

REGULATORY LIABILITY OF DIRECTORS AND OFFICERS

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In the current environment, officers and directors of public companies must not only be aware of their potential civil liability, including claims under the *Class Proceedings Act*, but also that their actions will be scrutinized by securities regulators. The Ontario Securities Commission's mandate is to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets and confidence in capital markets.¹ It is important that officers and directors of public companies, and their counsel, bear in mind the Commission's public interest mandate, which involves more than simply prosecuting breaches of specific provisions of the *Securities Act* and ensuring that aggrieved shareholders have obtained redress.² Rather, the Commission's focus is to ensure that necessary action is taken to protect the Ontario capital markets from any threat of future harm posed by the individual whose actions are in question.

This paper will discuss the regulatory liability of officers and directors in connection with public offerings of securities.

1. REGULATORY LIABILITY OF OFFICERS AND DIRECTORS IN CONNECTION WITH PUBLIC OFFERINGS

The Enforcement Provisions of the Act

The Commission has three statutory tools available to enforce compliance with Ontario securities law:

1. Prosecution before the Ontario Court of Justice under s.122 of the *Act*. This prosecution is subject to the *Provincial Offences Act* and a conviction carries a maximum fine of \$5 million (or triple the profit made or loss avoided in the case of insider trading) and up to five years imprisonment.

1 Section 1.1, *Ontario Securities Act* R.S.O. 1990, c. S. 5 as amended (the "*Act*")

2 Indeed, although s. 128 of the *OSA* allows the Commission to apply to the Superior Court for, *inter alia*, an order of restitution or damages, the Commission has, as a general rule, left such actions to the aggrieved shareholders themselves.

2. Administrative sanctions after a hearing before the OSC itself pursuant to s.127 (the "public interest" jurisdiction of the OSC).
3. Declaratory, injunctive and other orders (including the possibility of requesting restitution and/or damages) before the Superior Court of Justice.³

(a) Criminal Prosecution

One of the offences created under s.122(1) is the making of a statement in a prospectus (and certain other enumerated documents) that "in a material respect and at the time and in light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading". That section also makes any contravention of Ontario securities law an offence.⁴ Subsection (3) specifically deals with directors and officers and provides that where they authorize, permit or acquiesce in the commission of an offence under subsection (1) by the company (whether or not a charge has been laid or a finding of guilt has been made against the company) they are guilty of an offence. As this section creates a provincial offence, with penal consequences attached, guilt must be proven according to the rules of criminal evidence and beyond a reasonable doubt. Charter rights apply and the section provides for a due diligence offence.⁵

While s.122(3) appears to relate to criminal proceedings, an identical provision is contained in s.129.1. This applies more generally to administrative proceedings under s.127, and states that officers who acquiesce, permit or authorize the corporation's non-compliance with securities law are deemed not to have complied with securities law themselves.

(b) Administrative Sanctions

The OSC's second option is its public interest jurisdiction under s.127. This jurisdiction is very broad. The section simply provides:

"The Commission may make one or more of the following orders if in its opinion it is in the public interest to make the order or orders." (Emphasis added.)

3 OSA sections 122, 127 and 128.

4 Defined as the *Act*, the *Regulations*, and any decision of the commission or a director to which a person or company is subject. Other offences include, for example, fraud and market manipulation (section 126.1).

5 See Section 122(2)

The section then goes on to list a number of possible orders, including restrictions or suspensions of registration rights, trading rights and the right to exemptions under the *Act*, the right to review the practices and procedures of market participants, the right to make orders in respect of certain documents, including prospectuses (including an order of amendment) and the right to prohibit persons from holding office as directors or officers of an issuer. The Commission may also order a respondent to pay the investigation and hearing costs.⁶ The Commission's jurisdiction under s.127 was described in the following manner by the Supreme Court of Canada and in *Committee for the Equal Treatment of Asbestos Minority Shareholders v. The Queen in Right of Quebec et al*:

...The public interest jurisdiction of the OSC is not unlimited. Its precise nature and scope should be assessed by considering s.127 in context. Two aspects of the public interest jurisdiction are of particular importance in this regard. First, it is important to keep in mind the OSC's public interest jurisdiction is animated in part by both the purposes of the *Act* described in s.1.1, namely "to provide protection to investors from unfair, improper or fraudulent practices" and "foster fair and efficient capital markets and confidence in capital markets". Therefore, in considering an order in the public interest, it is an error to focus only on the fair treatment of investors. The effect of an intervention in the public interest on capital market efficiencies and public confidence in the capital market should also be considered.

Second, it is important to recognize that s.127 is a regulatory provision. In this regard, I agree with Laskin J.A. that "the purpose of the Commission's public interest jurisdiction is neither remedial nor punitive; it is protective and preventative, intended to be exercised to prevent likely future harm to Ontario capital markets"...the focus of regulatory law is on the protection of societal interests, not punishment of an individual's moral faults.

...[T]he purpose of an order under s.127 is to restrain future conduct that is likely to be prejudicial to the public interest in fair and efficient capital markets. The role of OSC under s.127 is to protect the public interest by removing from the capital markets those whose past conduct is so abusive as to warrant apprehension of future conduct detrimental to the integrity of the capital markets: *Re Mithras Management Ltd.* (1990), 13 O.S.C.B. 1600 ...

In summary, pursuant to s.127(1), the OSC has the jurisdiction and the broad discretion to intervene in Ontario capital markets if it is in the public interest to do so. However, the discretion to act in the public interest is not unlimited. In exercising its discretion, the OSC should consider the protection of investors and the efficiency of and public confidence in, capital markets generally. In addition, s.127(1) is a regulatory provision. The sanctions under the section are preventative in nature and prospective in orientation. Therefore, s.127 cannot be used merely to remedy securities act misconduct alleged to have caused harm or damages to parties or individuals.⁷

As should readily be apparent, sections 122 and 127 have very different purposes: the punishment of quasi-criminal conduct on the one hand and the regulation of conduct to protect the public interest on the other. The courts have been respectful of the remedial flexibility which the *Act* has granted the Commission in carrying out its various functions. In *Wilder v. Ontario (Securities Commission)*⁸, the Ontario Court of Appeal rejected an argument that allegations made against the respondent Wilder which mirrored precisely the language in s.122(1)(a) could not be pursued in a regulatory hearing pursuant to s.127 because the subject matter fell squarely and exclusively within the offence created by s.122. The court held that the legislature had clearly manifested its intention to provide the OSC with a range of alternative remedial options. Wilder's argument that he was being denied the burden of proof as well as evidentiary and Charter benefits available under s.122 was rejected on the basis that there was no criminal sanction attached to a s.127 order.⁹

(c) Declaratory Relief

The final and probably least familiar enforcement section is s.128, which permits the Commission to apply to the Superior Court for a declaration that a person or company has not complied with or is not complying with Ontario securities law. If the court makes the declaration, a number of remedies may be granted including restitution and damages. The Commission has not made use of this provision very often. With the advent of class proceedings and the development of an experienced plaintiff's bar, the use of this section will undoubtedly decline further. Indeed, in the recent case of *YBM Magnex International Inc*, (discussed further

7 (2001), 199 D.L.R. (4th) 577 at paras. 41-45 (hereinafter "*Asbestos*")

8 (2002), 53 O.R. (3d), 519

9 In practice, the Commission will often proceed with both s. 122 and s. 127 proceedings in respect of the same matter, especially in insider trading cases: see *Re M.C.J.C. Holdings* (2002) 25 O.S.C.B. 1183

below), the staff had indicated in a Notice of Hearing commenced under s.127 that it intended to apply to the Superior Court for further relief under s.128 in the event an order was made by the Commission under s.127. During the course of the s.127 hearing, a number of class proceedings commenced in both Canada and the United States settled. In the context of the settlement, Commission staff were asked to agree not to pursue their s.128 remedies should the civil settlement be approved by the court. They agreed to do so.

The Standard to Which Directors and Officers Will be Held in Regulatory Proceedings

Most business corporation statutes impose two obligations upon directors and officers. First, a good faith obligation: to act honestly and in good faith with a view to the best interests of the corporation. Second a diligence requirement: to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances.¹⁰

Recent jurisprudence would suggest that this statutory standard is relevant, but perhaps not sufficient of itself, to the determination of a director or officer's regulatory liability. Four cases are of note in clarifying the standards for directors and officers in respect of regulatory liability: *Standard Trustco*, *Cartaway*, *YBM* and *Melnyk*.

(a) Standard Trustco

In *Standard Trustco*¹¹ a federally incorporated trust company which was also a reporting issuer experienced serious financial problems. Its federal regulator, the Office of the Superintendent of Financial Institutions ("OSFI") became concerned about certain accounting practices, particularly loan loss provisions. On June 24, 1990, the trust company's parent was to release unaudited interim financial statements. The Superintendent of OSFI attended a board meeting at which he expressed concerns. He urged that an audit be performed on the interim financial results. Despite these views, the Board approved the unaudited financial statements and a press release was made showing modest profits. No mention was made of the financial problems or OSFI's concerns. When the audited financial statements were eventually prepared, they disclosed a massive loss.

¹⁰ *Canada Business Corporations Act*, R.S.C. 1985, c.C-44, as amended, s.122(1). Most of the provincial statutes including the O.B.C.A. contain identical language.

¹¹ *Re Standard Trustco et al.* (1992) 15 O.S.C.B. 4332

A s.127 hearing was held to determine whether the Commission should exercise its public interest jurisdiction against the company and certain officers and directors. It was clear that the press release was materially misleading. The real question was who bore responsibility.

As described earlier in this paper, the OSC noted that the obligation to make timely and accurate financial disclosure rested ultimately with the directors but in practice was shared by the directors, audit committee members and certain members of senior management. In determining the standard of care applicable, the Commission specifically referred to the statutory standard¹², however, it went on to say:

In addition, securities regulators through legislation, policies and decided cases have enunciated what they consider to be appropriate standards of conduct for directors and officers of public companies, which may go beyond the requirements of corporate law in order to protect the public interest....

In making our decision in this matter we had to go beyond whether the respondents complied with the O.B.C.A. and the L.T.C.A. We had to determine whether the conduct of the respondents was contrary to the public interest.¹³

The Commission then went on to analyze whether the conduct of the directors and officers met this public interest standard. A number of points are important.

First, in reaching the conclusion that the directors failed to exercise the prudence and diligence they ought to have exercised, the Commission took into account the fact that almost all, if not all, of the directors had backgrounds which suggested they were a relatively sophisticated group. This holding is in keeping with an established line of jurisprudence which holds that while directors must act reasonably (an objective standard), they are to be judged in comparison with what a person with their specific background and experience would do (which introduces a subjective element to the assessment).¹⁴ In the absence of any statutory rules establishing minimum qualifications for directors, it is submitted that this is a fair standard which, if properly applied, will not compromise the quality of corporate decision making.

12 In the instant case, the applicable statute was the *Loan and Trust Corporations Act* which imposed a standard of a "prudent director" rather than a "prudent person". The OSC made specific note of the fact that this difference in language was intended to reflect a greater standard necessary for deposit taking institutions.

13 *Standard Trustco, supra.*, p. 44

14 See also *Re Soper and The Queen* (1997) 149 D.L.R. (45th), 297 (F.C.A.) and in *Re City Equitable Fire Insurance Company Limited* [1925], 1 Ch. 407

Second, the Commission in *Standard Trustco* took a sceptical look at the director's reliance on management. It held that directors should not rely on management unquestioningly where they have reason to be concerned about the integrity or ability of management or where they have notice of a particular problem relating to management's activities. It is clear from this decision that directors will only be able to rely upon management where such reliance is reasonable.

Similarly, the decision makes clear that reliance upon the opinions of auditors, lawyers or other outside consultants will only be acceptable where it is reasonable in all of the circumstances. In *Standard Trustco*, an examination of the alleged reliance upon the lawyer is instructive. Neither management nor the Board sought advice on the disclosure issue from the company's general counsel, who was fully briefed and had a general understanding of the continuous disclosure obligations of the company. Instead, the general counsel was asked to call the outside lawyer at his cottage to brief him. The briefing was, to use a euphemism, "selective". A suggestion was made that OSFI was backing off on the numbers. On the basis of this briefing, the lawyer advised senior management that it was not necessary to make disclosure of OSFI's concerns. Most tellingly, earlier that day, the Board had already decided to authorize the release of the interim financial statements to the public *before the lawyer's advice was ever obtained*. The Board was criticized for all of this and specifically for failing to hear the advice for themselves. It should be noted that this aspect of the decision is entirely consistent with *Blair v. Consolidated Enfield Corp.*, the leading case on the ability of a director or officer of a corporation to rely upon legal advice. In that case the Supreme Court of Canada held that the ability of a director to rely upon advice should depend upon whether the lawyer was fully informed of the facts, whether the advice was ostensibly credible to a layperson and whether the issue was within the lawyer's area of expertise.¹⁵

Another important feature of the *Standard Trustco* decision is the Commission's commentary upon the defence advanced by certain respondents that they had told the regulator (OSFI) that they were going to release the financial results and the regulator did not object. The Commission held that, although it may have been appropriate for the directors to consider what the regulator said, it was up to the directors to make the decision relating to disclosure, not the regulator. In other words, the buck stopped with them.

15 (1993) 106 D.L.R. (4th) 193 at pp. 205-210

Finally, it is of interest to note the distinctions made by the Commission between various members of the Board and management. First, it held that members of the audit committee should bear somewhat more responsibility than the other directors because they had a greater opportunity to obtain knowledge about and to examine the affairs of the company than non-members had. The Chief Executive Officer and the controlling shareholder were accorded the most responsibility because they were largely in control at Board meetings and they appeared to be the ones who determined that the financial statement should not be released. With respect to outside directors, the Commission said the following:

Outside directors should play an important and effective role on a Board because of their separation and independence from management. They should ask questions of management and others in order properly oversee the company's operations and disclosure, particularly where they have notice that the company may have serious financial problems. In some cases it is appropriate for outside directors to make enquiries and have discussions in the absence of management where they have a concern about something which management has done. In this case, the outside directors failed to fulfil their role.

With respect to the officers, the Commission analyzed in some detail their individual role or function within the company and accorded responsibility in relation to their specific duties. They did take note of the fact that one of the officers (Seago) appeared to play a relatively subordinate role, at least in comparison to other officers, and the Commission was therefore inclined to attribute less responsibility to him.

(b) Cartaway

The second case of note which has considered the question of the standard of conduct applicable to directors in the context of regulatory proceeding is the decision of the Alberta Securities Commission in *Re Cartaway Resources Corp.*¹⁶ That case cited the *Standard Trustco* case with approval. It contrasted two decisions of the civil courts applying the "business judgment rule", which essentially holds that as long as the process employed in reaching a decision was rational or employed in good faith in order to advance business interests, the decision cannot incur liability on the part of directors. In *Revelstoke Credit Union v. Miller*¹⁷ Chief Justice McEachern

16 (2000), 9 A.S.C.S. 3092 (hereinafter "*Re Cartaway*")

17 (1984) 24 B.L.R. 271,

stated that the directors of a credit union were entitled to leave the management of the credit union to the manager and:

They [the directors] could only be faulted if something actually came to their attention which should have put them on notice, or if they failed to ensure the systems in place were adequate.

It also referred to *Caremark International Inc. Derivative Litigation*¹⁸, one of the leading U.S. cases applying the "business judgment rule", which stated that regardless of whether a judge or jury, considering the matter after the fact, believed the decision to be wrong, stupid or egregious, there was no liability as long as a rational process was employed in good faith to advance corporate interests. The Alberta Commission purported to distinguish between these decisions (which employed what it described as the "negligence test") and the *Standard Trustco* decision (which applied what it referred to as the "regulatory test"). The Commission went on to describe this distinction as follows:

The distinction between the regulatory test and the negligence test may be illustrated by the following example: a director makes a stupid, egregious decision, employing a process that was either rational or employed in good faith in order to advance corporate interests. The director would not be civilly liable to the corporation because the corporation chooses its own directors and it cannot properly hold those directors to an objective standard of prudence or due diligence beyond the *Caramark* criteria. If, however, an objective evaluation of the decision shows it to be contrary to the public interest, or a violation of securities law, then regulators may have a right and a duty to intervene in order to protect the integrity of the markets. The director's good faith, or reliance on a rational process, may be relevant factors to be considered, but they do not necessarily determine whether the decision is contrary to the public interest or a violation of securities law.¹⁹

After citing the principle in the *Gordon Capital* case that the fact that the respondent may have acted with a malevolent motive or inadvertently is not determinative of the regulator's right to exercise its regulatory power,²⁰ the Alberta Commission then concluded on this point as follows:

18 (1996), 698 A. (2d) 959

19 *Re Cartaway*, *supra*. note 17 at pp. 42-43

20 *Gordon Capital Corp. v. Ontario Securities Commission* (1990), 13 O.S.C.B. 2035, affirmed (1991) 14 O.S.C.B. 2713

In this case, we apply the regulatory test described in *Standard Trustco*: whether a director exercises appropriate prudence and due diligence, which will be determined *having regard to the particular circumstances of the director*, the information available and the systems in place to deal with such information. Bearing in mind the distinction between the regulatory test and the negligence test described above, it is also useful to consider the factors described in *Revelstoke* and *Caramark* in determining whether a director has exercised appropriate prudence and due diligence under the particular circumstances of the case.²¹ (Emphasis added.)

It is not entirely clear from this decision precisely how the “regulatory test” differs from the “negligence test”. If it simply means that a stupid or egregious decision cannot be defended on a purely subjective basis, that is clear enough. However, a careful reading of both *Standard Trustco* and *Re: Cartaway* appear to acknowledge that a director’s particular circumstances and background ought to be taken into account in judging his conduct against a standard of reasonableness. This is essentially consistent with the standard applied in civil cases.

(c) YBM

The facts of *YBM* for present purposes may be briefly stated. The company, YBM Magnex International Inc. (“YBM”) which was originally incorporated in Alberta, became a reporting issuer in Ontario in 1996 and its shares were subsequently listed for trading on the TSX. In November, 1997 YBM raised \$100 million through a prospectus offering. In May, 1998 the company's head office in Pennsylvania was raided by the FBI, and shortly thereafter trading in its shares was suspended. In June, 1999 YBM, through its Receiver, pleaded guilty to securities fraud in the United States.

YBM had its origins in eastern Europe; it was created out of a group of affiliated companies originally operated from Hungary. A number of its founding shareholders are alleged to have been members of organized crime. In the summer of 1996 YBM's board of directors became aware that YBM was the subject of an ongoing investigation conducted by the U.S. Department of Justice. Subsequently, a Special Committee of the board of directors was formed to investigate the situation. Ultimately, in early 1997 the Special Committee retained an independent consulting firm, Fairfax, to conduct an investigation. In April, 1997 the results of

21 *Re Cartaway supra.*, at p. 43

that investigation were summarized in a draft report of the Special Committee to the Board. Following the preparation of the draft Special Committee report, a decision was made by management and the Board to proceed with the public offering. Public disclosure in connection with the offering (in particular, by way of an annual information form (or AIF) incorporated in the preliminary prospectus and final prospectus) referred only obliquely to the work of the Special Committee and the findings of Fairfax.

Enforcement proceedings were initiated by staff against YBM, its officers and directors, and two investment dealers who underwrote the 1997 offering.²² Staff's primary allegation was that YBM filed a preliminary and final prospectus that failed to contain full, true and plain disclosure of all material facts, particularly the mandate and information obtained by and findings of the Special Committee. The directors and officers were alleged to have authorized, permitted or acquiesced in YBM's failure to make full disclosure. Staff's secondary allegation was that YBM had failed to comply with continuous disclosure obligations in failing to disclose in April, 1998 that Deloitte & Touche LLP (U.S.) advised the company that it would not perform any further services for YBM until YBM completed an in-depth forensic examination addressing Deloitte's concerns.

The YBM hearing took over 124 hearing days, and is probably the most ambitious enforcement proceeding ever mounted by Commission staff. The hearing panel's decision was released on June 27, 2003. Orders under s.127 of the Act were made against a number of the respondents, including a number (but not all) of the members of YBM's board of directors. The Commission concluded that YBM had failed to make full, true and plain disclosure as required by the Act. The Commission also appears to have concluded that YBM's officers and directors authorized, permitted or acquiesced in YBM's failure.²³ From the standpoint of this paper, the significant part of the decision is the section which examined whether the directors (and one officer) had a due diligence defence based on their actions including: forming the special committee, hiring outside investigators, relying on the special committee's report, and obtaining legal advice as to what disclosure should be made about the Special Committee's work.

22 *In the matter of the Securities Act R.S.O. 1990, c.S.5 as amended and YBM Magnex International Inc., et al* (hereinafter "YBM") (discussed released June 27, 2003)

23 *YBM, supra* Para 192

In its decision, the Commission noted the various approaches taken by regulators to the due diligence defence in prior jurisprudence, including *Cartaway* and *Gordon Capital*. Although in s.127 proceedings there was no specific due diligence defence provided in the *Act*, nevertheless "an order in the public interest may not be justified against a director, officer or underwriter if their investigation and belief was reasonable. In some cases, the investigation or belief may have been unreasonable but the facts will not otherwise call for an order against the public interest".²⁴

According to the hearing panel, this was not a civil proceeding and resort to the statutory standard of care under business corporations statutes was not appropriate. It was best from the regulatory perspective to examine the reasonableness of the respondents' conduct and their belief "from the perspective of a prudent person in the circumstances".²⁵ This entailed both objective and subjective elements, including the directors or officers degree of participation, access to information and skill.

In its analysis of the obligations of directors and officers the Commission also made a number of important observations, as follows:

1. while directors are not obliged to give continuous attention to the company's affairs, they have to react to events (their duties are "awakened") and must be active, not passive;
2. not all directors stand in the same position, and more may be expected of those with superior qualifications (for example, those with legal training);
3. more may be expected of inside directors (or outside directors who sit on committees) than outside directors;
4. directors may rely on the members of a special committee if that committee is comprised of disinterested directors; and
5. directors may rely on management and on outside professional advisors, provided that reliance would be unreasonable if the director was aware of facts or circumstances of such character that a prudent director would not rely on the advice.²⁶

The Commission also made some important findings about the conduct of the YBM Board as a whole. It held that the Special Committee process was flawed in a number of ways, including: the choice of Owen Mitchell, (a director but also key member of the First Marathon underwriting team), as chair, the failure of the Committee to follow-up on many issues raised by its initial

24 *YBM, supra* Para 175

25 *YBM, supra* Para 179

26 *YBM, supra* Para 186

investigation, the absence of other committee members at key meetings with the outside investigators, Fairfax, and the failure to obtain independent counsel for the committee.

The Commission criticized the quality of the legal advice the Board received on a number of issues, particularly on the disclosure to be made of the Special Committee mandate and findings in YBM's annual information form. The Commission questioned whether the Board's reliance on counsel was reasonable. Finally, the hearing panel suggested that the full Board should have met with Fairfax.

The Commission also examined the conduct of individual Board members with respect to the primary allegations advanced. It reserved its harshest criticism for Mitchell, who the Commission determined was in a conflict of interest, given his role in the underwriting syndicate, as Mitchell would expect to earn substantial fees if the offering proceeded. As an experienced officer and director, Mitchell "should have known better". The hearing panel concluded that his conflict adversely affected Mitchell's judgment in many ways (such as failing to provide the Special Committee report to the full Board). While Mitchell had taken a number of positive steps towards uncovering information critical to the business, "the risk at issue left little margin for error".²⁷ A defence of due diligence was unavailable to him.

In a much different category was David Peterson, a former Premier of Ontario who was a YBM board member but did not sit on the Special Committee. Peterson took an active role on the YBM board, questioned management and considered carefully the issues raised by the Special Committee's work. However, the Commissioners criticized Peterson for what can only be described as his poor judgment in failing to properly identify Mitchell's conflict and in relying too much on others with respect to the critical issue of disclosure of the Special Committee's findings. Moreover, given his background, experience and qualifications, the hearing panel was "disappointed" that he did not do more. Peterson had a due diligence defence available to him, but just barely.

The Commission also went through a similar analysis for a number of other directors, concluding that a due diligence defence was available to several outside directors (including one member of the Special Committee) but not another member of the Special Committee who was unable to

²⁷ YBM, *supra* Para. 282

demonstrate active involvement in its affairs. On the second subsidiary issue raised by the hearing several directors (including Mitchell) were also found to have no due diligence defence open to them.

It should be noted that the Commission dealt relatively leniently with YBM's Chief Financial Officer, Gatti, by holding that he was inexperienced, acted in good faith, and was entitled to rely upon more experienced members of management, the Special Committee, and their advisors.

In the end result, orders under section 127 were made against a number of officers and directors of YBM, including a prohibition against acting as a director or officer of a reporting issuer for a period of time and a significant costs award.

One of the obvious lessons from YBM is that it is not enough for a board to set up a process to deal with a disclosure issue – that process must be carried out scrupulously from beginning to end, on the assumption that it may be examined later. The idea of a Special Committee made sense: it fell down in the execution. The appointment of Mitchell as chair, the failure of the other members to participate in its work, lack of independent legal advice available to the Special Committee, and the sloppy handling of the Report all were serious deficiencies which made it difficult for the Board to argue that it could reasonably rely on the Committee's work.

The second lesson of YBM is that reliance on professional advisors – such as lawyers – takes a director only so far. The hearing panel was obviously unimpressed with the quality of the legal advice provided by YBM's counsel, Wilder, particularly on the key issue of disclosure. It was not enough for directors to rely on his advice – they had an obligation to second-guess it and, if necessary, to override it.

(d) Melnyk²⁸

On October 1, 2003, a truck carrying an anti-depressant drug known as Wellbutrin XL (“WXL”), which was manufactured by Biovail Corporation (“Biovail”) was involved in an accident on its way to delivering WXL to one of Biovail’s significant customers, GlaxoSmithKline Inc. (“GSK”). The accident occurred at the end of the third quarter (“Q3”) of Biovail’s fiscal year.

28 In the matter of the Securities Act R.S.O. 1990, c.S.5 as amended and Biovail Corporation., et al (hereinafter "Biovail") (decision released September 30, 2005)

Immediately following the accident, Biovail made a number of public disclosures stating, among other things (collectively, the “Statements”):

- i. That as a result of the accident, the WXL that the truck was carrying would have to be returned to Biovail’s manufacturing facility for inspection;
- ii. That Biovail would miss its projected earnings for Q3 (the “Earnings Miss”);
- iii. That some of the Earnings Miss was attributable to the accident because Biovail expected to recognise revenue from the sale of the WXL that the truck was carrying in Q3 but would no longer be able to do so (because the WXL was being returned to Biovail for inspection); and
- iv. That the expected revenue from the WXL involved in the accident was between \$10-20 million.

The OSC’s Staff alleged that the Statements were materially misleading or untrue and that Eugene Melynk (“Melynk”), Biovail’s Chairman and CEO, authorized, permitted or acquiesced in Biovail making the Statements. More specifically, Staff took the position that the expected revenue from the shipments to GSK that were involved in the accident could not have been recognized in Q3 and, therefore, it was materially misleading and contrary to the public interest to attribute any of the Earnings Miss to the accident. Staff’s allegations rested primarily on two facts:

- i. Biovail’s contract with GSK contained a delivery term that “BIOVAIL shall deliver all PRODUCT to GSK *F.O.B., GSK’s facilities in the U.S.A. (freight collect).*” [Emphasis added]. Staff took the position that this delivery term meant that title to the WXL did not transfer from Biovail to GSK until it was actually delivered to GSK’s facilities in the U.S. and, as a result, Biovail could not recognise revenue until delivery was complete; and
- ii. Biovail’s Q3 ended on September 30, 2003, and the trucks were in transit on October 1, 2003. Because Biovail could not recognise revenue until delivery was complete and there was no prospect of that occurring on or before September 30, 2003,

the revenue from the product that was involved in the accident could not properly be recognized in Q3.

Therefore, Staff took the position that the accident could not have contributed to the Earnings Miss and the Statements were materially misleading, thereby violating section 122 of the *Act*, and contrary to the public interest under section 127 of the *Act*.

In respect of section 122 of the Act, the Commission determined that the Statements were misleading but that, technically, section 122(a) only applies to materials, evidence or information that are “submitted to the Commission”. The Commission determined that the documents in which the Statements were made were filed on SEDAR but not “submitted to the Commission” and, therefore, Bioval and/or Melnyk had not violated section 122(a).²⁹ Furthermore, the statements were not “required to be filed” under Ontario securities law and hence Bioval and/or Melnyk had not violated section 122(b).

The OSC then addressed whether it could still sanction Melnyk for acting contrary to the public interest notwithstanding that the Statements did not contravene Ontario’s securities laws (*i.e.* section 122). The Commission determined that “there should be no doubt... that the Commission is entitled to exercise its public interest jurisdiction where any inaccurate, misleading or untrue public statement is made, whether or not that statement contravenes Ontario securities laws.” Accordingly, the Commission concluded that even if the Statements did not technically violate section 122, the Commission could nonetheless use its “public interest” power to sanction Melnyk for authorizing, acquiescing in or permitting the Statements if the Commission found that the Statements were inaccurate, misleading or untrue.³⁰

It was Melnyk’s position that he relied upon others at the company, particularly the Chief Financial Officer, and was entitled to rely upon their advice. Further, Melnyk claimed to be unaware of the terms of shipment of the WXL and to have not been directly involved in the preparation of at least some of the statements.

The Commission discussed the responsibilities of officers and directors as it relates to disclosure and the “public interest”. The Commission explained that “officers and directors have a central

²⁹ *Melnyk, supra* at para 370

³⁰ *Melnyk, supra* at para 383

role to play in ensuring that corporate disclosure is accurate and not misleading or untrue.” Furthermore, officers and directors with “superior qualifications” or inside directors are held to a higher standard in ensuring that those disclosure requirements are met.

The Commission clarified that in assessing whether a director or officer has acted contrary to the public interest, the OSC should consider whether the individual officer or director acted with “due care and diligence.” If so, the Commission “would not conclude that it is in the public interest to issue an order against him under section 127.”

Regarding Melnyk, the Commission determined that as CEO and Chairman, Melnyk (i) had access to all information he required; (ii) was directly involved in and made decisions in respect of the content of Biovail's public disclosures; and (iii) was responsible for final approval of the Statements. Furthermore, the Commission found that Melnyk was a "hands on" CEO who was directly involved in both the "conduct of Biovail's business" and its disclosure decisions. Accordingly, he had a “heavy responsibility” to ensure that the Statements were accurate and he could not simply rely on others to do so.

Melnyk did not provide any significant evidence of “due diligence” aside from asserting that he relied on other senior officers who were, according to Melnyk, better informed than he was. The Commission concluded that this did not satisfy Melnyk’s onus of demonstrating “due care and diligence.” Based on that conclusion and its finding that Melnyk “acquiesced, authorized or permitted” the release of Statements that were misleading, the Commission concluded that Melnyk acted contrary to the public interest.

The key point of this decision is that a heightened threshold for "due care and diligence" will apply to an officer or director who (i) is involved in the company's business and disclosure decisions; (ii) bears responsibility for disclosure decisions; and/or (iii) has access to the information required to confirm whether a statement is accurate. This threshold will not be met by asserting reliance on others.

Conclusion

In considering the conduct of an officer and director under section 127 of the *Act*, the OSC does not apply the legal standard of due care and diligence that might apply, for example, in a civil claim under the Ontario *Business Corporations Act*. In *YBM*, the panel applied a “prudent

person” test with objective and subjective elements. This may well be different from the objective test recently formulated by the Supreme Court of Canada in *People’s Department Stores Inc. v. Wise*³¹. The jury is still out as to whether as a practical matter the Commission applies a higher standard than the courts. Many observers felt that the *YBM* directors, particularly Peterson, were held to too low a standard, given the circumstances of that case. It remains to be seen whether the Commission will apply these principles on a consistent basis in the future.

³¹ 2004 S.C.C. 68