and up to 2 for the attractions of the corporation limited by shares]

(c) Assume that Needy Bank would be unwilling to lend Harry and Irma money, but Sally would be willing to make $20,000 available. Advise Harry and Irma as to how they might structure the funding of the corporation between equity and debt.

(8 marks)

Harry and Irma will each contribute $1,000 as equity capital in return for an equal number of common or equity shares each. They will share the profits and losses equally.
Sally may be issued with common shares (also known as equity shares) with special rights, such as preferred shares, or may wish to lend the money. The $20,000 may be invested on the basis of a mixture of the foregoing. If she lends the money she may lend to the corporation or to Harry and Irma personally so that they can invest the money in the business (in which case, they will either buy more shares in the corporation or lend the money to the corporation possibly on a secured basis).

The preferred shares would have limited voting rights and could offer a fixed rate of return and right to return of capital invested only.

Line of Credit:

A Line of Credit is an agreement with bank or number of banks for short term borrowings on demand. Generally speaking, financial institutions provide lines of credit without requiring the borrower to provide security. The borrower is, however, required to repay the “unspecific loan” in the time required in the grant of the line of credit. Generally speaking, in a line of credit the interest rate is higher than would be obtained with a term loan. A key driving force behind the higher interest rate is the absence of a formal loan document to govern the periodic borrowing of money to meet the borrower’s short term financing needs. Another reason for the higher interest rate is the lack of security to back up the line of credit. Where a financial institution is concerned about the repayment of the line of credit perhaps as a result of past dealings between the parties, the financial condition of the borrower, or the amount of credit granted in the line of credit, it is likely that security, generally in the form of an assignment of book debts, will be required. An assignment of book debts is required to be registered under applicable provincial legislation. Upon default in payment by the borrower, an assignment of book debts would enable the secured creditor to inform anyone owing money to the debtor to instead pay it to the creditor. This will not apply to Sally.

© ICSA, 2011

Term Loan (Secured by Mortgage):

Where a specific amount of money is required for a specific period of time, i.e. a term, the transaction is likely be a term loan, secured by a mortgage. The mortgage can be against land (real estate mortgage or charge) or a specific type of personal property, i.e. tangible personal property (chattel mortgage). The mortgage is registered against the land or the debtor's name in the case of a chattel. The mortgage gives notice to the world that the specified property is secured. The registration enables the creditor to have priority over anyone registered thereafter and any other third party even in a bankruptcy. The secured item belongs to the credit or up to the amount of money owed. Upon default under the mortgage, the secured credit or can seize and/or sell the property to pay off the balance owed on the loan. See the case of *Irving Oil Ltd. v. Central and Eastern Trust Co. et al.* which is a case that held that a mortgage is void if no consideration is given. See also *Clock Holdings Ltd c. Braich* which examines what is fair or adequate consideration.

Term Loan (Backed by Promissory Note):

A Promissory Note is an unconditional written promise to pay a specified sum of money on demand or at a specified date. A term loan backed by a promissory note is not a secured loan but rather an unsecured loan. A promissory note is merely a statement that the borrower owes the stated amount of money. With the grant of a promissory note, none of the security of the borrower is encumbered. A promissory note, however, is often times sought by lenders. A promissory note stands on its own. In the context of a promissory note, there is no need to prove the underlying transaction. As a result, an unsecured creditor who has a promissory note has a greater likelihood of being the successful party in litigation.

Debenture or Bond

A debenture is a generic term referring to instruments evidencing debts of a corporation. In a narrower sense, an unsecured promise to pay, or an obligation secured by a general charge on the corporation's assets.

A bond is an instrument under which a corporation pledges or mortgages the whole or part of its property to secure a loan.

Bonds and debentures can be defined in various ways. In the business environment, the term "bonds" can be used to mean as a promise to pay backed by the strength of the debtor's covenant (or promise to pay) with no security provided. In contrast, the term "debentures" can be used to mean a debt backed by security, even if contingent. For the purposes of this course, and as defined in the Guide, bonds are a subset of debentures.

A debenture can secure many types of property, land, or personal property or both. A debenture can also secure property currently held by the borrower or after acquired property. In the context of after acquired property, property, as mentioned in the debenture, even if obtained by the borrower after the execution of the debenture, is subject to the security under the debenture. See the case of *Re Rumford Holdings Ltd.* which is a case dealing with the determination of proper execution by a corporation of a debenture in a specific situation.

Sally could lend on a secured or unsecured basis. A loan to the corporation could be protected by personal guarantees from Harry and Irma with the grant of a charge

© ICSA, 2011

against the cottage to secure the repayment/guarantee Sally may also seek a general floating charge or debenture over the assets and business of the corporation. She may lend the money personally to Harry and Irma to buy the shares thereby avoiding the limited liability of the corporation (and, again, taking a charge against the cottage).

Shares & share capital (Chapter 3, 2.1&2.3); secured loans (Chapter 4, p 197).

[Marking guidance: 1 mark for each type of financing identified; up to 3 marks for descriptions of each of equity, preferred shares and lending.]

(d) On a different assumption, assume that Needy Bank agrees to lend $20,000 but Sally does not want to provide any money. Advise Harry and Irma as to the protections the bank would be likely to seek, over and above a simple loan agreement with the corporation.

(4 marks)

Needy Bank will be likely to require a joint personal guarantee of the corporation's obligations under the loan agreement from Harry and Irma. It may also insist on a charge against the holiday cottage to secure this guarantee. Either a secured line of credit or term loan secured by a mortgage may be appropriate. Needy Bank is also likely to seek a floating charge over all the assets and business of the corporation (a general floating charge). The combined loan and charge (security) is sometimes referred to as a debenture. Students may also mention other kinds of loan covenants mentioned above to ensure that Needy Bank has advanced warning of problems with the performance of the business.

© ICSA, 2011

2. Organa Limited is an organic fruit and vegetable wholesaler. The directors of Organa, (none of whom are shareholders of the corporation), are Tabatha, Ursula and Walter. Tabatha is the Procurement Manager and Ursula is the Sales Manager. Organa's articles of Incorporation are in the form of Articles for Private Corporations Limited by Shares and they include the following additional article:

"The activities of the corporation are restricted to the supply of organic fruit and vegetables to retailers and consumers and encouragement of the consumption of organic fruit and vegetables.

The directors may not purchase or authorize the purchase of non-organic fruit or vegetables."

The shareholders have discovered the following:

(i) The directors have signed an agreement with Freezit & Co, a business owned by Tabatha's husband, pursuant to which Organa agrees to purchase 100,000 packets of frozen carrots from Freezit at a price of $1 per packet. The carrots are not organic.

(ii) Ursula has signed an agreement to supply 300,000 kilograms of non-organic apples to Scrump Inc, an alcoholic cider producer, for $150,000.

Required

With reference to relevant legal authority, advise the shareholders:

(a) Whether or not Organa is bound by the agreement with Freezit.

(10 marks)

(b) Whether or not Organa is bound by the agreement with Scrump.

(10 marks)

(c) In relation to the above matters, what rights Organa has against any of its directors.

(5 marks)

(Total: 25 marks)

Marking scheme and suggested answers

With reference to relevant legal authority, advise the shareholders:

(a) Whether or not Organa is bound by the agreement with Freezit.

(10 marks)

At common law, the doctrine of *ultra vires* prevented a corporation from carrying out acts that fell outside its legal capacity. As a result, it was a requirement to set out the specific objects of the corporation in the Articles of Incorporations as to ensure that the proposed acts would not be outside or *ultra vires* the powers of the corporation. Under s16 (2) of the CBCA a corporation is prohibited from carrying on any business or exercising any power that it is restricted by its Articles from carrying on or exercising, nor shall the corporation exercise any of its powers in a manner contrary to its Articles.

© ICSA, 2011

However, the objects of a registered corporation no longer operate to limit its legal capacity (ss. 15 & 16 CBCA). The issue is therefore the authority of the directors to bind the corporation to the contract.

The directors, collectively, are authorized to commit the corporation to contracts (s 102 CBCA). This is subject to any other restrictionsThe restriction on objects of the corporation limits the exercise of the powers of the board to circumstances advancing the objects of the corporation and there is an express prohibition on the purchase of non-organic vegetables. Any purchase of non-organic vegetables is therefore beyond the powers of the directors and the power of the board to authorize any other person to bind the corporation.

Apparent Authority – In agency law, this is authority that the principal knowingly or negligently permits the agent to assume or which he holds the agent out as possessing. Authority that a reasonably prudent person, using diligence and discretion, in view of the principal's conduct, would suppose the agent to have. See the case of *Metcalfe v. Anobile, Hamer, and Kingsview Investments Incorporated.* Also, s 16of the CBCA protects persons contracting with a corporation in good faith by providing that in favour of such a person any limitation on the power of the directors in the constitution of the corporation can be ignored.

If the conditions are satisfied, this removes the restriction on the "powers of the directors" and Organa is bound by the contract. However, if Freezit attempts to rely on agency law they will be met by s.120 which deals with conflict of interest. A director is required to disclose conflicts of interest in writing to the corporation or have the nature and extent of the interest entered in the minutes of the board meeting. Where a director is a party to a "material contract" or has a "material interest" with the corporation, the material contract or interest must be disclosed. A director must make the disclosure at the meeting at which the proposed contract is first considered or at the first meeting after becoming interested in the contract. This is provided for in section 120 of the *CBCA*.
In addition to the fact that the agreement with Freezit may be binding on Organa because of the operation of agency law and apparent authority, Organa may still not have a right to avoid the agreement based on section 120 because the conflict of interest provision deals with the director and makes no reference to a director's husband or relative. Thus the contract may be valid in spite of Tabitha's husband's ownership of Freezit.

[Marking guidance: identification of key issue as authority of directors: up to 2 marks. Explanation of the legal basis of board powers, identification of limits in the question and relevance of this to the facts: 4 marks. Awareness of s.120, apparent authority and application to the facts: 5 marks.]

(b) Whether or not Organa is bound by the agreement with Scrump.

(10 marks)

The objects of a registered corporation no longer operate to limit its legal capacity (ss. 15 & 16 CBCA). (The objects clause is relevant because the contract is for non-organic apples, (and the supply is to a manufacturer, not a retailer or consumer, which good students may pick up on as arguably inconsistent with the articles but students will not be penalised for missing this detail)). The issue is therefore the authority of Ursula to bind the corporation to the contract.

Again, the directors, collectively, are authorized to commit the corporation to contracts(s 102 CBCA). This is subject to restrictions that may be in the Articles of Incorporation. The statement of objects limits the exercise of the powers of the board

© ICSA, 2011

to circumstances advancing the objects of the corporation. Any sale of non-organic apples to a cider manufacturer is therefore beyond the powers of the directors. It is also beyond the powers of the directors to authorize any other person (such as Ursula) to bind the corporation.

If we assume (for the reasons stated in the answer to (a)) that the conditions for the operation of agency contract and apparent authority described above are satisfied, this simply removes the restriction on the "powers of the directors", to authorize others to bind the corporation. The question remains, is Ursula authorized to bind the corporation? This is a matter of agency law. Ursula must have actual authority (Hely Hutchinson v Brayhead [1968]) or apparent authority (*Metcalfe v. Anobile*). Here, as she is the Sales Manager, it is likely that a third party would reasonably expect her to have the authority to sign the agreement. If s. 102 operates so as to enable the board to represent that Ursula has authority to contract (such representation being implicit in her appointment as Sales Manager), there is apparent authority and Organa is bound by the agreement. If the application of s.102 is narrower and simply operates in relation to direct, express authority granted by the board of directors, s. 102 cannot be relied upon. This leaves Freezit unable to rely on s. 102, subject to the common law rule that they have constructive knowledge of the constitution of the corporation and unable to rely on Royal British Bank v Turquand [1856] as the prohibition in the articles is absolute.

Accordingly, the agreement with Scrump may or may not be binding on Organa (the issue as to the broad or narrow effect of s. 102 is moot).

[Marking guidance: identification of key issue as authority of an individual director: up to 2 marks. Need for and application of s. 102 to the facts: 2 marks. Explanation of legal basis of individual director powers and discussion of agency law: 6 marks.]

(c) In relation to the above matters, what rights Organa has against any of its directors.

(5 marks)

A director of a corporation must act in accordance with the constitution of the corporation (S122 (2) CBCA). All of the directors are in breach of this duty to the corporation in relation to the agreement with Freezit. The corporation may sue its directors for breach of duty and claim any profits made by any of the directors, and any losses made by the corporation. (s122 CBCA). Section 122(3) makes it clear that nothing in the CBCA, the Articles of Incorporation of the corporation nor the corporation's by-laws affect this liability. If Organa were to be successfully sued by Scrump for failure to supply the apples, it could sue Ursula to recover any damages it was ordered to pay to Scrump.

Chapter 4, 1.8 – 1.9 (Power and duty of Directors, Directors' liability) and ss. 102 and 122 CBCA)
Chapter 2, 2.2 (objects of the corporation)

© ICSA, 2011

3. Aiden, is a director and the Head of Marketing of Bright Inc. His father, Carl, is an outside director of Dawling Inc. Both corporations are listed on the Main Market of the Toronto Stock Exchange.

One Friday evening, Aiden and his girlfriend, Emma, had been having dinner at Aiden's parents' house, when dinner had been interrupted by an urgent telephone call to Carl from Dawling's Corporation Secretary. Emma had overheard Carl say, "Let's make sure we get the timing right because the share price will take a dive once news of this hits the market".

The next day, when having dinner with her own parents, Emma mentioned that Carl had not seemed happy at dinner the night before, and that something very bad must have happened because Carl expected the Dawling share price to dive. She contrasted this with Bright, which, she explained, was about to sign an enormous international contract which would result in lots of overseas travel for Aiden.

On the following Monday morning, Dawling shares were trading at $2 each. Emma's mother, Geraldine, instructed her broker to sell her shares in Dawling and use the proceeds to buy shares in Bright. With the $200,000 proceeds from the sale of Geraldine's shares in Dawling, her broker bought 50,000 shares in Bright at $4 per share.

The following week, Dawling made a public announcement that it had settled an important legal case concerning the validity of a patent protecting one of its best-selling products. The price of Dawling shares promptly fell to $1.50. The same day, Bright shares gained $1 to trade at $5 following an article in the Financial Times reporting that the corporation had secured a lucrative five year marketing contract with a large international corporation. Geraldine was delighted and took her daughter out for lunch to celebrate. Emma is worried.

Required

(a) What, if any, disclosure obligations does a deemed insider have in relation to the settlement of the case and in relation to the lucrative contract?

(a) Who is an insider, what is insider trading and how is the law governing insider trading structured in Canada?

(7 marks)

(b) Discuss whether Aiden or Carl may have committed any criminal offences.

(7 marks)

(c) Discuss whether Geraldine may have committed any criminal offences.

(7 marks)

(Total: 25 marks)

Marking scheme and suggested answers

(a) Deemed insiders is a person who proposes to make a take-over bid (as defined in the regulations) for securities of a corporation, or to enter into a business combination with a corporation, is an insider of the corporation with respect to material confidential information obtained from the corporation and is an insider of the corporation for the purposes of subsection (s131(3) CBCA)

S. 128 of the Canada Corporations Regulations describes deemed insiders as follows

© ICSA, 2011

For the purposes of this Part,

(a) if a body corporate becomes an insider of a corporation or enters into a business combination with a corporation, a director or officer of the body corporate is deemed to have been an insider of the corporation for the previous 6 months or for any shorter period during which the director or officer was a director or officer of the body corporate, and

(b) if a corporation becomes an insider of a body corporate or enters into a business combination with a body corporate, a director or officer of the body corporate is deemed to have been an insider of the corporation for the previous 6 months or for any shorter period during which the director or officer was a director or officer of the body corporate.

Essentially a deemed insider will have the same obligations as an insider under the CBCA not to purchases or sell a security of the corporation with knowledge of confidential information that, if generally known, might reasonably be expected to affect materially the value of any of the securities of the corporation. A breach of such obligations will result in the deemed insider being liable to compensate the seller of the security or the purchaser of the security, as the case may be, for any damages suffered by the seller or purchaser as a result of the purchase or sale unless the insider establishes that

(*a*) the insider reasonably believed that the information had been generally disclosed;

(*b*) the information was known, or ought reasonably to have been known, by the seller or purchaser; or

(*c*) the purchase or sale of the security took place in the prescribed circumstances.

(b) Who is an insider, what is insider trading and how is the law governing insider trading structured in Canada?

(7 marks)

Who is an Insider? [3 marks]
To be an insider a person must have and know that he has insider information

The CBCA defines “insider” as:

1. directors of the corporation,
2. directors of the subsidiaries or affiliates of the corporation,
3. persons who directly or indirectly control 10% or more of the corporation's shares and
4. persons in special relationships with the corporation (see ss. 126(1) and 131(1), CBCA).

What is insider trading [2 marks]
Insider trading is a crime based on using inside knowledge or information for the purpose of making a profit or avoiding a loss. The CBCA requires dealing in ‘securities’ which are defined in s131 (2) of the CBCA and includes shares. (1 mark)

Inside information is not defined but the criteria are contained in s131 of the CBCA. The information must be confidential information that, if generally known, might reasonably be expected to affect materially the value of any of the securities of the corporation and should relate to particular securities (shares) or to a particular issuer of securities (a distributing corporation or its affiliates) and not to securities or issuers generally.

How is the law structured? [3 marks]

This behaviour is subject to criminal law and a civil regulatory regime.

© ICSA, 2011

The offences of insider trading are contained in s131 (4). The first offence is the dealing offence, which is the purchasing or selling of shares.

Merely disclosing the information is an offence unless it is in the proper performance of the function of a person employment, office or profession.
Insider dealing is an offence and punishable by a fine and or imprisonment. If convicted summarily, a person may imprisoned for a term not exceeding 6 months, a fine of either the greater of $1 million CAD or three times the profit made, or both imprisonment and the fine, s130(4) CBCA. Also, an offender may be liable to pay compensation upon a finding of civil liability under s131 (4) – (7) of the CBCA.

(b) Discuss whether Aiden or Carl may have committed any criminal offences.

(7 marks)

The behaviour is potentially insider trading. The offences in sections 126, 130 and 131 of the CBCA need to be considered. [1 mark]

Aiden [3 marks]
He has not dealt nor encouraged dealing in Bright shares. The only potential offence committed is disclosing insider information to another person otherwise than in the proper performance of the function of a person employment, office or profession.
.

Students should consider whether Aiden had information as an insider (ss. 126 and 131):
Was Aiden himself an insider? (yes)
Was he in possession of inside information? (yes)
Had the information been made public when he passed the information to his girlfriend? (no)
Did he pass the information to Emma otherwise than in the proper performance of his office/employment with Bright? (yes)
Students should also consider the availability of any defences, particularly, s. 130: if Aiden can show that he did not at the time expect any person, because of the disclosure, to deal in securities.

Carl [3 marks]
Analysis as for Aiden. Potentially, not a disclosure of information and s. 130 defence may be available.

(c) Discuss whether Geraldine may have committed any criminal offences.

(7 marks)

Did Geraldine, whilst having information as an insider, deal in securities the price of which were affected by the inside information? [1 mark]

Considering first, the Dawling information [3 marks]
Geraldine sold Dawling shares, therefore dealt in securities the price of which were affected.
Was she in possession of inside information? Arguably not, she had no specific information.
Even if it was:
Did she know that the information she had was inside information? It is not clear that she did not know that the information/problem worrying Carl was not public.
Did she know that the information came, directly or indirectly, from an inside source? Yes.

© ICSA, 2011

The defence Geraldine might have available is found in s. 130, that she would have done what she did in any event: she wished to invest in Bright and needed the funds.

Considering the Bright information [3 marks]
Geraldine Bought Bright shares, therefore dealt in securities the price of which were affected.
Was she in possession of inside information?
It was particular to Bright
It was precise and specific
It had not been made public
Was such that when made public had a significant effect on the share price
Did she know that the information she had was inside information? It is not clear that she did not know that the potential contract was not public or that she knew it would have a significant effect on the share price.
Did she know that the information came, directly or indirectly, from an inside source? Yes. S131 (1) (h)
Geraldine might try to argue (though she is unlikely to be successful), that one or more of the defences found in s. 130 are available to her:
(a) that she did not at the time expect the dealing to result in a profit attributable to the fact that the information in question was price-sensitive information in relation to the securities;
(b) that at the time she believed on reasonable grounds that the information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having the information; and
(c) that she would have done what she did even if she had not had the information.

Insider Information: sections 126, 130, 131 CBC; cchonline guide, Practice Questions.

© ICSA, 2011

4. The share capital of Praktique Ltd is 200,000 x $1 common shares and 20,000 x $1 preferred shares. The rights attached to the preferred shares are defined in the corporation's Articles of Incorporation which state that the preferred share dividends are 12% per annum payable on May 1 of each year, preferred share voting rights are restricted to dividend matters and, in the event of a winding up, preferred shares shall have priority as to return of capital. The directors of Praktique are Quinten, Roberta and Peter. Quinten and Roberta each own 30% of the common shares. The remainder are owned by Vince. The preferred shares are owned by Peter.

Praktique has been very profitable. Provided that it can raise additional capital, its growth prospects and future profitability are not in question but it is unlikely to make any profits this year. Whilst considering how much new capital they need and how best to raise it, Quinten and Roberta were advised that the preferred share dividend rights are significantly higher than interest rates at which Praktique can borrow. They developed a plan to restructure the capital of Praktique by paying off the preferred shares and issuing additional $1 common shares. They were advised that if 150,000 new $1 common shares are issued they should be priced at $3 per share. Quinten and Roberta are interested in purchasing the new shares.

When Peter is informed of the restructuring plan he is not happy. He has no wish to sell his preferred shares and wishes to buy 50,000 common shares.

Required

(a) Advise Praktique of the steps that need to be taken to issue the proposed new common shares.

(7 marks)

(b) Advise Vince what, if any, rights he may have if Quinten and Roberta issue the common shares to themselves.

(5 marks)

(c) Advise Peter whether or not his preferred shares may be cancelled without his agreement and, if they can, the steps Praktique must take to achieve this.

(7 marks)

(d) Advise Peter whether or not he is entitled to have any of the new common shares issued to him.

(6 marks)

(Total: 25 marks)

Marking scheme and suggested answers

(a) Advise Praktique of the steps that need to be taken to issue the proposed new common shares.

(7 marks)

Authority to issue is given to the board of directors by the CBCA s25 to issue all kinds of shares of the corporation subject to the provisions of the Corporation's Articles, by-laws or unanimous shareholders' agreement. Power is also conferred on the directors under section 103, subject to the Articles, by-laws or any unanimous shareholder agreement, to pass by-laws to regulate the business or affairs of the corporation. The by-laws will usually provide that shares are to be issued upon acceptance of a subscription by resolution of the board, but the discretion of the directors to issue shares will generally not otherwise be limited as long as shares are not issued for

© ICSA, 2011

improper purposes. Need to check the articles: do the directors have power to issue? In the absence of contrary information, the CBCA vests the directors of a corporation with the power to issue shares of the corporation and therefore there is no requirement for a shareholder resolution empowering the board to issue common shares is needed. [3 marks]

The Articles of a corporation may provide that no shares of a particular class may be issued unless the shares have first been offered to the persons holding shares of that specific class. If this right is provided in the Articles, the shareholders of the class have a pre-emption right to acquire the shares that are being offered, in proportion to their holdings of the shares of that class, before such shares can be sold to others and at such price and on such terms as those shares are to be offered to others (s. 28 of the CBCA).

Even if the Articles have provided for a pre-emption right for the holders of shares of a particular class, subsection 28(2) of the CBCA provides that the right will not exist in certain circumstances. No pre-emption right will exist if the shares are to be issued:

(1) For consideration other than money;

(2) As a share dividend, or;

(3) If they involve conversion privileges, options or rights previously granted by the corporation.

The directors must then check to see whether or not there is a provision in the Articles, any unanimous shareholders agreement or by law applying the statutory pre-emption rights (s.28). We are not told that there is therefore students should assume that statutory pre-emption rights not apply (s.28). The purpose of statutory pre-emption rights is to ensure existing equity or common shareholder stakes are not diluted by the issue of new shares. They apply on the issue of any class of shares as defined in s. 28. [3 marks]

The directors then need to pass a resolution to issue/allot the shares. [1 mark]

(b) Advise Vince what, if any, rights he may have if Quinten and Roberta issue the common shares to themselves.

(5 marks)

The consequences of failure to respect pre-emption rights, if they do exist are that the share issue is valid but the corporation and every officer who knowingly authorised or permitted the contravention are jointly and severally liable to comply with that provision or to summary conviction (s251 and s252 CBCA). There is a two year limitation period from when the issue arose within which to bring a claim. (s252 (2) CBCA).

Here, there is no indication that the shares need to be offered to anyone who holds common shares. Vince holds common shares but in the absence of a pre-emption right cannot bring a claim. If there was a pre-emption right he could bring a claim sections 28, 251 and 252.

(c) Advise Peter whether or not his preferred shares may be cancelled without his agreement and, if they can, the steps Praktique must take to achieve this.

(7 marks)

Yes, Peter's shares may be cancelled without his agreement. (S39 (6) CBCA [1 mark]

Explanation:

Section 38 of the CBCA permits a corporation by special resolution (i.e., a resolution passed by a majority of not less than two-thirds of the votes cast by shareholders who voted in respect of that resolution, or signed by all the shareholders entitled to vote on that resolution) to reduce its stated capital for any reason, including: (

1) extinguishing or reducing a liability in respect of an amount unpaid on any share;

(2) distributing to the holder of a share in any class or series of shares an amount not exceeding the stated capital of the class or series; and

(3) deleting an amount not represented by realizable assets.

Subsection 38(3) prohibits the reduction of stated capital if the corporation is or would become unable to pay its liabilities as they come due, or if the realizable value of the corporation's assets would be less than its liabilities because of the reduction.

Peter may not be willing to sign the Director's resolution containing a statement of solvency. If he is not, this may be a breach of duty. In practice, the shareholders may decide to remove him as a director using s. 109. To remove a director the votes of majority of the shareholders are needed to pass an ordinary resolution at a special meeting (s109). [4 marks]

Generally speaking, where a corporation wishes to change a provision in the Articles of Incorporation, e.g. corporate name, fixed number of directors, range of directors, etc. the requisite procedure is as follows:

a. Directors' Resolution stating the proposed change,
b. Special Resolution approving the change, and
c. Preparing and filing the Articles of Amendment in duplicate and any other required documentation together with the filing fee.

Only if the reduction of capital by cancelling the preferred shares is a variation of rights is a resolution supported by holders of 75% of the class whose rights are varied (i.e., Peter) needed (s38). Here, as the preferred shares have priority as to return of capital therefore can be bought out at nominal value, this will not be regarded as a variation of rights:. The preferred shares are being dispensed with in accordance with the contract in the articles. [2 marks]

(d) Advise Peter whether or not he is entitled to have any of the new common shares issued to him.

(6 marks)

This depends upon whether the preferred shares are common shares within the meaning of that term in s. 38 as, if they are, their holder, Peter, is entitled to be offered the new common shares on a pro-rata basis. [2 marks]

Applying the de facto definition of common shares in Canadian corporate law: shares other than shares that as respects dividends and capital carry a right to participate only up to a specified amount in a distribution, if the preferred shares are limited as to both their participation in dividends (yes) and participation in capital they are not common or

© ICSA, 2011

equity shares. Peter is therefore not entitled to be offered any of the common shares. [4 marks]

Issue of shares, Chapter 3, 2.1-2.3
Statutory pre-emption rights, CBCA, cchonline guide
Class rights and variation, Chapter 2, 2.5; chapter 3, 2.1-2.3

© ICSA, 2011

5. Sharpshirt Inc owns a chain of men's fashion shops. Having borrowed extensively to open new outlets, recent trading has been poor and Sharpshirt is experiencing financial difficulties. The shareholders and directors are convinced these financial difficulties will be short-lived, that sales and profits will improve over the coming year, and that Sharpshirt will, in time, be able to pay its debts in full. Sharpshirt's financial creditors, are nervous, particularly Loan Inc, which has not been paid the last three repayment instalments of the loan it made to Sharpshirt, secured by a general floating charge over all Sharpshirt's assets and business. Also, Tee Ltd, a trade creditor, tired of waiting for payment of the $25,000 it is owed, has sent Sharpshirt a demand notice for the sum.

Required

(a) Explain the process of winding up, liquidation and dissolution of corporations in Canada and how and by whom these would be commenced in the scenario above.

(10 marks)

(b) Explain the purposes of liquidation and receivership. Relating your answer to the scenario above, outline who may seek to appoint a liquidator, receiver or receiver manager, the processes for appointment, and whether or not a receiver or receiver manager can be appointed if a winding up application is pending.

(15 marks)

(25 marks)

Marking scheme and suggested answers

(a) Explain the process of winding up, liquidation and dissolution of corporations in Canada and how and by whom these would be commenced in the scenario above.

(10 marks)

In Canada the process of winding up of a corporation is excluded from the CBCA. However, most corporations which are provincially incorporated are governed by their provincial winding up regulations. Generally, a creditor may serve a demand notice on the corporation for an existing debt and subsequently, where the debt remains unpaid has the right to apply to the court that the corporation be wound up in order to settle such debt (depending on the provisions or limitations of the relevant provincial legislation).Winding up of a corporation refers to the process of stopping the corporation from carrying on business and settling all moneys owed and owing. It can be a time consuming process to terminate all business functions, collect moneys owed and debts payable to creditors, perform and/or terminate contracts etc. A liquidator(s) is appointed for winding up a corporation. A corporation that never carried on business cannot be terminated by winding it up.

In this case Sharpshirt may be able to commence an action seeking the winding up of the corporation in order to settle its creditors.

Liquidation occurs after winding up when all the debts of the corporation have been paid and all moneys owing have been collected. It enables the sale i.e., liquidation, of assets owned by the corporation. The monies arising from the sale of assets are then distributed to appropriate shareholders.

© ICSA, 2011

If Sharpshirt is able to settle its debts to Loan Inc and Tee Ltd, then it may not need to proceed with the liquidation of its corporation.

Dissolution refers to the termination of a corporation by the filing of the Articles of Dissolution. The filing of Articles of Dissolution effectively kills a corporation. Unless the corporation has never carried on business, dissolution can only occur after the winding up and liquidation (or at least a proposed liquidation) of the corporation.

Subject to rebirth by the filing of Articles of Revival, a Certificate of Dissolution effectively kills a corporation.

[4 marks]

Involuntary Dissolution (Cancellation)

In certain circumstances, the Director General under the *CBCA* may dissolve a corporation by issuing a Certificate of Dissolution or by applying to court for dissolution. The process enables the Director General to clear "dead" corporations off the register. There exists a publication requirement before the Director General can dissolve a corporation.

The Director may issue a Certificate of Dissolution if the corporation:

(i) has not commenced business within three years after the date shown in its certificate of incorporation,

(ii) has not carried on its business for three consecutive years,

(iii) is in default for a period of one year in sending to the Director any fee, notice or document required by this Act, or

(iv) does not have any directors or is in the situation described in subsection 109(4)-all the directors have resigned or been removed

There is a publication requirement before the Director General can dissolve a corporation.

Voluntary Dissolution

Where a corporation has never carried on business, it can be dissolved by the directors and the shareholders by the filing of Articles of Dissolution. In contrast, a more elaborate and time consuming process is required to dissolve a corporation that is carrying on business. In both situations, the <u>directors and shareholders</u> must approve the proposed dissolution. In the context of a corporation that is carrying on business, however, winding up and liquidation must occur prior to the proposed dissolution. A court ordered liquidation occurs where any interested party makes an application to the court for the termination of a corporation either due to a lack of agreement among shareholders and directors to the voluntary dissolution of the corporation and on showing that the dissolution would be just and equitable. The court appoints a liquidator who would be subject to court oversight. The court could dissolve the corporation after winding up and liquidation by a court order or by Articles of Dissolution being prepared and filed.

In addition, where a business is to be wound up and liquidated, the directors and shareholders may ask for a court supervised winding up and/or liquidation. The court oversight in the winding up and/or liquidation is a preventative measure to alleviate concerns regarding allegations by a creditor or other interested party that the liquidator acted improperly. A court supervised liquidation occurs where upon a belief that the winding up/and or liquidation of a corporation could be contentious, the directors, shareholders or liquidator request that the courts oversees the steps to dissolution to protect the parties from possible legal action. The final step is to file the Articles of Dissolution. Sharpshirt may be able to pursue this line of action should it believe that the dissolution of the corporation would be contentious

The principal ground on which creditors apply to have corporations wound up is that the corporation is unable to pay its debts. Here, any of Sharpshirt's creditors could apply to the court for the winding up of Sharpshirt on this ground

[6 marks]

(b) Explain the purposes of liquidations and receivership. Relating your answer to the scenario above, outline who may seek to appoint a receiver or receiver manager, the processes for appointment, and whether or not a receiver or receiver manager can be appointed if a winding up application is pending.

(15 marks)

A liquidator is a person appointed to carry out the winding-up of a company. A receiver is an officer of the court. Simplistically, a receiver is appointed to take charge of an asset or property from the holder(s) so that a judgment debtor may receive payment of an obligation (including an interest in the asset or property), which could not be extinguished by ordinary process of execution.

Under section 218 of the CBCA, liquidation of a corporation begins under an order from the court, and under section 220, the court would appoint the liquidator. The receiver may be appointed either by the court or under an instrument, which is a legal document in writing, e.g., a deed of conveyance (s. 98 of CBCA). If the receiver is appointed under an instrument, the receiver acts under direction of the court as well as in accordance with the instrument.

The liquidator has prescribed duties and powers, which are also set out in detail in sections 221 and 222 of the CBCA. These duties include collecting the corporation's property and assets, carrying on its business as required for orderly liquidation and settling or compromising claims.

A receiver does not carry on the business of the corporation. Subject to the rights of secured creditors, the receiver's duties are to receive any property of the corporation and the income from the property, and to pay the liabilities connected with it, as well as to realize the security interest of those on behalf of whom the receiver is appointed.

The receiver-manager has the additional duty of carrying on the business to protect the security interest of those on behalf of whom he or she holds the appointment (section 95).

Section 101 of the CBCA requires the receiver-manager to prepare financial statements of the same standard and form as the directors would be required to submit to the shareholders. The accounts of the receiver-manager's administration are

© ICSA, 2011

available during normal business hours for inspection by the directors of the corporation (paragraph 101(*e*)), although the director's powers cease as soon as the receiver-manager is appointed by the court (section 96). The receiver-manager is also required to prepare six-month reports; and upon completion of the receiver-manager's duties, to render a final account to the court and the corporation (paragraphs 101(*f*) and 101(*g*)).

The receiver or receiver-manager is required to act honestly and in good faith and deal with the corporation's property in a commercially reasonable manner (section 99).

. [8 marks]

Sharpshirt or its directors could seek to appoint a liquidator and a receiver manager. [1 mark]

Application *by a floating charge holder*: A floating charge is equitable in nature and is taken over the corporation's fluctuating assets such as stock in trade or book debts. The essential characteristics of a floating charge were identified by Romer J in ***Re Yorkshire Woolcombers Association*** [1902] as:

(i) a charge over arrange or class of assets;
(ii) that change from time to time; and
(iii) which allows the corporation to deal with the asset without the consent of the lender.

Subsequent cases have stressed that it is the third characteristic that is the badge of a floating charge.
Loan Inc's floating charge instrument will probably qualify for the purposes of applying to the court for the appointment of a liquidator to coordinate the winding up of sharpshirt and the payment of Loan Inc's debt [4 marks]

Appointment by Corporation: an application for the appointment of a liquidator may be made to the court by Sharpshirt, its directors or any creditor of Sharpshirt.
An order of the court appointing a person to be a liquidator may be made only if the court is satisfied that Sharpshirt is or is likely to become unable to pay its debts (this need not be satisfied if the applicant is the holder of a qualifying floating charge); and the liquidation order is reasonably likely to achieve the purpose of winding up. [4 marks]

Winding up (Chapter 7, 5)
Liquidation and receivership (Chapter 7,5; cchonline guide)

6. Anita, Betty, Nigel and Mason are each directors and owners of 25% of the shares of Xenon Inc, a corporation specializing in the sale of expensive metal jewelry. In April 2011, Anita bought a $105,000 car from the corporation for $70,000. At a board meeting in May 2011 at which only Nigel and Mason were in attendance, they retrospectively approved the sale. Betty, who is the sales director, spends a lot of her time abroad seeking new customers and was unable to attend this meeting.

   In June 2011, Anita took Nigel with her to a meeting with Drago Inc to discuss the renewal of a lucrative jewelry supply contract between Xenon and Drago which was about to expire. At the meeting, Anita proposed a 20% increase in the prices to be paid by Drago. Nigel was surprised but just sat and listened to Anita, thinking that she must have her reasons. After the meeting, Anita visited Drago alone and suggested that it should stop dealing with Xenon and contract with her directly as she could personally supply the same pieces of jewelry to them at 90% of the prices it had been

© ICSA, 2011

paying Xenon for the last 12 months. Drago subsequently allowed the supply contract with Xenon to expire and began to buy jewelry from Anita personally.

When Betty read the minutes of the May 2011 board meeting she became very concerned. She asked Nigel and Mason what they thought about the sale of the car and was shocked when they seemed unconcerned and expressed complete confidence in Anita.

Required

(a) Advise Betty as to any and all breaches of duty or other legal shortcomings arising from the facts.

(12 marks)

(b) Advise Betty as to whether a derivative action can be pursued, the steps involved in pursuing such action, and whether or not she could pursue such action without the support of Nigel and Mason.

(8 marks)

(c) Outline briefly any other application Betty may be able to make to obtain a remedy in the circumstances.

(5 marks)

(25 marks)

Marking scheme and suggested answers

(a) Advise Betty as to any and all breaches of duty or other legal shortcomings arising from the facts.

(12 marks)

Failure to comply with s. 120 and 122 [5 marks]

Directors must not profit at the expense of the corporation. Directors must avoid any conflict of interest between the directors' personal interests and those of the corporation. Directors may not divert opportunities or benefits from the corporation to themselves. A director, for example, may know that the corporation wishes to purchase property. The director cannot purchase the property to resell it to the corporation at significant personal profit. In such a situation, a conflict of interest would exist between the director's personal interests and the interests of the corporation.

Purchase of the car by Anita is below its value is not in the best interests of the corporation. The contract can be avoided, Anita must account for any profits and Anita, Nigel and Mason are all liable jointly and severally to compensate the corporation for any losses arising from the sale.

Duty to declare interest, s. 120 [2 marks]
Possible breach of s. 120, but is s. 120 applicable because Nigel & Mason either knew or ought reasonably to have known Anita was a party to the sale?

Duty to avoid conflicts of interest, s.120 and s122 [5 marks]
Anita securing the termination of the lucrative supply of jewelry to Drago by Xenon and supplying Drago herself is a breach of ss. 120 and 122 as she has a conflict of interest and has taken a corporate opportunity away from Xenon. Students may discuss any of UPM Kymmene Corp. v. UPM Kymmene Miramichi Inc.; Canadian Metals Exploration Ltd. v. Wiese.

Duty to act honestly and in good faith with a view to the best interests of the corporation s122(1)(a) and duty of care, skill and diligence, s. 122(1) (b) [2 marks]
Discussion of the possibility that Nigel and Mason may be in breach of these duties though a good student should note that the s. 122(1) (b) shortcoming is simpler to establish and provides adequate remedies.

(b) Advise Betty as to whether a derivative action can be pursued, the steps involved in pursuing such action, and whether or not she could pursue such action without the support of Nigel and Mason.

(8 marks)

As directors' duties are owed to the corporation, the proper claimant for breach of duty is the corporation (Foss v Harbottle).

The exceptions to the rule in *Foss v. Harbottle*, as set out in the English case *Daniels v. Daniels*, [1978] 1 Ch. 406, were that the court would interfere with a decision of a majority of the shareholders only in the following circumstances:

(1) where a shareholder suffers an attack on his or her individual rights as a shareholder;

(2) where the corporation is purporting to do by ordinary resolution that which its own constitution requires to be done by special resolution;

(3) where the act complained of is *ultra vires* the corporation; and

(4) where the act complained of constitutes fraud, and the minority are prevented from remedying the fraud because of the protection given to the fraudulent shareholders or directors by their majority.

The exception found in Cook v Deeks of where there was fraud on the minority where the wrongdoers were in control of both the board and the general meeting in which case a derivative action by a shareholder was permitted.

The common law right to bring a derivative action has now been replaced by section 239 of the CBCA (and is similarly found in most provincial corporate statutes).

.

S239 (2) of the CBCA provides that no action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

(a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action; (S.C. 2001, c. 14, s. 116.)

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

© ICSA, 2011

Conditions to be satisfied to bring a derivative action: Betty must be, and is a member. Betty can plead a strong prima facie case of breaches of directors' duties and also non-compliance with s. 122.
She must apply to the court for permission to continue a derivative action.
The court may make any of the following orders:

a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary;

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

[4 marks]

If permission is not refused at this stage, the court must include in its considerations (s. 263(3)), the good faith of Betty, the any authorisation or ratification; whether the corporation has decided not to pursue the claim and whether or not Betty has a personal cause of action she could pursue? (for example, a s. 241 application).

The test to apply to determine whether an action is personal or derivative is whether "it is the corporation which is the aggrieved party, and the plaintiff derives his status from the fact of injury to the corporation, the failure of the corporation to protect itself and the fact that the plaintiff is a shareholder": *Farnham v. Fingold,* [1972] 3 O.R. 688 (H.C.), rev'd on other grounds [1973] 2 O.R. 132 (C.A.).

The court is to have particular regard to views of members who have no personal interest direct or indirect in the matter If Nigel and Mason, as shareholders, do not support such a claim, a court is unlikely to give permission for Betty to continue with a derivative claim. [4 marks]

(c) Outline briefly any other application Betty may be able to make to obtain a remedy in the circumstances.

(5 marks)

As a member, Betty may petition the court under s. 241 (oppression remedy) where the conduct complained of is conduct of the affairs of the corporation and this has been unfairly prejudicial to her interests. Interests covers personal right abuses, breaches of duties owed to the corporation.

The typical remedy is a buy-out order, i.e., either (a) an order directing a corporation, or any other person (s), to purchase shares of the shareholder or (b) an order directing a corporation, subject or any other person (s), to pay the shareholder any part of the monies that the security holder paid for shares; among other remedies contained in s241 (3) CBCA..Daniels v. Fielder is a case dealing with application for relief from oppression. See also Golden Pheasant Holding Corp. v. Synergy Corporate Management Ltd.

© ICSA, 2011

The scenarios included here are entirely fictional. Any resemblance of the information in the scenarios to real persons or organisations, actual or perceived, is purely coincidental.

© ICSA, 2011