

# RECENT DEVELOPMENTS IN DIRECTORS' AND OFFICERS' LIABILITY

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## Introduction

For liability to arise, legal duties must first exist and have been breached. During the last five years corporate law cases decided by the Ontario Court of Appeal and the Supreme Court of Canada have reiterated and to some extent refined the scope of directors' duties. This paper will identify these leading cases and provide an overview of the key principles.

Also new within the last five years is the statutory regime found in Parts XXIII and XXIII.1 of the Ontario *Securities Act* which impose personal liability on officers and directors for misrepresentation and non-disclosure. This statutory regime relates to publically listed companies and encompasses misrepresentation in two contexts: the initial public offering and the trading of shares on the secondary market.

## Scope and Content of Directors' Duties

To briefly review the basics, the legal duties of corporate directors include the duty to manage and/or supervise management of the business and affairs of the corporation, and in so doing to act honestly, in good faith and in the company's best interests. This is captured by the concept that directors owe fiduciary duties to the corporation. In order to fulfill their fiduciary duties however the directors may need to look past the corporation itself and to consider the interests of its stakeholders.

In the 2008 decision of the Supreme Court of Canada in *BCE Inc. v. 1976 Debentureholders*, [2008] S.C.C. 69 the Court dealt with a claim of oppression under the *CBCA* at the suit of

bondholders of Bell Canada Inc. The alleged oppression was a plan of arrangement whereby an offer to purchase the shares of BCE Inc. (Bell Canada Inc.'s parent company) was to be financed in part by the assumption of significant new debt by Bell Canada. The complaining bondholders asserted that the transaction was oppressive to them as it diluted the value of their bonds.

In that context the Court held that directors' duties include the duty to treat the individual stakeholders equitably and reasonably. That said, the prime duty is clear: it is the duty to advance the best interests of the **corporation** and where the corporation's interests are in conflict with the individual interests of a stakeholder, the former must prevail.

The Court stated that a director's fiduciary duty is "a broad, contextual concept", not confined to short term profits or share value but rather focussing on the long term interests of the corporation.

In order to fulfill the duty it will be necessary if the context requires it for directors to consider the interests of creditors, shareholders, employees, suppliers, consumers and others to inform their decisions. In the case at bar, the interests of the debentureholders were plainly "on the table" when the BCE Inc. directors considered the various offers to acquire the company shares, as the debentureholders would inevitably be affected by any transaction. The directors, acting in the best interests of the corporation, were required to consider the long term and short term interests of that stakeholder in making their ultimate decision. On the evidence, it was plain that they had done so, hence the oppression claim failed.

Reference should also be made to *Peoples' Department Stores Inc. v. Wise*, [2004] 3 S.C.R. 461, dealing with directors' duties when the corporation is in the zone of insolvency. The appellant's assertion in that case was that directors owed fiduciary duties directly to creditors of a quasi-

insolvent corporation. Although the Court found that no such duty was directly owed, it did hold that, in such circumstances, it may be appropriate (but not mandatory) for directors to have regard to the interests of creditors.

Apart from fiduciary duties directors owe a duty of care. It is well-settled that corporate directors must act with reasonable care and diligence in the fulfillment of their role. Whether or not directors have adhered to this standard will usually be challenged after the fact of a corporate failure or a controversial business decision. A number of recent cases have re-examined the “business judgment rule”, a guideline used by the Courts to determine whether or not a director has fallen below the standard of care. The rule reflects the fact that what is generally being challenged in these cases is the exercise of business judgment by a director (i.e. a corporate acquisition, executive compensation, sale of a corporate asset, etc.).

The business judgment rule states that deference should generally be given to directors’ business decisions so long as the decision in question is within a range of reasonable alternatives. (See *Maple Leaf Foods v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.) and *Kerr v. Danier Leather Inc.*, [2007] 3 S.C.R. 331).

Courts have repeatedly emphasized that the norm is not perfection, but rather whether or not the business decision lies within the realm of reasonableness. As the Supreme Court of Canada stated in *Peoples*, directors and officers are not in breach of the duty of care if they act prudently and on a reasonably informed basis. Decisions must be reasonable “in light of all the circumstances about which the directors or officers knew or *ought to have known*”. (Emphasis added)

Deference of course has its limits. In *UPM-Kymmene Corp.*, (2002), 27 B.L.R. (3d) 53, upheld by the Court of Appeal, Justice Lax held that in approving an executive compensation package the board of directors failed to meet the standard of care because it failed to obtain sufficient information about the decision at hand and failed to deliberate on the decision adequately. The board had approved an extraordinarily generous compensation package. The evidence suggested that the compensation committee of the board devoted less than 10 minutes to considering the matter. Although the board had sought to rely upon a compensation expert's opinion, that expert had not been provided with all of the relevant facts and it was therefore not reasonable for the directors to have so relied.

This decision suggests that the deference paid to business decisions under the business judgment rule will be justified if and only if the directors have been "scrupulous in their deliberations and demonstrate diligence in arriving at decisions".

### **Personal Liability: Claims against Directors in their Personal Capacity**

Often when disappointed stakeholders bring statutory oppression claims they bring those claims against the directors and officers of the corporation personally as well against as the corporation itself. The test for finding personal liability under the oppression remedy has been articulated in *Budd v. Gentra Inc.* (1998), 11 O.A.C. 288. The Court in that case referred to the following situations in which orders against directors in their personal capacity might be considered appropriate:

1. Where directors have obtained a personal financial benefit from the conduct in question;

2. Where directors have increased their control of the corporation by means of oppressive conduct;
3. Where directors have breached a personal duty that they owe *qua* director;
4. Where directors have clearly misused corporate powers; and
5. Where imposing a remedy against the corporation will prejudice its innocent security holders.

*Budd v. Gentra* is important as it allows for personal liability of the officer and director even though his or her actions may be within the normal scope of a director's or officer's duty. Put another way, *Budd v. Gentra* "rejected the notion that the impugned conduct of the officer or director must be outside the normal scope of the director's or officer's duty, such that it exhibits a separate identity or interest from that of the corporation" (See *Lekushoff v. Research Capital Corp.*, [2008] O.J. No. 632 and *Incorporated Broadcasters Ltd. v. Canwest Global Communications Corp.*, [2008] M.J. No. 400).

### **Statutory Liability Under the Securities Act**

What is new in this field is the imposition of liability on officers and directors for misrepresentation and non-disclosure in connection with shares being traded on the stock market. This is contained in Part XIII.1 of the *Securities Act* (Sections 138.1 to 138.14), which came into force December 31, 2005.

Under these provisions officers and directors of reporting issuers may be sued for damages by anyone who buys or sells a company's stock during the period of time between the release of a

misleading statement in a document and the public correction of that misleading statement. It is not necessary for any of the prospective plaintiffs to prove that they relied upon the misleading statement or that they were even aware of it. Since this cause of action is available to all security holders without proof of reliance, these actions will inevitably be framed as class proceedings.

Liability may also be visited upon officers and directors who authorize, permit or acquiesce in the making of a public oral statement which contains a misrepresentation.

By the same token, directors and officers who have authorized, permitted or acquiesced in the failure of reporting issuer to make timely disclosure of material facts or material changes are also liable to persons buying or selling stock during the period of time that the non-disclosure was operative.

It is noteworthy that this liability applies not to just prospectuses, takeover bid circulars and like documents (called “core documents” in the statute) but to any document that is either filed with the Commission or would otherwise reasonably be expected to affect the market price of a security.

Section 138.5 outlines how damages are assessed against officers and directors found liable for misrepresentation or non-disclosure.

Of interest to the securities litigation bar, Section 138.8 of the *Act* states that no action may be commenced for secondary market liability without leave of the Court, which must be sought upon notice to each prospective defendant. Leave is to be granted only if the Court is satisfied that:

- (a) the action is being brought in good faith; and

- (b) there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.

The first case granting leave under this section is *Silver v. Imax Corporation*, [2009] O.J. 5573, a prospective class proceeding against Imax Corporation and numerous of its officers and directors. The plaintiffs alleged that misrepresentations existed in Imax's 2005 annual report and in a press release issued by Imax in the spring of 2006. It was alleged that those documents had not been prepared in accordance with GAAP, contrary to the defendants' representation of GAAP compliance.

The "good faith" element of the test was easily satisfied. The real issue was the threshold for demonstrating that the plaintiff had a reasonable possibility of success at trial. Justice van Rensburg determined that that element required the plaintiffs to submit evidence substantiating that a misrepresentation had occurred and connecting the defendants' conduct to the alleged misrepresentation. She held that the threshold test of reasonable prospect of success was satisfied "when there is something more than a *de minimis* possibility or chance that the plaintiff would succeed at trial". Much of the evidence and argument before the Court focussed on the defences available to the prospective Imax defendants. In Justice van Rensburg's view, the plaintiffs would fail if and only if the defendants evidence was compelling enough to effectively foreclose any possibility that the plaintiffs might win at trial.

Obviously from the perspective of the directors' and officers' defence bar, the Court in Imax set the leave threshold very low.

A motion for leave to appeal to the Divisional Court was heard by Mr. Justice Corbett who denied leave to appeal: see 2011 ONSC 1035. Since *Imax* was the first case dealing with this

issue there were no decisions which could be said to conflict with it. Regardless of how one formulated the onus, standard of proof and test to be applied to the affirmative defences, Corbett J. concluded that there was no reason to doubt the correctness of the motion judge's decision as in his view the evidence met the threshold no matter where it was set.

He did not expressly endorse the test chosen by Justice van Rensburg, but found no reason to doubt its correctness.

Although clearly these issues may be visited again in future cases, at present the decisions of Justices van Rensburg and Corbett signal that the prospective plaintiff in an action against directors under Section 138 of the *Act* need only prove that he or she has a slightly better than *de minimis* prospect of success in order to bring the action.