The Latest Cases and Statutes in Corporate Law in Canada and the United States

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Introduction

In Canada and the United States, corporations are governed by different statutes and common law concepts. Usually, these are the corporation statutes and securities laws. In this paper, I will give a basic overview of the traditional corporate law, and then I will discuss the latest cases and legislation that governs corporations in both countries.

In Canada and the United States, corporations are owned by shareholders who elect a board of directors that runs the corporation. The board appoints the senior managers who in turn appoint their underlings. The board of directors is responsible for supervising management and making sure that the corporation's affairs are kept in order. A rule known as the business judgment rule is a common law rule that protects the directors from excessive liability. Basically, it states that as long as the board is well informed and engages in procedurally sound decisions, the substance of the board's decisions will not be interfered with.

Recent cases in both Canada and the United States show that the courts are unlikely to interfere with the business decisions of the board. Some recent legislation, however, threatens to burden management with excessive regulation. This paper will focus on three cases, two Canadian and one American: *Peoples Department Stores Inc. v. Wise* (hereinafter *Peoples*);[1] *In Re Walt Disney Co.*

Derivative Litigation (hereinafter *Disney*);[2] *Kerr v. Danier Leather Inc.* (hereinafter *Danier*);[3] *Black v. Hollinger Int'l Inc.* (hereinafter *Hollinger*).[4] Additionally, a brief overview of the new additions to the *Ontario Securities Act* and its potential impact will be discussed, especially in light of recent developments in the United States, such as the *Sarbanes–Oxley Act.*

Ⅰ. A Quick Introduction to the Basic Duties

Shareholders elect a board of directors. They are the management of the corporation. Shareholders have little control over management in publicly trader corporations, except through electing directors. In closely held corp., shareholders have far more control and are usually the directors. The directors then appoint the full-time managers, known as officers, e.g. Chief executive officer (CEO). Directors are not full-time managers. Rather, they are supervisors or overseers. They need to exercise care in managing corporation and supervising management. They meet periodically. Attendance is highly recommended; otherwise a director can be liable for negligence. The directors approve all major decisions concerning company. The information on which they base their decisions is usually prepared by management.

While directors have discretion how to maximize shareholder wealth - they do not have discretion whether or not to maximize wealth. They are quasi-trustees, and the market would discipline them. Shareholders can vote to remove existing directors, and sometimes a slate of directors runs against existing shareholders.

Directors are divided into insider and outsider (independent) directors. Insiders are officers and other employees. Independent

1 [2004] 3 S.C.R. 461.
2 2005 WL 2056651 (Del. Ch.).
3 77 O.R.3d 321 (2005).
4 844 A.2d 1022 (Del. Ch.2004).

directors have no direct stake in corporation. There is a push today in both Canada and the United States for more independent directors. Insiders may have more incentive to look after best interest of corporation, since they have much at stake. Outsiders may not be able to adequately understand what is going on. Insiders, however, might be able to collude and maximize personal gain at expense of corporation.

Directors work in committees. The audit committee: audits the books and hires external auditor. The nominating committee selects outside directors (to be elected by shareholders), and the compensation committee sets executive salaries.

Directors owe the corporation fiduciary duties. The directors owe a duty of loyalty. Director and Senior Officers must abstain from self-dealing, usurping corporate opportunities, and competition during and after employment. The modern corporation is characterized by separation of ownership and control. This means that the owners' interests might not be represented adequately by managers who may have divergent interests. E.g. owners may want long-term focus, while managers want short-term. Owners want maximization of returns while managers want maximization of salary and perks.

The question then is how to align interests of managers with owners? The answer seems to be to create a proper of mix of positive incentives (e.g. stock options) and negative incentives (e.g. jail time for fraud and civil liability).

Ⅱ. Peoples

In *Peoples*, the facts of the case are as follows. Wise Stores acquired Peoples Department Stores from Marks & Spencer, but due to financing conditions in the sale, Wise was unable to amalgamate with Peoples. It had to maintain two separate entities, the Wise Stores and its subsidiary Peoples. Even though the same group owned them, they operated as two separate entities, and this caused managerial inefficiency. Specifically, the inventory acquisition systems

were being duplicated, which meant that the two stores were spending twice as much on the overhead involved in purchasing and managing inventory. They both operated from the same warehouses, and they both had the same employees looking after the inventory. The directors (who were also officers and major shareholders in the Wise Stores) decided to implement a new inventory procurement policy to avoid the duplication of costs. They had to keep the two entities separate (until the purchase price had been fully paid to Marks & Spencer), so the new inventory program was set up so that Wise would purchase overseas inventory, while Peoples purchased North American inventory. Peoples would then sell its inventory to Wise and vice versa. Peoples sold more to Wise than it purchased (reflecting the larger demand for North American products), and hence Wise accumulated a substantial amount owing to Peoples. Ultimately, the North American retail market collapsed at this time, and it did not spare Wise and its subsidiary Peoples. Both had to declare bankruptcy, and the *Peoples* case ensued.

Peoples' bankruptcy trustee managed to settle most of the debts owed, but the trade creditors' claims remained unsatisfied. The trustee sued the directors of Wise claiming that they had breached their fiduciary duties and duties of care to the creditors of Peoples in favor of Wise Stores. The trial judge agreed holding the directors personally liable for an amount of just over $4 million. The trial judge held that the directors had breached their duties to Peoples' creditors, since Peoples was in the vicinity of insolvency and this vicinity triggered a duty that he found based on his reading of British, Australian, and New Zealand case law. The directors appealed to the Quebec Court of Appeal, which reversed, and the trustees appealed to the Supreme Court of Canada, which affirmed the Court of Appeal.

The Court's starting point was Section 122 (1) of the *Canadian Business Corporations Act* (*CBCA*), which states that

> 122 (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall
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> (a) act honestly and in good faith with a view to the best

interests of the corporation; and

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

These two sections establish two distinct duties on directors, the Court opined, and they are fiduciary duties, as per subsection (a), and the duty of care, as per subsection (b).

Fiduciary duty in the context of corporate directors takes on many forms, but the underlying theme is that directors must not abuse the position of trust that they are in, and they must act honestly, discretely, and not profit personally from their position. In effect, the Court held that absent a showing of fraud or dishonesty, the Court was not prepared to find a breach of fiduciary duty. Insofar as there was a fiduciary duty (that was not breached), the Court held that such duties were owed to the Corporation directly and not to creditors. This comes from the plain reading of Section 122 (1) (a).

The Court rejected the idea that somehow when a corporation is in the vicinity of insolvency that the directors' fiduciary duties shift from the corporation towards the creditors. The Court noted that one reason it did not see any reason to extend directors' fiduciary duties was that creditors were already adequately protected by other provisions of *CBCA* such as the oppression remedy and the duty of care. The oppression remedy[5] allows creditors to seek relief from oppressive conduct by the corporation or its directors. The Court, hence, left open the possibility the idea that the trade creditors could have sued the Wise directors for oppression, which is a slightly different proposition than the trustees of Peoples suing the Wise directors. Nonetheless, this possibility should not be disturbing for directors, since the ability of creditors to sue directors has always existed since the existence of *CBCA*.

The Court held, however, that the directors owed the creditors a duty of care. This, the Court held, was because Section 122 (1) (b) was more open-ended than 122(1)(a) which limited the fiduciary duty

5 Section 242 of the *CBCA*.

to the corporation. Nonetheless, the Court held that the directors did not breach their duty of care to the creditors, because of the Business Judgment Rule (BJR). The BJR is a doctrine that essentially prevents courts from second-guessing business decisions that may not be as successful as anticipated. All that is needed is that the directors act in a reasonable manner and not a perfect manner. The Court took the unusual step of finding that the trial judge's finding of fact regarding the director's conduct "was factually incorrect and constituted a palpable and overriding error."[6] This despite the fact the Court's finding that the directors could have taken more steps to better inform themselves as to the adequacy of the new inventory management system.

Ⅲ. Disney

The *Disney* case demonstrates the power of the BJR. The case was decided under Delaware law, and stands for the simple proposition that courts will not second-guess business decisions made by the board of directors and senior officers even when the decisions do not turn out for the better.

In *Disney*, Michael Eisner the Chief Executive Officer (CEO) wanted to hire his long-time friend Michael Ovitz as President of the Walt Disney Corporation. Ovitz was already gainfully employed and handsomely compensated, so the question of compensation became the major obstacle in designing his employment contract. The chair of the compensation committee ultimately negotiated a package that guaranteed Ovitz in the event of termination without cause large cash payments and immediate vesting of stock options. The rest of the compensation committee approved the package in a quick meeting, and the full board approved of hiring Ovitz as President shortly thereafter. Both the compensation committee and the full board, however, were not aware of the details of the compensation

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6 *Peoples* at para. 68.

package until close to their approval of it.

When Ovitz did join Disney things did not go as expected. Constant disagreement over management decisions meant that Ovitz was no longer contributing to the company's development. Eisner was informed by Disney's general counsel that Ovitz could not be terminated for cause, so Eisner terminated him, thereby, triggering the termination without cause clause in Ovitz's contract. Ovitz was owed $140 million!

Disney's shareholders were outraged, and they sued Ovitz, Eisner, and other members of the board. After a lengthy trial, and despite the Chancellor's finding that the board did not perform according to best standards, the court ruled in favor of all the defendants. Ovitz was not a fiduciary when he negotiated his contract, and hence could not be held liable for his contract.[7] The decision by the board to allow Ovitz to be fired and receive the termination without cause compensation was also held non-actionable.[8] Ovitz could not be fired for cause, but the company was better off without him given his conflicting style of management. Furthermore, the initial decision to hire Ovitz at extremely generous terms was held not to be a cause for liability. Essentially, the court deferred to the compensation committee and the rest of the board's decision, despite the Chancellor having misgivings about the adequacy of the board's preparation when voting on hiring Ovitz.

Ⅳ. Danier

Danier also shows the power of the BJR in shielding officers from liability even when the officers issued misleading documents that caused a drop in the company's share price. Danier Leather Inc. was a privately held company that decided to go public and issue shares. As required by law, Danier issued a prospectus that detailed

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7 *Disney* at *37.

8 *Ibid*. at *38-39.

its financial statements for prior fiscal quarters as well as a forecast for a future quarter. The forecast turned out to be inaccurate in light of information learnt by senior management but not released to the public. Senior management did not correct the forecast nor reveal the information until after the closing of the public offering of shares. The question for the Ontario Court for Appeal to decide was whether management was under an obligation to continue disclosing material facts that would cast doubt upon the objective reasonableness of the forecasts contained in a prospectus especially before closing the public offering?

When a company issues the prospectus, but before closing, no doubt some of the information contained in the prospectus may turn out to be inaccurate. In Danier's case, it was the forecast that began to look inaccurate. This was because Danier's sales were lagging due to the warm winter and hence lower than expected sales of leather jackets. Weather, it turns out, was not a variable that management had paid attention to. Nonetheless, Danier's senior management thought they could still achieve their forecasts, and decided against disclosing the potentially inaccurate forecast. This was because Danier planned two promotions towards the end of the quarter for which the forecast was inaccurate. Despite their belief that they could achieve the forecast sales and revenues, Danier's lawyer recommended that they file an amendment with Ontario Securities Commission (OSC) informing them of the revised forecast given the new information. Upon this disclosure, many days after the closing, the stock price fell by about 30%. Nevertheless, because of the two promotions, Danier was actually able to substantially achieve its initial forecast.

A group of shareholders brought a class action lawsuit against senior management accusing them of prospectus misrepresentation, a claim the trial judge agreed with, but that the Ontario Court for Appeal disagreed with. Sections 57 (1) and 75 of the *Ontario Securities Act* (*OSA*) require any issuer of shares to notify the OSC of any material changes, as well as to issue news releases, and to correct the prospectus. The operative term in these two sections is "material change", which the Court distinguished from material facts. Material

change is defined in Section 1 (1) of the *OSA* as a change in the "business, operations or capital of the issuer" that would reasonably have an expected impact upon the stock price of the issuer. Material facts, on the other hand, are broader and encompass any fact that could affect the stock price. The basis of the shareholders' claim, however, lies in section 130 (1) of the *OSA*, which states that if a prospectus contains a misrepresentation, then the purchaser of the security during the period of distribution to the public shall be deemed to have relied on the misrepresentation and has a cause of action for damages against the issuer and everyone who signed the prospectus.

The question that faced the court was which section created the right, and which section created the remedy? According to the trial judge, section 130 (1) was sufficient to create both the right and the remedy; while the Court for Appeal rejected this and argued that sections 57 (1) and 75 created the right, and section 130 (1) only created the remedy. The Court reached this conclusion by looking at the *OSA* as a whole and not by reading section 130 (1) in a vacuum. For example, the Court noted that the *OSA* used material fact and material changes as being sources of liability for insider trading, but only required disclosure of material changes to the prospectus. Given that this was the proper legal interpretation, the only cause of action that the plaintiffs had was for non-disclosure of material changes. Given that the trial judge found that the change in weather, which led to the inaccurate forecast was a material fact and not a material change, the Court concluded that Danier and its senior managers could not held liable. The Court made it clear, though, that this was a finding of fact, which meant that in future cases, poor results that lead to inaccurate forecasts may constitute material changes.[9]

The Court took the extra step of examining whether the forecast in the prospectus impliedly represented that the forecast would be objectively reasonable? The Court held that a prospectus did no such thing, and at best represented management's best

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9 *Danier* at para. 88.

judgment about what the future held. From this conclusion, the Court then also held that even if there was an implied representation, the business judgment rule (and the fact that Danier did substantially achieve its forecasts despite the initial lower than expected sales) shielded management from liability. In other words, given that courts defer to management's skill and experience, the trial judge should not have second guessed management as to what lengths and efforts it should have gone to ascertain the bona fides of its forecast. The Court noted that the trial judge gave no consideration to the skill and expertise in assessing forecasts given their years of experience in the industry. The Court found that the trial judge's finding of fact that management made an unreasonable forecast was incorrect. This is another instance where an appellate court overturned a finding of fact by the lower court.

Directors should take solace from all the three previous cases, since they show an extreme amount of deference to management and its decisions, even when the decisions seem so wrong in hindsight. The fact that the Court in *Danier* even limited the scope of what was actionable in a prospectus to material changes bodes well for directors and managers in the future.

V. Hollinger

This case was brought in Delaware and has been affirmed by its Supreme Court. Conrad Black owned Ravelston Corp., which controlled 78% of Hollinger Inc., which in turn controlled Hollinger International. International used to own many newspapers including the Telegraph (British), the Jerusalem Post (Israel), and the Chicago Sun-Times (U.S.).

International's top management was employed through a contract with an affiliate of Ravelston. Most of the executives, including Black and his top subordinates, were directly employed by and owned stock in Ravelston, which received payments from International for its management of International. In May 2003, Tweedy Browne, one of International's largest stockholders, wrote to

the board. Tweedy Browne demanded that the board investigate the payment of over $70 million in non-competition payments made to Black, Radler, Atkinson, and another International executive, J.A. Boultbee.

A special committee was appointed to investigate the payments. Two more directors were added, plus outside counsel was retained. At some point Barclay brothers approached Black about selling *The Daily Telegraph*. Black did not initially respond favorably. By late October 2003, the Special Committee had come to a troubling conclusion; namely, that $15.6 million in so-called “non-competition” payments had been made by International to Black, Radler, Atkinson, and Boultbee — i.e., the International management team — without proper authorization.

The Special Committee asked all recipients of moneys to explain payments. Black tried to explain but not convincingly. Black feared the SEC launching a criminal investigation, so he decided to try to get the Special Committee off his back by asking them to hire Lazard Freres to look for ways to get value maximizing transactions. He also secretly reached out to the Barclays.

Black agreed to the termination of the management agreement with Ravelston on June 1, 2004; the continuation of the Special Committee investigation; the repayment of the non-competition payments on a defined schedule, with 10% due on December 31, 2003. Black, however, immediately violated agreement. He did not pay back fees. He invokes the “Fifth” in SEC investigations. He also secretly pursued the Barclay brothers to buy his whole block of Inc. shares, as opposed to just the *Telegraph*. He steers them away from Lazard. Barclays then announces their purchase of all of Inc.’s shares. Black repudiates his agreement. He claims he signed under fraudulent inducement (a duress type argument).

The trial court held (and the Supreme Court affirmed) that Black breached duty of loyalty by: 1) purposely denying the International board the right to fairly consider strategic opportunity; 2) diverting that opportunity to himself; and 3) misleading fellow directors about his conduct and failing to disclose dealings with the Barclays. The court prevented the deal from going through. Since

then, Black is facing criminal charges under U.S. federal anti-fraud laws.

Ⅵ. New Additions to *OSA* and *Sarbanes–Oxley*

The new additions to the *OSA*, creates a new source of liability for directors and officers for misrepresentations affecting secondary securities markets. It has also become known as C-SOx, or the Canadian SOx, a reference to the American securities act known as *Sarbanes–Oxley Act* (*SOx*). The Americans have also long had provisions allowing for liability for misrepresentations affecting secondary markets. These come from the U.S. *Securities and Exchange Act* (*SEA*). The *SEA* establishes the Securities and Exchange Commission (SEC), and authorizes it to combat illegal securities practices.[10] Section 10 (b) prohibits the use of "manipulative or deceptive device[s] or contrivance[s] in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors" when such deception is used "in connection with the purchase or sale of any security."[11] Shareholders can bring private suits against those who violate this and other sections of the *SEA* to recover the ill-gotten profits.[12] The SEC has promulgated various rules such as the very broad Rule 10 b-5, which prohibits the employment of "any device, scheme, or artifice to defraud," or the making of "any untrue statement of a material fact or … omit[ing] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or [engaging] in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[13]

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10 15 U.S.C. 78j.
11 15 U.S.C. 78j (b).
12 15 U.S.C. § 78t-1.
13 17 C.F.R. § 240. 10b-5.

SOx amended the *SEA* by adding more sources of liability and more requirements for senior management and directors. The Public Accounting Company Accounting Oversight Board was established to oversee the accounting industry (the constitutionality of this provision is currently under attack in a trial court). Section 201 requires that auditors must be independent, so that the company auditor is prohibited from providing non-auditor services (such as management consulting) to the company. Section 302 requires that the CEO and CFO of every company must personally certify the accuracy and reliability of each quarterly and annual report filed with the SEC. Section 301 requires that the audit committee of the board must be independent, and section 407 essentially requires the audit committee must have at least one financial expert on it. In response to the financial excesses of the Enrons and WorldComs, section 402 prohibits loans by the company to officers and directors, and section 304 contains a forfeiture provision which requires CEOs and CFOs whose misconduct requires the company to misstate its financial results to forfeit any bonus or equity based compensation received during a 12 month period following the inaccurate report.

The new additions to the *OSA*, added an extra section titled "Civil Liability For Secondary Market Disclosure." This now makes it easier for security holders to sue for misrepresentations affecting the secondary market. At common law, it was very hard to sue, since the plaintiff had to show actual reliance on the misrepresentation. Now any misrepresentation can be actionable regardless of whether the purchaser actually relied upon the misrepresentation, i.e. there is now "deemed reliance" on the misrepresentation. A fall in market price might be sufficient proof of the fraud. The new sections hold directors, officers, and experts liable regardless of fault - and represents a stark contrast with the United States, where the standard is actual fraud or *scienter*.

Due diligence can be a defense against claims of liability under section 138.4 (6), so that if a director, officer, or other potentially liable person makes a showing of reasonable investigation into any alleged misrepresentations, liability can be defeated. The problem, as I see it, is that this defense has existed in the United States (as a

defense to *scienter*), but it does not work practically. This explains the large number of settlements in the wake of the Enron and WorldCom scandals. Section 138.4 (3) also imposes liability for non-disclosure of material changes, something that was discussed in the *Danier* case. The question, is whether material changes is the standard against which the companies and its officers and directors will be measured against for secondary market liability, or whether this will only work for non-disclosure and material facts will be the standard for misrepresentation liability?

Finally, other new provisions call for the OSC to make rules that require the CEOs and CFOs to provide certifications related to internal and disclosure controls and procedures, and defining auditing standards for reporting on internal controls. The OSC has actually implemented rules that require CEOs and CFOs to personally attest to the validity of the financial statements just as Section 302 of *SOx* does. In fact, the document MI 52-109 explicitly allows those who have filed their 302 forms with the SEC to file the same forms with the OSC. The OSC has also required independent audit committees just as *SOx* does. An auditing oversight organization has also been formed similar to the American's oversight board.

Conclusion

Directors and officers need to pay attention more closely to these developments than traditional corporate notions of fiduciary duties and duties of care. The Business Judgment Rule seems to have adequately protected directors and officers, but the new securities legislation in Ontario may change all that. In Canada, we will now face two forces: the liability for secondary market misrepresentation and the ongoing developments of *SOx* that will translate into more compliance requirements by the OSC. Given that Canada has never seen the likes of American style litigation before, there is much to be anxious about for publicly traded companies.