Directors’ Duties in Canada

Torys provides comprehensive guidance on directors’ responsibilities and best practices 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.

June 2023

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1

Introduction

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.

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

- the incorporation, corporate governance and conduct of business corporations generally—for example, the federal *Canada Business Corporations Act* (CBCA) and the *Ontario Business Corporations Act* (OBCA)[1];
- corporations in regulated industries—for example, the federal *Bank Act* (Canada), *Trust and Loan Companies Act* (Canada) and *Insurance Companies Act* (Canada); and
- capital markets and securities transactions, 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.

Personal liability for directors under these statutes may be based on their own wrongdoing or failure, such as breaching the duties of loyalty and of care, described below in Chapter 3. Alternatively, and depending on the statute, the personal liability of directors may be based on wrongdoing by the corporation in circumstances where the director failed to take all reasonable steps to prevent the conduct from occurring or where the director is shown to have "authorized, permitted or acquiesced" in the commission of the offence by the corporation.

Directors' liability is a constantly evolving area. Emerging trends such as environmental, social and governance (ESG), diversity issues, privacy and cybersecurity, and shareholder activism have recently intensified the focus on the roles and responsibilities of directors in Canada.

[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. This guide does not address the unlimited liability corporation model available in some provinces.

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Corporate governance and the board's role

Supervision of management

Under Canadian corporate statutes, directors are responsible for the business and affairs of the corporation. The directors fulfill that responsibility by overseeing the management of the business and affairs of the corporation rather than being 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 senior management team is qualified and worthy of the trust and confidence of the directors.

Directors should also ensure that management informs them in detail about how management is exercising its responsibilities for the day-to-day running of the corporation. In this regard, directors should be able to perform the following key functions.

- Exercise strategic oversight:
  - consider the corporation's strategy and be involved at an early stage in any strategic initiatives.
- Oversee internal controls and information procedures:
  - satisfy themselves that the corporation has adequate internal control systems in place; and
  - 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.
- Exercise financial oversight:
  - reach agreement with management on sensible financial goals; and
  - settle the terms of the annual budget and the business plan, and ensure that management adheres to them.
- 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.

- Oversee personnel:
  - satisfy themselves that the senior management team is functioning capably and continues to be worthy of trust and confidence of the board;
  - 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 and subject to certain matters specified in the corporate statutes which may not be delegated, and to rely on management provided that reliance is reasonable 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. This reliance underscores the importance of the relationship between the board and management.

Directors have a defence to liability under the corporate statutes 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 normally prudent 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;
- have the expert give written advice; and
- examine and question the advice, where appropriate, and not accept it passively.

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 for board decisions. In practice, therefore, although committee mandates will impose responsibilities on board committees, a committee won't typically receive final decision-making power in respect of material matters. Instead, the role of most committees is to make recommendations to the full board, which retains final decision-making authority. This is consistent with the board's ultimate responsibility for all material matters affecting the corporation.

The corporate statutes do not in any event permit a board to delegate certain matters. For example, the CBCA 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

For 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 unexpectedly performs poorly or there is a concern about its public disclosure, attention is usually focused on the adequacy of corporate governance, the credibility of the financial statements and the audit committee's performance.

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 (i.e., excluding directors who are also officers or employees of the corporation or any of the corporation's affiliates).

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, 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 (being more junior 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.

Under securities law, public corporations must have at least three directors on their audit committees, all of whom must be independent, as defined below in the "Independence" subsection under "Governance guidelines and disclosure". Directors of venture issuers are not subject to the requirement of independence, although a venture issuer is required to have an audit committee composed of at least three directors, a majority of whom are not executive officers, employees or control persons of the venture issuer.

All members of the audit committee of a public corporation, other than a venture issuer, must be financially literate or agree to become financially literate within a reasonable period. In the latter case, the board of the corporation must be satisfied that making this limited exception to the financial literacy requirement will have no material adverse effect on the audit committee's ability to act independently and satisfy the other requirements of the rule.

An individual is financially literate if they 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.

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.

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;
- pre-approve 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; and
- 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 of the practical steps that an audit committee should take are summarized below.

- 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).
- Members should review and discuss plans and results with the auditor at various stages of the audit.

- **Before the audit**, discuss the audit plan in order to determine whether the nature and scope of the review are reasonable in the circumstances.
- **After the audit** (without management present), discuss the results of the audit, to determine whether:
  - there are special problem areas that the auditor will be referring to 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;
  - the auditor is satisfied with the quality and effectiveness of the financial recording procedures and systems; and
  - there are any differences of opinion between management and the auditor, or significant issues affecting financial reporting.
- **For the interim statements**, a similar approach as listed above should be used before and after a review of interim statements, recognizing that such a review is narrower in scope than an audit of year-end financial statements.

- The audit committee should discuss the interim and annual financial statements and MD&A in detail with management.
- If appropriate, after an audit 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 Chapter 11, below.

Nominating and corporate governance committee

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

- 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; and
- the nominating committee be responsible for identifying individuals qualified to become new board members, and for recommending them to the board for the next annual meeting of shareholders.

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. The nominating and governance committee will likely also oversee the implementation of board renewal and diversity initiatives.

Compensation committee

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

- 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:
  - reviewing and approving the corporate goals and objectives that are relevant to the CEO's compensation;
  - determining the CEO's compensation or making a recommendation to the board in that respect (after having evaluated the CEO's performance in meeting the applicable corporate goals and objectives);
  - 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 proxy circulars, offering documents and other disclosure documents before their public release.
- the compensation committee be authorized to engage and compensate outside advisers.

Directors increasingly face criticism from shareholders, and even litigation, alleging breach of directors' duties for what shareholders perceive as excessive executive compensation packages or executive compensation arrangements that may encourage excessive risk-taking behaviour. Executive compensation should align the interests of management with the interests of the corporation and its stakeholders. It is therefore important that board members, particularly those on the compensation committee, obtain appropriate advice (which may include advice from an independent executive compensation advisory firm), understand in detail, and are comfortable with all elements of a corporation's executive compensation arrangements. Key areas of focus include:

- target compensation levels exceeding appropriate benchmarks (such as peer group compensation levels);
- guaranteed bonuses, incentive programs without caps on the maximum payouts or other compensation arrangements 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;
- incentive arrangements that encourage excessive risk-taking behaviour;
- excessive perquisites, supplemental executive retirement plans and executive loans;
- a misalignment between executive compensation levels and company performance; and
- the terms and triggers of severance packages and change of control entitlements.

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). Equity-based compensation arrangements, pension and retirement benefits and potential payments to executives on a cessation of employment or a change of control must be described and quantified. The directors' compensation must also be disclosed and quantified. The reporting requirements for executive and director compensation are detailed and complex. These requirements are supplemented by governance best practices and proxy voting guidelines on compensation practices and disclosure that are published by institutional investors and proxy advisors.

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.

Corporations are increasingly focused on engaging shareholders on compensation matters. As a result, many large public companies give investors the right to participate in annual non-binding votes regarding the corporation's executive compensation practices (known as "say on pay"). While say on pay votes have been mandatory for U.S. public issuers for a number of years, say on pay is not currently required for Canadian corporations. However, a federal bill passed in 2019 would require that CBCA corporations hold annual say on pay votes once detailed regulations are adopted. Compensation committees (and boards) should carefully consider the company's approach to say on pay, since those votes carry significant practical weight, even though, technically, they are advisory.

Special 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. Boards are required to do so in the circumstances prescribed in Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions*, its Companion Policy and related regulatory guidance. This instrument imposes procedural fairness requirements on directors in transactions that are the subject of the instrument. The role of special committees of independent directors is discussed in detail in Chapter 4 below.

A director's independence in this context will depend on the facts and circumstances, including whether the director has an interest in or a connection to the transaction or to another party with an interest in the transaction. Moreover, special committee members may not receive fees based on completion of the transaction.

Conduct review committees

As discussed in Chapter 11, 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.

Other committees

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, though executive committees of the board are becoming rare).

Governance guidelines and disclosure

Comply or explain regime

In Canada, securities regulators have published:

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

This is a "comply or explain" regime, in which public corporations must indicate whether they comply with a particular guideline and, if they don't, how they otherwise meet its objective.

The emphasis in securities laws on the disclosure of corporate governance practices—as opposed to the imposition of mandatory requirements—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 a corporation to enforcement proceedings and sanctions. The regulators also use regular continuous disclosure reviews to identify non-compliance, incentivize robust and improved corporate governance disclosure and discourage boilerplate.

Having robust corporate governance policies in place and a board of directors and executive management team that cultivate a strong "tone from the top" in terms of compliance with those policies are important factors that can affect the outcome of regulatory proceedings relating to an alleged breach of securities laws. The corporation's governance policies and practices may be taken into account by securities regulators in assessing the appropriateness and severity of fines or other administrative penalties or sanctions.

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:

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[2] See National Policy 58-201, *Corporate Governance Guidelines.* In April 2023, Canadian securities regulators proposed for comment certain amendments designed to increase transparency about diversity on boards (including diversity beyond women) and in executive officer positions and to provide investors with more meaningful information concerning how diversity ties into strategic decisions.

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

- the board has a majority of independent directors (the test for independence is described below);
- the chair of the board be an independent director, or the board otherwise has a lead director who is independent;
- the independent board members meet regularly without non-independent members and management;
- the board adopts a written mandate that sets out its responsibilities;
- the board has a written code of conduct and ethics; and
- the board and its members be assessed regularly.

As noted above, the governance guidelines are not mandatory. It is this feature—best practice guidelines coupled with a disclosure requirement—that distinguishes the Canadian approach from the mandatory listing standards adopted by the U.S. stock exchanges.

Venture issuers—which are unlisted reporting issuers or issuers that are listed only on the TSX Venture Exchange, the Alternative Investment Market of the London Stock Exchange or the ICAP Securities and Derivatives Exchange—are subject to less onerous disclosure requirements, having regard to their size relative to TSX-listed issuers and the cost of meeting disclosure requirements.

Independence

Under Canadian securities rules, a director is classified as "independent" as a general matter (leaving aside conflict considerations that could arise in particular circumstances depending on the matter before the board) if a director 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". The fact that a director is a nominee of a controlling shareholder does not, alone, result in the director being non-independent (though it may affect independence for audit committee purposes if the director is an officer or employee of a controlling shareholder). 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 they are 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 the director is or, in a three-year "look-back" period, was:

- an employee or executive officer of the corporation;

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

- 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, in addition to meeting the foregoing conditions, a director must not be an officer 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.

Proxy advisory firms have adopted director independence guidelines that go further than the independence guidelines under Canadian securities law described above.

Diversity

Reflecting society's focus on gender equity, and a growing body of research indicating that diversity makes for higher-performing groups, Canadian securities laws require public corporations (except venture issuers) to disclose information about the representation of women on their boards of directors and among executive management[5]. Corporations must disclose:

- whether the corporation has adopted a written policy relating to the identification and nomination of women directors;
- the extent to which the board considers the representation of women in identifying and nominating board candidates and in making executive officer appointments; and
- whether the corporation has adopted targets and, if so, what those targets are for women on the board of directors and in executive officer positions.

Corporations must also disclose information about their board renewal mechanisms, such as term limits and age limits.

In addition to the representation of women, CBCA regulations require public CBCA corporations to disclose information about the representation on their boards of directors and among executive officers of visible minorities, Indigenous people and people with disabilities.

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[5] These rules are currently the subject of possible revision to expand their scope. See footnote 2.

ESG considerations

Environmental, social and governance (or ESG)— an umbrella term that has gained significant momentum in the corporate world—captures a wide variety of issues including management of environmental risks (such as climate change), social risks (such as diversity, employee relations and supply chain management) and corporate governance broadly.

As companies face increasing pressure to improve their ESG performance, their boards are increasingly focusing on ESG matters as a strategic priority. This pressure is coming from various sources. For example, ESG-related shareholder proposals are becoming more common in Canada, and there have been a greater number of ESG-related claims brought by stakeholders seeking to influence corporate policy and action. In addition, Canadian regulators are increasingly focusing on ESG-related issues, including on the disclosure by public companies of climate change related information.

The rapidly evolving ESG environment brings with it certain litigation risks that can involve novel applications of the law. Some of these risk areas include:

- tort claims brought in Canada against Canadian companies for incidents occurring in their foreign operations (e.g., one notable case involved human rights claims brought in Canada against a Canadian mining company with respect to its African workers);
- the potential for claims against directors (and officers) in relation to a corporation's efforts to address ESG issues, which may take the form of a derivative action, breach of duty or negligence; and
- the potential for claims related to ESG disclosure.

To assess and manage risks and to leverage opportunities and improve performance related to ESG, boards are increasingly considering the following:

- their composition, to determine whether they have the appropriate skills and expertise to understand and address key ESG-related risks and opportunities facing the organization;
- their governance structures, to ensure they are adequate to oversee the organization's implementation of ESG objectives and performance;
- their responsibilities and reporting structures, to ensure that ESG-related responsibilities and reporting obligations are clearly defined and, as appropriate, embedded in the board and committee charters;
- emerging ESG-related issues and trends, in order to better understand the views of different constituencies and maintain and improve relationships with key stakeholders over time;
- how ESG-related considerations have been, are being and can be integrated throughout the organization;
- setting executive compensation performance thresholds to maximize, and align with, ESG-related targets and strategic priorities; and

- how the organization can set credible ESG-related targets and whether the organization has sufficient resources to successfully implement those targets.

Privacy, cybersecurity and electronic marketing

Canada's federal *Personal Information Protection and Electronic Documents Act* (PIPEDA) embodies the core principle that an individual's knowledge and consent are required for the collection, use or disclosure of personal information, except where this knowledge and consent are inappropriate (such as in emergencies or to comply with court orders). Personal information is defined as information about an identifiable individual. PIPEDA applies to federal and provincial organizations in respect of personal information collected, used or disclosed in the course of commercial activity, and to the personal information of employees of federal works, undertakings or businesses (such as banks and airlines).

Organizations subject to PIPEDA or provincial privacy laws must notify the regulator and affected individuals of breaches of personal information that create a "real risk of significant harm" to an individual. Organizations must keep internal records of all privacy breaches (even those not reported) for two years, to facilitate regulatory audits and the identification of systemic privacy flaws. Noncompliance with breach reporting obligations can attract fines of up to C$100,000.

Civil privacy litigation is increasing in volume and financial cost for many organizations. There are statutory and common law causes of action for invasions of privacy which can ground litigation against organizations as well as their directors.

There are currently no cybersecurity laws of general application in Canada. Rather, various industry regulators have issued guidance on cybersecurity expectations and best practices, notably in the financial services, securities and health care sectors. Some of these guidelines require organizations to report cyber breaches to the applicable regulator and encourage information sharing among participants to address industry-wide cyber threats. If federal cybersecurity legislation proposed in 2022 comes into force, industry regulators in the financial services, energy, telecom and other sectors will have enhanced audit and enforcement powers against the organizations they regulate with respect to cybersecurity standards. PIPEDA also imposes obligations to appropriately safeguard personal information, whether in physical or electronic form, and its mandatory breach reporting requirements may apply to cybersecurity breaches.

The market for cybersecurity insurance is active in Canada, as organizations look to insure both the corporation and its directors against claims arising from cybersecurity incidents. However, some organizations may find it increasingly difficult or expensive to get appropriate cybersecurity insurance coverage. It is worth noting that litigation trends in the U.S. market suggest that there may be an increase in litigation in Canada seeking to hold directors personally liable for data breaches that significantly affect business operations, profits and share price.

Canada's federal "anti-spam" law (commonly known as CASL) prohibits, among other things, the sending of commercial electronic messages to or from Canada without the consent of affected individuals. There are certain exceptions to these prohibitions. Significantly, consent may be implied under the law if the recipient of a message has an existing business relationship (as defined in CASL) with the sender. In addition, the law requires that commercial electronic messages (which include email, texts, and direct social

media messages) must contain both contact information for the sender and a mechanism for recipients to unsubscribe from receiving any further messages.

The federal regulator may investigate complaints under CASL and impose fines up to C$10 million for non-compliance by organizations and penalties up to C$1 million for violations by individuals including directors and officers. Organizations are expected to keep detailed records to demonstrate their compliance with the law.

CASL is primarily enforced by the Canadian Radio-television and Telecommunications Commission, with additional jurisdiction for the OPC and Competition Bureau with respect to certain offences involving personal information and misleading advertising, respectively. The legislation includes a private right of action that would permit civil litigation for violations, but this has not yet been proclaimed into force.

Personal liability of directors, officers and others who send, authorize, or permit noncompliant electronic messages is expressly contemplated in CASL, although the law provides for a due diligence defence where organizations and directors have taken sufficient steps to comply with the law, including through internal policies and procedures relating to electronic communications, employee training and monitoring and record retention practices.

Shareholder voting on governance matters

Proxy voting guidelines

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 ESG matters.

Proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis (GL) are also active in Canadian public markets. Their voting recommendations can carry significant weight with their clients on such issues, particularly where institutional investor clients as a practice follow those voting recommendations.

While proxy advisory firms frequently update their areas of interest, ISS and GL have recently focused attention on the following areas that are relevant for directors:

- the representation of women on boards,

- board race/ethnicity diversity,
- climate disclosure, and
- the role of the board in overseeing cybersecurity issues and steps taken to educate directors on that front.

Majority voting rules

The TSX requires listed issuers, other than those that are majority controlled, to have adopted a majority voting policy for uncontested director elections, unless they otherwise satisfy the majority voting requirements in a manner acceptable to the TSX. In order to comply with the TSX rules, the majority voting policy must, in substance, provide for the following requirements.

- A director must immediately tender a resignation to the board if they are not elected by at least a majority of the votes cast.
- The board must accept the resignation absent exceptional circumstances, and in any case must make a decision within 90 days after the meeting.
- The board's decision must be announced promptly by news release, and if the resignation has not been accepted, the news release must fully explain that decision.

The TSX majority voting policy requirement fills a gap in most Canadian corporate statutes, which currently provide for shareholders to vote for or withhold their role in the election of directors, with the consequence that a director nominee will be elected as long as the nominee received a single vote in favour. Effective August 31, 2022, the CBCA was amended to provide for majority voting for the election of directors of a distributing corporation (e.g., a reporting issuer under securities legislation). These corporations no longer need to have a policy in place to comply with TSX requirements since the CBCA now provides for a substantially similar regime.

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Directors’ duties generally

The duty of loyalty

Directors, as fiduciaries, are held to a very high standard of loyalty and good faith in their conduct in relation to the corporation. The duty of loyalty and good faith 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.”

Canadian corporate law formerly adhered to a “shareholder primacy” view under which the best interests of the corporation were determined by reference to the interests of “shareholders as a whole”. Canadian courts have now rejected that approach in favour of a stakeholder view of the corporation according to which the “best interests of the corporation” are not to be equated with the interests of any single stakeholder group and are to be determined having regard to the interests of all of the relevant constituencies that together comprise the corporate enterprise.

The CBCA has codified this approach for CBCA corporations by stating that, when acting with a view to the best interests of the corporation, directors and officers “may consider, but are not limited to considering”:

- the interests of shareholders, employees, retirees and pensioners, creditors, consumers and governments;
- the environment; and
- the long-term interests of the corporation.

This duty to act with a view to the best interests of the corporation precludes a director from acting with a view to advancing personal 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).

Where the interests of all stakeholder groups are aligned, determining the best interests of the corporation is straightforward. However, where the interests conflict, the directors are to engage in a balancing exercise. The relative weight to attach to the conflicting interests and the timeframe by reference to which the interests are to be considered are matters of business judgment for the directors.

The stakeholder view of the corporation under Canadian corporate law aligns with the increasing focus of investors on ESG matters. The board, in pursuing the best interests of the corporation, is empowered to focus on long-term sustainability and not solely on short-term shareholder value maximization, and should

consider impacts on employees, customers, the community and the environment, and factor these considerations into the corporation’s strategy and business plan.

While directors are not to equate the corporation’s interests solely with shareholder interests, shareholders are clearly a critical stakeholder and engagement with the shareholder base is appropriate and beneficial. To do so provides valuable input and protects against distracting and expensive proxy fights. Boards of directors are expected to engage with shareholders and be responsive to their concerns. Directors’ tenure depends on maintaining the confidence of shareholders since shareholders have been empowered through corporate governance reforms, including majority voting and say on pay.

An important aspect of the duty of loyalty is the avoidance of conflicts between a director’s duty to the corporation and personal interests or duties to others with their own interests. The latter is a potential issue in circumstances where the director is a fiduciary of other enterprises whose interests intersect with, and are not necessarily aligned with, the interests of the corporation on whose board the director sits. Directors should regularly review their other commitments and have discussions with the chair to determine whether there is a conflict.

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 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 these circumstances, the statutes require the director to refrain from voting on a resolution to approve the contract or transaction except in limited prescribed circumstances (a contract relating primarily to the director’s compensation, or for indemnification or insurance, or 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, prudent directors who find themselves 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.

A conflict that is serious and ongoing may not be amenable, as a practical matter, to being dealt with through ad hoc disclosure, abstention from voting, or absenting from the deliberations. In some circumstances, the director may have to resign.

A further aspect of the duty of loyalty is the director’s obligation to protect the confidentiality of all non-public information that the director receives in their capacity as director and not to use the information for any purpose other than for the discharge of the director’s duties.

This confidentiality obligation may conflict with commercial reality in the context of nominee directors, where there may be an expectation that directors nominated by significant shareholders will convey information

back to the shareholders who nominated them. Canadian courts have not yet provided clear guidance on the particular question of whether and in what circumstances information sharing by a nominee is permitted. It is clear, however, that information sharing is permitted if the corporation consents. Consent could be provided in advance on a blanket basis (by way of a shareholders agreement or board policy, for example), or provided on an as needed basis. Consent could also be implied by the circumstances, such as in a situation where it is the reasonable expectation of the parties involved that the nominee director will report to the nominating shareholder information learned at board meetings, which could include a situation where the nominee director is nominated pursuant to a nomination agreement.

Even with consent, information sharing remains subject to the nominee director's overriding duty of loyalty to the corporation. This means that the nominee director could potentially be responsible for any misuse of the information by the nominating shareholder. It is therefore important that arrangements are in place with the nominating shareholder to ensure that disclosure of the information is limited to those with a need to know and that the information will not be misused to the detriment of the interests of the corporation.

Managing conflicts of interest can also be challenging for a nominee director who shares information with the nominating shareholder. For example, where the shareholder may be considering a transaction involving the corporation, information sharing may not be possible, and the nominee director's participation in board discussions may have to be limited. Another way that conflicts may materialize is under the "vital aspect" principle, whereby a nominee director may be required to disclose to the corporation information of which the director is aware that is confidential to the nominating shareholder if that information goes to a vital aspect of the corporation. Resignation may be the only way to manage that conflict of interest.

In circumstances where confidential information is material and the corporation is a Canadian reporting issuer, the disclosure of that information to the nominating shareholder raises the question of whether the prohibition of "tipping" under securities laws is engaged. Under anti-tipping rules, a nominee director may not disclose material facts or material changes about the issuer to another person until such information has been generally disclosed other than in the "necessary course of business".

What constitutes the "necessary course of business"? This exception has been broadly interpreted by regulators, who have noted that the exception "exists so as not to unduly interfere with a corporation's ordinary business activities", also recognizing that disclosure of material information to controlling shareholders may in some cases fall under this exception.

Information sharing between nominee directors and nominating shareholders should not offend the anti-tipping prohibition under Canadian securities laws, given the "necessary course of business" exception, so long as information sharing is done confidentially and narrowly with limited scope. While the nominee director may be able to share material undisclosed information with the nominating shareholder, that shareholder is prohibited from further sharing of that information or trading in the issuer's securities until the information is generally disclosed. In addition to sharing material undisclosed information, providing a trading recommendation when in possession of material undisclosed information is also prohibited. Chapter 7 discusses this in greater detail.

Another aspect of the duty of loyalty is the obligation of directors not to divert, for their personal benefit or for the benefit of another business, business opportunities that come to their attention that could be of interest to the corporation.

The duty of care

Canadian corporate statutes require directors, in the exercise of their powers and discharge of their duties, to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."

The standard of care is objective in that a director's conduct is tested by reference to a "reasonably prudent person". Directors with special expertise—for example, lawyers or financial professionals—should expect to be held to the standard of a reasonably prudent person who has that expertise.

In contrast to the duty of loyalty, which is owed only to the corporation itself, the duty of care is potentially owed not only to the corporation, but also to stakeholders directly. The effect of this is to make alleged breaches of the duty of care actionable directly by and in the name of individual stakeholders, rather than any claim having to be brought by or in the name of the corporation (by way of derivative action), as is the case with a claim alleging a breach of the duty of loyalty. This increases the exposure of directors to claims alleging breach of the duty of care, as compared with duty of loyalty claims.

In practical terms, the directors' duty of care includes the following requirements.

- Directors' decisions must be *informed* judgments that take into account all material information reasonably available in the circumstances.
- Directors who rely on information provided by management or others should ask themselves whether they have reasonable grounds for doing so.
- Directors must take due care to consider the relevant information—or instance, they must take the necessary time to review key documents or summaries and to deliberate.
- Directors must take an active and direct role in their oversight of management and of key matters such as decisions concerning diversification, financings, acquisitions and divestitures, cybersecurity and ESG.
- Having regard to the very important role of the audit committee, directors should satisfy themselves, through the audit committee reports to the board and related discussions, that the committee is discharging its responsibilities effectively.

Corporations have been under increasing pressure to manage risks that could lead to an organizational crisis, and to respond swiftly if needed. Increasingly, activist shareholders are looking to hold boards accountable for lost share value caused by a failure to respond when a crisis arises. In order to reduce the risks that have the potential to become a crisis, the board should inform itself about the culture "on the ground" and make sure that complaints are taken seriously and addressed promptly. The board should ensure that robust whistleblower, privacy, social media usage, anti-corruption, use of technology, occupational health and safety, and harassment and discrimination policies are in place and reviewed and updated regularly. The board should also have a crisis management plan in place to quickly deal with any events that could lead to a crisis.

The board should ensure that the senior management team includes individuals with the appropriate expertise to identify and manage cybersecurity risks. The board should also ensure that management is actively engaged in taking appropriate steps to mitigate risks of material harm to the corporation or its stakeholders, including by developing in advance and maintaining policies and protocols for addressing potential cybersecurity breaches.

Implementation of appropriate written policies and procedures is a critical factor in enabling the board to demonstrate that it has discharged its duty of care. We discuss policies and similar documents in various contexts in this guide by way of examples of areas in which specific policies are either statutorily required or desirable. Written policies must be formulated with care and tailored to the corporation they are meant to serve. A policy that is suitable for one corporation may be inappropriate for another. 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.

Business judgment defence

The courts recognize that they are ill-equipped to second-guess the business judgments of directors, for example with respect to business strategies or corporate transactions. Courts will not generally substitute their judgment for that of the directors, who are the statutorily constituted body to make business decisions on behalf of the corporation. Courts will not intervene merely on the basis that had the decision in question been theirs to make, they would have decided differently than the directors did on the merits. Before the courts will intervene, the decision of the directors must have been compromised by a material flaw in the process by which the decision was reached, or the decision must be patently unreasonable such that it could not have been arrived at in good faith.

The merits of directors' business judgments will not be second-guessed if all the following are true:

- their decision was unconflicted, any actual conflicts having been addressed through recusal of conflicted directors or by forming a special committee of independent directors to deal with the matter;
- the directors asked themselves and answered the correct question, namely, "What is in the best interests of the corporation having regard to the implications for all affected stakeholders"?;
- the directors acted on the basis of all material information reasonably available in the circumstances, including professional advice;
- the directors took adequate time to deliberate; and
- the decision in question falls within the range of reasonable possible choices, measured against the criterion of the best interests of the corporation.

This last point may require directors to engage in a balancing exercise where the corporation's best interests are unclear because the interests of different affected stakeholders are not aligned. As long as the directors, in that balancing, consider all affected stakeholder interests and respect legal rights and reasonable expectations, they will have complied with their duties and their business judgment will be respected by the courts.

To establish these preconditions for business judgment deference, directors should ensure that their decision-making process 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 actually considered in reaching the decision.

Other bases for personal liability

The statutory oppression remedy confers on courts a broad remedial jurisdiction to make any order the court thinks "fit" to rectify corporate conduct that the court considers unfairly prejudices or unfairly disregards the interests of any stakeholder. Fairness is tested by reference to the "reasonable expectations" of stakeholders as to their treatment by the corporation.

The courts' remedial powers under the oppression remedy extend to making orders for compensation of aggrieved stakeholders against directors personally where directors have exercised their powers in a way deemed unfair to the complainant. Absent self-dealing or the appropriation of corporate opportunities, directors do not normally face personal liability under the oppression remedy. For personal liability to be an appropriate remedy in the circumstances, one would normally expect to see present:

- the breach by the director of the duty of loyalty or care,
- a personal benefit derived by the director from the conduct in question, and
- undue prejudice to other stakeholders from a remedy against the corporation rather than against the director personally.

The law is in a state of flux as to the exposure of directors to personal liability under tort law (e.g., for negligence or negligent misrepresentation) for wrongs committed by the director in their capacity as director, on behalf of the corporation, with a view to the best interests of the corporation. Courts have traditionally been reluctant to allow claims against directors where the factual basis for the claim is the same as for a parallel claim simultaneously asserted, or that could be asserted, against the corporation. Exceptions to the general rule protecting directors against personal liability in tort were made in circumstances where the director was acting at least partly for personal interest or where the conduct in question could be characterized as fraudulent or dishonest.

Recent cases appear to be eroding this protection of directors against personal liability in tort. Some cases suggest that there is no principled basis for shielding directors from liability just because the tortious conduct was committed on behalf of the corporation. In other words, if directors do anything to a third party for which they would be personally liable if they had done it on their own behalf, they may not be able to escape personal liability merely because they did it on behalf of the corporation in performance of their corporate responsibilities.

Directors' duties in the change of control context

Enhanced role for target board

The board's role is particularly prominent in change of control transactions because of the significance of such transactions for the corporation, the potential for management to be conflicted and the potential for misalignment between different stakeholder groups. While it is appropriate for management and the corporation's advisors to be very involved in the process, the process must be led by the board or a committee of the board, independently of management.

Issues that the board may be faced with include difficult business judgments as whether to engage with an offeror, to support or reject an offer, to agree to measures to protect a supported deal, to seek out alternatives to an offer, and to implement and continue to deploy defensive measures against an offer.

Target directors' responsibilities in a change of control include:

- providing adequate information to shareholders to allow them to make a fully informed decision about a take-over bid or an acquisition proposal;
- making a meaningful recommendation to shareholders to accept or reject a bid or acquisition proposal or provide reasons why they are not doing so; and
- considering whether to solicit or receive potentially superior alternatives and whether any proposed support or merger agreements allow for that flexibility.

In addressing these issues, directors must discharge their duties of loyalty and care. Directors will have honoured their obligations and their decisions will not normally be second-guessed by courts if they follow the process and procedures described below.

The board should consider, as a threshold matter, whether a proposal presents any conflicts for directors.

Conflicts may be addressed through the recusal of conflicted directors from decision-making concerning the proposal or by forming a special committee of independent directors to deal with the proposal. Whether or not there are director conflicts, a special committee may be desirable as a matter of convenience to facilitate decision-making on a timely basis.

The board should consider and assess potential management conflicts. For example, where management positions are threatened, management compensation is affected or management simply has a particular view of the merits of a change of control transaction, the board (or special committee), and not management, should have carriage of the process of considering and responding to the proposal.

The directors should examine "what is in the best interests of the corporation". For this purpose, the corporation's interests are not determined by reference to the interests of shareholders alone. The mandate of the board in this context is not to maximize shareholder value. Rather, the corporation's interests must be assessed by reference to the interests of all affected stakeholders, including creditors and employees.

Directors should tread carefully if they are considering sacrificing shareholder value for the interests of creditor or other stakeholder interests beyond the legal rights and reasonable expectations of these groups.

Directors must make their decisions on the basis of all material information reasonably available in the circumstances. This means:

- obtaining 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];
- being aware of all alternatives reasonably available to the corporation in the circumstances;
- understanding the background to all important decisions they are asked to make, including the business and financial implications of any actions or transactions; and
- questioning management and independent advisers about all aspects of the matter under consideration, including the information and assumptions on which advice was based.

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

The decisions directors make must fall within the range of reasonable choices measured against the criterion of the best interests of the corporation. In the change of control context, the interests of affected stakeholders that must be considered in determining the best interests of the corporation may well not be aligned. For example, on the question of whether to support a premium offer that will put greater leverage on the corporation, supporting that offer might be in the interests of current shareholders, but contrary to the interests of creditors and employees. In such circumstances, while respecting legal rights and reasonable expectations, directors must engage in a balancing exercise, with the weight to assign the conflicting stakeholder interests being a matter of business judgment for the directors.

Process is critical to demonstrating that the board has appropriately fulfilled its duties. 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, demonstrating 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

[6] Decisions of the Ontario Securities Commission and the Court of Appeal for the Yukon Territory have identified concerns that may arise when a fairness opinion is prepared by a financial adviser who is being paid a success fee, and concerns with the adequacy of disclosure regarding financial advice. Staff of Canadian securities regulators subsequently released guidance on material conflicted transactions addressing disclosure of compensation arrangements for financial advisors, and disclosure of the methodology used in rendering a fairness opinion. Directors should carefully consider compensation arrangements with financial advisors and the corporation's disclosure of financial advice, especially in connection with transactions that may be controversial. In some circumstances, directors should consider obtaining a second fairness opinion from an advisor not compensated on a success-fee basis.

maintained and should include copies of all relevant materials provided to board members to assist with their decision making.

Defensive tactics

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

Securities law, in contrast to corporate law, continues to adhere to the shareholder primacy paradigm in its regulation of change of control transactions. Canadian securities regulators will not permit target directors, using defensive tactics, to frustrate shareholder access to an offer, even if the directors have reached a well-founded conclusion that the offer is not in the best interests of the target, having regard to all affected stakeholders. In these circumstances, Canadian securities regulators, using their public interest jurisdiction, may make orders against the target neutralizing the defensive measure.

Defensive measures that frustrate a bid were traditionally distinguished from measures that merely delayed shareholder access to the bid to allow the target board time to seek out potentially superior alternatives. Tactical poison pills, designed to expand shareholder choice, were historically tolerated by securities regulators for a time-limited period in view of the short minimum period bidders had to leave their offers open for. In 2016 the Canadian take-over bid rules were amended and now require that a take-over bid be open for at least 105 days, which eliminates the rationale for poison pills as a defensive measure. Absent unusual circumstances, securities regulators are now very unlikely to allow a target board to use a poison pill merely to extend the timing of a hostile bid.

Target boards have also turned to private placements as a defensive measure, issuing shares to friendly investors unlikely to tender to the hostile bid. Securities regulators have adopted an approach to this defensive measure that considers whether the private placement has a bona fide corporate purpose along with the impact of the share issuance on the take-over bid dynamic and the target shareholders' ability to respond to the bid.

"Break fees" payable in the event that the target in a negotiated acquisition abandons the transaction (relying on a fiduciary-out) in favour of a superior unsolicited proposal can function as a form of defensive tactic. Setting the break fee unreasonably high could have the effect of discouraging other potential acquirors from proposing a superior transaction, depriving target shareholders of a choice that would otherwise have been available to them. Granting an option to the purchaser under a negotiated acquisition to purchase a key asset of the target in the event the target abandons the transaction could have the same effect.

Excessive break fees and asset lock-ups are not as amenable to the securities regulators' public interest jurisdiction (in contrast to poison pills and private placements, which involve the issuance of securities) since they are provided for by way of contract, which securities regulators lack the power to invalidate. The available remedy would be to cease-trade the entire impugned transaction, a drastic remedy that is inconsistent with protecting shareholder choice. However, court challenges may be ineffective in light of the stakeholder interest model of the corporation in Canadian corporate law, the absence of a value-maximization mandate and the application of the business judgment rule.

Deal protection measures in negotiated transactions

In a negotiated acquisition, the acquirer will seek to protect the transaction against competition from potentially superior proposals that could be made to the target following announcement of the deal, but prior to closing. Conversely, the target directors, having regard to their duties, will be concerned about the potential for superior proposals. They will, on the one hand, not want to be unduly constrained in the event of a superior proposal, but on the other hand, will not want to deter the “bird in the hand” if the acquirer’s willingness to make an attractive offer is conditional on reasonable protection from competition. This dynamic is typically addressed through some combination of “fiduciary out”, “no-shop”, “go-shop”, “break fee” and “reverse break fee” clauses in the acquisition agreement in a negotiated acquisition.

It is customary to include a “no-shop” clause in the agreement between an acquirer and a target. This provision protects the acquirer’s transaction by preventing a target from actively seeking out competing offers. The “no-shop” is typically 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 circumstances. Before a target exercises its fiduciary out, the agreement may require that it give the initial acquirer a chance to match the competing offer.

Some deals may also include 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 initial acquirer 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 break fee, also known as a “termination fee”, to the initial acquirer, typically in the range of 3% to 4% of the transaction’s value. Break fees may justifiably be somewhat higher for smaller deals, when the absolute value of the break 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.

When challenged, a break fee in the 3% to 4% range will likely be found by a Canadian court to be a reasonable step of the target board to induce a transaction viewed by the directors as in the best interests of the corporation. Setting break fees too high could violate the target board’s fiduciary duties by unduly discouraging other potential acquirers from proposing a better transaction. Many institutional shareholders’ voting guidelines require them to reject transactions involving excessive break fees.

Reverse break fees, being a fee payable by the acquirer to the target if the acquirer abandons the transaction, have also been seen in transactions when the target was not initially for sale or when it was necessary to compensate the target for additional regulatory or legal risks or for the risk that the acquirer will be unable to obtain financing to complete the transaction. In many cases, these reverse break fees are structured as the sole remedy for an acquirer’s failure to close, making the deal effectively an option for the acquirer, and the fee the option price.

Responding to shareholder activism

The issues that may arise for boards in the context of a take-over bid or negotiated acquisition transaction may also arise when directors are responding to shareholder activism. Now an established feature of the corporate landscape in Canada, activist shareholders seek change in the governance or management of the corporation. They may engage privately with the board to urge a course of conduct or seek board representation on a consensual basis, or they may go directly to the other shareholders, resulting in a fight for control of the board up to and including a contested shareholder's meeting.

In a proxy fight, the board must be cognizant of potential conflicts of interest. Where an activist is seeking to replace the board, the incumbent directors must consider, among other things, the extent to which resistance to the activist (and the related expenditure of corporate resources) is justified on the ground of good faith protection of the corporation's best interests. Depending on the nature of the shareholder activism, a special committee may be required to address board conflicts.

There are a number of alternatives directors can consider to forestall activism or respond to activist initiatives, provided such measures are pursued in good faith with a view to, and are justifiable by reference to, the best interests of the corporation, as opposed to the personal interest of directors in entrenching themselves. Some of these strategies may include:

- engaging with shareholders in advance to better position directors to manage shareholder activism if it arises;
- "advance notice" by-laws which prevent a surprise contested shareholders meeting by requiring advance notice of director nominations, and which are common in Canada and have been accepted by the courts and investor advisory firms; and
- defensive measures once a proxy fight has been commenced—that may include challenges to require disclosure, alleging violations of proxy solicitation rules and/or a private placements of shares to friendly shareholders—which may be challenged by shareholders and reviewed by securities regulators as a kind of defensive measure, or by the courts as improper entrenchment in breach of the director's duty of loyalty.

In addition to responding to shareholder activists seeking to control or influence the direction of the corporation, directors may have to respond to short selling activists. Short sellers borrow and then sell the target's shares with a view to repurchasing those borrowed shares at a lower price. It is essentially a bet against the corporation's stock.

As a general matter, Canadian securities regulators acknowledge that short selling may be useful in providing the market with liquidity and price discovery. However, to assist in a trading strategy, and to precipitate the hoped-for decline in share price, some short sellers may also publish their views as to why the target's shares are overpriced. Short attacks of this kind may be harmful to the corporation and its shareholders, especially when the information published by the short seller misrepresents the true state of affairs of the target.

To date, there have not been effective regulatory or civil legal remedies for addressing a “short and distort” short campaign of this kind, although certain provincial securities acts have already or may include a prohibition on misleading promotional activity. The Canadian Securities Administrators (CSA) issued a Consultation Paper on activist short-selling in 2020 which resulted in CSA Staff Notice 25-306 in late 2022, but no substantive regulatory reform has yet occurred.

Confronted with a short attack, target directors should investigate the allegations, and carefully review the corporation’s disclosure record, to ensure that it accurately discloses the disputed issues. In the absence of other effective remedies, additional disclosure may be the target’s most valuable tool to respond to short attacks.

4

Special committees

When to create a special committee

Whenever a board of directors is dealing with a matter that presents a conflict of interest for some of its members, it must adopt an appropriate process for dealing with it. A conflict can be addressed through the recusal of conflicted directors. In circumstances where multiple directors are conflicted or for reasons of convenience, the board can create a special committee of independent directors to lead the directors' process and make recommendations to the full board.

The use of special committees of independent directors has long been endorsed by courts as an effective means of addressing conflicts, protecting decisions supported by such committees from a successful attack on the ground of board conflicts. Regulators also favour and promote the use of such committees. 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 Chapter 11, federal financial institutions are required to have a standing special committee of independent directors, called the "conduct review committee", to review related party transactions.

Whether to create a special committee depends 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 the corporation or a significant asset 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.

A significant practical reason to constitute a special committee in some circumstances is that the board itself is too big and unwieldy to supervise an intensive process that will require numerous meetings, often called on short notice. A special committee may make sense in these circumstances simply for convenience, even in the absence of board conflicts (though as board sizes have shrunk in recent years, this rationale for a special committee has become less common).

Special committee composition and mandate

Determining which directors are unconflicted and eligible is a threshold matter, and depends on the board members' understanding, through disclosure, of the relationships that directors have that may create those conflicts. Eligibility will turn on the nature of the transaction or other matter being considered and the parties involved. For instance, directors associated with a controlling shareholder and management directors would not be regarded as independent for the purpose of considering a change-of-control transaction.

The committee should be established with as much lead time as reasonably possible.

The committee's mandate should be settled to the satisfaction of the committee members and should be broad enough not to constrain the committee unduly. If the committee is being established for convenience and not to deal with conflicts, this should be made clear in the mandate. The mandate should address:

- the role of the committee—to make recommendations to the full board and not to make final decisions on behalf of the board; and
- the authority of the committee—including to engage independent legal and financial advisors (or such other advisors as may be required) to assist in its work.

Any special compensation for committee members should be arranged at the outset. It is important for maintaining the objectivity of the committee that any compensation not depend on a particular outcome (i.e., no success fees).

Special committee process

The committee should follow a process in reaching its decisions that will enable it to demonstrate to a court or securities regulator that it has exercised independent and informed judgement. There are a number of key ingredients of a good process which are summarized below.

It is normally advisable for the committee to hire independent legal and financial advisors, after satisfying itself as to their independence. 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. The following factors are among those that may be relevant.

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

The committee should receive legal advice regarding the committee's responsibilities in the context of the matter in question, and the committee should become fully informed on the business and legal dimensions of the matter. The committee should understand and test the factual basis, including assumptions, for all opinions on which the committee proposes to rely. The committee should also take adequate time to deliberate having regard to the complexity of what must be decided.

The committee should ensure that the minutes of the committee meetings summarize the matters discussed and the advice obtained (and that copies of written advice are kept) so that it is clear that the committee

members have focused on the important issues, proceeded in a thoughtful and informed manner, and acted with a view to the best interests of the corporation, considering the interests of all affected stakeholders.

A special committee typically makes recommendations to the full board for final decision by the board. 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 decision, to establish reasonable reliance on the report of the special committee and on the advice of the committee's financial adviser.

5

Securities offerings

This Chapter reviews 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 take-over bid, and, in certain circumstances, to securities privately offered by way of an offering memorandum or similar disclosure document.

Directors' liability

Prospectuses that are used to offer securities to investors must be accurate and complete in all material respects. The prospectus (including any documents incorporated by reference in the prospectus and any marketing materials that are used by the corporation and investment dealers as part of the marketing effort) must not misstate or omit any "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. This is a prospective assessment of the likely market impact of information.

Each director of the corporation issuing securities under a prospectus (or any amendment) is personally liable to the investors for losses suffered if the prospectus contains a "misrepresentation". A misrepresentation is:

- an untrue statement of "material fact", being a fact that would reasonably be expected to have a significant effect on the market value of the securities issued or proposed to be issued; or
- an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made.

The due diligence defence

A director will not be liable for a misrepresentation (whether by misstatement or omission) in a prospectus if they conducted a reasonable investigation that provided the basis for a conclusion that there was no misrepresentation in the prospectus.

Directors should consider the following steps and procedures in order 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 disclosure preparation process so that they may reasonably conclude that:
  - the prospectus (including any documents incorporated by reference in the prospectus and any marketing materials) was prepared carefully;
  - the officers responsible for the areas of business described in the prospectus have read and have had an opportunity to comment on the contents of the prospectus; and
  - the disclosure was checked against the applicable form requirements including the statutory standard mandating that prospectuses provide “full, true and plain” disclosure of all material facts relating to the offered securities.
- 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, and should also ensure that the corporation’s auditor actively participates in the process.
- Experts like lawyers and auditors whose opinions or reports are included, or incorporated by reference, in the prospectus should provide appropriate consents in order to help shield the directors from liabilities for those “expertised” portions of the prospectus, although directors must still establish that they had no reasonable grounds to believe and did not believe that the experts’ report contained a misrepresentation or that any extract from the report reproduced in the prospectus did not fairly represent the report.
- Before the board meeting at which the prospectus is to be reviewed and approved, the senior officer responsible for its preparation should send the current 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 to approve it 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 compare the description of the corporation contained in it against their own knowledge of the corporation’s business and financial condition.
- Directors should satisfy themselves that the underwriters have conducted a reasonable investigation of the business, financial condition and prospects of the corporation and have discussed any significant issues with representatives of the corporation so that the underwriters were able to arrive at informed decisions and opinions regarding the quality of the disclosure in the prospectus (underwriters also face liability for misrepresentation in a prospectus, also certify the contents of the prospectus and also have a due diligence defence if they are sued by investors).
- 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 judgments about the disclosure in the prospectus.

6

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 as soon as practicable 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 timely and 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.

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," subject to certain exceptions. 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, new material information may have to be disclosed even if it does not reflect or signify a change in the business and affairs of a corporation, which is a higher standard.

Canadian issuers that access U.S. capital markets by offering securities to U.S. investors 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 any 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.

Disclosing material changes

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 promptly filed with securities regulators. 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 may have an impact on the market price of the corporation's securities. Making this decision is particularly difficult when evaluating an unexpected business development, or 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 will not protect the good faith but incorrect disclosure decisions of directors.

There is no bright-line test for determining materiality. In the context of whether a material change has occurred regarding a significant transaction, 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 *per se* material changes *to the corporation* and therefore do not trigger disclosure obligations. However, an external development may result in a material change to the corporation, which would require disclosure. Similarly, fluctuating financial results may reflect a material change to the business, and that would require disclosure.

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]. Below 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 (e.g., 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 because, if confidentiality is lost or rumours begin to circulate, the corporation will generally be required to make immediate public disclosure;
- divulging the information on a selective basis may constitute illegal tipping; and
- 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)[8], 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.

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 similar regime is in place in other Canadian jurisdictions.

[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 Chapter under "Liability for Continuous Disclosure" and "Confidential Material Change Reports".

[8] Venture issuers are not required to file an AIF; however, many do so voluntarily so as to be eligible to file short form prospectuses.

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 its affairs. The disclosure violation ends when the disclosure failure is corrected. The right of action for damages is most likely to be exercised through class actions, and may include investors who purchased securities on a Canadian exchange or in Canada. 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, which is a fairly low threshold. Court approval is also required for any proposed settlement of any action.

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.

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

If management of a corporation believes that a pending material event may have crystallized to the point of being a "material change", yet 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 and may be particularly beneficial where a corporation is facing a difficult judgment call about whether information is material.

Despite this, the actual incidence of corporations making confidential material change filings is not high, 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 confidential disclosure of material changes.

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 they 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 they 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. These disclosure policies are discussed in detail below.

Forward-looking statements

An additional defence is available against allegations of misrepresentations in forward-looking information. For directors to enjoy the benefit of the defence, the following 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.
- 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 this defence[9]. First, the cautionary language must be customized to the particular circumstances and 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. The defence does not require issuers to include every conceivable risk that might cause forward-looking information not to come true. Rather, 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 to liability are available for directors in each of these cases.

Selective disclosure

It is an offence under Canadian securities laws for any insider of a reporting issuer (which includes a director) to communicate material non-public 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

[9] See Ontario Securities Commission Policy 51 – 604 – *Defence for Misrepresentations in Forward-Looking Information*.

immediately apparent that market participants considered the information to be material. Market evidence is difficult to refute.

When material information is communicated on a selective basis in the necessary course of business, it is prudent to do so pursuant to a confidentiality agreement. It is illegal for the recipient of that information to communicate it to others or to trade in the corporation's securities (or to recommend that others trade) 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, the media or other market participants generally are not.

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[10]. 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—not as the first or primary means of communicating material information, but as an additional way of ensuring the broadest possible dissemination—by posting information on the corporation's website or disseminating it via other social media channels concurrently with issuing a news release or filing information with securities regulators.

It is important that boards 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 and material information and prevents selective disclosure. Most 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 with market practices 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

[10] See National Policy 51 – 201 – *Disclosure Standards*.

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 very important to establishing a due diligence defence to civil liability claims for disclosure violations. 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.

Although disclosure policies will vary from one corporation to another, every policy should do at least the following:

- establish procedures to ensure that material information that is required to be disclosed is done so in a timely manner, and that 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 material non-public information, including trading and tipping restrictions—and what their responsibilities are and what to do when the policy is breached;
- establish that selective disclosure of material information is not permitted, that when any selective disclosure of corporate 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, and that if improper selective disclosure occurs, the policy should require immediate issuance of a news release;
- identify spokespersons authorized to communicate with third parties and require that all communications be made by only these spokespersons, and whenever information is disclosed by more than one individual, it should be done so consistently;
- require that earnings and other financial guidance (including quarterly and annual) be given initially in news releases that are broadly disseminated and only discussed in a conference call that is fully accessible to shareholders and market participants following the news release;
- clarify 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; and
- address how social media and other new communication opportunities or technologies will be used by the corporation as part of its disclosure platform, and ensure that this platform is subject to proper review and oversight (including guidelines for employee engagement about the corporation on social media).

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.

7

Insider reporting and insider trading

Directors are insiders

Under Canadian securities legislation, a director is a "reporting insider"[11] of a public corporation if they serve as a director of:

- the public corporation;
- a "major subsidiary" of the public corporation, meaning the subsidiary accounts for 30% or more of the consolidated entity's assets or revenue; or
- an entity that is a "significant shareholder" of the public corporation, meaning an entity that beneficially owns or exercises control or direction over more than 10% of the public corporation's voting shares[12].

Insider reports

Within 10 days of becoming a "reporting insider", each director must file an initial insider report with securities regulatory authorities who beneficially owns or exercises control or direction over:

- any securities of the corporation, whether debt or equity, voting or non-voting, common or preferred, and including stock options; or
- any related financial instrument, such as derivatives or other contracts or arrangements that, directly or indirectly, have the effect of altering a director's economic interest in, or exposure to, the corporation.

This report is filed electronically through the Internet, using the System for Electronic Disclosure by Insiders (SEDI). Ownership is deemed to pass on the date of trade and not on the settlement date. Nil reports 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

[11] The bulleted list refers to categories of directors who are reporting insiders. There are, of course, other categories of reporting insiders specified in securities laws, such as chief executive officers, chief financial officers, parent companies and other significant shareholders of public corporations.

[12] These directors are exempt from insider reporting if they do not, in the ordinary course, receive or have access to material information about the public corporation before such information is generally disclosed.

for the previous six months (or any shorter period that the person was a director of the acquiring corporation). Accordingly, the director must file, within 10 days, any insider reports that they would have had to file during the look-back period.

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 months (or any such shorter period that the director was a director of the acquired corporation). Accordingly, the director must file, within 10 days, any insider reports that they would have had to file during the look-back period.

Each director must disclose any changes in his or her beneficial ownership of, or control or direction over, securities or related financial instruments of each public corporation of which the director is a reporting insider. Each sale, purchase or other change must be reported separately (that is, sales, purchases and other changes are not netted). The report must be filed within five 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.

In addition, directors and other persons in a special relationship with a public corporation may not inform (known as "tipping"), 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. Similarly, recommending or encouraging another to trade, while in possession of material non-public information, is prohibited.

Canadian securities law imposes relatively harsh penalties for breaches of the rules governing insider trading. 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.

Even if trading activity does not technically breach the insider trading rules under securities laws, sanctions may be imposed if securities regulators determine that the trading activity undermined the integrity of the capital markets and was contrary to the public interest. A number of cases have shown the willingness of regulators to take action in circumstances where the impugned conduct fell short of an actual violation of insider trading rules.

A director who breaches the above restrictions regarding trading in 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 Chapter, including the civil liability referred to below.

Directors who are found to have breached the trading prohibition may 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 one of the following is true:

- 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 CBCA, as well as directors of their subsidiaries, are prohibited from:

- short selling any share of the public corporation or any of its affiliates, subject to limited exceptions; and
- selling a call or buying a put in respect of any security of the corporation or any of the corporation's affiliates.

The CBCA provides penalties including fines not to exceed the greater of $1 million and three times the profit made or imprisonment for a term not exceeding six months or both.

Criminal code offences

An insider may also be guilty of an indictable offence and liable to imprisonment for a maximum term of 10 years if an insider, directly or indirectly, buys or sells a security knowingly using inside information.

8

Competition law compliance

Enforcement

Canada's *Competition Act* contains criminal and civil provisions prohibiting a variety of anti-competitive conduct, including:

- conspiracies, agreements or arrangements between competitors to fix prices, allocate customers or markets, or fix, control, prevent, lessen or eliminate the production or supply of a product or service;
- agreements or arrangements between employers to fix, maintain, decrease or control salaries, wages or terms and conditions of employment or to not solicit or hire each other's employees;
- bid rigging;
- deceptive marketing;
- abuse of dominant position; and
- other business practices, such as refusals to deal, price maintenance, exclusive dealing and tied selling, where these practices have an adverse effect on competition or are likely to do so.

Canada's Competition Bureau enforces the various provisions of the *Competition Act* with a view to both punishing offenders and deterring anti-competitive conduct. Enforcement includes prosecuting corporations as well as individuals, such as employees, officers and directors of corporations, who contravene the *Competition Act*. In some cases, when a corporation commits an offence under the *Competition Act*, any officer or director of the corporation in a position to have directed or influenced the policies of the corporation in respect of the prohibited conduct is deemed to be a party to and guilty of the offence. Fines and penalties can be significant, depending on the provision contravened, including uncapped fines and penalties of up to 3% of annual global revenue for a corporation.

In addition, the *Competition Act* provides for the mandatory notification and review of mergers meeting certain transaction size thresholds and for the review of any potentially anti-competitive merger of any size.

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

Implementing a compliance program

A credible and effective competition law compliance program requires the following:

- management support and communication of the importance of the program so that employees also see compliance as a priority;
- substantive provisions that reflect and address particular competition law risks facing the corporation and its employees; and
- mechanisms to discover and report non-compliance.

The specific elements of a program should include the following:

- a compliance manual that is provided to each relevant employee or other representative of the corporation (and its subsidiaries);
- training programs that are conducted on a regular basis;
- monitoring of compliance measures implemented; and
- certification procedures, pursuant to which employees confirm that they: (i) understand the competition laws that govern their conduct and that of the corporation; (ii) agree to adhere to those laws and to the corporation's policies, principles and rules for compliance; (iii) know who in the corporation to contact with questions regarding conduct or compliance; and (iv) acknowledge that failure to so comply will constitute grounds for disciplinary action, including dismissal.

9

Pensions

Pension benefits legislation requires employers who sponsor defined benefit pension plans to fund future benefit liabilities on a going concern and solvency basis through monthly contributions determined by an actuary. Employers who sponsor defined contribution pension plans are required to make the monthly contributions set out in the applicable plan text. The legislation also imposes fiduciary standards of care and other obligations on the administrator of the pension plan and its fund. The administrator is generally responsible for investment of pension fund assets, payment of benefits and day-to-day plan operations. Employers often act as both the sponsor and the administrator of a single employer pension plan.

Generally, a person's failure to comply with the fiduciary standards of care and other obligations imposed by pension benefits legislation (including the obligation to make contributions to the plan when due) is guilty of an offence. In Ontario, such a person is liable for a fine of up to $100,000 for the first conviction and not more than $200,000 for each subsequent conviction. Directors or officers who cause, authorize, permit, 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.

In addition, the Ontario pension regulator has the authority to impose administrative penalties for certain contraventions under Ontario pension legislation. The administrative penalties are subject to maximum penalty amounts: $10,000 per contravention or failure to comply by an individual (which may include a director), and $25,000 per contravention or failure to comply in the case of a person other than an "individual". Administrative penalties are an enforcement tool that can be imposed on their own or in conjunction with the other enforcement options available under pension legislation as noted above.

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 and other statutory obligations of the pension administrator are met, thereby reducing the risk of directors' liability under pension benefits legislation. The Canadian Association of Pension Supervisory Authorities (CAPSA) has released guidelines that, although voluntary, establish industry best practices against which pension administration and related governance structures are generally measured.

Best practices relating to pension governance structures call for the following:

- the rules and responsibilities 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 review the administration of the pension plan and the discharge of the roles and responsibilities of the governance participants are established and the plan governance structure is reviewed on a regular basis;
- documentation that evidences implementation of plan administration and governance procedures is developed and maintained;
- the board and pension committee receive and consider regular reports (including those relating to the funding status 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 defined contribution or capital accumulation 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.

10

Environmental and occupational health and safety liabilities

Liability for environmental and occupational health and safety is of concern to directors of many corporations because of the potential for significant penal sanctions for both 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 the main environmental responsibilities of directors.

- 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.
- The CBCA also now enables directors and officers to consider the environment when acting with a view to the best interests of the corporation.
- Reasonable care typically includes ensuring the corporation has established an environmental policy, implemented a proper system to prevent contraventions of environmental laws, appointed competent and qualified persons to oversee the implementation of the system and taken reasonable steps to monitor compliance with the policy and the effective operation of the system.
- 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.
- Upon receipt of these reports, directors should ensure that management is appropriately correcting any problems identified in a timely manner.

Provincial regulators may, in some cases, name directors and officers personally in a regulatory order requiring the investigation or remediation of contamination or the completion of other environmental management measures. Such orders may be issued, for example, where a director is alleged to have management or control over a contaminated property. In some provinces, like Ontario, there is no statutory scheme for reimbursing parties named to such an order in the event the order is successfully challenged.

Environmental regulators may, in some cases, hold directors and officers personally responsible for acts and environmental offences committed by the corporation where, for example, the director or officer directed, authorized, assented to, acquiesced in or participated in the commission of such offence.

Thus, although attention to environmental concerns can reduce the potential for liability, it also creates a risk of increased liability if directors become aware of problems and do not deal with them, or to the extent directors influence the implementation of an environmental management system, including, for example, by making decisions about the remediation of a contaminated site or by exercising financial oversight of an environmental program. Clear assignment of environmental responsibilities to management 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 consider 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;

- consider ensuring the corporation establishes and adequately implements an independent system to periodically audit the corporation's environmental management system and policy;
- carefully consider the board's legal obligations and the consequences of any decision that would influence how the environmental management system is implemented, particularly where such decision involves initiating, modifying or terminating environmental remediation or other environmental programs; and
- ensure that the directors have sufficient protection—through indemnity agreements with the company, environmental insurance or otherwise—in relation to potential environmental liabilities.

Reporting guidelines

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

- Boards should receive a report, as soon as possible, on any event or condition that has or is likely to have significant environmental or health impact or that is likely to lead to significant safety risks, attract public attention (especially at the provincial or national level) or have significant financial implications.
- Boards should receive a report quarterly on:
  - environmental compliance and significant investigations or legal proceedings;
  - the progress 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.
- Boards should receive a report annually on:
  - the progress of 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.

All reports should be submitted by the proper company officials.

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 ensuring that the corporation establishes a health and safety committee, implements worker safety plans and complies 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.

11

Directors of federal financial institutions

This Chapter focuses on the special duties and responsibilities of directors of banks under the *Bank Act* (Canada), federally incorporated trust or loan companies under the *Trust and Loan Companies Act* (Canada) and federally incorporated insurance companies under the *Insurance Companies Act* (Canada). Each is referred to as a "financial institution," and their governing statutes are referred to collectively in this Chapter 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 "act honestly and in good faith with a view to the best interests of the financial institution" and to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".

No more than two-thirds of the directors may be "affiliated" with the financial institution. Furthermore, 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, must be resident Canadians at the time of election or appointment.

Required committees and procedures

The legislation specifically requires directors to establish:

- an audit committee having explicit duties;
- a conduct review committee to ensure that related party transactions are monitored and appropriately evaluated;
- procedures to resolve conflicts of interest, and a committee to monitor these procedures;
- in the case of banks, a committee to ensure that the bank is complying with the consumer provisions under the *Bank Act* (Canada);

- in the case of trust, loan and insurance companies, 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, a policy regarding the management of par accounts, and criteria for changing the premium or charge for insurance, amount of insurance or surrender value in respect of adjustable policies.

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 in Chapter 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 Superintendent of Financial Institutions (Superintendent) 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; and
- 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 for which the actuary is responsible.

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.

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 the Superintendent.

Consumer protection committee

In 2022, a robust new consumer framework was introduced under the *Bank Act* (Canada), and banks are now required to designate a committee to oversee compliance with the consumer provisions. A standalone committee is not required – the committee can be subsumed as part of an existing committee, such as the audit or conduct review committee. The majority of the members of the consumer protection committee must be independent of or "unaffiliated" with the bank, and none of the members of this committee may be officers or employees of the bank or a subsidiary of the bank. Generally, the responsibilities of the consumer protection committee are to:

- require management to establish procedures for complying with the consumer provisions under the *Bank Act* (Canada);
- review the procedures established by management to determine whether they are appropriate to ensure that the bank is complying with the consumer provisions;
- require management to report at least annually on the implementation of the procedures and on any other activities that the bank carries out in relation to the protection of its customers;
- after each committee meeting, report to the board on matters reviewed by the committee; and
- ensure that the proceedings of the committee are reported annually to the Commissioner of the Financial Consumer Agency of Canada.

Guidance from the Office of the Superintendent of Financial Institutions

Corporate Governance Guideline

The Office of the Superintendent of Financial Institutions (OSFI) has developed a principles-based *Corporate Governance Guideline* (CGG) 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. The most recent version of the CGG, published in September 2018, places a greater focus on board effectiveness, while providing directors with greater discretion as to how they can meet OSFI's corporate governance expectations. The CGG also contains clear principles that replace OSFI's board expectations previously contained in risk management and capital guidelines and advisories.

The board's key responsibilities, per the CGG, consist of approving and overseeing:

- the financial institution's short- and long-term business plan, strategy, and significant strategic initiatives;
- the financial institution's risk appetite framework, internal control framework, codes of ethics and conduct, and significant policies and plans related to the management of capital and liquidity;
- the appointment, performance review, compensation and succession of the CEO and other key members of senior management including the heads of the oversight functions;
- the mandate, resources and budgets for the oversight functions; and
- audit plans, both internal and external.

In addition, the board should provide advice and guidance to senior management, as appropriate, on:

- significant operational, business, risk, and crisis management policies and their effectiveness; and
- business performance and the effectiveness of risk management.

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 governance, 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 relevant provisions of the legislation, as well as OSFI's *Supervisory Framework* and *Assessment Criteria*.

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 boards 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, OFSI

states that the board of directors is responsible for providing stewardship and oversight of management and operations of the entire institution. Its key responsibilities include:

- guiding, reviewing and approving the business model and associated objectives, strategies and plans;
- reviewing and approving corporate risk policy including overall risk appetite and tolerance;
- ensuring that senior management is qualified and competent;
- reviewing and approving organizational and procedural controls;
- ensuring that principal risks are identified and appropriately managed;
- ensuring that compensation for employees, senior management and the board is aligned with the longer-term interests of the financial institution;
- reviewing and approving policies for major activities; and
- providing for an independent assessment of management controls.

Diversity

As part of its 2023 Budget, the federal government announced its intention to amend the *Bank Act* (Canada), the *Insurance Act* (Canada) and the *Trust and Loan Companies Act* (Canada) to apply the CBCA diversity disclosure requirements for directors and senior management of federally regulated financial institutions. See Chapter 2.

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Insolvent corporations

A corporation may be insolvent on a balance sheet basis (i.e., its liabilities exceed the value of its assets) or on a cash flow basis (i.e., it is unable to meet its obligations as they generally come due). Often, directors are first confronted with insolvency considerations as a result of a corporation's cash flow and related working capital constraints, and they may be slow to respond to the challenges facing the corporation.

Insolvency is of particular concern for directors because: (i) there may be heightened risk of personal liability in such circumstances, including by reason of additional duties or obligations arising under applicable insolvency legislation; (ii) some protections customarily available to directors—such as indemnification from the corporation—may be of little or no comfort where the corporation is insolvent; and (iii) the ensuing financial losses that may be suffered by creditors and shareholders of the corporation, together with the public court process that accompanies formal insolvency proceedings, typically results in the conduct and activities of directors in the lead-up to and during insolvency receiving much greater scrutiny, often with the benefit of hindsight.

Where insolvency occurs, certain claims may be made against the corporation's directors, including:

- claims by employees arising from their employment (e.g., unpaid wages and vacation pay, and in some provinces, also unpaid claims for severance and termination entitlements);
- claims by the corporation (and trustees in bankruptcy) against directors who vote for or consent to payments of dividends or redemptions of shares when the corporation is insolvent or rendered insolvent as a result and without reasonable grounds for the directors to have believed otherwise;
- claims by the government for the failure to deduct, remit and pay requisite retail sales taxes and certain payroll and other source deductions (i.e., amounts deducted from employee wages on account of CPP, unemployment insurance, and income tax);
- claims in respect of outstanding pension obligations;
- claims in respect of environmental obligations; and
- claims in respect of an offence by the corporation under the *Bankruptcy and Insolvency Act* (Canada), where a director has directed, authorized, assented to, acquiesced in or participated in the commission of the offence.

In addition, directors ought 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 heightened measures 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, including:

- ensuring 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;
- ensuring management is properly directed, equipped and empowered to address the challenges facing the corporation, including obtaining additional expertise or skillsets if needed to navigate financial distress;
- making optimal use of available time and resources or liquidity, including commencing the pursuit of restructuring, refinancing, recapitalization and other strategic initiatives in a timely manner;
- increasing the frequency of board meetings and enhancing reporting to the board by management;
- ensuring that segregated trust accounts and remittance procedures have been established to adequately provide for wages, taxes, source deductions and other statutory trusts;
- having all directors' dissents to board resolutions noted in the minutes of the meeting;
- obtaining appropriate professional advice, including legal advice, and preparing for the possibility of a bankruptcy or insolvency filing (whether to pursue a liquidation or a restructuring) under the *Companies' Creditors Arrangement Act* (Canada), the *Bankruptcy and Insolvency Act* (Canada) or other applicable legislation;
- reviewing the scope of any directors' liability insurance and give notice under such insurance of any potential claims, and ensuring that appropriate coverage (including run-off insurance) is in place;
- ensuring that the corporation has entered into an indemnity agreement with each director, as permitted by the by-laws and the relevant governing statute; recognizing, however, that in an insolvency, such an indemnity may be of limited or no value;
- where appropriate, charging unencumbered corporate assets, or obtaining third-party guarantees or indemnities, to stand as security for the payment of amounts for which directors may be liable;

- retaining independent legal counsel to advise the directors on how to protect against personal liability in the circumstances; and
- if necessary, resigning.

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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 CBCA and the 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:

- the director acted honestly and in good faith[13] with a view to the best interests of the corporation, or
- in the case of a criminal or an administrative action or proceeding that is enforced by a monetary penalty, the director had reasonable grounds for believing that their 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 the director or former director 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 a director ought to have done, and
- acted honestly and in good faith with a view to the best interests of the corporation and, if applicable, had reasonable grounds for believing its conduct was lawful.

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.

[13] 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.

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 these 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;
- 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; and
- if the by-laws are changed, there may be some uncertainty as to which provision should apply to a particular claim, something that has come back to haunt directors in situations in which by-laws were changed after the directors left the board.

Contracts of immunity

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 (e.g., 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[14]—as long as the director agrees to repay the advances if a court determines they are 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, defence costs in actions brought against the director on behalf of the corporation they serve 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.

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, 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.

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 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.

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[14] Both the CBCA and OBCA expressly permit the advance of costs. These statutes also require a director to repay the monies if they do not ultimately meet the statutory standard necessary for indemnification.

Exclusions

Director's liability policies may contain a number of exclusions, which are provisions permitting the insurer to deny coverage. Common ones include claims arising out of:

- environmental pollution;
- 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;
- deliberately fraudulent or criminal acts;
- a director receiving a profit or advantage to which they were not legally entitled;
- bodily injury or death of any person;
- taxes (though employee withholding taxes are frequently now covered);
- matters that are uninsurable by law; and
- an action by the corporation against an insured.

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. Most policies these days provide that there is no deductible under any circumstances for directors.

The corporation versus insured exclusion is intended to protect the insurer from collusion 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:

- 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 on behalf of the corporation without the active involvement of the corporation against the directors.

Entity coverage and defence costs

A directors' liability policy may also cover the corporation for losses it suffered for matters such as securities violations and employment 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).

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. Two solutions to these problems are to:

- 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 exclusive benefit of the directors also avoids any risk that prior claims made against the corporation may exhaust the coverage otherwise available to directors. In this regard, it is recommended that directors consider obtaining what is known as a Side A difference in conditions excess policy. This type of policy has coverage that is only available to directors (i.e., coverage is not shared with the corporation) and it typically has far fewer exclusions than the primary policy (e.g., fines, penalties and taxes are often covered).

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.

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.
- 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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