Corporate Brief

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# HOW TO REDUCE EXPOSURE ASSOCIATED WITH PANDEMIC-RELATED CORPORATE MISCONDUCT

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The economic and workplace upheaval associated with the COVID-19 pandemic has placed unique and intense pressures on businesses and market sectors.

History has taught us that the more downward pressures there are on businesses, the more likely that bad employee and business partner behavior will occur. This kind of conduct can give rise to class action and regulatory liability.

At the same time, work-from-home protocols, travel restrictions and shifting demands within workplaces can put a strain on investigative priorities. However, proactive, focused and remedial internal review and investigation at the first sign of questionable behavior should continue to be prioritized as a powerful tool to mitigate and neutralize the pernicious effects of misconduct.

This article highlights issues that business leaders should be on the watch for, and how they should mobilize to address them in our changed and challenged workplaces.

## Business disruption can cause misconduct

Whether the bursting of the dot.com bubble at the turn of the century, the financial crisis of 2008 or the economic impacts of the current pandemic, major societal events can put multiple internal and external pressures on companies and their personnel. After the recession in 2008, white-collar crime, including fraud, spiked[1]. We have seen signs of a similar pattern emerging from the pandemic. Financial performance may be down. Share price may be languishing and volatile. Employees are under increased pressure, managing domestic and work stressors. Business partners are subject to similar issues. All these pressures can create a higher than usual impetus for bad judgement and business misconduct.

It is important for business leaders to acknowledge and be sensitive to these pressures and the potential misconduct that may result, including:

- **Languishing financials and share price**: Can lead to improper adjustments to financial reporting, improper sales practices or public disclosure that glosses over poor results.
- **Pressured employees**: Employees may have an increased propensity to put their own financial self-interest ahead of client or stakeholder interests, which can lead to

[1] Association of Certified Fraud Examiners, "ACFE Survey of Experts Finds Increase in Fraud During Economic Crisis", April 16, 2009.

misappropriation of corporate opportunities and other personal misconduct. Employees under high stress may also be more likely to mistreat co-workers, giving rise to Code of Conduct violations.

- **Stressed business partners**: Business partners may offer improper incentives to obtain contractual commitments, engage in misrepresentations or inflated financial reporting to artificially meet targets, or cut corners on diligence regarding business referrals.

## Misconduct gives rise to corporate liability

Corporate liability flowing from bad employee or business partner behavior generally comes in two forms: regulatory action and civil litigation, including class actions. Governments and regulatory agencies are often under public pressure to "do something" about bad behavior that affects consumers. Increased regulatory interest in investigating and prosecuting white-collar crime followed the 2008 financial crisis[2]. Similarly, regulators are likely to investigate the impacts of pandemic-related misconduct.

For example, securities regulators in the U.S. and in Canada have clamped down on businesses engaged in capital raising who have made bogus representations about COVID-19 medical treatments[3]. Regulatory investigations and prosecutions are usually a harbinger for civil litigation based on the same underlying conduct[4]. Finally, internal and regulator whistleblower programs increase the chances of any bad behavior being exposed[5].

The legal impacts of exposed bad behavior can take many forms, including breach of public company disclosure obligations, violation of health and safety or employment laws as well as bribery and other corrupt business practices.

## Mitigation and neutralization of pandemic-related litigation and regulatory exposure

One of the best defences to legal and regulatory liability associated with improper conduct is self-detection and remediation that is made possible through the early identification, investigation and assessment of potentially problematic conduct and its impacts.

While there may be an inclination to suspend or delay investigations until workplaces are "back to normal", this is not advisable. Delayed action can lead to compromised or lost evidence and continued misconduct (and thus continued or increased risk exposure). It can also signal to potential bad actors that misconduct may be undetected or tolerated.

Companies should remain prepared to take steps to manage the risks posed by the pandemic and business disruptions. These steps include:

- **Tools to enhance identification of liability-inducing conduct.**
  - *Maintain a strong compliance culture*. It is always important to maintain a strong compliance culture, particularly in times of economic uncertainty. Officers and directors should understand if and how a company's culture is creating or reducing risk. Exemplary tone from the top is even more important in times of business stress.
  - *Emphasize and enhance reliance on lines of defence*. Review lines of defence to ensure that corners are not being cut and that compliance personnel are on heightened watch.
  - *Encourage whistleblower and other grass-roots reporting*. Ensure there are internal processes for self-reporting such as whistle-blower reports.

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[2] See, for example, Ontario Securities Commission "Statement of Priorities for Fiscal 2010-2011".

[3] Cracking down on COVID-19 fraud: U.S. and Canadian securities regulatory enforcement update.

[4] For example, civil litigation followed regulatory action in *AIC v. Fisher*, 2013 SCC 69.

[5] Ontario Securities Commission, News Release dated June 29, 2018, "OSC Whistleblower Program contributing to a stronger culture of compliance".

- **Review, assess, and if warranted, investigate properly.**
  - *Document and report bad behavior*. Any questionable conduct should be taken seriously, reviewed, documented and reported. This is particularly important during the pandemic, when corporate processes and decision-making may be decentralized, and normal work-streams may be conducted remotely.
  - *Be prepared to conduct virtual investigations*. If the concerns persist after initial review, investigate. While the pandemic poses practical considerations in how investigations may be conducted, these should not impede organizations from moving forward. Investigation protocols can be adapted. Interviews can be conducted using videoconference platforms (companies should make sure to choose a platform and to put protocols in place to ensure privacy) or in person using appropriate social distancing and health and safety procedures.
  - *Consider all potential sources of liability*. Every investigation should consider all potential sources of liability (including regulatory breach and sanction, civil claims by shareholders, class action risk and employee claims). This is particularly important during the pandemic, as businesses are managing a broad array of risks in rapidly shifting regulatory and litigation environments.

- **Remediate and mitigate.**
  - *Mitigate*. Prioritize employee health and wellness. Remind and encourage employees to use mental health and employee assistance programs. Make sure employees take vacation. Emphasize the importance of compliance during these times. Consider tailored training and awareness-raising programs for employees. Take steps to ensure that any misconduct is not perpetuated while an investigation proceeds. To mitigate any regulatory or class action exposure, prioritize and vigilantly investigate and put an immediate stop to potential damaging conduct. Early and effective self-detection and cessation can have a direct impact to lessen regulatory sanctions and damages awarded in litigation.
  - *Remediate*. It is important to be mindful of mitigation strategies after misconduct has been revealed. For example, companies should consider whether the issue should be self-reported to regulators or law enforcement, and whether proactive remedial steps can be taken to resolve any compliance gaps. Many regulators give credit for early self-reporting and remediation[6], and a permanent fix to liability-inducing conduct can cap damage claims from third parties.

# IN THE NEWS

## Taskforce Makes Proposals to Modernize Regulatory Framework for Ontario Capital Markets

In February of 2020, the government of Ontario established the Capital Markets Modernization Taskforce (the "Taskforce") with a mandate to review and modernize Ontario's capital markets. The Taskforce embarked upon the first major review of the securities regulatory framework in Ontario since 2003.

On July 9, 2020, the Taskforce issued an interim report (the "Report"), making several recommendations, including major structural reforms to the Ontario Securities Commission (the "OSC")

Following its establishment, the Taskforce consulted with approximately 110 stakeholders, including capital markets regulators, market exchanges, financial institutions, industry associations, independent intermediary firms, law firms, publicly traded companies and investor advocacy groups. The Taskforce posed the following question to stakeholders: "What changes to the current regulatory regime do you see as necessary to modernize this ecosystem in order to make Ontario one of the most attractive capital markets in the world?"

In response to stakeholder feedback, the Taskforce is now proposing substantive changes to the regulatory framework for Ontario's capital markets.

[6] OSC Staff Notice 15-702, Revised Credit for Cooperation Program.

Among its recommendations, the Taskforce proposes to separate the regulatory and adjudicative functions of the OSC, either through a separate tribunal, comprised of adjudicators and its own staff, within the current OSC structure, or, alternatively, by creating a new capital markets adjudicative tribunal as a separate entity from the OSC.

The Report suggests that a tribunal within the existing OSC structure would report to the existing Adjudicative Committee of the OSC Board and continue to maintain a collaborative, yet independent, relationship with OSC regulatory policy staff and allow adjudicators to stay knowledgeable on the most recent regulatory developments. A new separate tribunal would be independent of the OSC and report directly to the Minister of Finance with no institutional relationship with OSC regulatory policy staff.

Another Taskforce proposal is to provide the OSC with greater tools to oversee the Canadian securities industry's major self-regulatory organizations, the Investment Industry Regulatory Organization of Canada (which oversees investment dealers) and the Mutual Fund Dealers Association of Canada (which regulates mutual fund dealers), and any self-regulatory organization that may replace them in the future.

According to the Report, this would allow the OSC to ensure that both self-regulatory organizations fulfill their public interest mandate and that their approach to regulating registered firms is not overly burdensome or costly. This would also allow the OSC to fulfill its own objective of fostering fair and efficient capital markets through its oversight of the self-regulatory organizations. Stronger governance is also required to ensure that the appointment of the board of directors of each self-regulatory organization is independent of the management of the self-regulatory organization.

The Taskforce proposes the creation of a new single self-regulatory organization to regulate both investment dealers and mutual fund dealers, suggesting that a single self-regulatory organization would reduce costs for dually regulated investment dealers and would result in a streamlined approach to enforcement.

The Taskforce calls for enhanced diversity, proposing amendments to securities legislation to require Toronto Stock Exchange-listed companies to set targets and annually provide data in relation to the representation of women, black people, indigenous people and people of colour on boards of directors and in executive officer positions.

The Taskforce further proposes to amend securities legislation to set a 10-year maximum tenure limit for directors, with an allowance that 10% of the board can exceed the 10-year maximum for up to two years. This is aimed to encourage an appropriate level of board renewal. The Report states, "The issue of board entrenchment and board renewal is a concern from a governance perspective as continued refreshment of the board helps to ensure that fresh and diverse perspectives and skills are brought into the boardroom."

The Taskforce heard from multiple stakeholders that the current proxy and shareholder voting system reflects an imbalance between activist shareholders and the boards of publicly traded companies. Accordingly, the Taskforce proposes the introduction of a regulatory framework for proxy advisory firms to provide companies with a right to "rebut" proxy advisory firm reports.

The Taskforce also proposes a framework that ensures proxy advisory firms are not in a conflict of interest when providing services to companies and recommendations to clients by restricting proxy advisory firms from providing consulting services to companies in respect of which proxy advisory firms also provide clients with voting recommendations.

Currently, a shareholder is not required to disclose beneficial ownership of, or control or direction over, voting or equity securities of a publicly traded company until it reaches the 10% threshold. The Taskforce believes that, in an era of increased shareholder activism, the 10% early warning reporting threshold is too high. The Taskforce proposes decreasing the shareholder reporting threshold in Ontario from 10% to 5%.

According to the Report, providing transparency of significant holdings starting at the 5% level will enable companies to more proactively engage with their shareholder base and enable shareholders to benefit from increased awareness of sizable ownership interests.

In total, the Report contains 47 "high-impact" policy proposals. The Taskforce will now seek additional input from stakeholders in response to the Report and will be accepting submissions until September 7, 2020. The Taskforce will then prepare a final report for the Minister of Finance.

To view the Report, please visit:

https://files.ontario.ca/books/mof-capital-markets-modernization-taskforce-report-en-2020-07-09.pdf

## CRA Further Extends Corporate Tax Payment Deadline

For a second time, the Canada Revenue Agency (the "CRA") has extended the corporate income tax payment deadline in respect of the 2019 tax year.

The payment date for the 2019 tax year was previously extended to September 1, 2020 for balances and instalments payable by corporations under Part I of the *Income Tax Act* due on or after March 18 and before September 1, 2020.

Now, the payment due date for corporate income tax returns has been extended to September 30, 2020. Penalties and interest will not be charged if payments are made by the extended deadline of September 30, 2020.

The filing date for the 2019 tax year was previously extended to September 1, 2020 for corporations that would otherwise have a filing deadline in June, July or August 2020. That filing due date remains unchanged. However, in recognition of the difficulties caused by the COVID-19 pandemic, the CRA announced that it will not impose late-filing penalties where a current year corporate tax return is filed late provided that it is filed by September 30, 2020.

## Extension of Unpaid Leave for Employees in Federally Regulated Industries

The *Canada Labour Standards Regulations* have been amended to provide that employees in federally regulated industries are entitled to an unpaid leave of up to 24 weeks, rather than up to 16 weeks, if they are unable or unavailable to work for reasons related to the COVID-19 pandemic.

The *COVID-19 Emergency Response Act*, which received Royal Assent on March 25, 2020, amended the *Canada Labour Code* (the "Code") to create a temporary new leave to allow employees in the federally regulated private sector to take unpaid job-protected leave if they were unable or unavailable to work for reasons related to COVID-19. The Code sets the maximum length of such a leave at 16 weeks, or another number of weeks prescribed by regulation.

Providing additional unpaid, job-protected leave to federally regulated employees enables them to avail themselves of the Canada Emergency Response Benefit (the "CERB"). Under the CERB, employees who have stopped working by reason of the pandemic are eligible to receive $500 per week. On June 26, 2020, the maximum CERB eligibility period was increased from 16 to 24 weeks, so the extension of leave for federally regulated employees aligns with that program.

Federally regulated industries include airlines, railways, interprovincial trucking, ports, banks, telecommunications and interprovincial pipelines.

# LEGISLATIVE UPDATE

## Alberta

### Investment Attraction Corporation Established

On July 7, 2020, the Honourable Tanya Fir, Minister of Economic Development, Trade and Tourism, introduced the *Alberta Investment Attraction Act* (Bill 33). The legislation, which establishes a Crown corporation known as the Invest Alberta Corporation, received Royal Assent on July 29.

Ms. Fir said, "This bill will enable the creation of an investment attraction corporation that will attract job-creating private-sector investment from across Canada and around the world. The new corporation will pursue high-value and high-impact investment opportunities that will bring numerous economic benefits to Alberta. We know investment is one of the primary drivers of economic growth and job creation. New investments into the province will support the conditions for growth by creating jobs, increasing economic development, and expanding the competitiveness of our province's leading industries and subsectors."

The mandate of the corporation is to promote, identify and pursue investment in Alberta, to deliver investment attraction services, targeted and customized for investors, and to support the government of Alberta's trade promotion and advocacy activities.

The corporation is empowered to loan money, issue loan guarantees, purchase shares or other forms of equity and to enter into joint ventures or partnerships.

The directors and officers of the corporation have the same fiduciary duty and duty of care as set out for directors and officers of private sector corporations in the Alberta *Business Corporations Act*.

## Federal

### Legislation Extends Wage Subsidy

On July 20, 2020, Bill C-20, entitled *An Act respecting further COVID-19 measures*, received first reading in the House of Commons. The legislation, which amends the *Income Tax Act* (the "ITA") to extend an emergency wage subsidy, received Royal Assent on July 27.

Under the *COVID-19 Emergency Response Act, No. 2*, which received Royal Assent on April 11, 2020, the ITA was amended to introduce the Canada Emergency Wage Subsidy (the "CEWS") as a means of protecting jobs by helping businesses keep employees on the payroll during the COVID-19 pandemic.

To be eligible for the CEWS, the general requirement was for an employer to have experienced a revenue decline of 30% for a particular reference period.

The CEWS provided eligible employers with a subsidy of 75% of employee wages, up to a maximum of $847 per employee per week, excluding employees who did not deal at arm's length with the employer.

Bill C-20 amends the ITA to revise the eligibility criteria for the CEWS in order to support those employers hardest hit by COVID-19. It also extends the CEWS to November 21, 2020, with the ability to extend the CEWS by regulation to no later than December 31, 2020.

Bill C-20 makes the CEWS more accessible to a broader range of employers by providing a gradually decreasing base subsidy to all eligible employers that are experiencing a decline in revenues. This is intended to help employers with less than a 30% revenue loss, while also ensuring those who have previously benefited could still qualify, even if their revenues recover and no longer meet the 30% revenue decline threshold.

Bill C-20 introduces a top-up subsidy of up to an additional 25% for employers that have been most adversely affected by the COVID-19 crisis.

Bill C-20 addresses technical issues identified by CEWS stakeholders, such as providing continuity rules to address circumstances where an employer purchased all or substantially all of another entity's business assets.

Under Bill C-20, the subsidy of 75% of employee wages is no longer automatic, as the subsidy percentage varies in proportion to the amount of the employer's revenue decline and may be reduced as the program winds down.

The Honourable Bill Morneau, Minister of Finance, said, "As we continue to safely restart the economy, many Canadian businesses and workers are continuing to face significant challenges and uncertainty. With the Royal Assent of Bill C-20, our government is once again showing workers and businesses that we have their back. The re-designed Canada Emergency Wage Subsidy will ensure that more Canadian workers can count on the support they need to return to work as our economy safely re-opens."

# RECENT CASES

## Corporation Failed to Remit Source Deductions in 2008, Director of Corporation Transferred Property to Spouse in 2008 and, Although Corporation's Tax Debt Not Returned Unsatisfied Until 2011, Spouse Liable for Unremitted Source Deductions

Federal Court of Appeal, April 2, 2020

Domenic Colitto ("Domenic") was a director and shareholder of Precision Technologies Inc. ("Precision"). On May 2, 2008, Domenic transferred a 50% interest in two real properties to his spouse, Caroline Colitto ("Caroline"), for nominal

consideration. Between February and August of 2008, Precision failed to remit source deductions to the Minister of National Revenue (the "Minister"). Consequently, the Minister issued a notice of assessment to Precision for unremitted source deductions, interest and penalties on October 10, 2008. On August 6, 2009, a certificate for Precision's tax debt was registered with the Federal Court under section 223 of the *Income Tax Act* (the "Act"). On November 23, 2010, direction to enforce the writ registered with the Federal Court was made to the sheriff. Precision's tax debt was executed and returned unsatisfied on January 4, 2011. The Minister issued a notice of assessment to Domenic on March 28, 2011 pursuant to section 227.1 of the Act, which provided that directors of a corporation that had failed to withhold and remit source deductions from salaries paid to its employees were jointly and severally liable with the corporation to pay the amount that should have been withheld and remitted and any interest or penalties relating to it. On January 13, 2016, the Minister assessed Caroline in respect of the property transfers pursuant to section 160 of the Act, which imposed tax liability on the spouse of the transferor of property that was transferred in a non-arm's length transaction for all amounts the transferor was liable to pay under the Act. Caroline appealed on the ground that the transfers of the properties by her spouse should not be subject to section 160 because Domenic was not liable for Precision's unremitted source deductions until January 4, 2011, the date Precision's debt was executed and returned unsatisfied, and, therefore, was not liable at the time of the transfers on May 2, 2008. The Tax Court allowed Caroline's appeal on the ground that Domenic's personal liability under section 227.1 of the Act did not arise until 2011, when Precision's tax debt was executed and returned unsatisfied and, therefore, the transfers of properties in 2008 were not caught by section 160 of the Act. The Minister appealed.

The appeal was allowed. The sole issue on appeal was whether Domenic's liability under section 227.1 was "in or in respect of" his 2008 taxation year, within the meaning of subparagraph 160(1)(*e*)(ii). Subsection 227.1(1) provided that where a corporation failed to withhold or remit an amount as required under the Act, a director of the corporation at the time the corporation was required to withhold or remit was jointly and severally liable with the corporation to pay the amount in question. The Tax Court concluded that subsection 227.1(1) was silent about when the director's liability arose, but although the English version of subsection 227.1(1) may have been ambiguous, any ambiguity in the meaning of subsection 227.1(1) was eliminated when one considered the context and purpose of the provision. The most important contextual factor was found in subsection 227.1(2). The Tax Court read subsection 227.1(2) to suggest that a director's liability did not "arise until the relevant preconditions set out in subsection 227.1(2)" were met, but, contrary to the Tax Court's reading of the provision, subsection 227.1(2) made clear that it was subsection 227.1(1) that imposed liability upon directors. Subsection 227.1(2) was a relieving provision that set out specified circumstances when the liability otherwise imposed by subsection 227.1(1) could be avoided. Subsection 227.1(2) did not state that a director was not liable for the corporation's default "unless and until" the specified actions took place. This was the language that would be required to effect the result found by the Tax Court. The Tax Court impermissibly read the words "and until" into subsection 227.1(2) in order to conclude that a director's liability did not arise under subsection 227.1(1) "unless and until the relevant preconditions in subsection 227.1(2) are satisfied". Subsection 227.1(1) was enacted to strengthen the Crown's ability to enforce the statutory obligation imposed on corporations to remit source deductions. It was perceived that a corporation, particularly a corporation in financial difficulty, might prefer to default on its obligation to remit taxes to satisfy creditors whose claims were more immediately pressing. The directors' liability provision was enacted to deter corporations from pursuing such a course. The provision was based on the presumption that a decision by a corporation to default on its remittance obligations would originate with the directors. The interpretation adopted by the Tax Court rendered this purpose nugatory and pointless. The Tax Court's interpretation would allow a director significant time following the corporation's default to reorganize his or her financial affairs to avoid personal financial responsibility. Parliament could not have intended the directors' liability provision to be avoided as it was in the present case. Domenic's liability for unremitted source deductions arose in or in respect of the 2008 taxation year. The Tax Court erred in law in finding otherwise. The fact that a director could be required to pay a corporation's debt only after collection efforts had been exhausted against the corporation was not inconsistent with the director's liability arising in or in respect of an earlier taxation year.

*Colitto v. Canada*,
2020 ACLG ¶ 79,946
2020 BCLG ¶ 79,370
2020 CCLR ¶ 201,527
2020 CCSG ¶ 51,807
2020 OCLG ¶ 52,183

## Corporation Not Entitled to Declaration that Three Shareholders, Who Acted Independently of Each Other, Improperly Solicited Proxies

Alberta Court of Queen's Bench, February 18, 2020

The applicant Karnalyte Resources Inc. ("Karnalyte") was a publicly traded corporation. The respondents, Mr. Phinney, Mr. Brown and Mr. Van Dam, were shareholders of Karnalyte. Mr. Phinney served as Karnalyte's CEO, president and a director until May 2014. In December 2014, Mr. Brown became part of a group known as the "Concerned Shareholders Group", established to address the direction being taken by the then Karnalyte board of directors. As noted in a press release, the Concerned Shareholders Group acted in concert with Mr. Phinney, who then held about 15% of Karnalyte's shares, in "working to preserve and enhance shareholder value". The Concerned Shareholder Group engaged in a heated battle against the re-election of the existing board of directors. The directors and management of Karnalyte were strongly criticized in very personal terms. After a formal proxy contest that included the filing of an early warning report and the preparation and distribution of a dissident proxy circular that disclosed Mr. Phinney was acting jointly and in concert with 23 other shareholders, including Mr. Brown, Mr. Phinney was elected to Karnalyte's board and reappointed as president and a new board was installed. In April 2015, the Concerned Shareholders Group was disbanded. In March, 2016, Mr. Brown started a group of shareholders called the "Friends of Karnalyte Resources", formed to act as an unofficial communication medium between Karnalyte and its shareholders. Mr. Phinney served as a Karnalyte director from May 2015, and as its chairman from July, 2015 until May 2017, at which time he was not re-elected as a director. His employment as Karnalyte's president was terminated in June 2017 by the board of directors elected at the 2017 annual general meeting. Mr. Brown did not support Mr. Phinney for re-election in 2017. Mr. Van Dam, a shareholder and a friend of Mr. Phinney's brother, had nominated two individuals to stand for election as directors in 2017, but they were unsuccessful. In 2018, certain shareholders contacted Mr. Van Dam to ask if these two nominees would run again, and, if so, whether they could pledge their shares to him to support a shareholder proposal to that effect. Mr. Van Dam agreed to accept certain pledges and to make the shareholder proposal nominating the two individuals. In January 2018, Mr. Van Dam nominated the same two people he had nominated in 2017 for seats on the Karnalyte board, although in this proposal to Karnalyte he mistakenly stated that he represented more than 20% of Karnalyte shareholders, later saying this was a typographical error. Mr. Van Dam wrote to Mr. Zachanowich, the chairman of the Karnalyte board, nominating himself and the two same nominees as candidates for election to the board. In this letter, he stated that he represented more than 5% of the Karnalyte shares. Karnalyte advised Mr. Van Dam that his proposals did not meet the legal requirements for nominating directors for election. Mr. Phinney attempted to requisition a special meeting of shareholders for the purpose of nominating three individuals as directors, who were not the same individuals as nominated by Mr. Van Dam. Mr. Phinney was advised that his request did not meet all the legal requirements and that the board would not call a special meeting. Karnalyte announced that its annual general meeting would be held on June 7, 2018. Mr. Phinney submitted a new shareholder proposal on the basis that he was the holder of over 5% of the Karnalyte shares, seeking to have the same three individuals nominated for election to the board. Karnalyte took the position that Mr. Phinney's proposal did not need to be included in its Management Proxy Circular because it failed to comply with the requirements of the Alberta *Business Corporations Act* (the "ABCA") and with Karnalyte's advance notice by-laws. It rejected the proposal, in part on the basis that the common shares held by Mr. Phinney comprised less than 5% of Karnalyte shares. Mr. Van Dam sent another shareholder proposal to Karnalyte, proposing himself and the same two individuals as in his previous proposal as nominees for election to the board of directors. Karnalyte rejected the proposal on the basis that the number of shares held by shareholders named in his application totalled less than the 5% threshold required for a shareholder requisition. Mr. Van Dam made a further shareholder proposal, including with his request all of the pledge sheets he had received from shareholders, only to be told that the request was out of time. He asked for a comparison of his list of pledges with the company's records, but received no response. Karnalyte distributed its Notice of Annual and Special Meeting and a Management Information Circular, which did not include either Mr. Phinney's or Mr. Van Dam's proposed nominees for directors. Mr. Phinney and Mr. Van Dam filed a joint application to the Alberta Securities Commission (the "ASC") for an exemption from the requirements of the ABCA with respect to proxy solicitation. Although the exemption application stated that Mr. Phinney and Mr. Van Dam were acting jointly and in concert with each other under the heading "facts" in the application, and that they may wish to solicit proxies, both Mr. Van Dam and Mr. Phinney said they did not in fact ever solicit proxies. Meanwhile, Mr. Brown was posting messages on the Stockhouse forum, expressing the growing anger and frustration he was hearing from shareholders about the board's lack of transparency and inactivity. Some of the Stockhouse messages were heated and unrestrained. Mr. Wheatley, the president of Karnalyte, issued a press release indicating that he had issued a letter to shareholders containing "important

information regarding a serious threat to the value of shareholders' investment in Karnalyte as a result of the reckless actions of a number of self-interested individuals." The press release urged shareholders to vote for management nominees to Karnalyte's board of directors. The press release noted that certain shareholders were "actively seeking to take control of the company and its board of directors, at the expense of other shareholders. Karnalyte has written the letter to shareholders as such shareholders are flagrantly ignoring basic corporate and securities laws, as well as long-established Karnalyte corporate policies." The letter to shareholders contained very negative comments about Mr. Brown and Mr. Phinney. Mr. Brown posted a Stockhouse message urging shareholders to support Mr. Phinney. Karnalyte brought an application against the respondents for a declaration that they improperly solicited proxies in relation to the Karnalyte 2018 annual general meeting in violation of applicable corporate and securities law. On the same day, Karnalyte sent a letter to all provincial securities commissions alleging that Mr. Phinney, Mr. Van Dam and Mr. Brown were engaging in the illegal solicitation of dissident proxies. Karnalyte sent a cease and desist letter to Mr. Phinney and Mr. Brown. Karnalyte complained to the ASC, alleging improper proxy solicitation by Mr. Phinney and Mr. Van Dam prior to the annual general meeting. The ASC asked Mr. Phinney and Mr. Van Dam for an explanation, but took no action on the complaint, instead granting the exemption order sought by Mr. Phinney. At the annual general meeting, the management slate of directors was elected by a majority of 55% of the votes. It was an uncontested election with respect to the directors, in the sense that the shareholders only had the option of voting for the slate of directors or withholding their vote.

Karnalyte's application was dismissed. Pursuant to sections 150 and 151 of the ABCA, a person other than on behalf of management of an Alberta corporation with more than 15 shareholders could not solicit proxies unless they had prepared and circulated a dissident's proxy circular and obtained an exemption from the ASC. Section 147 of the ABCA defined "solicit" or "solicitation" to include the sending of a form of proxy or other communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy vote. Mr. Phinney and Mr. Van Dam did not solicit proxies without obtaining an exemption order. Both denied soliciting any proxies. Karnalyte did not support its allegations that they solicited proxies with evidence other than circumstantial evidence. Plausibility or suspicion was not sufficient to meet the burden of proof. Mr. Phinney, Mr. Van Dam and Mr. Brown were not acting in concert such that they were required to file early warning disclosure under securities regulation (National Instrument 62-104). Mr. Phinney and Mr. Van Dam did not deny that they knew each other, but stated that their attempts to nominate directors were undertaken independently, and that they did not discuss them with each other until after they discovered that all their attempts had been rejected, about the time the Karnalyte Management Information Circular was distributed. It was noteworthy that their nominees were not the same. Karnalyte relied heavily on the statement in their application to the ASC that Mr. Phinney and Mr. Van Dam were acting jointly and in concert, but that statement, viewed in context, appeared to refer to the fact that they initially made a joint application for an exemption. Since Karnalyte failed to satisfy its burden of providing cogent evidence that Mr. Phinney and Mr. Van Dam were acting jointly or in concert, or that they were soliciting proxies, there was no reason why they would have had to file early warning disclosure. There was no persuasive evidence that Mr. Brown and Mr. Phinney were acting jointly or in concert with each other. The requirement of filing early warning disclosure was not triggered through the holding of proxies. Karnalyte submitted that the mere fact of holding proxies for more than 10% of the shares of a public company gave rise to a requirement to filing early warning disclosure, and that therefore Mr. Phinney and Mr. Van Dam were in breach of this securities regulation, but there was no evidence that Mr. Van Dam or Mr. Phinney had the power to direct the management and policies of the shareholders for whom they held proxies in accordance with section 3 of the *Securities Act*. A proxy holder was not granted control or given beneficial ownership of shares for which a proxy was given in the absence of any other agreement. The respondents did not acquire control of the shares for which they held proxies. As proxy nominees, they were obligated to vote as directed by the shareholder (or may have been given authority to decide how to vote in the specific instance of the 2018 meeting). To the extent the nominee exercised the authority granted to it via the form of proxy, the nominee only interacted with the voting right, which was only one of the rights that made up the bundle of rights constituting property in the security. A proxy did not confer a beneficial interest in the securities or legal control to the proxy holder. As a result, there was no need to file an early warning report. Mr. Phinney did not breach the ASC exemption order such that it was invalidated. Karnalyte alleged that the exemption order was based on misrepresentations of fact that *prima facie* invalidated it, but most of the alleged misrepresentations related to Karnalyte's submission that Mr. Phinney and Mr. Van Dam were acting jointly and in concert, which was not the case. Karnalyte did not establish that there were any misrepresentations in the order. With respect to Karnalyte's allegation that Mr. Brown solicited proxies on his own, the Stockhouse posting by Mr. Brown was a communication to shareholders on a public forum that could be reasonably calculated to result in the withholding of a proxy vote for the election of directors.

As Mr. Brown failed to sent a dissident proxy circular to the shareholders of Karnalyte, the posting was an unlawful solicitation of proxies. However, Karnalyte suffered no damages from that solicitation, as the management slate of directors was elected. Mr. Brown issued a full public apology prior to the meeting, serving to neutralize his posting at least in part. Despite his error, no further remedy was necessary against Mr. Brown. He was caught up in a vicious battle among old enemies.

*Karnalyte Resources Inc. v. Phinney*,
2020 ACLG ¶ 79,947
2020 BCLG ¶ 79,371
2020 CCLR ¶ 201,528
2020 CCSG ¶ 51,808
2020 OCLG ¶ 52,184

## Applicant 50% Shareholder/Director Granted Leave to Commence Derivative Action against Respondent 50% Shareholder/Director for Breach of Fiduciary Duty but Applicant Not Entitled to Interim Injunction Removing Respondent as Director

Ontario Superior Court of Justice, January 27, 2020

Ms. Macreanu and Mr. Godino jointly operated two companies, Home Textiles Inc. ("Home Textiles") and Bed & Bath Warehouse Inc. ("Bed & Bath"), as an integrated business for over 20 years and had a close relationship. Each was a director and 50% shareholder in the companies and they built a successful business. Their relationship soured and they were no longer able to work together following the breakdown in their business relationship. Ms. Macreanu travelled to Russia for a major medical procedure and, after her return to Canada, remained housebound before gradually returning to work. Ms. Macreanu claimed that Mr. Godino took advantage of her illness-related absence and slow recovery to justify his efforts to marginalize her and take over the companies. She alleged that Mr. Godino engaged in self-dealing, directed verbal abuse to her, excluded her from business decisions and sabotaged leases in order to compromise the companies' ability to carry on business. Ms. Macreanu claimed that Mr. Godino acted in a self-interested manner by readying Home Textiles' LG Home brand for his future use in competing business endeavours once the companies stopped operating, by unilaterally deciding to enter into a lease arrangement for a Home Textiles warehouse to ready this property for his own future business use, by refusing to sell clothing items, which Ms. Macreanu had purchased from a Macy's liquidation auction sale, through the companies, by appropriating a personal ownership interest in company equipment for his own future business activities and by compromising lease renewals to free himself to acquire these established houseware outlet locations for his own future business interests. Ms. Macreanu also claimed that that Mr. Godino advised staff and third parties that the companies would cease business operations, despite having no agreement with her to do so. Mr. Godino denied that he engaged in self-dealing or marginalization efforts. He claimed that he conducted himself in accordance with an agreement that he made with Ms. Macreanu to wind up the companies. Ms. Macreanu acknowledged that the parties wanted to end their business relationship but denied that they agreed to terms for winding up the companies. She claimed that their inability to agree on terms for separating their business relationship led Mr. Godino to marginalize her aggressively in an effort to wind up the companies. Mr. Godino denied that he improperly tried to wind up the companies. Ms. Macreanu commenced an action against Mr. Godino for oppression remedies pursuant to section 248 of the Ontario *Business Corporations Act* (the "OBCA"). In this proceeding, Ms. Macreanu applied for leave to bring derivative actions against Mr. Godino pursuant to section 246 of the OBCA and for an interlocutory injunction pursuant to subsections 246(4) and 248(3) of the OBCA to remove Mr. Godino as a director of the companies and to restrain him from harming the companies. Mr. Godino alleged that Ms. Macreanu agreed to wind up the companies before she resiled from the agreement. He claimed that the parties were deadlocked without any reasonable prospect of resolving their differences due to animosity and a lack of trust. As such, Mr. Godino brought cross-applications to wind up the companies under section 207 of the OBCA.

Ms. Macreanu's application for leave to bring derivate actions was allowed, her application for an interlocutory injunction was dismissed and Mr. Godino's cross-applications were dismissed. The parties did not agree upon terms or a plan to wind up the companies, or otherwise end their business relationship. Ms. Macreanu sent an email message confirming the

parties' shared intent to end their business relationship by starting a process to separate themselves, but this preliminary agreement by the parties to go their separate ways did not constitute an agreement on essential terms to wind up the companies or otherwise end their business relationship. There simply was no agreement on how their business relationship would end (e.g. what would happen to the companies, how the parties would deal with the leases for their business locations, what would happen to the merchandise, how the companies would deal with employees or how other aspects of the businesses would be concluded). Mr. Godino's submission that the decision by the parties to part ways necessarily contemplated or entailed a winding up of the companies was not persuasive. It clearly was open for the parties to agree for one to buy out the other, which they tried and failed to negotiate. Both parties clearly wished to conclude their business relationship, and each predicted or discussed potential scenarios with friends and colleagues about when or how their business relationship might conclude, but there was no evidence that the parties agreed on essential terms to wind up or dissolve the companies. It was also clear that Ms. Macreanu did not agree to wind up the companies. Mr. Godino left a package of draft documents for her to review and sign. These documents proposed a separation for the parties based on a dissolution of the companies and mutual releases from any claims arising from their business relationship. Ms. Macreanu refused to sign the documents. There was no evidence of a mutual intention by the parties to create a legally binding agreement to wind up the companies, as the parties did not agree on essential terms for doing so. With respect to Ms. Macreanu's application for leave to commence a derivative action, she was a proper complainant under section 245 of the OBCA and she had satisfied the 14-day statutory notice requirement under subsection 246(2) of the OBCA. It was undisputed that the directors would not bring or diligently prosecute the proposed action because Mr. Godino, one of two directors for both companies, would not agree to ratify a decision to bring proceedings against himself for any wrongdoing. Ms. Macreanu was acting in good faith by pursuing well-founded derivative claims against Mr. Godino on behalf of the companies. From the evidence on the applications, it was accepted that Ms. Macreanu demonstrated a reasonable basis for claiming that Mr. Godino breached his fiduciary and good faith duties as a director of the companies by self-dealing and interfering with or sabotaging the companies' business interests. Ms. Macreanu's allegations demonstrated a well-founded basis to claim that Mr. Godino acted in a self-interested manner. Ms. Macreanu had a well-founded basis to claim that Mr. Godino unilaterally announced a termination date to staff and third parties out of self-interest to prompt a wind up of the companies that would free himself to run a competing business. Mr. Godino submitted that leave for Ms. Macreanu's proposed derivative actions should not be granted because her claims against him essentially were in the nature of personal claims that could and should be dealt with in her oppression remedy action, but Ms. Macreanu's proposed derivative actions were essentially based on breach of fiduciary duty claims against Mr. Godino, a director of both companies, which was a cause of action belonging solely to the companies. The relief available in an oppression remedy was not necessarily exclusive to the relief available in a derivative action and both forms of relief frequently intersected or overlapped when factual circumstances supported both remedies. Regardless of the remedial overlap between derivative and oppression actions, Ms. Macreanu demonstrated well-founded grounds to proceed with a derivative action for the breach of fiduciary duty claim against Mr. Godino, and she was not precluded from pursuing her proposed derivative action or required to proceed only by way of her oppression action, despite arguably being able to seek relief appropriately in that proceeding. The requirements under section 246 of the OBCA for leave to bring a derivative action were to be given a liberal interpretation in favour of the complainant because the provision was remedial and was set out in broad and permissive terms. Proceeding with both the derivative and oppression actions would not entail costly inefficiencies or risk inconsistent findings that would compromise the best interests of the companies. Ms. Macreanu satisfied the test for leave to bring her proposed derivative actions and, accordingly, leave was granted for the derivative actions to proceed. However, Ms. Macreanu was not entitled to injunctive relief to remove or restrain Mr. Godino from further acting as a director of the companies. On an application for leave to bring a derivative action, an interim order for relief could be made under subsection 246(4) of the OBCA. Moreover, a complainant seeking an oppression remedy could seek an interim order under subsection 248(3) of the OBCA. A three-part test generally applied to an application for prohibitive interlocutory injunctive relief. The applicant was required to show (1) a serious issue to be tried; (2) irreparable harm if the application was refused; and (3) the balance of convenience favoured granting the injunctive relief pending a decision on the merits. Ms. Macreanu met the threshold of showing there was a serious issue to be tried, having a well-founded claim that Mr. Godino breached his fiduciary duties as a director to the companies. She adduced persuasive evidence of Mr. Godino's pattern of engaging in self-dealing and systematically excluding her from business activities. However, Ms. Macreanu failed to demonstrate irreparable harm. The companies could continue operating from almost all locations and were not facing an immediate existential threat of being unable to continue as going concerns. The companies seemed able to continue carrying on business without suffering permanent market loss or irrevocable reputational damage until this litigation was finally

determined. Ms. Macreanu led fairly compelling evidence that Mr. Godino progressively excluded her from business activities, but Mr. Godino denied that he tried to exclude Ms. Macreanu from the business affairs of the companies and claimed that he acted in good faith to act in accordance with what he believed was a common understanding that he had reached with Ms. Macreanu to dissolve the companies. Although Mr. Godino's actions gave rise to real concerns in respect of both the derivative and oppression claims, the collective harm that his actions may have caused was not sufficiently serious to constitute irreparable harm to the companies or to Ms. Macreanu for which damages could not provide adequate compensation. With respect to the balance of convenience, removing Mr. Godino as a director would be highly prejudicial. Home Textiles and Bed & Bath were established and successful companies. The parties could continue running the companies on an interim basis pursuant to the terms of an interim consent order that they previously agreed to. Pursuant to that order, Mr. Godino agreed to abide by his fiduciary duties to the companies, undertook to allow Ms. Macreanu full and unfettered access to the companies to enable her to fulfill her duties as a director, and further undertook to not compete with the companies or solicit interference with any employees, customers, landlords, suppliers, manufacturers or distributors. In addition, the parties agreed as a term of the consent order to conduct all business of the companies in writing and to include each other in all future communications. The interim arrangement under the consent order was less than ideal for the companies or the parties, particularly over a longer or sustained period of time, given the parties' difficulties with their business relationship, but it afforded a workable interim arrangement on a temporary basis until this matter could be finally determined. An order under subsection 248(3) for an interlocutory injunction to remedy oppressive conduct should be a tailored remedy that goes no further than necessary to rectify the oppressive or unfairly prejudicial conduct and be responsive to the reasonable expectations of a company's shareholder and should only be considered when other less drastic measures would not suffice. The same considerations applied to an interim injunction under subsection 246(4). Mr. Godino was not entitled to an order to wind up the companies pursuant to section 207 of the OBCA. The court rejected Mr. Godino's submission that the parties began proceedings to wind up the companies voluntarily, so he was not entitled to an order to wind up the companies under clause 207(1)(*b*)(ii). The just and equitable ground under clause 207(1)(*b*)(iv) for winding up a company was remedial and intended to prevent a party from disregarding the obligations it assumed by participating in the company. Mr. Godino submitted that the court should order a wind up of the companies because the parties were deadlocked and unable to complete their earlier agreement to wind up the companies or otherwise work together in the best interests of the companies, but Mr. Godino was required to show a reasonable expectation (based on his business relationship with Ms. Macreanu) that the companies were to be wound up if irreconcilable differences arose between the parties. He did not lead any evidence that the parties expected to wind up or dissolve the corporations if an irreconcilable difference arose. Mr. Godino submitted that the current level of disharmony and breakdown in their business relationship effectively made sustained and long term consensus unachievable and justified a winding up of the companies and, by showing a reasonable inference that the parties would not have expected their business association to continue as a long term arrangement in the face of their soured business relationship and deadlock, Mr. Godino demonstrated that circumstances existed to invoke the clause 207(1)(*b*)(iv) wind up power. However, winding up was a draconian remedy that negatively impacted the affected company and its employees if ordered. Given its drastic nature, and particularly in cases where the company was capable of being operated profitably, the court's clause 207(1)(*b*)(iv) equitable discretion to make a winding up order should be exercised only as a last resort. The parties clearly wanted to go their separate ways but were deadlocked in terms of their inability to agree on essential terms for ending their business relationship. However, instead of winding up the companies, it seemed evident that both parties would prefer to entertain a fair buyout arrangement, which so far had eluded them. A subsection 248(3) remedy that permitted one of the parties to purchase the shares owned by the other would be the most just and equitable way to fully determine this matter. To implement this remedy, the court had to make a determination as to whether it would be more just and equitable to order Ms. Macreanu or Mr. Godino to be the purchaser. Should the equities be equally balanced, then the only available alternative would be the winding up of the companies. A trial was required to understand properly the narrative of what occurred in this case. It would be appropriate for the cross-applications to wind up the companies to proceed to a trial and be heard together with the derivative and oppression actions.

*Macreanu v. Godino*,<br>
2020 ACLG ¶ 79,948<br>
2020 BCLG ¶ 79,372<br>
2020 CCLR ¶ 201,529<br>
2020 CCSG ¶ 51,809<br>
2020 OCLG ¶ 52,185

## In Determining Fair Value of Dissenting Shareholder's Shares, Judge Correctly Used Negotiated Deal Price as Starting Point, then Referred to Other Market-based Factors

British Columbia Court of Appeal, April 30, 2020

Chaparral Gold Corp. ("Chaparral") was a mining company engaged in the development of two early-stage properties in Nevada. Chaparral had been formed as part of a spin-out transaction involving International Minerals Corporation ("IMZ") and other companies. Paradigm Capital Inc. ("Paradigm") acted as the independent financial advisor to IMZ and provided a valuation and fairness opinion in connection with the spin-out. Paradigm was of the opinion that the fair market value of a Chaparral share was in the range of $0.58 to $0.85. Waterton Precious Metals Bid Corp. ("Waterton") made an unsolicited hostile bid to acquire all shares of Chaparral for $0.50 per share. Chaparral's board of directors rejected this bid, citing various concerns, including that it undervalued the company's assets, was "financially inadequate" and "highly conditional". Chaparral's board appointed an independent special committee, which comprised three independent directors, to consider the hostile bid and to make recommendations to the board. Chaparral entered into negotiations to explore potential transactions with 13 companies (the "white knights"), all of whom executed confidentiality agreements. They received access to certain corporate documents, including the valuation provided by Paradigm. Chaparral received three expressions of interest for its shares, each in the range of $0.60 per share. Chaparral disclosed a potential liability to the U.S. Environmental Protection Agency (the "EPA"). The white knights that had made offers withdrew from the bidding process. Chaparral also entered into a confidentiality agreement with an additional company, but this did not lead to an offer. Waterton increased its offer to $0.55 per share. Chaparral's board again recommended that shareholders reject the bid, but approximately 16.83% of its shares were purchased by Waterton, increasing Waterton's total shareholdings in Chaparral to approximately 19.72%, just below the 20% required for effective control of the company. Meanwhile, Chaparral attempted to settle its dispute with the EPA. The special committee recommended opening a dialogue with Waterton to see if a fair and reasonable transaction could be negotiated. Chaparral's board accepted the recommendation and instructed management to enter into negotiations with Waterton. This led to a plan of arrangement, in which Waterton offered to acquire all shares in Chaparral for $0.61 per share in cash. Paradigm provided an opinion to the special committee that the fair market value of shares was in the range of $0.45 to $0.76 per share and that the proposed arrangement was fair, from a financial point of view, to Chaparral shareholders. The special committee considered, among other things, that Waterton's offer arose from a comprehensive negotiation process and represented a premium to current and historical trading prices of Chaparral shares. The special committee recommended that Chaparral's board approve the arrangement. The board did so and then recommended that shareholders vote in favour of the arrangement, providing several reasons for supporting the transaction, including that the board had pursued a variety of strategic alternatives before negotiating with Waterton and that the offer price provided a "significant premium" for shareholders. The EPA demanded that Chaparral pay US $6.3 million within 30 days to resolve the environmental issues. The arrangement was approved at a special meeting of shareholders, with approximately 99.48% of votes in favour of the arrangement. The arrangement received court approval. The appellant was minority shareholder of Chaparral who opposed the arrangement. The appellant exercised his dissent rights under the British Columbia *Business Corporations Act* (the "BCBCA") and petitioned the Supreme Court, seeking to have it find the fair value of Chaparral shares to be between US $1.60 and $1.85. The judge determined that the fair value for the appellant's shares was the price under the arrangement, namely $0.61 per share (the "deal price"). The judge found that this price was arrived at by sophisticated, arm's length parties, negotiating in an unburdened open market, and that these conditions ensured the price was reflective of fair value. The appellant appealed, arguing that the judge erred in law by failing to apply the established legal framework for determining the fair value of a dissenting shareholder's shares pursuant to paragraph 245(2)(*a*) of the BCBCA and committed palpable and overriding errors in relation to certain findings of fact in his analysis of market forces.

The appeal was dismissed. The judge did not start with a presumption that the deal price was fair. Rather, he correctly used the deal price as a starting point and then referred to other market-based factors to ascertain whether the price was fair to the dissenting shareholder. He also considered all relevant evidence and exercised judgment in the determination of fair value, including the history of the acquiring and target companies, the trading price of the shares in the public market, the evolution and formulation of the plan of arrangement, the value of the shares specified in the plan of arrangement and opinions regarding value of expert witnesses. The judge was correct in relying on the negotiated deal price. That price was the outcome of the behaviour of participants in a real market and was of immediate and direct

probative value. The judge considered all of the evidence and the relevant market-based factors to conclude that the deal price was equivalent to the fair value of the shares. There was a solid evidentiary foundation for the judge's findings. With respect to expert evidence, the judge was careful to delineate the rationale for his preference of the opinions of Waterton's expert to those of the appellant's expert, which included the latter's failure to adequately consider the overwhelming shareholder approval of the arrangement, the deal price, which was negotiated between arm's length parties where open and unrestricted market forces were engaged, the fact that the deal price, in comparison to the original hostile bid offers, included a valuation of Chaparral's mining properties, the trading price of Chaparral shares on the stock exchange and the effect of Chaparral's potential EPA liability and its disclosure in its public filings on the fair market price of Chaparral shares. The judge provided sound reasons for preferring the market-based analysis of Waterton's expert over the hypothetical valuations of the appellant's expert. Although Waterton's expert was asked to evaluate whether the deal price was established in the context of a fair market value transaction, rather than providing a comprehensive independent valuation, the judge was entitled to rely on his analysis of market forces in assessing whether the deal price was equivalent to fair value. There was no error in the judge's approach, nor in his findings of fact with respect to the real evidence provided by market forces.

*Bamrah v. Waterton Precious Metals Bid Corp.*,
2020 ACLG ¶ 79,949
2020 BCLG ¶ 79,373
2020 CCLR ¶ 201,530
2020 CCSG ¶ 51,810
2020 OCLG ¶ 52,186

## Application Judge Erred in Ordering Forced Sale of Appellants' Shares as Oppression Remedy for Non-payment of Dividends and in Finding No Breach of Duty by Respondent Director Who Appropriated Opportunity

Ontario Divisional Court, April 15, 2020

The respondent Woodland Poultry Ltd. ("Woodland") was a corporation wholly owned and controlled by the respondent Angelo Georgakakos ("Angelo"). Woodland operated a poultry farm. The respondent KEAN Holdings Inc. ("KEAN") was a holding corporation. The appellants, Angelo's children, were shareholders of KEAN, but Angelo was the sole director of KEAN by virtue of his ownership of special shares in the company. Prior to 2016, Angelo owned 51% of the shares of a family holding company, the respondent ABG Holdings Inc. ("ABG"), and his wife, Bessie Georgakakos ("Bessie"), owned 9%. Angelo held the other 40% of ABG shares in trust for the appellants. Both Angelo and Bessie were directors of ABG. Angelo and Bessie were divorced. In 2016, Bessie transferred her shares of ABG to KEAN and resigned as a director of ABG. At the same time, ABG changed its name to AG Holdings Niagara Inc. ("AG"). Riverview Poultry Limited ("Riverview") was neither owned nor controlled by any member of the Georgakakos family. Riverview was a profitable poultry processing operation. Prior to the events that gave rise to this case, Riverview was owned in equal parts by five shareholders. One of those shareholders was ABG. In 2010, one of the shareholders of Riverview decided to sell half of his shares (10%) to the other four shareholders in equal portions (2.5% each), including ABG. However, rather than causing ABG to purchase the Riverview shares, Angelo caused his own company, Woodland, to purchase them. The shares were purchased by Woodland in 2010 for $562,500. In 2014, Woodland purchased a further 0.28% of Riverview's shares for $147,647, bringing Woodland's total shareholdings in Riverview to approximately 2.8%. In February 2017, Angelo caused Woodland to sell its shares of Riverview to AG for $2,750,000, gaining a profit of $2,039,853 on the sale. To pay for the shares, Angelo caused AG to set the purchase price off against a debt of $3,678,000 owed by Woodland to AG. Prior to June of that year, AG had never declared a dividend, notwithstanding that it had retained earnings of more than $11.5 million dollars according to a report of the appellants' expert. In June 2017, the appellants brought an application under the Ontario *Business Corporations Act* (the "OBCA") and the *Trustee Act*, alleging that Angelo had engaged in a course of self-dealing in breach of his fiduciary duty and that he had acted oppressively as the sole director of AG by failing to declare any dividends on the shares he held for them in trust. The appellants sought a declaration under section 248 of the OBCA that the affairs of AG had been conducted in an oppressive manner. By way of remedy, they sought an order varying or setting aside the Riverview share purchase agreement between Woodland and AG, an order requiring Angelo to disgorge any monies and profits paid to him by AG and an order appointing the appellants and Bessie as directors of AG.

In January 2019, the application was amended to include a request for an order directing the respondents to transfer to the appellants their shares in AG and KEAN, together with the pro rata share of the assets of AG and KEAN attributable to those shares. The appellants also sought an order that Angelo and Woodland pay them $1,146,418, representing the loss to the appellants of the opportunity to purchase the shares of Riverview, as calculated by the appellants' expert. This sum was comprised of the lost dividends declared on the shares while they were owned by Woodland and the price paid for the shares by AG beyond what Woodland had paid for them. The application judge held that Angelo had not breached his fiduciary duty with respect to the purchase of the Riverview shares by Woodland. With respect to the appellants' claim that the affairs of AG were being conducted oppressively under section 248 of the OBCA, the application judge found that AG had engaged in oppressive behaviour toward the appellants by not paying out any dividends until after the application was commenced. However, rather than granting any of the relief requested by the appellants, the application judge ordered that AG purchase the shares of the appellants. The appellants appealed.

The appeal was allowed. The application judge erred in concluding that Angelo had not breached his fiduciary duty in connection with the purchase by Woodland of the Riverview shares. Angelo was under a fiduciary duty as a director of AG. A corporate director had both a statutory and a common law duty to act honestly and in good faith with a view to the best interests of the corporation, as required by paragraph 134(1)(*a*) of the OBCA. A director's fiduciary duty required him to avoid situations in which his interests conflicted with those of the corporation and dictated that a corporate director must not appropriate for himself an opportunity properly belonging to the corporation. Where a director had an interest in a transaction with the corporation, section 132 of the OBCA required that the director's disclosure of his interest be in writing or entered into the minutes of the directors meeting at which the proposed transaction was first considered and precluded the director from voting on the transaction. However, full disclosure of the director's interest in a transaction was not enough and the transaction had to be in the best interests of the corporation, even where a director had made proper disclosure of his interest in the transaction. With respect to the purchase and sale by Woodland of the Riverview shares, the application judge was correct in finding that Angelo and Bessie at least acquiesced in the purchase by Woodland of Riverview shares in 2010 by virtue of a directors' resolution that was passed in 2009. However, he failed to refer to the fact that Angelo voted on that resolution, in contravention of subsection 132(5) of the OBCA. He also failed to refer to the fact that there was a second Riverview share purchase in 2014, which was not approved by any resolution whatsoever. Woodland later sold the Riverview shares to AG for a very substantial profit. There was no evidence that Angelo disclosed his plan to sell the Riverview shares to AG. Thus, Angelo failed to meet his onus with respect to the duty to disclose. The application judge also failed to refer to the fact that AG would not have had to pay what it did to purchase the Riverview shares had it been the one to purchase the Riverview shares originally, which it was entitled to do as a Riverview shareholder. In focusing, instead, on the fact that Riverview was not paying dividends at the time its shares were purchased by Woodland, the application judge failed to consider evidence that showed that Riverview was retaining earnings. This was the reason Woodland was later able to justify the price at which it sold the shares to AG. Had the Riverview shares been purchased by ABG in 2010 and 2014, it would have been the beneficiary of these retained earnings, rather than Woodland. The purchases by Woodland, therefore, were not in the best interests of AG. Where a director transacted with the corporation, as Angelo did when Woodland sold the Riverview shares to AG, the onus was on the director to prove that the transaction was a proper one. The director must prove that he put the interests of the corporation above his own. The application judge placed the onus on the appellants to prove that Angelo put the interests of Woodland ahead of those of AG, rather than requiring that Angelo prove the transaction was in AG's best interests. The application judge's reversal of the burden of proof constituted a legal error. The application judge's decision on the issue of whether Angelo breached his fiduciary duty to AG could not stand. No conclusion was available on the evidence other than that Angelo breached his fiduciary duty by appropriating an opportunity for Woodland in purchasing the Riverview shares and by later selling those shares to AG at a substantial profit. It was not necessary to remit the matter to any other court to remedy the breach. It was ordered that Angelo and Woodland pay the sum of $1,146,418 to AG, which was the amount of money Woodland gained and AG lost as a result of Angelo's self-dealing. The application judge erred in ordering AG to purchase the appellants' shares as a remedy for failing to declare dividends. Section 248 of the OBCA provided the court with very broad discretion to deal with oppressive conduct. Where a court found that such conduct had occurred, subsection 248(3) provided that the court could make any interim or final order it thought fit. However, the broad discretion provided to an application judge under the OBCA was constrained by its purpose. The reasonable expectations of the aggrieved parties were central to the issue of oppression and those expectations served both to determine whether the impugned conduct had resulted in oppression and to delimit the remedy. The remedy fashioned under subsection 248(3) could only be used to rectify the oppression. It was implicit in the application judge's finding of oppression that the appellants had a reasonable expectation that they would be paid

dividends. In ordering that the appellants sell their shares to AG, the application judge found that the relationships between the shareholders were irreparably broken, but the evidence before the application judge was insufficient to permit this conclusion. There was some evidence before the application judge that the relationship between Angelo and the rest of his family had been *damaged*. This included evidence that Bessie and Angelo had divorced, that the children had commenced an oppression application against Angelo and that Bessie appeared to have sided with the children. However, there was no evidence in the affidavits of the witnesses, nor from the cross-examination of them, to support the application judge's finding that the relationship between Angelo and his children had been damaged *irreparably*. In fact, there was evidence to the contrary, as Angelo deposed that, rather than having the appellants' shares in AG held in trust, the appellants should hold their own shares now that they were all over the age of majority. This was evidence from which the application judge could have inferred that Angelo was of the view that the corporation could continue to operate with the appellants as shareholders, not the opposite. Moreover, even if it the application judge's finding of irreparable damage could be supported on the evidence, the remedy of a forced sale of the appellants' shares to the corporation went beyond what was necessary to rectify the oppression. AG was simply a holding company for the profits it received from its shares in Riverview and there was no evidence that much, if any, active management was necessary. The application judge's order was manifestly unjust in punishing the appellants and rewarding Angelo. The appellants never asked for an order forcing or allowing the corporation to buy their shares, nor did Angelo or the corporation make such a request. The appellants came to court looking for a seat on the board and left without even a share in the corporation. The application judge's order failed to consider the appellants' reasonable expectations, which never included losing their equity in AG, even for a price. Notwithstanding the application judge's finding that Angelo had oppressed the appellants by failing to distribute the profits AG received from Riverview, his order had the effect of allowing Angelo to receive all of AG's future revenue from that source. The application judge's order requiring the appellants to sell their shares to AG was set aside. It was ordered that the shares of AG presently held by Angelo for the appellants in trust be transferred to KEAN, that Angelo be removed as a director of KEAN and that the appellants be appointed as directors in his place.

*Georgakakos v. Georgakakos*,
2020 ACLG ¶ 79,950
2020 BCLG ¶ 79,374
2020 CCLR ¶ 201,531
2020 CCSG ¶ 51,811
2020 OCLG ¶ 52,187

**CORPORATE BRIEF**

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