Responsibilities of Directors in Canada

From voting rules to disclosure, Torys offers comprehensive insight on the role of directors of publicly traded companies in Canada.

A Business Law Guide

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The Purpose and Scope of this Guide

This business law guide is a general overview of certain legal and business matters that may be relevant to the responsibilities of public company directors in Canada.

It is important to note that the information contained in this guide is accurate as of the date shown below. Because the laws and policies of governments and regulatory authorities may change from time to time, some of the information may no longer be accurate when you read this.

In this guide, unless the context suggests otherwise, the term “a province” or “provinces” of Canada indicates also “a territory” or “territories” of Canada.

This guide of course does not encompass all the possible legal, business and other issues that may have an impact on or be relevant to the responsibilities of a director in Canada. And since it is a general overview, this guide should not be regarded as either exhaustive in subject matter or comprehensive in discussion. It is not, therefore, a substitute for qualified, professional advice.

July 2009

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Introduction

A Public Corporation Focus

This guide focuses on directors of public corporations with securities traded on a stock exchange such as the Toronto Stock Exchange. Although much of this guide is equally applicable to directors of private corporations, it does not deal with certain aspects unique to private corporations, such as the role of unanimous shareholder agreements.

The Scope of Directors' Statutory Liabilities in Canada

In Canada, directors' statutory liabilities are extensive. The statutes that impose liability include those governing:

- The incorporation, corporate governance and conduct of business corporations - for example, the federal *Canada Business Corporations Act* (CBCA) and the *Ontario Business Corporations Act* (OBCA);[1]
- The incorporation, corporate governance and conduct of corporations in regulated industries - for example, the federal *Bank Act*, *Trust and Loan Companies Act* and *Insurance Companies Act*; and
- Capital markets and securities transactions (including securities laws and regulations), employment and labour, occupational health and safety, environmental protection, taxation (income, health, retail sales, goods and services, commodities, customs and excise), pensions, bankruptcy and insolvency, and similar matters.

The basis on which these statutes impose liability varies. In some cases, directors may be personally liable for their own wrongdoing or failure, such as breaching the duties of loyalty and of care, described below in part 3, "Directors' Duties." In other cases, directors may be personally liable for wrongdoing by the corporation. In this second category, the provisions cover situations ranging from absolute liability offences (in which a director may not make the excuse that he or she did not know about the conduct or took all reasonable steps to prevent the conduct from occurring) to situations in which either a due diligence defence is available or the director must be shown to have "authorized, permitted or acquiesced" in the commission of the offence by the corporation.

[1] References in this guide to "Canadian corporate statutes" and similar terms mean the CBCA and the OBCA unless otherwise indicated. Generally, the business corporation statutes of other Canadian provinces and territories are similar to these statutes, although there are some differences.

Policies and Procedures

A determination of whether or not directors have met the statutory standard of care of a reasonably prudent person would normally depend on whether directors have implemented, or have required management to implement, written policies in particular areas. We discuss policies and similar documents in various contexts in this guide.

With respect to these policies, please note the following:

- These are merely examples of areas in which specific policies are either statutorily required or desirable.
- A written policy (or program or manual) that contains unrealistic objectives or that is not followed after it is adopted can be more harmful than not having a written policy at all.
- Policies and procedures should be tailored to the corporation they are meant to serve. A policy that is suitable for one corporation may be inappropriate for another.

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Corporate Governance and the Board's Role

Supervision of Management

Under Canadian corporate statutes, the directors' role is to oversee the management of the business and affairs of the corporation rather than be directly involved in the day-to-day management of the corporation.

The starting point for directors, in fulfilling their oversight role, is to satisfy themselves that the individuals who make up senior management are qualified and worthy of the trust and confidence of the directors.

Directors should also ensure that management informs them in detail about how it is exercising its responsibilities for the day-to-day running of the corporation. In this regard, directors should do the following:

- Satisfy themselves that management is monitoring the performance of the business;
- Reach agreement with management on sensible financial goals;
- Settle the terms of the annual budget and the business plan and ensure that management adheres to them;
- Consider the corporation's strategy and be involved at an early stage in any strategic initiatives;
- Satisfy themselves that the corporation has adequate internal control systems in place;
- Satisfy themselves that management has implemented appropriate systems and policies to ensure that management and the board have all the information they need to manage the corporation and make informed judgments, as well as to ensure that any material positive or negative developments are immediately brought to their attention;
- Monitor financial results and other material developments to determine whether or not performance is:
  - consistent with forecasts, and
  - comparable with returns obtained by competitors operating in similar business and economic environments.
- Settle senior management compensation; and
- Plan for the succession of senior management.

Reliance on Management, Financial Statements and Experts

The law permits directors to delegate to management where appropriate, in accordance with their responsibilities. Directors may not, however, rely on management if it would be unreasonable to do so in the circumstances. Directors must not be unquestioning recipients of financial statements or other information from management. On each issue, directors should ask themselves if they have reasonable grounds to question the content of a statement or other information, or management's interpretation of the information.

Directors have a defence to liability under the corporate statutes, including for a breach of the duty of loyalty and the duty of care (discussed in part 3), when they have relied in good faith on:

- Financial statements of the corporation represented to them by an officer of the corporation or in a written report of the corporation's auditor as fairly presenting the financial position of the corporation in accordance with generally accepted accounting principles; or
- A report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by that person.

Directors should be both careful and proactive when they wish to rely on the advice or opinions of experts. For example, it is desirable for directors to:

- Satisfy themselves that the expert has the appropriate qualifications and experience to advise on a particular question;
- Have management confirm that the expert has access to all relevant information;
- Hhave the expert give written advice; and
- Examine and question the advice, where appropriate, and not accept it passively.

Governance Guidelines and Disclosure Rule

In Canada, securities regulators have issued:

- A policy setting out corporate governance guidelines that reflect best practices;[2] and
- A rule that requires public corporations to describe specific aspects of their governance practices.[3]

This is essentially a "comply or explain" regime in which public corporations must indicate whether they comply with a particular guideline or, if not, how they otherwise meet its objective. Securities regulators are considering changes to the existing regime (see "New Canadian Governance Proposal," later in this part).

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[2] See National Policy 58-201, *Corporate Governance Guidelines*.

[3] See National Instrument 58-101, *Disclosure of Corporate Governance Practices*.

Governance Guidelines

The governance guidelines are very similar in substance to the listing standards of the New York Stock Exchange and reflect current North American best practices in governance.

The corporate governance guidelines recommend, among other things, that:

- The board comprise a majority of independent directors (the test for independence is described in the next section);
- The chair of the board be an independent director, or the board otherwise have a lead independent director;
- The independent board members meet regularly without non-independent members and management;
- The board adopt a written mandate that sets out its responsibilities;
- The board have a written code of conduct and ethics; and
- The board and its members be assessed regularly.

The governance guidelines are not mandatory. It is this feature – voluntary compliance coupled with a disclosure requirement – that distinguishes the Canadian approach from the mandatory listing standards adopted by the U.S. stock exchanges.

Governance Disclosure Rule

The Canadian disclosure rule requires disclosure about each of the major aspects covered in the governance guidelines. Corporations are required to disclose whether they have adopted the recommended approach or, if their practices depart from that approach, to describe the procedures implemented to meet the same governance objective. (Corporations listed on the TSX Venture Exchange are subject to less onerous disclosure requirements.)

This emphasis on disclosure is intended to give public corporations the flexibility to tailor governance practices to their own circumstances while giving investors sufficient information to assess those practices.

Failure to provide adequate disclosure is a breach of securities laws and could expose the issuer to enforcement proceedings and sanctions. The regulators use their regular continuous disclosure reviews to attempt to ensure that the corporate governance disclosure portrays what is actually happening in the boardroom and is not merely boilerplate.

Definition of Independence

Under Canadian securities rules, a director is “independent” if he or she has no direct or indirect material relationship with the corporation (which, for the purposes of the definition of independence and the discussion below, includes any parent and subsidiaries of the corporation).[4]

A “material relationship” is one that could, “in the view of the issuer’s board, be reasonably expected to interfere with the exercise of a member’s independent judgment.” Under the rules, the fact that a director is a nominee of a controlling shareholder does not alone result in the director being determined as not independent (though it may affect independence for audit committee purposes, as described further below). However, the board should assess all relationships between the corporation and a director to determine whether any of those are material relationships. These could include commercial, charitable, industrial, banking, consulting and legal relationships.

A director will be deemed to have a material relationship with the corporation if he or she is a partner or an employee of the internal or external auditor of the corporation.

A director will also be deemed to have a material relationship with the corporation if he or she is, or in a three-year “look-back” period was:

- An employee or executive officer of the corporation;
- A former partner or employee of the internal or external auditor who personally worked on the corporation’s audit;
- An executive officer of another entity if a current executive officer of the corporation serves or served, at the same time, on the compensation committee of that other entity; or
- In receipt of more than $75,000 in direct compensation from the corporation during any 12-month period (except for acting as a director or committee member), excluding fixed amounts of compensation under a retirement or deferred compensation plan for prior service with the corporation if receipt is not in any way contingent on continued service.

Immediate family members having relationships similar to those described above may also taint a director’s independence.

To be independent for audit committee purposes, a director must not be an executive or employee of any controlling shareholder (subject to exemptions in limited circumstances) and cannot receive *any* direct or indirect compensation from the corporation, except for board and committee work.

[4] See National Instrument 52-110, *Audit Committees*.

Board Committees and Delegation

The law also permits (and in the case of audit committees, requires) directors to delegate some of their responsibilities to one or more committees of directors.

The way a board committee deals with a particular matter will affect all the directors, who share ultimate responsibility. In practice, therefore, although committee mandates will impose responsibilities on board committees, it is not generally the practice to delegate final decision-making power in respect of material matters to a committee. On the contrary, most committees make recommendations to the full board when material decisions or approvals are required because the entire board should provide its views in that regard.

The corporate statutes do not permit a board to delegate certain matters. For example, the *Canada Business Corporations Act* does not permit a board to delegate the power to fill a vacancy on the board or in the office of auditor; issue securities (except as authorized by the full board); purchase or redeem shares; declare a dividend; approve annual financial statements; or approve certain disclosure documents.

Audit Committee

The Canadian *corporate statutes* require that public corporations establish an audit committee composed of at least three directors, a majority of whom are not *inside* directors (that is, directors who are also officers or employees of the corporation or any of the corporation's affiliates).

In most corporations, the audit committee is the most important board committee and, ideally, should supervise all financial matters. The responsibilities of audit committee members should not be underestimated. When a corporation suddenly performs poorly or fails, attention is usually focused on the adequacy of corporate governance, the credibility of the financial statements and the audit committee's performance.

Audit Committees of Public Corporations

Canadian *securities law* requirements now significantly exceed the Canadian corporate law requirements for audit committees. Canada's securities regulators have adopted a rule that governs the role and composition of audit committees of public corporations; the rule is similar to requirements for audit committees in the United States. Canadian issuers that are listed on a U.S. stock exchange are exempt from most of the requirements of the Canadian rule if they comply with the U.S. stock exchange listing standards that apply to domestic U.S. issuers. The rule distinguishes between venture issuers and non-venture issuers. An issuer that is not listed on the Toronto Stock Exchange (but is listed on the TSX Venture Exchange, for example) is a venture issuer and is subject to less stringent requirements.

Independence

Under securities law, public corporations must have at least three directors on their audit committees, all of whom must be independent as described above. Venture issuers are not subject to this requirement, although corporate law may require them to have an audit committee composed of a majority of non--management directors.

Financial Literacy

All members of the audit committee of a public corporation, other than a venture issuer, must be financially literate. An individual is financially literate if he or she can read and understand a set of financial statements that present a breadth and level of complexity of accounting issues generally comparable with the breadth and complexity of the issues expected to be raised by the corporation's financial statements.

An audit committee member who is not financially literate may be appointed to the audit committee if that person agrees to become financially literate within a reasonable period. The board of the corporation must, however, be satisfied that this will have no material adverse effect on the audit committee's ability to act independently and satisfy the other requirements of the rule.

Venture issuers are not required to have financially literate audit committee members.

Authority

Audit committees of public corporations must be given the authority to engage independent counsel and other advisers, set the compensation for any advisers retained and communicate directly with the internal and external auditor.

Role and Mandate

Under the Canadian audit committee rule, the audit committee of a public corporation must have a written charter that sets out its mandate and responsibilities. The rule requires the audit committee to do the following, at a minimum:

- Recommend to the board the external auditor to be nominated for appointment by the shareholders.
- Recommend the compensation of the external auditor.
- Be directly responsible for overseeing the work of the external auditor, including resolving disagreements between management and the auditor about financial reporting.
- Preapprove all non-audit services to be provided by the external auditor.
- Review the financial statements, management's discussion and analysis (MD&A) and earnings news releases before the information is publicly disclosed.
- Be satisfied with and periodically assess the adequacy of procedures for the review of other corporate disclosure that is derived or extracted from the financial statements.
- Establish procedures for the receipt, retention and treatment of complaints about accounting, internal controls or auditing matters and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.
- Review and approve the issuer's policies regarding hiring current and former partners and employees of the current and former external auditor.

Under the rule, the corporation must require the auditor to report directly to the audit committee.

The audit committee is permitted to delegate the preapproval of non-audit services by the external auditor to one or more independent members of the audit committee, who are required to report back to the full committee. The audit committee may also establish specific policies and procedures for engaging the auditor to perform non-audit services.

Some Practical Steps

Some of the practical steps that an audit committee should take include the following:

- Members of the committee should become familiar with the corporation's operations to help them understand how those operations are reflected in the financial statements (e.g., the decision to own versus lease assets will affect the way some items appear in financial statements).
- The committee should discuss with the external auditor any differences of opinion between management and the auditor, and significant issues affecting financial reporting.
- The committee should monitor the external audit function by:
  - reviewing and discussing the audit plan directly with the auditor before the audit in order to conclude, on an informed basis, that the nature and scope of the review are reasonable in the circumstances; and
  - discussing the results of the audit directly with the auditor (without management present) to determine whether
  - there are special problem areas to which the auditor will be referring in the auditor's letter to management;
  - the auditor is satisfied with the nature and scope of the auditor's examination;
  - the auditor has received full cooperation of management and staff of the corporation; and
  - the auditor is satisfied with the quality and effectiveness of the financial recording procedures and systems.
- A similar approach should be used for any review of interim statements that the auditor may perform (recognizing that such a review is narrower in scope than an audit). The committee should also discuss the interim and annual financial statements and MD&A in detail with management.
- If appropriate after a committee meeting, the committee should fully report its material recommendations to the board, providing conclusions and the financial information it reviewed in reaching its conclusions, to enable the directors to be satisfied with the recommendations.

With regard to federal financial institutions, the audit committee's role is discussed further in part 12, below.

Nominating/Corporate Governance Committee

The best practices guidelines issued by the Canadian securities regulators recommend the following:

- The board appoint a nominating committee that is composed entirely of independent directors.

- The nominating committee adopt a written charter that sets out its responsibilities.
- The nominating committee be responsible for ensuring that the board comprises an appropriate complement of suitably experienced directors.

Many corporations also establish a governance committee that is responsible for the corporation's overall approach to corporate governance. The current practice is typically to create a combined nominating and governance committee, since board membership and composition are important elements of a corporate governance system.

Compensation Committee and Compensation Issues

Compensation Committee

The best practice guidelines issued by the Canadian securities regulators recommend the following:

- The board appoint a compensation committee that is composed entirely of independent directors.
- The compensation committee adopt a written charter that sets out its responsibilities.
- The compensation committee be responsible for:
  - determining the CEO's compensation or making a recommendation to the board in this respect (after having evaluated the CEO's performance in meeting the corporate goals and objectives that are relevant to compensation and that the committee has set for the CEO);
  - making recommendations to the board regarding the compensation of other officers and directors;
  - making recommendations to the board regarding incentive-compensation plans and equity-based plans; and
  - reviewing executive compensation disclosure in the proxy circular and in offering documents before their public release.
- The committee also be authorized to engage and compensate outside advisers.

Executive Compensation Issues and Disclosure

Directors increasingly face criticism from shareholders for what they perceive as excessive compensation packages for executives. In some cases, approval of excessive compensation packages has also been considered a breach of directors' fiduciary duties. It is therefore important that board members, particularly those on the compensation committee, understand in detail and are comfortable with all elements of a corporation's executive compensation plan. Areas of focus should include:

- Base salary payments exceeding appropriate benchmarks (such as peer group compensation levels);
- Bonus compensation packages that are not tied to rigorous measures of a corporation's success;
- Compensation plans that may unduly focus on short-term performance instead of the longer term; and

- The terms and triggers of severance packages.

Directors must also be satisfied that any grants of equity securities (including options) to management are made at times, and for exercise prices, that meet the requirements of corporate and securities laws and stock exchange rules.

Each year, public corporations are required to report on the individual compensation of the CEO, the CFO and the three highest-paid executive officers (other than the CEO and the CFO). Retirement benefits must also be quantified, and potential payments on termination or a change of control must be described. The directors' compensation must also be disclosed. The reporting requirements for executive compensation are detailed and complex, and cover matters such as equity compensation, options, long-term incentive payments and perquisites.

If a public corporation has a compensation committee, that committee would typically oversee reporting on compensation (and, as noted above, this is a recommended best practice of securities regulators), particularly if an issuer has a complex compensation regime.

Say on Pay

Canadian corporations are increasingly granting investors the right to participate in non-binding annual votes regarding executive compensation (known as "say on pay"). Many corporations are doing so as a result of shareholder proposals advocating this type of vote. Compensation committees (and boards) should carefully consider any approach to say on pay, since it is expected that such votes will carry significant practical weight, even though, technically, they are advisory.

Other Committees

Boards of directors now generally establish special committees of independent directors to deal with specific transactions in which some of the board members may have or be perceived to have a conflict of interest. The role of special committees is discussed in part 5, below.

As discussed in part 12, boards of directors of federally regulated financial institutions are required to have a *standing* special committee, called a "conduct review committee," to review related party transactions.

The board may establish other committees for specific purposes (such as an environmental compliance committee or pension committee) or for general purposes (such as an executive committee).

New Canadian Governance Proposal

Canadian securities regulators have published a draft proposal that would extensively alter the current approach to governance in Canada, including the test for director independence (under which, even for audit committee purposes, relationships with a controlling shareholder would not alone vitiate independence). The thrust of the proposal is to give issuers much more discretion in their approach to governance by adopting a principles-based regime. It is not clear at this stage (as of July 2009) whether,

or when, the proposal will be implemented, but we expect that in any event it would not take effect before 2010.

Proxy Voting Guidelines Adopted by Institutional Shareholders

Institutional shareholders in Canada have followed the lead of their U.S. counterparts by adopting and publishing proxy voting/corporate governance guidelines that focus to a considerable extent on corporate governance practices. These institutional shareholders include the Canada Pension Plan Investment Board, the Ontario Municipal Employees Retirement System, the Ontario Teachers' Pension Plan Board and the Caisse de dépôt et placement du Québec. The Canadian Coalition for Good Governance, representing a significant number of Canadian institutional shareholders, promotes best governance practices and the alignment of the interests of boards and management with those of the shareholders.

The guidelines and standards of these institutions set out their policies on a broad range of corporate governance and related issues and the manner in which the institution is likely to vote on them, including the composition of boards and board committees, executive compensation, takeover protection, shareholder rights and social responsibility.

Proxy service firms such as RiskMetrics (formerly Institutional Shareholder Services) are also active in Canadian public markets. Their voting recommendations can carry significant weight with their clients on similar issues.

Majority Voting Rules

A corporate governance practice is developing among corporations whereby directors who receive less than a majority of favourable votes from shareholders in an uncontested election are asked to resign. This is, however, by no means a standard practice. In considering whether to adopt this practice, corporations should first examine their own particular board complement, including the number of independent board members, and financially literate board members for audit committee purposes. This is necessary because a corporation must ensure that it can implement such a practice while continuing to comply with all legal requirements regarding board composition.

Canadian Issuers Listed in the United States

Canadian issuers that access the U.S. capital markets by offering securities to U.S. investors and/or becoming listed on a U.S. stock exchange become subject to ongoing reporting and corporate governance obligations imposed by the Securities and Exchange Commission (SEC) and the relevant stock exchange. The most significant difference between U.S. and Canadian laws in this area is that U.S. law requires an auditor's attestation of an issuer's internal financial controls, but Canadian law does not. Otherwise, U.S. reporting and governance obligations are very similar to Canadian requirements. Where there are cross-border differences in corporate governance standards, U.S. stock exchanges generally permit issuers to follow Canadian practices in lieu of complying with U.S. requirements, as long as issuers disclose the differences.

3

Directors’ Duties

The Directors’ Duty of Loyalty and Good Faith

Directors, as fiduciaries, are held to a very high standard of loyalty and good faith in their conduct in relation to the corporation. This duty has been codified by Canadian corporate statutes in the requirement that directors “act honestly and in good faith with a view to the best interests of the corporation.”

In practical terms, the duty of loyalty and good faith requires the following:

- Each director must act with a view to the best interests of the corporation, as opposed to his or her own interests or those of a particular constituency of the corporation (such as a controlling shareholder, a class of shareholders, creditors or others, even if they have nominated the director).
- Each director must recognize and deal appropriately with conflicts of interest. This can be challenging for a director who serves on more than one board; each director should regularly review his or her other commitments and have discussions with the chair to determine whether there is a conflict.
- A director may not divulge confidential information received in his or her capacity as a director and may not use that information for personal advantage or for the advantage of another corporation of which he or she is a director.
- A director may not divert opportunities for personal benefit or the benefit of another business if they could be of interest to the corporation.

While the courts are reluctant to second-guess business decisions made by directors, they do not hesitate to intervene when the decision is tainted by conflict of interest or when the process or result suggests bad faith.

Conflicts of Interest

The Canadian corporate statutes specifically require each director (and officer) to disclose in writing (or request to have entered in the minutes of the board meeting) the nature and extent of the director’s interest in a material contract or transaction or in a proposed one with the corporation. This provision applies if the director is a party to the contract or transaction or is a director or officer of, or has a material interest in, a party to the contract or transaction.

In the situation described above, the statutes require the director to refrain from voting on a resolution to approve the contract or transaction except in narrow circumstances (such as a contract relating primarily to

the director’s compensation, a contract for indemnification or insurance or a contract with an affiliate). The OBCA also requires the director not to take part in any discussions regarding the contract or transaction.

A director who fails to declare an interest properly (that is, in sufficient detail and at the right time) or fails to abstain from voting can be called to account for any gain or profit from the contract or transaction, and the contract or transaction can be voided.

In practice, a prudent director who finds himself or herself in a potential conflict situation will go beyond these statutory requirements to ensure that there is no appearance of a conflict of interest that could taint the board’s deliberations on the matter in question.

In an extreme case, if a conflict cannot be dealt with through disclosure, not voting or absenting himself or herself from the deliberations, the director may have to resign.

The Directors’ Duty of Care, Diligence and Skill

In addition to imposing a duty of loyalty and good faith, Canadian corporate statutes require directors to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.’

Accordingly, a director’s conduct will be measured against an objective standard. In practical terms, the directors’ duty of care, diligence and skill requires the following:

- Directors’ decisions must be *informed* judgments - decisions that take into account all material information reasonably available in the circumstances.
- Directors must take due care to consider the relevant information; this means, for instance, that they must take the necessary time to review key documents or summaries and to deliberate.
- Directors must take an active and direct role in key matters such as decisions concerning diversification, financings and acquisitions, and divestitures. Directors should not be passive in these important matters.
- Directors who rely on information provided by management or others should ask themselves whether they have reasonable grounds for doing so (see discussion under “Reliance on Management, Financial Statements and Experts” in part 2, above).
- Having regard to the very important role of the audit committee (as discussed in part 2), directors should satisfy themselves, through the audit committee reports to the board and related discussions, that the committee is discharging its responsibilities effectively.

The Supreme Court of Canada has held that the duty of care is owed not only to the corporation but potentially also to stakeholders directly. These rulings significantly increase directors’ exposure to claims alleging that they have breached their duty of care.

The Business Judgment Rule

In assessing whether or not directors have fulfilled their duty of care in particular cases, the Supreme Court of Canada (in *Peoples Department Stores Inc. (Trustee of) v. Wise*) has stated that courts should be reluctant to second-guess business judgments made by unconflicted directors when the decision in question falls within the range of reasonableness:

> Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known. In determining whether directors have acted in a manner that breached the duty of care, it is worth repeating that perfection is not demanded. Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.

To establish that the business judgment rule has been satisfied, directors should ensure that the process whereby they make their decisions is appropriately documented, including in minutes of directors' meetings. These minutes should reflect not only the decision reached by the directors but also what they considered in reaching the decision. In part 4, below, under "Advice for Directors as a Result of *BCE*," we describe in further detail important elements of a board process. Although the discussion in that section focuses on an acquisition context, many of the elements apply equally to all contexts.

The Oppression Remedy

The oppression remedy found in Canadian corporate statutes is an important weapon available to corporate stakeholders who feel they have been treated unfairly.

The oppression remedy entitles corporate stakeholders to apply to a court to seek financial compensation and other remedies, including against directors personally, if the corporation or its affiliates, or a director of the corporation or its affiliates, acts in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any securityholder, creditor, or director or officer.

The oppression remedy is a broad and flexible remedy that enables corporate stakeholders to challenge corporate actions that are contrary to "reasonable expectations," even when no breach of legal rights has occurred. Reasonable expectations can be created of public corporations through commercial practice, through commitments made by formal or informal agreements and through corporate disclosure.

Although it is possible for a court to find that directors acted oppressively, directors have the protection of the business judgment rule in most cases that allege oppression. Absent self-dealing or the appropriation of corporate opportunities, directors do not normally face personal liability under the oppression remedy.

Personal Liability for Tort Claims

Recent decisions in Ontario indicate that directors and officers can be sued personally in tort for their conduct as directors,[5] even when they have acted in good faith and within the scope of their duties, and when they believed they were acting in the best interests of the corporations they serve.

Therefore, directors and officers of corporations in Ontario need to look beyond the already considerable list of potential statutory liabilities imposed on directors and officers, and consider whether or not the actions they take on behalf of their corporations could expose them to personal liability under common law tort claims.

The fact that corporations may act only through their directors, officers, employees and others continues to make this area of law somewhat murky. Litigants sometimes make allegations of wrongdoing directly against directors and officers, seeking to gain a tactical advantage or in the hope of accessing insurance when the corporation itself has insufficient assets or is insolvent. Until recently, Ontario courts tended to rebuff these attempts to implicate directors personally in claims that in substance concern the conduct of the corporation.

The trend to greater protection has been reversed. The Court of Appeal for Ontario has stated:

> [T]here is no principled basis for protecting the [directors] from liability for their alleged conduct on the basis that such conduct was in pursuance of the interests of the corporation.

In other words, if directors or officers do anything to a third party that would be actionable if they had done it on their own behalf, they cannot escape personal liability merely because they did it on behalf of the corporation in performing their corporate responsibilities.

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[5] "Tort" includes, for example, negligence or negligent misrepresentation.

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Directors' Duties in a Takeover Bid or an Acquisition

When directors consider their duties in the face of a takeover bid or in connection with a possible acquisition, the starting points are the directors' duties of loyalty and care (these are discussed in part 3). Until a Supreme Court of Canada decision issued in December 2008, it was uncertain exactly how those duties would be applied in a takeover bid or an acquisition context. That decision, in *BCE Inc. v. 1976 Debentureholders*, shed some light on this question. However, the *BCE* decision leaves directors without much practical guidance on how to reconcile the conflicts that often arise, in a change-of-control context, between the interests of the different constituencies that make up the corporation.

The BCE Decision

The fundamental issue in *BCE* was the scope of the directors' duties in the context of a proposed acquisition of BCE Inc. in which the shareholders' interest (obtaining the highest possible price for their shares) conflicted with the bondholders' interest (maintaining the credit rating and value of their bonds). Was it sufficient for directors, in discharging their duties, to maximize value for shareholders while respecting the contractual rights of the bondholders, as BCE submitted? Or were the directors required to consider the broader economic interests of the bondholders and to give those interests some weight, as the bondholders submitted?

According to the Supreme Court, even in a change-of-control context, acting with a view to "the best interests of the corporation" requires directors to consider the interests of all stakeholders and not to equate the interests of the corporation with the interests of shareholders alone. This decision therefore explicitly rejects the view that the directors of a target corporation have an overriding duty to maximize shareholder value in a change-of-control transaction. However, having rejected that view of the duty of directors, the Court endorsed the conduct of the BCE board, which defined its objective precisely as maximizing shareholder value, subject only to satisfying the contractual obligations to bondholders. While largely accepting the bondholders' view of the directors' duties, the Court ruled against the bondholders because, on the facts of *BCE*, they had no reasonable expectation to anything more than the contractual rights enshrined in the trust indenture under which their bonds were issued.

Although the Court has thereby sent an arguably mixed message, the decision makes one thing clear: the decisions of directors are to be given a high degree of deference. As long as directors get their process right, respect the legal rights and reasonable expectations of all securityholders and creditors, and consider the interests of all stakeholders affected by their decision, their balancing of conflicting stakeholder interests

in determining the best interests of the corporation will be treated as a matter of business judgment that is not to be overturned by the courts unless it falls outside the range of reasonableness.

Advice for Directors as a Result of BCE

The *BCE* decision confirms the importance of the process whereby directors make their decisions. A good process will normally include the following key elements:

- **Asking the right question.** Directors must not equate the interests of the corporation with the interests of shareholders and seek only to maximize shareholder value. They must consider the interests and reasonable expectations of all affected stakeholders, while treading very carefully if they are considering sacrificing shareholder value in the interests of creditor or other stakeholder interests.

- **Unconflicted decision making.** Directors' decisions must be made by non-conflicted directors.

- **Informed decision making.** Directors must make their decisions on the basis of all material information reasonably available in the circumstances.
  - They must obtain appropriate financial, legal and other advice, including possibly obtaining a fairness opinion from a financial expert regarding the fairness to shareholders (and, potentially, other securityholders) of any transaction.[6]
  - They must canvass all alternatives reasonably available to the corporation in the circumstances.
  - They must be informed of the background to all important decisions they are asked to make, including the business and financial implications of any actions or transactions.
  - They must ask questions of management and independent advisers about all aspects of the matter under consideration, including the information and assumptions on which the advice was based.

- **Due deliberation.** Directors must have adequate time to deliberate in reaching decisions, which will often require more than a single meeting of directors to consider an extraordinary transaction.
  - They should be given advance notice of significant matters and draft copies of key documents or summaries of the material provisions of those documents.
  - They should be given an opportunity before a meeting to read the operative documents or summaries so that they can come to the meeting prepared.

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[6] With respect to fairness opinions, note that a hearing panel of the Ontario Securities Commission has stated its view that a fairness opinion prepared by a financial adviser who is being paid a success fee does not assist an independent committee (and by extension the board as a whole) in demonstrating the due care they have taken in complying with their fiduciary duties. In this regard, boards may want to consider, in a particular circumstance, obtaining a fairness opinion from a second firm of financial advisers that is not entitled to a success fee on the transaction.

- **Appropriate record keeping.** Records should be kept of directors' decisions, enabling them to demonstrate that they discharged their duties of loyalty and care.
  - Minutes of directors' meetings should summarize the matters discussed and the advice obtained so that it is clear that the directors were focusing on the important issues, proceeding in a thoughtful manner and acting with a view to the best interest of the corporation.
  - Records of directors' meetings should be maintained and should include copies of all relevant materials provided to board members to assist with their decision making.

The Role of Securities Regulators

Canadian securities regulators are authorized under securities laws to regulate takeover bids or other acquisition transactions involving any transfers of shares. In doing so, they may intervene where they consider that a bid or acquisition does not comply with securities laws or that intervention is in the public interest. Securities regulators have adopted a policy that includes the following principles:

- **Protecting bona fide interests of shareholders.** The primary objective of the takeover bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target corporation.
- **Encouraging auctions.** Canadian securities regulatory authorities consider that unrestricted auctions produce the most desirable results.
- **Shareholders making takeover bid decisions.** The decision to respond to a takeover bid is ultimately one that the shareholders have the right to make.

It is unclear what Canadian securities regulators would do if directors followed a course of action they believed was in the best interests of the corporation as described in *BCE*, but which conflicted with the foregoing principles. As noted above, any such action should be approached cautiously and with the advice of counsel.

Additional Considerations for Directors

Directors in an acquisition process should also bear in mind the following:

- **Dilution issues for acquirors.** Acquirors should be aware that the TSX is considering a rule that would require a listed corporation's shareholders to approve the acquisition of a publicly listed target if dilution to acquiror shareholders would exceed 50%. The Ontario Securities Commission (OSC) has (unexpectedly) required such an approval in a case in which dilution would have exceeded 100%.
- **Providing information to shareholders.** A key responsibility of target directors is to provide adequate information to shareholders to allow them to make a fully informed decision about a bid or an acquisition proposal.
- **Making a recommendation.** Directors are also required to make a meaningful recommendation to shareholders to accept or reject a bid or an acquisition. If they do not make a recommendation, they must provide reasons why they are not doing so.

- **Seeking out alternatives.** Depending on the circumstances, the directors may conclude that it is appropriate to seek out alternative transactions more favourable to the target corporation than an existing bid or acquisition. Directors must carefully consider whether support or merger agreements are flexible enough to allow for consideration of any superior offers that may arise (see also the discussion below under "Fiduciary-Out Clauses and Breakup Fees").
- **Forming an independent special committee.** In cases of bids or acquisition proposals that would involve management board members who have, or are perceived to have, conflicts of interest, directors should consider creating an independent special committee as described in more detail in part 5, below.

Defensive Tactics/Poison Pills

One of the most difficult problems faced by target corporation directors in managing a takeover bid process is the extent to which they may take defensive measures against a bid that they believe may not be in the best interests of the corporation.

Relying on the *BCE* decision, a target corporation board could attempt to justify a much more robust defence to a hostile bid than has previously been thought consistent with the directors' fiduciary duties. For example, a target corporation board could defend the continued deployment of a shareholder rights plan, or "poison pill," in the face of a highly leveraged offer that envisaged the breakup of the target. The grounds for such action would be that the success of the offer, while value-maximizing for shareholders, was nonetheless contrary to the best interests of the corporation (which would cease to exist if the offer succeeded) and of non-shareholder constituencies (e.g., employees who could lose their jobs), who are entitled to fair treatment. It remains to be seen whether securities regulators, who (as described above) have given primacy to the protection of target corporation shareholder interests in the regulation of takeover bids, would tolerate the sacrificing of shareholder value in the name of fairness to other stakeholders.

Poison pills consist of certain rights granted to existing shareholders (either before or in the face of an unsolicited bid or as part of a target's takeover preparedness program). These rights allow existing shareholders (other than the bidder) to either purchase target shares at a substantial discount or require the corporation to buy them back at a substantial premium, in each case rendering an unsolicited bid uneconomic because of massive dilution of the bidder's position. These plans have generally been cease-traded by Canadian securities regulators after approximately 45 days, the plans having served their purpose of buying some time for the target board to formulate its response to an unsolicited bid. A target board may be given more latitude by securities regulators to maintain a rights plan when one of the bidders has a significant ownership position that could block other bidders and reduce the likelihood of another offer being put forward.

Fiduciary-Out Clauses and Breakup Fees

It is customary to include a "no-shop" clause in an agreement between an acquiror and a target. This provision prevents a target from soliciting competing offers. However, this clause is combined with a "fiduciary-out clause," which entitles the target's board to consider unsolicited alternative transactions, if

necessary, to fulfill its fiduciary duties in the particular circumstance. Before a target exercises its fiduciary out, the agreement may require that it give the incumbent bidder a chance to match the competing offer.

A relatively new feature of some deals, particularly deals involving financial buyers, is a “go-shop” clause. A go-shop provision gives a target a specified period of time – usually 30 to 60 days after signing a transaction agreement – to actively seek out a more favourable transaction. A target may negotiate a go-shop if an auction has not been conducted and the board believes, in exercising its fiduciary duties, that it needs to check the market to ensure that the deal agreed to with the incumbent acquiror represents the best deal in the circumstances.

If a target decides to abandon a transaction in favour of an alternative transaction, it will usually have to pay a breakup fee, also known as a “termination fee,” to the incumbent bidder, typically in the range of 2%–3% of the transaction’s value. Breakup fees may justifiably be somewhat higher for smaller deals, when the absolute value of the breakup fee is still reasonable or when an auction has been conducted and the target’s value has therefore been tested by the market. In that case, the board may be more confident that vigorously protecting the deal is in the best interests of the corporation.

Setting breakup fees too high could violate the target board’s fiduciary duties by unduly discouraging other potential acquirors from proposing a better transaction. Many institutional shareholders’ voting guidelines require them to reject transactions involving excessive breakup fees.

Reverse breakup fees have also been seen in recent transactions when the target was not initially for sale or when it was necessary to compensate the target for additional regulatory or legal risks (as compared with an alternative transaction) or for the risk that the bidder will be unable to obtain financing to complete the transaction. In many cases, these reverse breakup fees are structured as the sole remedy for a bidder’s failure to close, making the deal effectively an option for the bidder, and the fee the option price.

5

Independent Special Committees of the Board

When to Create a Special Committee

Whenever a board of directors must make a decision that presents a conflict of interest to some of its members, it should adopt an appropriate process for dealing with that conflict. In some cases, directors may simply declare their conflict and abstain from voting, and/or withdraw from the board's deliberations. However, in other cases those steps may seem inadequate.

The alternative is for the board to create a special committee of independent directors and ask for its recommendations. Courts have long accepted this practice and have rejected shareholder challenges to decisions supported by such committees if the committees were genuinely independent and did a thorough and complete analysis in making their recommendations.

Regulators also favour and promote the use of independent special committees. The Ontario and Quebec securities regulators have encouraged (and in some cases require) the use of ad hoc special committees to consider, among other things, related party transactions. In addition, as discussed in part 12, federal financial institutions are required to have a *standing* special committee, called the "conduct review committee,' to review related party transactions.

The decisions whether and when to create a special committee depend on the specific facts. Common circumstances in which a special committee is established include a proposal to acquire the corporation that involves management, and a sale of significant assets of the corporation to a major shareholder. But a special committee may also be desirable in many circumstances that are much less clear-cut. Management and the members of the board should be sensitive to identifying situations in which an independent special committee is appropriate or necessary.

Often a significant reason to constitute a special committee is the recognition that the board itself is too big and unwieldy to supervise an intensive process that will require numerous meetings that are often called on short notice. If the special committee is not being established to deal with conflicts, this should be clear in the board mandate establishing the special committee.

Basic Duties and Obligations of Directors Not Affected

Independent directors who serve on an ad hoc special committee (or a standing special committee of a financial institution) are first and foremost directors of their respective corporations. In that capacity, they

are bound by the duty of loyalty and good faith and the duty of care, diligence and skill (discussed in parts 3 and 4, above). The important point is that directors who serve on this type of committee must do so in the broader context of discharging their duties and fulfilling their obligations as directors of the corporation as a whole.

Creating an Independent Special Committee

The threshold matter in constituting a special committee is determining who the independent directors are. This will vary depending on the nature of the transaction or the matter being considered. For instance, directors of a controlling shareholder or management directors would not be regarded as independent when they are proposing a change-of-control transaction. Sometimes it is not possible to appoint a special committee that is completely independent. In these cases, practical judgments must be made.

Once it has been determined which directors are independent in the particular circumstance, the basic principles for creating an ad hoc special committee can be stated simply. The committee should be established with as much lead time as possible. Its mandate should be settled to the satisfaction of the committee members and should make clear whether the committee is authorized to negotiate with interested parties. Any special compensation for committee members should be arranged at the outset, and it is important for maintaining the objectivity of the committee that any compensation not depend on a particular outcome (i.e., no success fees or defence fees). The committee should not have authority to make final decisions but should simply make recommendations to the board.

In addition to establishing the mandate of the independent special committee, the board should authorize the special committee to appoint independent financial and legal advisers, if it wishes to do so.

The committee should establish the scope of the engagement of its advisers, agree with them about the scope of their proposed activities and establish a timetable for reporting to the committee.

Independent Valuator

If a formal valuation is required by securities rules, the disclosure document to be sent to shareholders must state that the valuator has been determined to be qualified and independent, and the document must disclose the basis of that determination.

As to the independence of valuators, a number of factors may be relevant, including:

- The potential for bias as a result of the valuator’s involvement (i) in an evaluation, appraisal or review of the financial status of the corporation or a related party; or (ii) as a lead or co-lead underwriter during the previous 24 months; and
- The materiality to the valuator of its financial interest in the completion of the proposed transaction or in future business involving the corporation or a related party.

The OSC takes the view that an actual conflict of interest and lack of independence exist if the valuator’s compensation includes a success fee on completion of the transaction.

Committee Process

The committee should follow an appropriate process in reaching its decisions so that it can demonstrate to a court that it has exercised an independent and informed judgment. Although the process will vary according to the nature of the matter being considered, when a material transaction involves issues about value, the independent special committee should generally take these steps:

- Seek guidance from outside counsel regarding the committee's legal responsibilities in the context of the proposed transaction.
- Consider hiring a financial adviser to provide advice about fair value and a fairness opinion, or a valuation if one is required by securities laws (ensuring that the adviser's compensation arrangement does not vitiate its independence).
- Ensure that it has had access to all relevant information, either directly or through its advisers, including all information regarding the interests of any particular party.
- Understand the business and financial implications of the proposed transaction.
- Review the terms of the transaction and ensure that all elements likely to affect the committee's assessment of the fairness and appropriateness of the transaction are disclosed to the committee.
- Have the committee's advisers attend the relevant portions of meetings held to discuss the committee's recommendations.
- Review with the financial adviser the various potential methods of valuation, obtain the financial adviser's opinion on the analyses and relevant comparative data and discuss with the financial adviser its approach to value.
- Discuss with the financial adviser the form of the adviser's opinion and the underlying investigations, assumptions and methodology so that the committee has reasonable grounds for relying on the opinion.
- Consider all prior and current valuations and offers that are required to be disclosed under securities laws.
- Negotiate the terms of the transaction if that is part of its mandate and is desirable and, in any event, supervise the carrying out of the transaction to ensure that it is completed on the agreed terms.
- Consider the alternatives to the proposed transaction.
- Prepare a report and its recommendations to the full board.
- Ensure that the committee takes adequate time to develop and consider its conclusions.
- Ensure that the minutes of the committee meetings
  - reflect the fact that the committee members have been counselled on their legal duties and responsibilities; and

- summarize the matters discussed and the advice obtained so that it is clear that the committee members are focusing on the important issues, proceeding in a thoughtful and informed manner and acting with a view to the best interests of the corporation.

As noted above, a special committee typically makes recommendations to the full board with respect to the particular transaction it is considering. The board should consider in detail the special committee's recommendations and should receive a presentation by any financial adviser to the special committee, if that is relevant. The purpose of these procedures is to enable the board, in reaching its conclusions on the particular transaction, to establish reasonable reliance on the report of the special committee and on the advice of its financial adviser.

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Securities Offerings

This part discusses the potential liability that directors face when a corporation offers securities to the public in a capital-raising transaction by way of a prospectus. Similar principles apply to securities distributed to the public by selling securityholders; to securities offered as consideration in a takeover bid; and, in certain circumstances, to securities privately offered by way of an offering memorandum.

Directors' Liability

Prospectuses that are used to offer securities to investors must be accurate and complete in all material respects. The prospectus must not misstate or omit "material facts" about the business or financial condition of the corporation whose securities are being offered.

Under Ontario securities law, the definition of "material fact" incorporates a move-the-market standard. A fact is material if it would reasonably be expected to have a significant effect on the market price or value of the issuer's securities.

Each director of the corporation issuing securities under a prospectus is *personally liable* to the investors for losses suffered if the prospectus misstates or omits a material fact.

The Due Diligence Defence

A director will not be liable for a misrepresentation (including a misstatement or omission) in a prospectus if he or she conducted a reasonable investigation to provide the basis for a conclusion that there was no misrepresentation.

What can directors do to minimize the likelihood that a prospectus contains a misrepresentation and maximize the likelihood that they may rely on the due diligence defence?

- Directors must familiarize themselves with the process used to prepare the prospectus so that they may reasonably conclude that it was prepared carefully.
- Directors should satisfy themselves that the offering is being conducted by experienced representatives of the underwriters, appropriate representatives of the corporation and experienced lawyers for the corporation and the underwriters; directors should also ensure that the corporation's auditor actively participates in the process and provides any required consents.
- Before the board meeting at which the prospectus is to be reviewed and approved, the senior officer responsible for its preparation should send a draft to the directors and invite any questions or

comments so that the draft may be improved if necessary. The period between the directors' receiving the draft document and the board meeting should be sufficient to enable the directors to adequately review the document and provide feedback.

- Directors must examine the prospectus for accuracy and completeness and to compare the description of the corporation contained in it against their own knowledge of the corporation's business and financial condition.
- Directors should be satisfied with the process by which the prospectus was prepared and that the disclosure contained therein was checked against the statutory disclosure standard. In particular, the directors should confirm that the officers responsible for the areas of business described in the prospectus read and had an opportunity to revise the contents of the prospectus.
- Directors should satisfy themselves that the underwriters conducted a reasonable investigation of the business, financial condition and prospects of the corporation and discussed any significant issues with representatives of the corporation so that the underwriters were able to arrive at informed decisions and opinions regarding the disclosure in the prospectus.
- The directors may also ask the corporation's management and lawyers to undertake an additional review or analysis of specific issues to guide the board in its disclosure judgments.

7

Timely and Continuous Disclosure and Disclosure Policies

Complying with Securities Laws

Canadian securities laws require public corporations in Canada to publicly file with securities regulators various financial and non-financial information throughout the year. Public corporations must also issue a news release immediately after a “material change” has occurred in the corporation’s business or affairs, and file a material change report “forthwith” and in any event within 10 days.

Under Ontario securities law, the definition of “material change” reflects a move-the-market standard. A “material change” is

> a change in the business, operations or capital of the corporation that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the corporation or a decision to implement such a change made by the board of directors of the corporation or by senior management of the corporation who believe that confirmation of the decision by the board of directors is probable.

Although the corporation is responsible for complying with its continuous disclosure obligations, directors (or officers) who authorize, permit or acquiesce in a breach of these obligations may be subject to enforcement proceedings (which could lead to sanctions, fines and even imprisonment), in addition to possible civil liability, discussed further below.

The TSX’s timely disclosure policy goes further than securities law in that it requires listed corporations to disclose “material information,” not just “material changes.” Material information is

> any information relating to the business and affairs of a company that results in or would reasonably be expected to result in a significant change in the market price or value of any of the company’s listed securities.

Under the TSX approach, therefore, information may be material even if it does not reflect or signify a *change* in the business and affairs of a corporation.

Disclosing Material Changes

Approval of Important Matters and News Releases

When the board approves a material transaction or matter, it should take steps to ensure that an accurate news release is issued immediately through a wire service and that a material change report is filed with securities regulators on a timely basis. Whenever possible (subject to any timing constraints), the board or a board committee should review and approve each such news release before its publication. Directors should act immediately if there is uncertainty about whether any material information publicly disseminated by the corporation (whether by news release or otherwise) contains a misrepresentation.

Materiality Determinations

The definition of “material change” requires directors and officers to make a judgment, either alone or with the advice of capital markets professionals, about whether certain information will be considered important to investors and have an impact on the market price of the corporation’s securities. Making this decision is particularly difficult during the negotiation of a significant transaction, when the transaction is approaching agreement but is not yet fully settled. Directors and officers often seek advice from the corporation’s lawyers on both when and what to disclose. While acting in accordance with legal advice is sensible, that alone is not a shield against liability, since courts will judge the actual correctness of the disclosure decision. In its decision in *Kerr v. Danier Leather Inc.*, the Supreme Court of Canada said that the business judgment rule (described in part 3, above) will not protect good faith but incorrect disclosure decisions by directors.

There is no bright-line test for determining when a material change has occurred in the context of a significant transaction. However, the OSC, in *Re AiT Advanced Information Technologies Corp.*, noted that an important factor in determining whether a material change has occurred is whether both parties are committed to proceeding with the transaction and whether a substantial likelihood exists that the transaction will be completed. The OSC also noted that if a board’s governance process is effective and the board is properly motivated in making determinations about material changes, the OSC will be reluctant to interfere with the resulting disclosure decisions.

Outside the context of significant transactions, in *Danier*, the Supreme Court observed that financial results often fluctuate in response to factors that are external to the issuer, and suggested that these external factors are not material changes *to the corporation* and therefore do not trigger disclosure obligations. Notwithstanding this aspect of the *Danier* decision, a board should proceed extremely cautiously if it proposes not to make public disclosure concerning a development affecting the corporation on the basis that it was driven by external factors.

The TSX timely disclosure policy contemplates that in limited circumstances, disclosure of material information may be delayed and kept confidential temporarily if the immediate release of the information

would be unduly detrimental to the interests of the corporation.[7] These are some of the circumstances mentioned in the policy:·

- Disclosure would prejudice the issuer's ability to pursue specific and limited objectives or to complete a transaction or series of transactions that are underway – for example, premature disclosure that a corporation intends to purchase a significant asset may increase the cost of the asset.
- Disclosure would provide competitors with confidential corporate information that would be of significant benefit to them.
- Disclosure would prejudice the successful completion of ongoing negotiations.

When disclosure of material information is delayed on this basis, the following applies:

- The corporation must take precautions to ensure that the information remains confidential; if confidentiality is lost or rumours begin to circulate, the corporation will generally be required to make immediate public disclosure. In addition, divulging the information on a selective basis may constitute illegal tipping.
- The corporation should take steps to ensure that a blackout period is instituted to prevent intentional or inadvertent illegal insider trading in the corporation's securities by directors, officers and other persons in a special relationship with the corporation.

Other Continuous Disclosure

There are numerous other continuous disclosure requirements for public corporations in Canada. Some of the documents that must be publicly filed with securities regulators include audited, annual financial statements and accompanying management's discussion and analysis (MD&A), an annual information form (AIF), interim financial statements and accompanying MD&A, proxy circulars, business acquisition reports and material contracts. These and other continuous disclosure documents must be carefully prepared, particularly in view of the potential liability for continuous disclosure violations, discussed in the next section.

Liability for Continuous Disclosure

The *Securities Act* (Ontario) establishes a regime that gives anyone who, during a continuous disclosure violation, buys or sells a security in the secondary markets a statutory right of action for damages against the corporation, certain of its officers and directors and, depending on the circumstances, controlling shareholders and experts.

A disclosure violation begins when a misrepresentation about the corporation is made in a public document or a public oral statement, or when the corporation fails to make timely disclosure of a material change in

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[7] If the material information also constitutes a material change, a procedure under securities legislation permits non-disclosure of the material change for a short period of time if a confidential material change report is filed. The filing of a confidential material change report should be done only on the advice of counsel. See the discussion in this part under "Liability for Continuous Disclosure, Confidential Material Change Reports."

its affairs. The disclosure violation ends when the disclosure is properly made. The right of action for damages is not restricted to Ontario residents and is most likely to be exercised through class actions. This remedy is in addition to (i) any enforcement proceedings that a securities regulator may commence for an alleged disclosure violation, and (ii) other remedies that may be available under tort law.

Directors are potentially liable for any misrepresentation in a document, subject to the availability of a defence such as the due diligence defence discussed below. They are, however, liable for a misrepresentation in a public oral statement or the failure to make timely disclosure only if they "authorized, permitted or acquiesced in" the disclosure violation.

In response to concerns over the possibility of "strike suits" (unmeritorious claims intended to result in a quick settlement), the legislation requires leave of the court before an action may be brought. The court must be satisfied that (i) the action is being brought in good faith, and (ii) the plaintiff has a reasonable prospect of success at trial. Court approval is also required for any proposed settlement of any action.

Recovery Limits

The maximum amount that may be recovered from each director or officer is $25,000 or half of his or her compensation for the past 12 months, whichever is greater. The limit does not apply to those who knowingly violate the disclosure rules. Accordingly, plaintiffs who bring actions against directors in connection with these provisions often allege that a disclosure violation was deliberate.

The limit on recovery from a public corporation itself is higher: $1 million or 5% of the corporation's market capitalization, whichever is greater.

Public Presentations and Oral Statements

Liability under the continuous disclosure regime also applies to oral statements that are made in circumstances that would induce a reasonable person to believe that the information will be generally disclosed.

As a result, public presentations and oral statements by people who speak on behalf of the corporation, including directors and officers, must be carefully planned. Impromptu remarks should be avoided. It is important to make and retain electronic or other records of public presentations and oral statements, such as those made on conference calls with analysts. Those responsible for corporate disclosure should be intimately familiar with those records, recognizing them as a significant aspect of the corporation's disclosure record. After speeches and other communications of information to third parties, the senior officers involved should consider whether any misrepresentations were made and take corrective action accordingly.

Confidential Material Change Reports

Since the civil liability regime came into effect at the end of 2005, more issuers have considered the option of filing confidential material change reports under provisions of securities laws that existed before then but were seldom used. If management of a corporation believes that a pending material event may have crystallized to the point of being a "material change" but public disclosure would be unduly detrimental, the

corporation can instead file a confidential material change report. Doing so will offer significant protection from liability in respect of disclosure violations. However, the civil liability regime has not resulted in a significant increase in the incidence of confidential filings, partly because a securities regulator or claimant may still challenge the reasonableness of the corporation's opinion that public disclosure would be unduly detrimental.

Directors of issuers listed in multiple jurisdictions also need to consider whether the laws of that jurisdiction permit this approach.

Correcting Misrepresentations or the Failure to Make Timely Disclosure

It is important for directors and officers to immediately take steps to remedy any misrepresentation or failure to make timely disclosure. This will limit exposure to damages, because the shorter the disclosure violation period, the fewer the investors who will have traded during the period. In addition, a director or an officer who learns of a misrepresentation or failure to make timely disclosure will have a defence to liability if he or she immediately notifies the board and ensures that corrective action is taken. The nature of the corrective action will depend on the circumstances.

Due Diligence Defence

All potential defendants may avoid disclosure liability if they can demonstrate that they took reasonable care. For this due diligence defence to be successful, the director, officer or other defendant must prove that he or she conducted (or caused to be conducted) a reasonable investigation before the release of a document, the making of a public oral statement or the failure to make timely disclosure, and had no reasonable grounds to believe that a disclosure violation would occur.

One of the factors a court will consider in deciding if a defendant has satisfied his or her due diligence defence is whether the corporation had in place a suitable system to ensure compliance with disclosure obligations. Therefore, adherence to an appropriately designed, written disclosure policy is essential for every public corporation and this will be the cornerstone in demonstrating due diligence and establishing a defence to liability for any disclosure violation. A disclosure policy is also a key element of the disclosure controls and procedures that the CEO and CFO must certify as part of their certification of annual and interim filings. The directors should ensure that suitable policies and procedures are adopted, and that compliance is monitored. A disclosure policy should authorize specified individuals to make statements on behalf of the corporation. The policy should also set forth a process and assign responsibility for reviewing public disclosure and determining when material changes have occurred. The substance and purpose of corporate disclosure policies is discussed in greater detail below, under "Corporate Disclosure Policies.'

Forward-Looking Statements

A defence is also available against allegations of misrepresentations in forward-looking information. For directors to get the benefit of the defence, certain requirements must be satisfied: there must be a reasonable basis for any forecast or projection; the material factors and assumptions that were used in preparing the forward-looking information must be disclosed; and reasonable cautionary language must be included (proximate to the forward-looking information) identifying the material factors that could cause actual results to vary from the forward-looking information. To help satisfy these requirements in the case

of forward-looking information presented orally, the issuer may refer the audience to its publicly available documents filed with securities regulators.

The OSC has issued a policy statement that explains how it approaches the interpretation of certain aspects of the defence. First, the cautionary language must be customized to the particular circumstances, not be boilerplate. Second, the more closely tied a particular risk factor or assumption is to a particular forecast, projection or conclusion, the closer those risks and assumptions should appear in relation to the forward-looking information. When there is a close tie, the risks and assumptions may need to immediately precede or follow the forward-looking information, or a cross-reference may be required to appropriately link the information. However, the defence does not require issuers to include every conceivable risk that might cause forward-looking information not to come true; instead, the disclosure should focus on significant and reasonably foreseeable risk factors. Finally, whether or not there is a "reasonable basis" for forward-looking information will depend in part on the reasonableness of the underlying assumptions, the inquiries made and process followed in preparing and reviewing the forward-looking information.

Other Defences

If a report of an accountant, actuary, appraiser, auditor, engineer or other expert is included, summarized or quoted in a public document or a public oral statement, the corporation should obtain the written consent of that expert for such publication or statement. When disclosure is based on a third party's disclosure that is publicly filed with securities regulators, the disclosure should explicitly refer to the source of the information. Defences are available in each of these cases.

Protecting Against Liability

Directors of public corporations potentially face personal liability under Ontario's civil liability regime for disclosure violations. It would be prudent for directors, particularly outside directors, to assess whether their oversight of management and direct involvement in continuous disclosure matters are sufficient both to reduce the risk that claims will be made and, if claims are made, to establish that the directors have met an appropriate standard of diligence.

Selective Disclosure

It is an offence under Canadian securities laws for any insider to communicate material information on a selective basis (that is, to certain market participants and not to others), other than in the necessary course of business. This means that it is illegal to communicate to analysts and other market participants information that could reasonably be expected to significantly affect the market price or value of an issuer's securities without first or simultaneously issuing a news release making general and broad disclosure of this information. The difficulty, of course, is in determining whether or not particular information, if publicly disclosed, would significantly affect an issuer's stock price. In making that decision, issuers must consider both quantitative and qualitative issues. For instance, a relatively minor failure to meet earnings guidance could have a substantial market impact. Unfortunately, when information is disclosed on a selective basis, unusual market activity may make it immediately apparent that market participants considered the information to be material; hindsight is difficult to refute when the market has spoken.

When material information is communicated on a selective basis in the necessary course of business, it is also illegal for the recipient of that information to communicate it to others or to trade in the corporation's securities before the information has been generally disclosed. If the public corporation believes that there has been a "leak,' or that material information has otherwise been disclosed on a selective basis in circumstances in which the information may be improperly used by market participants, the public corporation has an obligation to immediately issue a news release making general disclosure.

It is important for issuers to obtain legal advice about whether the selective communication of information is required in the necessary course of business. For instance, communications to rating agencies or a controlling shareholder may be justified as taking place in the necessary course of business, but communications to analysts or other market participants generally are not.

Best Practices

Canadian securities regulators have published best practice guidelines for issuers on (i) providing investors with fair access to information and (ii) avoiding selective disclosure in their dealings with analysts and institutional investors. The regulators' goal is to encourage corporations to aim for best practices in their disclosure regime, not just a minimum level of compliance with the law. These best practices include

- Having a written disclosure policy;
- Limiting the number of authorized spokespersons;
- Giving the public access to conference calls with analysts; and
- Using the Internet and other technologies to better disseminate information, by posting information on the corporation's website concurrently with issuing a news release or filing information with securities regulators.

It is important that boards of directors and management assess whether their corporation's current practices and procedures in these areas are adequate, and that they review these matters periodically.

Corporate Disclosure Policies

Generally, a corporate disclosure policy should specify the legal obligations of the corporation and its employees to ensure that the corporation complies with its disclosure obligations, manages confidential information and prevents selective disclosure. Corporate attitudes have undergone a sea change in this area over the last several years. Many Canadian public corporations have recognized the importance of adopting such policies and have put these in place; a corporation that does not have an appropriate policy is out of step and exposed to regulatory and other action. Directors need not play a direct role in managing confidential corporate information. Rather, they should ensure that an appropriate policy is in place and should receive periodic reports from management regarding significant issues related to the operation of the policy, including information about any selective disclosure made in contravention of securities law.

Key objectives of the disclosure policy are to ensure that employees are aware of applicable legal requirements, know how to conduct themselves in day-to-day business and know what to do when the rules

are breached. When created and adhered to, a disclosure policy will be instrumental in establishing a due diligence defence to civil liability claims for disclosure violations, as discussed earlier in this part. It is important to ensure that the policy adopted can and will be complied with. No issuer should ever put itself in a position in which a corporate policy is adopted but not complied with or complied with only after a breach.

What should be dealt with in a corporate disclosure policy? Although disclosure policies will vary from one corporation to another, every policy should do at least the following:

- Establish procedures to ensure that (i) material information that is required to be disclosed is done so in a timely manner; and (ii) information that is disclosed publicly, including to analysts (whether orally or in writing), does not contain a misrepresentation and is not misleading.
- Clearly articulate the legal obligations of the corporation and its officers and employees with respect to confidential corporate information. Directors and others with knowledge of material facts must be aware of the applicable insider trading rules and must not trade in the corporation's securities while possessing that information until it has been generally disclosed. More generally, officers and employees should know what is prohibited, what their responsibilities are and what to do when the policy is breached.
- Establish that selective disclosure of material information (as described earlier in this part, under "Selective Disclosure") is not permitted. When any selective disclosure of corporate financial information is contemplated, the policy should require advance vetting of that information by appropriate senior officers who are familiar with the issuer's public disclosure record to ensure that the information is not material. If selective disclosure of material information occurs, the policy should require immediate issuance of a news release.
- Identify spokespersons of the corporation who are authorized to communicate with third parties such as analysts, media and investors, and require that all communications be made by only these spokespersons. Whenever information is disclosed by more than one individual, it should be done so consistently.
- Require that earnings and other financial guidance be given initially only in news releases that are broadly disseminated. This would include news releases announcing quarterly and annual financial results. Such guidance should be discussed in a conference call only following the issuance of the relevant news release. The policy should require that any such conference call be fully accessible to all shareholders and other market participants. Make clear that there is no commitment to update earnings guidance beyond any periodic reconciliations with actual results and any disclosure that may be required by securities laws.

The above list does not set out all of the matters that may be included in a corporate disclosure policy. Rather, it is a list of the core principles.

8

Insider Reporting and Insider Trading

Directors Are Insiders

Under Canadian securities legislation, a director is an "insider" of:

- The corporation that the director serves;
- Every other corporation of which the corporation that the director serves beneficially owns or exercises control or direction over more than 10% of the voting shares; and
- Corporations of which the director (or corporations controlled[8] by the director) beneficially owns or exercises control or direction over more than 10% of the voting shares.[9]

Insider Reporting

Initial Reports

Within 10 days of being elected a director of a public corporation, each director who beneficially owns or exercises control or direction over any securities of the corporation must file an initial insider report with securities regulatory authorities. This report is filed electronically through the Internet, using the System for Electronic Disclosure by Insiders (SEDI). A nil initial report need not be filed.

If a corporation (private or public) that a director serves acquires more than 10% of the voting securities of a public corporation, the director will be deemed to have been an insider of the acquired public corporation for the previous six months (or any shorter period that the person was a director of the acquiring corporation). A director must file any insider reports that are required to be filed as a result.

Conversely, if more than 10% of a corporation that a director serves is acquired by a public corporation, the director will be deemed to have been an insider of the acquiring public corporation for the previous six

[8] For example, through the ownership of more than 50% of the voting shares.

[9] We have not given a complete list because the rules are highly technical. For example, in some cases, a director could be viewed as beneficially owning securities that are owned in the name of the director's spouse. Similarly, the director could exercise control or direction over securities owned in the name of and beneficially owned by the director's spouse.

months (or any such shorter period that the director was a director of the acquired corporation) and will have to file the relevant insider reports.

Report of Changes

Each director must disclose any changes in his or her beneficial ownership of, or control or direction over, securities of each public corporation of which the director is, or is deemed to be, an insider. Each sale, purchase or other change must be reported separately (that is, sales, purchases and other changes are not netted). Directors must disclose beneficial ownership of, or control or direction over, *all* securities of the issuer - debt or equity, voting or non-voting, common or preferred. This obligation extends to any agreement, arrangement or understanding that, directly or indirectly, has the effect of altering a director's economic interest in a security or an economic exposure to a corporation. Directors should report both the grant and the exercise of options. Ownership is deemed to pass on the date of trade and not on the settlement date.

The report must be filed within 10 days of the date of the change. These changes are also reported electronically on SEDI.

Illegal Insider Trading

Canadian securities legislation prohibits insiders and other persons or corporations in a "special relationship" with a public corporation from purchasing or selling securities of the corporation while possessing knowledge of a material fact or material change that has not been generally disclosed.

Prohibition on Tipping

Directors and other persons in a special relationship with a public corporation may not inform, other than in the necessary course of business, other persons or corporations of material facts or material changes with respect to the corporation before they have been generally disclosed.

Fines and Imprisonment

Canadian securities law imposes relatively harsh penalties for breaches of the rules governing insider trading. For example, under Ontario securities law, the minimum fine is equal to the profit made or loss avoided, and the maximum fine is equal to the greater of $5 million and triple the profit made or loss avoided. Penalties can also include imprisonment for up to five years less one day.

Illegal insider trading may also result in a hearing before securities regulators. Sanctions can include a requirement that all profits from insider trading be disgorged, an administrative penalty of up to $1 million, loss of trading rights and a prohibition on serving as a director or officer of a public corporation.

Accountable to the Corporation

A director who breaches the above restrictions regarding a corporation's securities may be accountable to the corporation for any resulting benefit or advantage. This is in addition to the other liabilities discussed in this part, including the civil liability referred to below.

Civil Liability

Directors who are found to have breached the trading prohibition will also be liable for the amount of damages (determined by reference to the trading prices of the relevant securities) suffered by the purchaser or seller of the securities, unless:

- The director reasonably believed that the material fact or material change had been generally disclosed; or
- The material fact or material change was known or ought reasonably to have been known to the seller or purchaser.

Special Prohibitions Under the CBCA

Directors of public corporations incorporated under the *Canada Business Corporations Act* (CBCA), as well as directors of their subsidiaries, are prohibited from:

- Short-selling any share of the public corporation or any of its affiliates; and
- Selling a call or buying a put in respect of any security of the corporation or any of the corporation's affiliates.

Criminal Code Offences

A person is guilty of an indictable offence and liable to imprisonment for a maximum term of 10 years if he or she, directly or indirectly, buys or sells a security knowingly using inside information that he or she:

(i) Possesses by virtue of being a shareholder of the issuer of that security;

(ii) Possesses by virtue of or obtained in the course of a business or professional relationship with the issuer of that security;

(iii) Possesses by virtue of or obtained in the course of a proposed takeover, reorganization, amalgamation, merger or similar business combination with that issuer;

(iv) Possesses by virtue of or obtained in the course of his or her employment, office, duties or occupation with the issuer or a person referred to in (i) or (iii) above; or

(v) Obtained from a person who possesses or obtained the information in a manner referred to in (i) to (iv) above.

The *Criminal Code* defines "inside information" as information relating to or affecting the issuer of a security or a security that has been issued, or is about to be issued, and that:

- Has not been generally disclosed; and
- Could reasonably be expected to significantly affect the market price or value of a security of the issuer.

The *Criminal Code* also makes tipping an offence. A person is guilty of:

- An indictable offence and liable to imprisonment for a maximum term of five years; or
- An offence punishable on summary conviction

if that person knowingly conveys to another person inside information that he or she possesses or obtained in a manner referred to above, knowing that there is a risk that the other person will use the information to buy or sell, directly or indirectly, a security to which the information relates, or that the person may convey the information to another person who may buy or sell such a security.

9

Competition Law Compliance

Enforcement

Canada's *Competition Act* (the Act) contains criminal and civil provisions proscribing a variety of anti-competitive conducts, including:

- Conspiracies, agreements or arrangements to fix prices, to allocate customers or markets, or to control, prevent or lessen product production or supply;
- Bid rigging;
- Deceptive marketing and telemarketing;
- Abuse of dominant position; and
- Other business practices, such as refusals to deal, price maintenance, exclusive dealing and tied selling, where these practices have a significant adverse effect on competition.

Many of the offences under the Act are punishable by jail terms of up to 14 years and fines at the discretion of the court. In addition, certain reviewable conduct is subject to the imposition of administrative monetary penalties of up to $10 million.

Canada's Competition Bureau enforces the various provisions of the Act with a view to both punishing offenders and deterring anti-competitive conduct. Enforcement includes prosecuting individuals, such as employees, officers and directors of corporations, who contravene the Act. In some cases, when a corporation commits an offence under the Act, any officer or director of the corporation who was in a position to direct or influence the policies of the corporation in respect of the prohibited conduct is deemed to be a party to and guilty of the offence.

To prevent or minimize the risk of contravening the Act and to detect any contraventions that may occur, boards of directors should require their corporations to implement credible and effective antitrust compliance programs.

Implementing a Compliance Program

In its information bulletin on compliance programs, the Competition Bureau describes a credible and effective program as follows:

> To be credible, a program must demonstrate the company's commitment to conducting business in conformity with the law. To be effective, it needs to inform employees about their legal duties, the need for compliance with internal policies and procedures as well as the potential costs, actual and opportunity (i.e., the cost of not complying with the law), of contravening the law and the harm it may cause to the Canadian economy.

A successful implementation of a compliance program requires the following:

- Management must understand the importance and necessity of the program and support it so that employees take it seriously.
- The person responsible for implementing and overseeing the program should be a high-level individual with a significant role in the corporation (i.e., someone who can be expected to administer and enforce the program diligently).
- The program should reflect and deal with the particular risks facing the corporation. If a corporation operates in several jurisdictions, its compliance program should reflect the competition law requirements of each of those jurisdictions.

An effective compliance program should include: (i) a formal compliance manual that is provided to each relevant employee or other representative of the corporation (and its subsidiaries); and (ii) formal training programs that are conducted on a regular basis. Upon completing their training, participants should be in a position to certify that they understand the competition laws that govern their conduct and that of the corporation; they should agree to adhere to those laws and to the corporation's policies, principles and rules for compliance; and they should acknowledge that failure to so comply will constitute grounds for disciplinary action, including dismissal.

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Pensions

Pension benefits legislation requires employers who sponsor defined benefit plans to fund future benefit liabilities on a current basis and requires employers who sponsor defined contribution plans to make the required contributions monthly. The legislation also imposes standards of care and other obligations on the administrator of the pension plan and fund. The administrator is generally responsible for the investment of pension fund assets and day-to-day plan operations. Employers often act as both sponsor and administrator.

Generally, failure to comply with the standards of care and other obligations under pension benefits legislation is a quasi-criminal offence. In Ontario, a person is liable for a fine of up to $100,000 for the first conviction and $200,000 for each subsequent conviction. Directors who participate or acquiesce in, or fail to, take all reasonable care in the circumstances to prevent, the commission of an offence are liable for fines of up to the same amounts. If the offence relates to a funding obligation, a court may, in addition to any fine imposed, order the employer and possibly the directors of the employer to pay the unpaid amounts.

Effective oversight, management and administration of a pension plan and pension fund investments should form part of a properly designed pension plan governance structure. A primary goal of this structure is to ensure that the pension plan is properly administered and that the fiduciary obligations of the pension administrator to the plan members are met, thereby reducing the risk of directors' liability under pension benefits legislation. In 2004, the Canadian Association of Pension Supervisory Authorities released two separate guidelines that, although voluntary, establish benchmarks against which pension governance structures are generally measured. One of the guidelines applies only to "capital accumulation plans," or CAPs (including defined contribution pension plans and group registered retirement savings plans), and it recommended that plan administrators ensure compliance with the guidelines by December 31, 2005.

A proper pension governance structure calls for the following:

- Mandates regarding pension plan and fund administration are clearly described for the board, pension committee, senior officers, investment managers, pension fund trustees and other participants in the governance process;
- Procedures to implement the mandates (such as regular pension committee meetings) are established and the plan governance structure is reviewed on a regular basis;
- Documentation that evidences implementation of plan administration procedures is developed and maintained;
- The board or pension committee receives and considers regular reports (including those relating to proper funding of the plan, compliance and performance measurement and monitoring of all

participants in the governance structure with decision-making authority) from others involved in plan administration;

- For CAP plans, selection of investment options are made according to risk, diversification and liquidity factors; members are provided with appropriate information and decision-making tools; service providers are selected and measured against established criteria; and all fees, expenses and penalties borne by the members are disclosed;
- Checks and balances (e.g., to avoid unauthorized investments) are developed; and
- The governance process is made transparent through communication to plan members, beneficiaries and other stakeholders.

11

Environmental and Occupational Health and Safety Liabilities

Liability for environmental and occupational health and safety matters is of concern to directors of many corporations. These matters can be particularly important because of the potential for significant penal sanctions for corporations and directors. Directors' liability insurance policies may not cover such sanctions. In addition, the potential reputational impact can be severe.

Directors' Environmental Responsibilities

The following are directors' main environmental responsibilities.

- Federal and certain provincial (e.g., Ontario) statutes impose a duty on directors and officers to take all reasonable care to prevent the corporations they serve from unlawfully discharging contaminants into the natural environment and contravening other environmental laws.
- Reasonable care typically includes establishing an environmental policy, implementing a proper system to prevent contraventions of environmental laws and taking reasonable steps to monitor compliance with the policy and the effective operation of the system.
- Directors should ensure that management is appropriately correcting any problems identified in a timely manner. Directors should receive periodic reports from management on the operation of the system. These reports would typically focus on activities that have resulted in, or that may result in, the corporation's potential or actual non-compliance with environmental laws.
- Although attention to environmental concerns can reduce the potential for liability, it also creates a risk of increased liability if directors are aware of problems and do not deal with them. Clear assignment of environmental responsibilities and effective follow-up can minimize this risk.

Practical Steps for Directors

In corporations where environmental concerns are relevant, boards should consider taking the following practical steps:

- Establish an environmental policy that reflects the corporation's commitment to environmental protection and review the policy annually;

- Assign responsibility for the implementation of the environmental policy to a senior executive (possibly the CEO) in the corporation, with instructions to ensure proper delegation of environmental matters to competent and qualified persons;
- Require the establishment of an environmental management system that is sufficient, given the nature and location of the corporation's business, to ensure compliance with environmental laws and the corporation's environmental policy;
- Require that the environmental management system monitor the emergence of new environmental laws (e.g., greenhouse gas emission reduction requirements) and assesses the impact of such laws on the corporation;
- Review reports on environmental performance and compliance, investigations and legal proceedings, assessment programs and other key issues. In instances of material non-compliance or issues of significant concern, review the adequacy of the corporation's responses to those situations and require follow-up reports to ensure that any concerns identified by the review have been properly addressed or resolved.
- Review reports of any event or condition involving the potential for significant environmental damage, risk to public health or safety, significant public controversy or any other significant liability and review and approve management's action plans relating to these events and conditions;
- Review and consider issues of significant environmental concern, including long-term environmental liabilities, for all projects, acquisitions and dispositions that require board approval or that have the potential for major environmental liability;
- Review reports on environmental issues of major current public concern and on emerging public and legal issues; and
- Consider the establishment, and oversee the adequacy of the implementation, of an independent system to periodically audit the corporation's environmental management system and policy.

Reporting Guidelines

The following list is an example of appropriate reporting guidelines for submitting reports to the board, in keeping with the above requirements:

Report as soon as possible

- Any event or condition that has or is likely to have significant environmental or health impacts or to lead to significant safety risks, attract public attention (especially at the provincial or national level) or have significant financial implications.

Report quarterly

- Environmental compliance and significant investigations or legal proceedings;
- Progress on the conduct of each regular environmental performance assessment and the significant recommendations resulting from the assessment; and

- Key issues or significant concerns associated with ongoing operations, major projects or future plans.

Report annually

- Progress in the implementation of the environmental policy;
- The effectiveness of the environmental management system;
- The strategic and annual plan for further improvements to the environmental management and operating systems of the corporation;
- Budgets regarding environmental operating, capital and research expenditures;
- Plans for the conduct of environmental performance assessments, including the key issues to be dealt with, for the coming year; and
- Long-term liabilities and the adequacy of financial provisions as recorded in the accounts of the corporation.

Occupational Health and Safety

Directors must take all reasonable care to ensure that the corporation they serve protects the health and safety of its workers and complies with Ontario's *Occupational Health and Safety Act* (OHSA), or equivalent statutes in certain other provinces and territories, and all regulations made or orders issued under these statutes. Discharging these duties may include the establishment of a health and safety committee, the implementation of worker safety plans and compliance with orders of the Ministry of Labour.

In several cases, directors, as well as the corporations they serve, have been convicted of offences for violating the OHSA, most often when a particular director had significant involvement with the operations of the corporation and did not take all reasonable care to ensure that the corporation complied with the OHSA. And in rare instances, directors may be held criminally responsible under the *Criminal Code* for workplace health and safety matters.

As with environmental matters, in the area of occupational health and safety, it is prudent in many cases for directors to require management to implement a compliance program to protect the corporation's workers and to ensure that there are regular reports to verify that the program is effective.

12

Directors of Federal Financial Institutions

This part focuses on the special duties and responsibilities of directors of banks under the *Bank Act*, federally incorporated trust or loan companies under the *Trust and Loan Companies Act* and federally incorporated insurance companies under the *Insurance Companies Act*. Each is referred to as a "financial institution," and their governing statutes are referred to collectively in this part as the "legislation."

The Standard of Care and Qualification

Directors of a financial institution are required to manage or supervise the management of the business and affairs of the financial institution.

As in the case of other corporations, directors are expected to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

At least one-third of the directors must be independent of or "unaffiliated" with the financial institution. Furthermore, the following must be resident Canadians at the time of each director's election or appointment: at least one-half of the directors of a financial institution that is a subsidiary of a foreign financial institution and a majority of the directors of any other financial institution.

Required Committees and Procedures

The legislation specifically requires directors to establish:

- An audit committee having explicit duties (see "Audit Committee" below);
- A conduct review committee to ensure that related party transactions are monitored and appropriately evaluated (see "Conduct Review Committee" below);
- Procedures to resolve conflicts of interest, and a committee to monitor these procedures;
- Procedures to provide disclosure of information to customers as required by the legislation and for dealing with customer complaints, and a committee to monitor these procedures;
- Investment and lending policies, standards and procedures; and

- In the case of insurance companies that issue participating (par)policies, rules for determining the dividends or bonuses to be paid to par policyholders.[10]

Audit Committee

The majority of the members of the audit committee must be independent of or "unaffiliated" with the financial institution and none of the members of this committee may be officers or employees of the financial institution or its subsidiaries. In addition to the matters discussed above in part 2 of this guide, audit committees of financial institutions have explicit statutory responsibilities to:

- Review the financial institution's annual statement (which is required by the legislation) before the directors approve it;
- Require management of the financial institution to implement and maintain appropriate internal control procedures;
- Review such returns of the financial institution as the Office of the Superintendent of Financial Institutions (OSFI) may specify;
- Review, evaluate and approve the procedures noted above;
- Review any investments and transactions that could adversely affect the well-being of the financial institution that the auditor or any officer of the financial institution may bring to the attention of the committee;
- Meet with the auditor to discuss the annual statement, the returns and transactions referred to above;
- Meet with management and the chief internal auditor, or the officer or employee acting in a similar capacity, to discuss the effectiveness of the internal control procedures established for the financial institution.

In the case of insurance companies, the committee is required to discuss with the chief actuary those areas of financial presentation and disclosure that the actuary is responsible for.

The key message for members of audit committees of financial institutions is to obtain confirmation that both the external and the internal audit and accounting procedures of the financial institution are conducted in a proper and effective manner and in accordance with all applicable standards.

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[10] Bill C-57, which was enacted on November 25, 2005 contains, among numerous other amendments to the legislation, requirements for insurance companies aimed at increasing the protection of par policyholders. However, the section of this bill that proposed the following requirements for directors has not been proclaimed in force: (i) to establish a policy regarding the management of par accounts; and (ii) to establish criteria for changing the premium or charge for insurance, amount of insurance or surrender value in respect of adjustable policies.

Conduct Review Committee

The legislation contains a broad prohibition on transactions with related parties. Certain transactions are permitted if they are in accordance with procedures established by management, are on market terms and are, in some cases, reviewed by the conduct review committee. The majority of the members of the conduct review committee must be independent of or “unaffiliated” with the financial institution, and none of the members of this committee may be officers or employees of the financial institution or a subsidiary of the financial institution. Generally, the responsibilities of the conduct review committee are to

- Require management to establish procedures for the review of transactions involving related parties of the financial institution (“related party” is elaborately defined and includes a parent or an affiliate of the institution, other than a subsidiary; a director or senior officer of the institution or its parent; and a corporation controlled by a director or senior officer);
- Examine the procedures established by management for reviewing related party transactions and assess their effectiveness;
- Review the practices of the financial institution to ensure that any transactions with related parties that may have a material effect on the financial institution’s stability or solvency are identified;
- After each committee meeting, report to the board on all transactions and other matters reviewed by the committee; and
- Ensure that the proceedings of the committee are reported annually to OSFI.

Guidance from the Office of the Superintendent of Financial Institutions

Corporate Governance Guideline

OSFI has developed a *Corporate Governance Guideline* that describes for directors of financial institutions its expectations for corporate governance and the factors it takes into account in assessing the quality of governance of a financial institution.

In addition to providing general information about the responsibilities of directors and hallmarks of effective corporate governance, this guideline highlights the attributes of effective board performance in relation to risk management, the establishment of an adequate and sound system of internal controls and the development of independent oversight functions (including an elaboration on the role of the audit committee). OSFI’s guideline is intended to complement any other guidance on corporate governance issued by, among others, securities regulators, stock exchanges and governmental and international bodies. OSFI expects financial institutions to be aware of emerging best practices that are applicable to their institution.

Supervisory Framework

As part of the *Supervisory Framework*, which was developed by OSFI to provide a process to assess the safety and soundness of financial institutions, OSFI assesses the board of directors of financial institutions. Within the assessment criteria that OSFI uses in this respect, and which provide insight into the factors OSFI looks at in determining the quality and strength of a financial institution's board of directors, OSFI states the following regarding the role of the board of directors:

> The Board of Directors is responsible for providing stewardship and oversight of management and operations of the institution. Its key responsibilities include:
>
> - Reviewing and approving organizational structure and controls;
> - Ensuring that management is qualified and competent;
> - Reviewing and approving business objectives, strategies and plans;
> - Reviewing and approving policies for major activities;
> - Providing for an independent assessment of, and reporting on the effectiveness of, organizational and procedural controls;
> - Monitoring performance against business objectives, strategies and plans;
> - Reviewing and approving sound corporate governance policies; and
> - Obtaining reasonable assurance on a regular basis that the institution is in control.

Sound Business and Financial Practices

Reflecting the emphasis on prudential regulation of financial institutions, OSFI has issued guidance on sound business and financial practices. As part of such guidance, which is set out in a number of guidelines, OSFI expects directors of all financial institutions to ensure that appropriate controls are in place to manage the reputational risks to their corporations. Furthermore, OSFI expressly requires directors to oversee the establishment of and adherence to policies and procedures regarding:

- Deterring and detecting money laundering and terrorist financing activities;
- Outsourcing business activities, functions and processes;
- The risk-control framework that manages interest rate risk, in the case of banks and trust and loan companies; and
- Complying with all legislation, regulations and regulatory directives applicable to activities of financial institutions and their subsidiaries worldwide.

Furthermore, as part of its guidance on sound business and financial practices, OSFI has issued a guideline setting out principles to assist financial institutions in establishing policies and procedures to conduct assessments of the suitability and integrity of their directors and senior management; these assessments must be conducted on an ongoing and regular basis.

13

Insolvent Corporations

Corporate insolvency exposes directors to heightened personal liability under various federal and provincial statutes. In cases of insolvency, certain claims may be made against the corporation's directors, including

- Claims by employees arising from their employment, for example, wages and vacation pay (although such amounts may constitute priority payments under the *Wage Earner Protection Program Act* (Canada));
- Claims by the corporation (and trustees in bankruptcy) against directors who vote for or consent to corporate finance actions such as loans, guarantees, payment of dividends or redemption of shares;
- Claims by the government for the deduction, remittance and payment of taxes, including the goods and services tax and provincial sales taxes, and for certain payroll and other source deductions; and
- Claims arising out of other statutory trusts or from the improper winding up of a corporation's business.

In addition, directors have a duty to ensure that the corporation carries on business only if it can meet its liabilities as they become due and there is a reasonable expectation of newly incurred obligations being satisfied. Directors may be personally liable if the corporation conducts business while insolvent.

Directors of insolvent corporations also face heightened risk under their corporate duties of loyalty and of care. As always, they must consider the interests of creditors of the corporation as well as the interests of shareholders and other stakeholders. However, in these circumstances, the interests of these different constituencies are most likely to conflict; therefore, these directors face the difficulty of balancing competing interests with no clear criteria to guide their decision making.

In addition, directors of an insolvent corporation face very difficult decisions regarding the timely disclosure of material information.

Directors of corporations experiencing financial difficulty should take special steps to protect themselves. Any actions that would involve changes to the corporation's financial course of conduct should be taken well before the financial difficulties of the corporation become acute, since changes made while the corporation is insolvent, or on the eve of insolvency, may later be reviewed and even reversed. In addition to taking necessary steps to demonstrate due care and diligence in all their decision making, directors may need to take special steps that include the following:

- Ensure that the financial reporting and payment systems of the corporation are operating appropriately and that reports are being received by directors on an accelerated basis so that they can monitor key financial numbers on a real-time basis;

- Ensure that segregated trust accounts and remittance procedures have been established to adequately provide for wages, taxes, source deductions and other statutory trusts;
- Have all directors' dissents to board resolutions noted in the minutes of the meeting;
- Obtain insolvency advice and prepare for the possibility of a filing under the *Companies' Creditors Arrangement Act* (Canada) or the *Bankruptcy and Insolvency Act* (Canada);
- Review the scope of any directors' liability insurance and give notice under such insurance of any potential claims;
- Ensure that the corporation has entered into an indemnity agreement with each director, as permitted by the by-laws and the relevant governing statute; recognize, however, that in an insolvency, such an indemnity may be of no value;
- Where appropriate, charge unencumbered corporate assets, or obtain third-party guarantees or indemnities, to stand as security for the payment of amounts for which directors may be liable;
- Retain independent legal counsel to advise the directors on how to protect against personal liability in the circumstances; and
- If necessary, resign.

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Indemnities and Liability Insurance

Canadian corporate statutes contain provisions permitting corporate indemnification and liability insurance for directors. These are an important means of risk management for directors.

Indemnities

The *Canada Business Corporations Act* (CBCA) and the Ontario *Business Corporations Act* (OBCA) have both *permissive* and *mandatory* indemnification provisions. For example, the CBCA and OBCA *permit* the corporation to indemnify a director or former director against all reasonably incurred costs, including amounts paid to settle a legal action or satisfy a judgment, where the person is, or was, involved by reason of being or having been a director if:

(i) He or she acted honestly and in good faith[11] with a view to the best interests of the corporation; and

(ii) In the case of a criminal or an administrative action or proceeding that is enforced by a monetary penalty, he or she had reasonable grounds for believing that his or her conduct was lawful.

With the approval of a court, a corporation may also indemnify directors and former directors against all costs and expenses reasonably incurred in respect of actions by or on behalf of the corporation if the above conditions are met.

Under the *mandatory* indemnification provisions in the CBCA and OBCA, a director or former director is *entitled* to an indemnity from the corporation for all amounts reasonably incurred to defend an action or proceeding in which he or she is made a party by reason of being or having been a director, if the person seeking indemnity:

- Was not judged by the court or other competent authority to have committed any fault or omitted to do anything he or she ought to have done; and
- Fulfils the conditions set out in (i) and (ii) above.

[11] It is usually assumed that the director acted in good faith. In cases in which the corporation suggests that this requirement has not been met, directors can help establish “good faith” by demonstrating that they sought legal advice before acting and were reasonable in relying on that advice.

Much discussion has taken place about the meaning, scope and overall adequacy of these statutory provisions. It is generally agreed that it is prudent for directors to augment these statutory provisions through the corporate by-laws, a contract of indemnity and directors' liability insurance, as discussed below.

By-laws

It has become common practice for corporations in Canada to include an indemnification provision in their by-laws that mirrors the statutory indemnities but that substitutes mandatory language ("the corporation *shall* indemnify ... ") for the permissive language of the statute ("the corporation *may* indemnify ... ") .

Although it is desirable for directors to ensure that the corporation's by-laws contain this kind of mandatory indemnification provision, reliance on the by-laws alone is not a desirable risk-management strategy for at least two reasons:

- Since the by-laws simply mirror the applicable statute, any uncertainties and ambiguities in the interpretation of the statute will be imported into the by-laws; and
- Since the indemnification provision in the by-laws does not constitute a contract between the director and the corporation, the director cannot prevent the provisions of the by-laws from being changed. If the by-laws are changed, there may be some uncertainty as to which provision should apply to a particular claim. This has come back to haunt directors in situations in which by-laws were changed after the directors left the board.

Contracts of Indemnity

It is generally agreed that because of the ambiguities and uncertainties in relying on the indemnity in a corporate by-law, directors should obtain a contractual indemnity from the corporation. It is important that the contract of indemnity be reviewed from the perspective of the directors.

It would be prudent for a person who has been asked by a corporation to act as a director of another corporation to obtain a contractual indemnity from the asking corporation, as well as from the other corporation the director will serve.

Directors should seek to obtain as broad an indemnity as possible and to resolve any uncertainties or ambiguities of the statutory scheme in the director's favour. Although there are no hard and fast rules, contracts of indemnity should cover the following:

- Broadly define the "costs, charges and expenses" for which directors are to be indemnified - for example, legal and other professional fees, out-of-pocket expenses for attending discoveries, trials and hearings and the costs involved in enforcing indemnification should be fully recoverable;
- Expand the scope of an "action or proceeding" for which indemnification is to be provided to include any civil, criminal, administrative, investigative or other claim, action, suit or proceeding - whether anticipated, threatened, pending, commenced, formal or informal, continuing or completed - and any appeals;

- Extend the scope of the indemnification to circumstances in which the director is made a witness or participant in a proceeding;
- Include a process for advances of funds to cover ongoing costs and expenses, before the final disposition of the relevant claim, action or proceeding,[12]- as long as the director provides a written undertaking to repay the advances if a court determines he or she is not legally entitled to be indemnified; and
- Require the corporation to purchase and maintain insurance that provides an appropriate level of directors' liability coverage.

Note that from time to time securities regulators, in reaching settlements with directors or officers regarding alleged securities law violations, have made it a condition of settlement that the directors or officers not seek indemnification from the corporation.

Directors' Liability Insurance

The OBCA and the CBCA permit a corporation to purchase and maintain insurance for the benefit of current and former directors. Such insurance is important because it provides broader protection where indemnification may not be available - for example, amounts paid to settle actions brought against the director by or on behalf of the corporation he or she serves when court approval for such payment has not been received. A claim for indemnity under a corporate by-law or contract for indemnity may also be worthless if the corporation becomes insolvent.

The Nature of Directors' Liability Insurance

Directors' liability insurance is provided primarily on a claims-made basis (as opposed to an occurrence basis). Claims-made policies cover directors for claims that are actually *made* during the life of the policy and usually for a short period after the policy expires, regardless of when the events giving rise to the claim occurred.

Typically, claims-made policies are renewed each year with the same insurer. If the policy is not renewed, coverage is lost with respect to claims that have not actually been made. Because new insurers sometimes exclude all claims arising from wrongful acts that *occurred* in the past, corporations should not switch insurers or allow policies to lapse without speaking to a reputable insurance adviser about the availability of adequate coverage.

Exclusions

A directors' liability policy is not a standard form contract. The policy must be carefully reviewed to determine the adequacy of the coverage and the appropriateness of the exclusions and endorsements. We

[12] Both the CBCA and OBCA have been amended in recent years to expressly permit the advance of costs. These statutes also require a director to repay the monies if he or she does not ultimately meet the statutory standard necessary for indemnification.

recommend that directors select a board member to review any policy, to participate in the negotiation of the terms of the policy and to report to the board.

Full disclosure of material information (e.g., circumstances that may give rise to a future claim) is crucial when applying for insurance because failure to do so may give the insurer the right to deny coverage in the event of a claim. To protect innocent directors in the event of a misrepresentation, policies should contain a severability clause that ensures that statements made by the corporation or any single director are not imputed to any other director. Similarly, if coverage is excluded as a result of actions of one insured director (who acted dishonestly, for instance) coverage should nonetheless be available for the other directors.

Some of the exclusions (i.e., provisions permitting the insurer to deny coverage) that may be contained in a directors' liability policy include claims arising out of:

- Environmental pollution;
- Insider trading;
- Libel or slander;
- Prior claims;
- Prior circumstances that were known but not disclosed (a severability clause should ensure that one director's knowledge is not imputed to other directors);
- Statutory fines or penalties;
- The dishonesty of a director;
- Deliberately fraudulent or criminal acts;
- A director receiving a profit or advantage to which he or she was not legally entitled;
- Matters that are uninsurable by law; and
- An action by one insured against another insured (the so-called insured versus insured exclusion).

Other exclusions, which are less common, may exclude coverage for claims arising out of merger and acquisition activity, sexual harassment or failure of the corporation to remit employee deductions or pay other liabilities for which directors may be personally liable by statute. Directors should also pay attention to exclusions and endorsements that may limit coverage significantly (e.g., does "loss" include settlement payments?).

A policy usually provides coverage to the corporation that has indemnified its directors for claims against them. In cases in which there is a high deductible for this corporate indemnification coverage, policies often contain a "presumptive indemnification" clause, which states that the higher deductible (which could exceed $1 million) applies to directors if the corporation could have or should have indemnified them, but did not. To avoid the risk of having to pay the higher deductible if the corporation becomes insolvent, directors should ensure that the presumptive indemnification clause does not apply when the corporation is unable to indemnify directors because of financial impairment.

The Insured Versus Insured Exclusion

The insured versus insured exclusion is intended to protect the insurer from collusion between different insured individuals or between insured individuals and the corporation (when the corporation is also insured) in making claims against the insurer. Two matters that should be addressed if there is such an exclusion are as follows:

- The policy should make clear that the insurer cannot rely on this exclusion to deny coverage when a trustee in bankruptcy is making a claim against the directors (on the basis that the trustee is suing on behalf of the corporation that is an insured under the policy); and
- Similarly, coverage should not be denied for a derivative action that is brought by or on behalf of the corporation against the directors.

Entity Coverage

A directors' liability policy may also cover *the corporation* for losses it suffered for matters such as securities violations, oppressive conduct, employment claims or pollution claims. This is referred to as "entity coverage." Entity coverage can be beneficial because it avoids disputes about the allocation of loss between an insured (a director) and a non-insured (the corporation).

However, when entity coverage is subject to the same overall policy limit as that for directors' liability, there is a danger that the corporation may use up the entire policy limit in respect of claims made against it or that if the corporation becomes insolvent, a trustee in bankruptcy will claim the policy and its proceeds as property of the corporation in priority to the claims of directors. Here are two solutions to these problems:

- Provide in the policy that the directors' claims have first priority on the payment of all insurance proceeds; and
- Provide for excess coverage for the benefit of the directors only.

Excess coverage for the benefit of the directors only also avoids any risk that prior claims made against the corporation may exhaust the coverage otherwise available to directors.

As a result of the corporate scandals in the United States, many insurance advisers are now recommending that inside directors (i.e., members of management) not be insured under the same policy as outside directors. This is because, in a number of cases, the relevant insurance coverage is being exhausted by the defence costs and other claims of inside directors who are directly embroiled in the relevant scandals; outside directors may therefore be left with no coverage. Another solution is for a director to obtain, at the expense of the corporations on whose boards the director sits, a separate personal liability policy that covers only the director.

Defence Costs

A directors' liability policy should cover legal and other costs and expenses incurred in defending a claim, and such costs and expenses should be advanced by the insurer as they are incurred. It is preferable that defence costs not be applied against the overall limit of coverage, although such "cost in addition" coverage

is not the norm. Similarly, defence costs should be included for purposes of determining any deductible payable by an insured under the policy.

Managing the Risk of Personal Liability

Directors' liability insurance is an important component of managing the risk of personal liability of directors.

Directors should make sure of the following key points regarding directors' liability insurance:

- The policy remains in good standing to cover future claims as they are made;
- The policy covers directors' legal and other costs of defending themselves;
- The policy covers former directors (because a legal action may be commenced years after the occurrence of events giving rise to the claim);
- Directors know how to make a claim and notify the insurer immediately upon becoming aware of a circumstance that could give rise to a claim;
- The policy exclusions are appropriate; and
- The policy provides appropriate coverage on an insolvency.

Directors' liability insurance has become very complex, and directors should ensure that they receive their own expert advice about proposed terms.

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