CANADA BUSINESS CORPORATIONS ACT

DISCUSSION PAPER

FINANCIAL ASSISTANCE AND RELATED PROVISIONS

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EXECUTIVE SUMMARY

FINANCIAL ASSISTANCE AND RELATED PROVISIONS

Section 44 of the Canada Business Corporations Act (CBCA) is one of the most complex provisions in federal corporate law. The section restricts the giving of loans, guarantees and other kinds of financial assistance by a CBCA corporation where the directors have reasonable grounds for believing that the corporation cannot meet specific assets and solvency tests. The restriction is applicable in two types of circumstances: financial assistance to directors, shareholders and certain other persons related to the corporation; and financial assistance to any person for the purchase of shares of the corporation or an affiliated corporation. If financial assistance is granted in contravention of s. 44, the directors may be liable to reimburse the corporation for the amount of the financial assistance and lenders may not be able to rely on guarantees granted by the corporation.

The policy behind the section appears to be to protect the corporation's creditors and the minority shareholders from impairment of its capital through financial assistance given to corporate insiders where there are reasonable grounds for believing the corporation is or, after giving the financial assistance, will be insolvent.

Related to s. 44 is s. 120 which requires directors and officers of CBCA corporations to disclose whether they are a party to a material contract with the corporation or have an interest in a person who is a party to a material contract with the corporation.

This paper seeks to:

- describe the current s. 44 regime and its origin and purpose;
- situate s. 44 within the overall framework for conflict of interest established by corporate law;
- compare other regimes;
- consider general problems/issues relating to s. 44;
- review comments already made on s. 44 by CBCA stakeholders;
- present options and recommendations for amending or repealing s. 44; and
- review problems and options with respect to s. 120.

Section 44 must be examined within the overall framework of rules dealing with conflict of interest in the corporate setting. Enormous amounts of capital and income of CBCA corporations are available to be used by directors and officers of the corporation for the benefit of all corporate stakeholders, including minority shareholders and creditors. Because directors and officers have power to control this capital and profit, the law imposes on them fiduciary duties to

the corporation. Directors and officers must "act honestly and in good faith with a view to the best interests of the corporation."

It is the potential conflict between the fiduciary role of corporate insiders and their ability to enter into transactions with the corporation that has led the common and civil laws, corporate legislation and other statutes to attempt to fashion rules to protect other stakeholders. The main challenge has always been to provide reasonable protection while allowing a corporation flexibility in its financial and business dealings.

There is no one definitive approach to the regulation of conflict of interest and the granting of financial assistance. In place of an assets/solvency test for financial assistance and directors' liability, some regimes have:

- **!** little or no regulation. In these regimes the common law of directors' fiduciary duty is often relied on to address abuses;
- **!** enhanced disclosure obligations;
- **!** corporate governance restrictions such as review of related party transactions by a committee of independent directors;
- **!** financial limits on assistance;
- **!** absolute prohibition on giving financial assistance when a company is or would become insolvent; and
- **!** imposition of liability on directors for all debts of a corporation that trades while it is insolvent.

The cost of a transaction may be augmented because of the necessity to comply with s. 44. These additional costs may affect a corporation's competitiveness in the market. There may also be a negative impact on competitiveness through loss of opportunities because of an inability to obtain financing for certain projects. On the other hand, s. 44 may be important in protecting the capital of the corporation from misuse or diversion by insiders for personal benefits. The additional transaction costs may be money well spent in protecting the corporation's capital.

Legal practitioners and others have raised a long list of technical problems with s. 44 including unpredictable liability for directors. Clarifying or eliminating s. 44 may reduce unpredictable and therefore unfair liability imposed on the directors. Accountants and lawyers are reluctant to provide solvency opinions. Therefore, directors may not be able to benefit from the good faith reliance defence (subs. 123(4)) currently available to them. On the other hand, eliminating or reducing the statutory rules on financial assistance (and other conflict of interest rules) may lead to greater reliance on the courts to set the standards for proper conduct among directors.

Another concern with the section is that while it appears to cause problems for directors and others, the protection it affords creditors and minority shareholders may be questionable.

Unlike pre-1975 federal rules, there is no absolute prohibition on financial assistance. The statute only requires that the solvency and assets tests be met. In other words, although a transaction may severely abuse the shareholders, may result in a clear conflict of interest and may even be a breach of fiduciary duties and therefore be in contravention of other CBCA provisions, the transaction still might not offend s. 44. On the other hand, s. 44 may usefully impose a minimum standard for directors in respect of creditor and shareholder protection.

Another issue is what role should corporate law play with respect to financial assistance and other related-party transactions of publicly-traded corporations and what is the appropriate interplay between corporate and securities laws. Publicly-traded CBCA corporations and related parties are subject to regulation by provincial securities laws. These laws supplement or duplicate the disclosure and transactional rules imposed by the CBCA.

The paper presents eleven options for dealing with these problems, including the repeal of s. 44 and the replacement of the solvency and assets tests with a variety of options. Some of the alternative options include a best interests of the corporation test, disclosure or notice, and shareholder approval of transactions which are material and the maintenance of s. 44 with clarifications.

The paper concludes by recommending that in respect of share purchase financial assistance, s. 44's solvency/assets test requirements should be maintained and clarified.
In respect of related party financial assistance, the paper recommends that the CBCA be amended to replace the solvency/assets tests with three requirements: disclosure, a best interests of the corporation test and director or shareholder approval.

The paper suggests an additional requirement for publicly-traded CBCA corporations namely that all material related-party transaction with significant shareholders, directors and officers of the corporation or the holding corporation and their associates, shall also be reviewed by a conduct review committee made up of independent directors.

Material Contracts

The paper discusses ten concerns raised in regard to s. 120. A number of the concerns focus on the content of the required disclosure and to whom the disclosure should be made. For example, the paper canvasses the issue whether the continuing disclosure requirement imposed by subs. 120(6) needs to be clarified. The paper recommends the adoption of the Alberta corporate law requirement that general disclosure be given within the 12-month period preceding the time at which disclosure would otherwise be required.

Other issues address the ability of interested directors to vote on material contracts, the duty to account as well as standards and tests which must be met. For instance, the paper discusses whether the standard "reasonable and fair to the corporation" is appropriate and fair to

the directors. After review of the issue, four options are presented: (1) maintain the present "reasonable and fair" test; (2) amend the provision by removing the "reasonable and fair" test and requiring only disclosure and either director or shareholder approval in order to render the contract being non-voidable; (3) replace the "reasonable and fair" test with a requirement that the contract be "in the best interests of the corporation"; and (4) replace the "reasonable and fair" test with a subjective test such as the board or director was reasonably justified in concluding, at the time the financial assistance was given, that it was in the best interests of the corporation.

The recommendations contained in the discussion paper are not in any sense government or even departmental policy. Rather, they are ideas that have come about largely through preliminary discussions with stakeholders across the country. This paper, and the consultations that will follow, are intended to solicit new ideas on how the financial assistance provisions can be improved. All suggestions are welcome.

CANADA BUSINESS CORPORATIONS ACT

FINANCIAL ASSISTANCE AND RELATED PROVISIONS

I. INTRODUCTION

[1] Section 44[1] of the Canada Business Corporations Act[2] (CBCA) is one of the most complex provisions in federal corporate law. The section restricts the giving of loans, guarantees and other kinds of financial assistance[3] by a CBCA corporation. The restriction is applicable in two types of circumstances: financial assistance to directors, shareholders and certain other persons related to the corporation; and financial assistance to any person for the purchase of shares of the corporation or an affiliated corporation. If financial assistance is granted in contravention of s. 44, the directors may be liable[4] to reimburse the corporation for the amount of the financial assistance and lenders may not be able to rely on guarantees granted by the corporation.[5]

[2] The policy behind the section appears to be to protect primarily the corporation's creditors and secondarily the minority shareholders from impairment of its capital through financial assistance given to corporate insiders where there are reasonable grounds for believing the corporation is or, after giving the financial assistance, will be insolvent.[6] While s. 44 does not prohibit financial assistance transactions and a corporation is generally permitted flexibility in its financial dealings, s. 44 does place restrictions on a corporation's ability to give financial assistance in certain circumstances.

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[1] Reproduced in full in Appendix A.

[2] R.S.C. 1985, c. C-44.

[3] Section 44 restricts the giving, "directly or indirectly", of "financial assistance by means of a loan, guarantee or otherwise". The CBCA does not provide any other definition of the expression "financial assistance". See discussion of this issue in Appendix C, Issue 7.

[4] Under par. 118(2)(d) read in conjunction with s. 44.

[5] The problems experienced by lenders with s. 44 are discussed below in Parts V(a) and (c) and in Appendix C, Issues 17-18.

[6] See further discussion of the policy behind s. 44 under Part II(c) below.

[3] Since its adoption in 1975, there have been numerous complaints[7] that s. 44 is vague, confusing, creates commercial anomalies and financing/re-structuring problems. For instance, expressions used in s. 44, such as "directly or indirectly," "realizable value" and "loan, guarantee or otherwise," give rise to difficulties in interpretation.[8] Repeal or revision of s. 44 has been identified as a priority by CBCA corporations, directors, lenders, lawyers and accountants.

[4] The uncertain wording used in s. 44 causes legal practitioners considerable difficulty in providing clients with unqualified opinions. Moreover, in 1988, the Auditing Standards Steering Committee of the Canadian Institute of Chartered Accountants (CICA) issued an auditing opinion that accounting practitioners should not provide an opinion on matters related to solvency.[9] Because directors may not be able to obtain adequate advice from either their lawyers or accountants, s. 44 appears to impose unfair and unpredictable liability on them. It may also hinder the competitiveness of CBCA corporations.[10]

[5] Problems have also been identified with s. 120 of the CBCA which deals with another conflict of interest situation: directors and officers with interests in material contracts with the corporation.

[6] This paper seeks to:

- describe the current s. 44 regime and its origin and purpose (part II of this paper);
- situate s. 44 within the overall framework for conflict of interest established by corporate law (part III);
- compare other regimes (part IV);
- consider general problems/issues relating to s. 44 (part V);
- review comments already made on s. 44 by CBCA stakeholders (part VI);
- present options and recommendations for amending or repealing s. 44 (part VII) and

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[7] John Howard, one of the authors of the "Dickerson Report" (R. W.V. Dickerson, J.L. Howard, L. Getz, Proposals for a New Corporations Law for Canada (Ottawa: Information Canada, 1971)) which led to the enactment of the CBCA, noted in 1976 that the financial assistance provision "has elicited more controversy than all of the other sections in the Act put together."

[8] Technical problems raised with respect to s. 44 are discussed in Appendix C and more general problems are discussed in Part V below.

[9] Canadian Institute of Chartered Accountants, Auditing and Related Services Guideline -- Aug-4 "Services on Matters Relating to Solvency", CICA Handbook. See detailed discussion below under Part V(d).

[10] See discussion below in Part V(b).

- **!** review problems and options with respect to s. 120 (Part VIII).[11]

[7] Recommendations and options are given simply to help focus discussion. No final determination of the most appropriate options will be made by Industry Canada until the completion of consultations.

II. SECTION 44

A. THE PROVISION

[8] A CBCA corporation has the capacity and the rights, powers and privileges of a natural person (subs. 15(1)). Thus, in principle, a corporation has the right to give financial assistance by means of loans, guarantees or otherwise to whomever.

[9] However, this right is curtailed by CBCA s. 44 as well as fiduciary and other duties imposed.[12] Section 44 places limits on the giving of loans, guarantees and other financial assistance to a very broad range of specified persons who have some connection with the corporation,[13] for any purpose (related party financial assistance[14]); and to any person, in connection with the purchase of shares issued by the corporation or an affiliated corporation (share purchase financial assistance). Some of the confusion arising out of this section may be that it attempts to deal with these two separate types of transactions within a single rule.

[10] Section 44 prohibits financial assistance in these two circumstances where the directors have "reasonable grounds for believing that" either the corporation is or would become insolvent

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[11] This paper is developed in part from the following detailed reports: Institute of Law Research and Reform, Financial Assistance by a Corporation: Section 42, The Business Corporations Act (Alberta), Report for discussion No. 5 (Edmonton: August 1987) and Institute of Law Research and Reform, Financial Assistance by a Corporation: Section 42, The Business Corporations Act (Alberta), Final Report No. 54 (Edmonton: August 1989) (hereinafter Alberta LRI Discussion and Final reports); and from a paper prepared by Georges Dubé, Lavery, de Billy, Montréal, under contract with Industry Canada.

[12] See discussion in Part III below.

[13] Persons specified in the section are "any shareholder, director, officer or employee of the corporation or of an affiliated corporation or to an associate of any such person". Both affiliated corporation and associate are defined in s. 2.

[14] As described above, the provision is broadly drafted and catches persons who might not otherwise be seen to be "insiders" able to influence the decision-making of the corporation. For example, the provision restricts financial assistance given to any shareholder, even one holding a very few shares, and to any employee.

or the corporations assets are or would be less than all of its liabilities and stated capital.[15] Financial assistance therefore seems to be permitted in circumstances other than the two specified or where there are no such reasonable grounds.

[11] Directors who authorize financial assistance contrary to s. 44 are personally liable to the corporation for the amount of such financial assistance.[16] The statute provides the directors with the limited good faith reliance defence which permits directors to avoid liability where they rely in good faith upon the financial statements or a report of a lawyer, accountant or other professional.[17] However, as noted above, directors appear to be having difficulties in obtaining legal and accounting opinions which would permit reliance on this defense.

[12] Subsection 44(2) sets out certain exceptions whereby financial assistance is expressly permitted whether or not there are reasonable grounds for believing the corporation is insolvent, etc. For example, subs. 44(2) permits financial assistance to be given to employees in accordance with a share purchase plan or to a subsidiary in any circumstance. Finally, subs. 44(3) permits the corporation and lenders for value in good faith without notice of the contravention of the section to enforce the contract. There is some uncertainty in the lending community as to how far this section protects lenders.[18]

[13] Section 44 was adopted as part of a remodelled federal business corporate law in 1975.[19] Except for some minor changes in 1978 and 1994,[20] the current provision is largely the same as the provision adopted in 1975.

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[15] A corporation's stated capital is the full amount of consideration received by the corporation for any shares it issues. See CBCA, s. 26.

[16] See par. 118(2)(d).

[17] CBCA, subs. 123(4). Another discussion paper on the subject of Directors' Liability, released November 1995, analyzes whether the good faith reliance defence should be replaced by a full due diligence defence. See the Industry Canada discussion paper on Directors' Liability released November 1995, Issue 7, at pages 22-5.

[18] See discussion in Appendix C, issue 17.

[19] Section 42 of the Canada Business Corporations Act, S.C. 1974-75, c. 33.

[20] Enacted by An Act to amend the Canada Business Corporations Act, S.C. 1978-79, c. 9, s. 17 and by An Act to amend the Canada Business Corporations Act, S.C. 1994, c. 24, s. 10. The 1978 amendments "restructur[ed] the section without any change of policy" (1978 Senate Briefing Book). Some of the paragraphs were switched around and par. 44(2)(d) was added expressly permitting downstream loans from parent corporations to their subsidiaries. Previously, under the provision as adopted in 1975, only upstream loans were expressly permitted. The 1994 amendment added subs. 44(2.1) which defines the phrase "wholly-owned subsidiary" to include "grandchildren" subsidiaries and other subsidiaries in the corporate chain for the purpose of upstream financial assistance.

B. ORIGIN

[14] The two types of transactions restricted by s. 44, related party and share purchase financial assistance transactions, have separate histories, although they became linked together in federal business corporate law in 1930.

[15] With respect to related party financial assistance, federal business corporate law prohibited all "loans" to shareholders, from the enactment of the first federal statute in 1869[21] until the adoption of the CBCA in 1975.[22] In 1934, the prohibition was extended to also prohibit loans to directors.[23] Over the years, certain limited exemptions were provided, in respect of loan companies and in respect of loans to purchase living accommodation, but essentially a strict prohibition was maintained until 1975.

[16] The restrictions placed on share purchase financial assistance transactions are of more recent origin. Many authors[24] trace the restrictions on share purchase financial assistance to the common law rule that corporations are prohibited from "trafficking" in their own shares, stated in the English case of Trevor v. Whitworth.[25] In that case, the company purchased, prior to liquidation, over 4,000 of its shares and the value of that purchase amounted to more than one fourth of the paid up capital of the company. The court held that:

> The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorized. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely . . . on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders. . . .
>
> What was the reason which induced the company in the present case to purchase its shares? If it was that they might sell them again, this would be a trafficking in the shares,

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[21] Joint Stock Companies by Patent Act, S.C. 1869, c. 13, s. 47.

[22] See Canada Corporations Act, R.S.C. 1970, c. C-32, s. 17. Part I of this statute, dealing with federal business corporations, was repealed and replaced by the CBCA in 1975.

[23] The Companies Act, 1934, S.C. 1934, c. 33, subs. 15(1).

[24] See for example, Jonathan Levin, "Financial Assistance" (Canadian Bar Association - Ontario, Continuing Legal Education, Basic Corporate Practice, April 27, 1985) pp. 1 and following and Nicholas Dietrich, Working with the Ontario Business Corporations Act: The Practitioner's Experience (The Law Society of Upper Canada, Department of Continuing Education, 1989), page 1.

[25] (1887), 12 App. Cas. 409 (H.L.).

> and clearly unauthorized. If it was to retain them, this would be to my mind an indirect method of reducing the capital of the company.[26]

[17] The specific origin of the statutory restrictions on financial assistance in respect of share purchases is a recommendation made in 1926 by the U.K. Greene Committee on corporate law. The Committee considered specifically the leveraged buy-out[27] type of transactions:

> A practice has made its appearance in recent use which we consider to be highly improper, a syndicate agrees to purchase from the existing shareholders sufficient shares to control a company [sic] the purchase money is provided by temporary loan from a bank for a day or two, the syndicate nominees are appointed directors in place of the old board and immediately proceed to lend to the syndicate out of the company's funds (often without security) the money required to pay off the bank. Thus in fact the company provides money for the purchase of its own shares. This is a typical example but there are, of course, many variations. Such an arrangement appears to us to offend against the spirit if not the letter of the law which prohibits a company from trafficking in its own shares and the practice is open to the gravest abuses.[28]

[18] In 1929, the U.K. Companies Act was amended to prohibit "financial assistance" in connection with a purchase of the company's shares, with certain limited exceptions.[29] The

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[26] Ibid., pages 415-7.

[27] A leveraged buy-out (or LBO) is a transaction whereby the purchaser of a corporation uses the assets of that corporation to finance the acquisition. A recent example of a proposed LBO is the May 1995 takeover bid of Chrysler Corporation made by Kirk Kerkorian. The $22 billion (U.S.) bid depended on $13 billion in borrowed funds, $5.5 billion from the target company, Chrysler Corporation, and only $3.5 billion from the bidders. See "Kerkorian pulls offer for Chrysler," Globe & Mail (June 1, 1995): B1.

[28] Nicholas Dietrich, Working with the Ontario Business Corporations Act: The Practitioner's Experience (The Law Society of Upper Canada, Department of Continuing Education, 1989), at 2. More recently, Frederick Toole in "Financial Assistance by Corporations [:] S. 43 Business Corporations Act (N.B.)" in New Brunswick CLE Corporate Law Conference (September 14, 1990) commented at page 1:

> The late 1980's saw the climax of the "leveraged buy-out" - a transaction whereby an acquiring corporation or other vehicle uses the assets of its target to finance the acquisition. While large-scale take-overs such as that of RJR Nabisco raised the public profile of LBO's, the highly publicized financial difficulties caused to Allied Stores Corp. and Federated Department Stores Inc. by Campeau Corporation's takeover have demonstrated the serious consequences that can be caused to the target corporation when its assets are leveraged to the point where it exceeds the ability of the corporation to generate sufficient revenue to carry the debt.

[29] Companies Act, 1929 (U.K.), s. 45.

following year, the Canadian federal corporate law was amended, but unlike the U.K. law,[30] the federal statute combined the new share purchase financial assistance prohibition with the then existing related party financial assistance prohibition.[31] The prohibitions with narrow exceptions remained largely unchanged until the CBCA was enacted in 1975.

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[30] At that time, the U.K. company legislation did not prohibit loans to shareholders and directors. Indeed, the U.K. Greene Committee Report recommended against any prohibitions on loans to shareholders and directors. However, the 1945 U.K. Cohen Committee recommended:

> There is nothing in the present Companies Act to prevent a director or officer of a company from borrowing from the company, though section 128 requires the details of the loans to be disclosed in the accounts with certain exceptions ... . We consider it undesirable that directors should borrow from their companies. If the director can offer good security, it is no hardship to him to borrow from other sources. If he cannot offer good security, it is undesirable that he should obtain from the company credit which he would not be able to obtain elsewhere. Several cases have occurred in recent years where directors have borrowed money from their companies on inadequate security and have been unable to repay the loans. We accordingly recommend that, subject to certain exceptions, it should be made illegal for any loan to be made by a company or by any of its subsidiary companies or by any other person under guarantee from or on security provided by the company or by any of its subsidiary companies to any director of the company.

Board of Trade, Report of the Committee on Company Law Amendment (June 1945), pages 49-50. U.K. companies legislation was amended in 1948 giving effect to that recommendation (see Companies Act, 1948 (U.K.) c. 34, s. 190) but this new provision on related party financial assistance was, and is today, kept separate from the leveraged buy-out financial assistance provision adopted in 1929.

This 1948 U.K. provision was both narrower and broader in certain respects than the federal corporate legislation of that day. The U.K. legislation did not prohibit financial assistance to shareholders (only directors). However, the U.K. provision prohibited all types of financial assistance, not just loans.

[31] See The Companies Act Amending Act, 1930, S.C. 1930, c. 9, adding s. 56D to R.S.C. 1927, c. 27. The provision was consolidated in the new companies legislation The Companies Act, 1934, S.C. 1934, c. 33, s. 15. Dietrich, note 24, p. 3, comments:

> It is not clear why a "self-dealing" conflict-of-interest type of provision which focused on status of the recipient was joined with the concept which was aimed at a particular practice (a company dealing in its own shares) and which ignored the status of the recipient. Perhaps the answer lies in conceptualizing the "purpose" aspect as an indirect form of the "status" aspect as it involves vendors and purchasers of a company's shares. Viewed in that context, both parts of the prohibition involve borrowing by persons with some actual or prospective authority over the affairs of the corporation for purposes other than for the benefit of the corporation. The common denominator appears to be the giving of financial assistance and the risk of harm to creditors and/or minority shareholders.

[19] The basis of the current solvency elements of the section is the "Jenkins Report," produced by the 1962 U.K. Company Law Committee under Lord Jenkins.[32] The Report stated that the policy behind prohibited financial assistance was primarily to protect creditors, and, additionally, to protect minority shareholders.[33] It recommended that financial assistance for the purchase of a company's shares be allowed if a statutory declaration of solvency were made by the directors and filed with the Registrar of Companies to protect creditors, and if each transaction received special resolution (75%) approval to protect shareholders.[34] It further advocated giving a dissenting minority which holds 10% or more of the shares of a corporation or of any class of shares 28 days to apply to a court to block a transaction,[35] since simple shareholder approval could do little to protect the minority.

[20] In 1971, the issue of financial assistance transactions was dealt with in the draft act proposed by the Dickerson Report but little commentary was provided.[36] The draft act proposed retaining the absolute prohibition on share purchase financial assistance but would permit related party financial assistance if shareholders approved by special resolution and solvency/assets tests were met.

[21] The 1975 CBCA financial assistance provision replaced the old prohibitions with the solvency/assets tests for both share purchase transactions and related party financial assistance. The 1975 provision did not, however, adopt a shareholder approval process for either share purchase transactions as recommended by the Jenkins report or for related party financial assistance as per the Dickerson Report.

[22] Another important change in 1975 was that the CBCA expressly permitted a corporation to give financial assistance[37] to a holding (parent) corporation "if the corporation is a wholly-owned subsidiary of the holding body corporate." This new exemption was not recommended by Dickerson, nor was it found in the original draft bill tabled in 1973.[38] The materials prepared for

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[32] Company Law Committee, Lord Jenkins, pres., Report (:) Command Paper 1749 (U.K.: 1962).

[33] Ibid., p. 58, paragraph 160.

[34] Ibid., p. 65, paragraphs 178 and 179.

[35] Ibid., p. 68, paragraph 187.

[36] Dickerson Report, note 7, vol. 2, paragraph 5.16 and Vol. 1, paragraphs 145-6.

[37] And exempted the transaction from the application of the solvency/assets tests.

[38] See clause 40, Bill C-213, tabled on July 18, 1973. Interestingly, subclause 40(4) provided that:

> A corporations shall not guarantee an obligation of another person unless

Parliament explaining the policy rationale for the CBCA provisions (the 1975 CBCA briefing book) gave the following reason for the change: "Paragraph (c) has been added to facilitate the borrowing arrangements that are commonly made in today's business world."[39]

[23] It appears that the effect of this change, in addition to permitting more mundane intercorporate financing and securing of transactions, was to nullify one of the original goals of the financial assistance provision, namely the prohibition of leveraged buy-outs.[40] Other than a question of timing,[41] the exemption appears to allow a corporation that purchases all the shares of another corporation to then obtain financial assistance from that wholly-owned subsidiary, including financial assistance for any debt acquired to purchase the subsidiary. In other words, the exemption added in 1975 seems to expressly permit one type of transaction, the leveraged buy-out, that the provisions was originally designed to prohibit.

> (a) the person is a holding body corporate and the corporation is a wholly-owned subsidiary of the holding body corporate;
> (b) the person is a subsidiary of the corporation;
> (c) the directors have reasonable grounds for believing that the guarantee will further the business of the corporation; or
> (d) the shareholders approve the guarantee by special resolution.

Therefore, with respect to guarantees only, the 1973 Bill did provide an exemption. Further, this provision also provided an additional exemption, in respect of guarantees, by shareholder approval.

In 1975, section 42 of Bill C-29, which was enacted as the CBCA, dropped the provision on guarantees and simply added the provision on wholly-owned subsidiaries to the exemption dealing with all types of financial assistance. The concept of shareholder approval was also dropped.

[39] This type of financial assistance can be referred to as "up-stream" financial assistance. In 1978, the exemption provision was amended to also permit "down-stream" financial assistance "to a subsidiary body corporate of the corporation"; S.C. 1978, c. 9, s. 17. Also, an amendment was made by Bill C-12 in 1994 to define the term "wholly-owned subsidiary" to allow upstream financial assistance from a "grandchild" subsidiary: S.C. 1994, c. 24, s. 10.

[40] In respect of LBOs made by a corporation and which results in the purchaser acquiring all the shares of the corporation. An LBO made by an individual would not be exempted.

[41] Timing of financial assistance transactions is discussion in Appendix C, issue 6.

[24] It should also be noted that the CBCA reversed the common law prohibition on a corporation trafficking in its own shares. The statute now expressly permits the corporation to purchase or otherwise acquire its own shares, although solvency and assets tests similar to those in s. 44 must be satisfied.[42]

C. PURPOSE OF SECTION 44

[25] Given this history, the policy behind s. 44 is not completely clear. The policy appears to be to protect those in the corporation with limited power (minority shareholders and creditors) from sharp practices of those with power (controlling shareholders, including the takeover bidder, directors, and officers). One author has commented that:

> Under the common law rule enunciated in Trevor v. Whitworth, the courts' primary concern was to protect the creditors of the corporation from the ill effects of the diminution of the issued and outstanding capital of the corporation which would result from the purchase by the corporation of its own shares from existing shareholders. It would appear that the protection of creditors of the corporation remains the primary object of the modern statutory financial assistance provisions, even though the financial assistance may not result in a reduction of the capital of the corporation giving it. A secondary object would appear to be the protection of minority shareholders of the corporation giving financial assistance.[43]

[26] As noted above, the provision does not prohibit the transactions but only requires a solvency and assets test to be met. Presumably, meeting the test meant that creditor and minority shareholder interests were not threatened. The exception provided in 1975 for wholly-owned subsidiaries providing (up-stream) financial assistance to parent corporations appears to nullify the protection for creditors in respect of leveraged buy-outs. The section applies not only to corporate insiders, those closely related to the corporation and who could affect corporate decision-making, but also to employees and minority shareholders who have a very small stake in the company.

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[42] CBCA, s. 34 and following and s. 30. Also relevant is subs. 15(1) which provides that CBCA corporations have all the capacity, rights, powers and privileges of a natural person.

[43] G. Gordon Sedgewick, "Guarantees, Security and the Giving of 'Financial Assistance' by Corporations" (Paper presented at an Insight conference, 1986), at p. 6.

[27] Another author has commented, with respect to the policy behind the exemptions in subs. 44(2), that:

> Section 20[44] is not wholly consistent on its face. If creditors are the main concern of the section it makes no sense that their interests are not addressed in [the upstream exemption provision]. Equally anomalous is why the exemption is restricted to corporate parents as opposed to other types of legal entity. Nor, if minority shareholders are the focus, is there any apparent justification for the restriction on financial assistance between affiliates, each wholly-owned by the same holding body corporate, when each may financially assist its parent. One must also question the wisdom of certain exemptions such as financial assistance for living accommodation, which are susceptible of abuse.
>
> . . . Lawyers and their clients are understandably dissatisfied with section 20. It is strewn with pitfalls for the unwary and its operation, from a policy point of view, is uncertain and uneven. At best, it is anachronistic and inconsistent, and in light of the existence of alternative remedies and duties, likely unnecessary.[45]

[28] In many ways, the CBCA liberalized the granting of financial assistance[46] by restricting it only where there are reasonable grounds for believing that the corporation is insolvent or could not meet a strict assets test.

[29] We believe that the primary purpose of s. 44, discerned from the provision as drafted, is to protect the corporation's creditors, and to a lesser extent minority shareholders,[47] from impairment of its capital through financial assistance given to corporate insiders where there are reasonable grounds for believing the corporation is insolvent. While s. 44 does not prohibit financial

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[44] Of the Business Corporations Act (Ontario), R.S.O. 1990, c. B.16, (hereinafer Ontario BCA). This provision is similar to CBCA, s. 44.

[45] Dietrich, note 24, pages 24-5. By alternative remedies and duties, the author is referring to the oppression and derivative actions and fiduciary duties.

[46] This is particularly the case with the share purchase type of financial assistance transactions. With the related party type transaction, while generally permitting financial assistance except where the solvency and assets tests are not met, the number of non-regulated transactions have been greatly expanded. The previous legislation only prohibited "loans" to "shareholders or directors". Section 44 regulates all types of financial assistance, not just loans, and the restrictions apply to a much wider group of related parties, including officers, employees and associates of shareholders and directors.

[47] Shareholder protection is also a goal because s. 44 seeks to guard the corporation's capital. However, as Canadian law requires no minimum capital contribution, the protection of the corporation's capital will not be meaningful in many cases because there may be little capital to protect.

assistance and a corporation is generally permitted flexibility in its financial dealings, the provision sets a minimum standard that directors must meet.

III. FRAMEWORK FOR CONFLICT OF INTEREST

A. CBCA RULES

[30] Section 44 must be examined within the overall framework of rules dealing with conflicts of interest in the corporate setting. The corporation is the major form of business organization in Canada. Enormous amounts of capital and income of CBCA corporations are available to be used by directors, officers and controlling shareholders (the corporate insiders) for the benefit of all corporate stakeholders, including minority shareholders and creditors. However, those corporate insiders could instead misallocate corporate resources for their own benefit.

[31] Because directors and officers have power to control this capital and profit, the law imposes on them fiduciary duties to the corporation. Directors and officers must "act honestly and in good faith with a view to the best interests of the corporation" (par. 122(1)(a)). For example, directors and officers are not entitled to obtain any property or business opportunity belonging to the corporation or for which the corporation is negotiating, without its approval. Where the directors breach this duty, they must account to the corporation for any profits they made.

[32] However, because corporations are involved in business and commerce with a view to profit, directors and officers need not avoid all conflict of interest with the corporation.[48] Indeed, subject to certain safeguards, corporate law allows directors and officers to contract with the corporation, to receive financial assistance from the corporation, to purchase corporate assets or sell assets to the corporation and to trade in shares in the corporation. With respect to financial assistance, employee share purchase plans and corporate loans to directors and officers, which encourage them to purchase shares of the corporation, may be beneficial to the corporation by aligning the interests of these stakeholders with those of the owners. Financial assistance may be considered a reasonable part of incentive packages designed to attract the best management.

[33] It is the potential conflict between the fiduciary role of corporate insiders and the ability they have to "do business" with the corporation that has led the common and civil law, corporate legislation and other statutes to attempt to fashion rules to protect other stakeholders. The main challenge has always been to provide reasonable protection while allowing a corporation flexibility in its financial and business dealings.

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[48] Unlike other fiduciaries such as trustees.

[34] While the primary corporate law rules controlling conflict of interest are the fiduciary duties, there are many other such rules. Section 44 is one of these conflict rules. Others include disclosure of interest in material contracts (s. 120),[49] the duty of care (par. 122(1)(b)), insider trading disclosure, restrictions and liability (ss. 126-131), disclosure of material financial assistance transactions in the proxy materials,[50] disclosure of executive compensation,[51] and the oppression remedy (s. 241).[52] The CBCA regulations require financial statements and audits to be prepared in accordance with the CICA Handbook[53] which requires disclosure of certain related party transactions.[54] Each of these rules, including s. 44, is part of the CBCA regime to control abuses by corporate insiders of their position of power.

[35] The above rules are largely directed towards the related party type of financial assistance transaction. However, fiduciary duties are also relevant to the issue of leveraged buy-outs and the CBCA has a code relating to takeover bids.[55] The CBCA takeover bid rules are largely designed to ensure that the rights and interests of the various parties involved in a take-over bid -- shareholders, the offeror and the target corporation -- are adequately protected. CBCA s. 199 deals with the question of financing of the bid:

> Where a take-over bid states that the consideration for the shares deposited pursuant thereto is to be paid in money or partly in money, the offeror shall make adequate

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[49] This section is considered in detail in Part VIII of this paper. It should be noted that this section is a codification of another aspect of the fiduciary duty as developed at common law -- directors must fully disclose to the corporation any personal interest they may have in contracts entered into with the corporation.

[50] CBCA, s. 149 and CBCA Regulations, SOR/79-316, par. 35(i).

[51] CBCA, s. 149, CBCA Regulation par. 35(t) and Form 26. Mandatory proxy disclosure is not imposed on all CBCA corporations. Rather, only those corporations with fifteen or more shareholders must solicit proxies and therefore disclose material financial assistance transactions and executive remuneration.

[52] The CBCA also provides for a statutory derivative remedy which allows shareholders and others to sue on behalf of the corporation (s. 239). Unlike the oppression remedy which provides independent grounds for legal action, the derivative action does not create a right of action; rather it only allows others to exercise an existing right of action (e.g., breach of fiduciary duties by the directors) and sue on behalf of the corporation.

[53] CBCA Regulations ss. 44-5.

[54] See CICA Handbook, section 3840.

[55] CBCA Part XVII (take-over bids).

arrangements to ensure that funds are available to make the required money payment for such shares.[56]

B. OTHER CONFLICT OF INTEREST RULES APPLICABLE TO CBCA CORPORATIONS

[36] In addition to the CBCA rules described above, CBCA corporations are subject to other conflict of interest rules. The Bankruptcy and Insolvency Act[57] provides that certain transactions, including financial assistance transactions, made by an insolvent corporation with related parties can be challenged. The legislation also imposes certain civil and penal liabilities on directors for fraudulent and other transactions of the corporation.

[37] In addition to the rules found in federal bankruptcy legislation, many provincial statutes prohibit fraudulent conveyances and fraudulent preferences. The Alberta Law Reform Institute Final Report on financial assistance carefully reviewed relevant Alberta legislation which the Report saw as "another potential tool for controlling prohibited financial assistance by a corporation."[58]

[38] In respect of publicly-traded CBCA corporations, the CBCA rules are supplemented by disclosure and other rules imposed by provincial securities legislation. Many of these rules overlap, such as those dealing with insider trading and proxy solicitation. Securities laws require broad disclosure by CBCA publicly-traded corporations in respect of initial and subsequent public offerings, executive compensation and through the continuous disclosure regime.

[39] Some provinces also impose rules respecting related party transactions by publicly-traded corporations. For instance, Ontario Securities Commission Policy 9.1 requires disclosure, valuation, and minority approval for certain types of related party transactions.[59] A related party

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[56] The CBCA discussion paper on Take-over Bids examines whether s. 199 should be supplemented with rules restricting leveraged buy-outs. See Issue V, at pp. 47-52.

[57] R.S.C. 1985, c. B-3, ss. 95-6, 100, 101, 137, 201 and 204.

[58] Alberta LRI Final Report, note 11, on financial assistance at pages 67 and following. We have not reviewed fraudulent conveyance and preference legislation in other provinces but we presume that similar rules are applicable in all provinces.

[59] Policy 9.1 defines related parties to include persons or companies controlling shares with more than ten percent of the voting rights or otherwise with sufficient rights to affect materially the control of the issuer and directors and officers of the issuer or related party or an affiliate of any related party (subs. 2.2(14)). Related party transaction is defined to mean any transaction involving the acquisition or assumption of an asset, treasury security or liability of a related party or vice versa "by any means, including a transfer, merger, amalgamation, restructuring, arrangement, reorganization, grant of an option, royalty or other interest" (subs. 2.2(15)). A

transaction that would be a material change[60] must be disclosed in a press release and in documents filed with the Ontario Securities Commission, where possible 21 days in advance of the transaction.[61] Where the value of the asset or the treasury security or the principal amount of the liability subject to the related party transaction exceeds 25% of the issuer's market capitalization, the transaction is subject to a valuation requirement (by a qualified and independent valuer) and to a requirement of approval of the transaction by the majority[62] of the minority shareholders.[63]

[40] Lastly, Policy 9.1 also recommends a special committee review: "Issuers involved in a related party transaction should consider and if reasonable to do so follow the special committee review and related procedures set forth in Part VII of this Policy Statement."[64]

IV. OTHER APPROACHES TO CONFLICT OF INTEREST

[41] There is no one definitive approach to the regulation of conflict of interest and the granting of financial assistance. In place of an assets/solvency test for financial assistance and directors' liability, some regimes have:

- little or no regulation. In these regimes the common law of directors' fiduciary duty is often relied on to address abuses (Delaware General Corporation Law[65] (Delaware GCL), Model Business Corporation Act[66] (Model BCA));

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leveraged buy-out could fall within this definition.

[60] Material change is defined in the Ontario Securities Act, R.S.O. 1990, c. S.5, s. 1 to mean "a change in the business, operations or the capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer . . ."

[61] Section 17.1.

[62] In some cases, a two-thirds requirement is imposed (see subs. 31.1(2)).

[63] Sections 18 and 20.

[64] Section 19. The overlap between corporate laws is discussed below in Part V(e).

[65] DEL. CODE ANN. Tit. 8 (1993).

[66] 1994 Revised Edition.

- enhanced disclosure obligations (The Business Corporations Act[67] of Saskatchewan (Saskatchewan BCA), Alberta Law Reform Institute Discussion and Final Reports);
- corporate governance restrictions such as review of related party transactions by a committee of independent directors (Bank Act[68]);
- financial limits on assistance (Bank Act);
- absolute prohibition on giving financial assistance when a company is or would become insolvent (British Columbia Company Act[69] (British Columbia CA));
- imposition of liability on directors for all debts of a corporation that trades while it is insolvent (Australian Corporations Act[70] (Australian CA) and U.K. Companies Act (UKCA)).

[42] These and other alternative approaches to the s. 44 regime are briefly summarized in this Part. For a more detailed review, see Appendix B.

A. FIDUCIARY DUTIES/BENEFIT TO THE CORPORATION

(i) The Delaware GCL:

[43] The Delaware GCL, at s. 143, allows corporations to offer financial assistance to officers, directors or employees of the corporation or its subsidiaries, if doing so can reasonably be expected to benefit the corporation. This financial assistance may be with or without interest, secured or unsecured and if secured, any security which the board approves is acceptable, including a pledge of the corporation's shares. The Delaware GCL also includes a provision relating to interested director contracts or transactions. Section 144 requires an interested director to disclose the material facts relating to the contract, and as well, it requires board, committee or shareholder approval. If none of these requirements is met, the transaction may still be protected if it was fair to the corporation when it was authorized. In addition, subs. 122(13) specifically provides that a corporation may give financial assistance to related corporations within a wholly owned corporate group. The only limit to this power is that the assistance is "necessary and convenient to the conduct, promotion or attainment of the business of the contracting corporation." Although there is no codification of director's duty of care in the Delaware GCL, corporations may limit the personal liability of directors for breach of fiduciary duty except in limited instances, such as when a director derives an improper personal benefit from a transaction.

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[67] R.S.S. 1978, c. B-10.

[68] S.C. 1991, c. 46.

[69] R.S. 1979, Chap. 59.

[70] The Corporations Act, No. 109, 1989.

(ii) The Model BCA:

[44] The Model BCA does not specifically prohibit loans or other forms of financial assistance to related parties, although certain transactions involving directors may be regulated under subchapter F entitled "Directors' Conflicting Interest Transactions." According to the American Bar Association's commentary, the issue of conflict of interest and other persons such as non-director officers and employees of a corporation is dealt with by the law of agency.[71] Even if a director is involved in a transaction with the corporation, if the specific situation falls outside the definition of conflicting interest transaction, the transaction may not be attacked on the grounds of director conflict of interest. If however, a transaction is considered to be a conflicting interest transaction and certain conditions, including disclosure by the director are met, the Act provides three safe harbours from attack: (1) director approval; (2) shareholder approval; or (3) the transaction is established to have been fair to the corporation at the time of commitment. If any of the conditions are not met the transaction may be attacked as being a director conflict of interest.

B. ENHANCED DISCLOSURE

(i) The Saskatchewan BCA:

[45] In 1992, Saskatchewan repealed its financial assistance provision, which was virtually identical to CBCA s. 44, and replaced it with a new regime. Saskatchewan's new permitted loans and guarantees provision is found at s. 42 of the Saskatchewan BCA. There is no solvency or assets test and the new regime is permissive, subject to disclosure to shareholders of the nature and extent of the financial assistance given. The regime distinguishes between distributing and non-distributing corporations as to time of disclosure. Both types of corporations, however, must disclose the same information. The Saskatchewan BCA has disclosure of interest in material contract provisions that are similar to the CBCA with two exceptions. A Saskatchewan corporation may, by unanimous shareholder agreement, opt out of the application of these provisions. If a corporation does so, it is also not subject to the rules of common law and equity in regard to disclosure of interest in material contracts and the voting on those contracts by directors.

(ii) The Alberta Law Reform Institute (LRI):

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[71] The law of agency deals with "a relationship existing between two persons. One, called the agent, is legally considered to represent the other, called the principal, in a way which affects the principal's legal position in relation to third parties." (Daphne A. Dukelow & Betsy Nuse, eds., The Dictionary of Canadian Law (Toronto: Carswell, 1995), at p. 33). The agent is in a fiduciary relationship with the principal and therefore owes fiduciary duties to the principal. The employee/employer relationship may be considered an agency relationship.

[46] The Alberta Business Corporations Act[72] (Alberta BCA) financial assistance provision (s. 42) is identical to the CBCA with one addition. The Alberta BCA requires annual disclosure of financial assistance given by corporations to interested parties.[73]

[47] In 1989, the Alberta LRI made several recommendations regarding the financial assistance provision. Their report calls for the repeal of the financial assistance prohibitions and their replacement with disclosure requirements for non-distributing corporations. The report also suggests that regulation of financial assistance given by distributing corporations be transferred to provincial securities law jurisdiction. Further, the report expresses a concern that the repeal of section 42 would have an adverse effect on creditors unless creditors have access to the derivative action as an alternative remedy. To allay this concern, the report cites an Alberta Court of Queen's Bench case[74] that gave a complainant creditor leave to bring a derivative action. However, this order was stayed on appeal pending the outcome of the creditor's action for liability against the corporation and no derivative action was ever brought. If a creditor is not ultimately considered to be a complainant by the courts, then the report recommends that for the purposes of a derivative action, the definition of complainant be amended to include creditors.

C. COMPREHENSIVE CONFLICT OF INTEREST REGIME INCLUDING REVIEW BY INDEPENDENT COMMITTEE AND FINANCIAL LIMITS

[48] The Bank Act regulates the issue of financial assistance to related parties in Part XI entitled Self-Dealing. Banks are prohibited from entering into any "transaction" (not just for financial assistance) with a related party unless it is authorized by the Bank Act. The Bank Act defines transactions to include guarantees, investments in securities of a related party, taking an assignment or acquiring a loan from a third party made to a related party and taking a security interest in the securities of a related party. This list is not exhaustive. A review of the permitted transactions sections of the Bank Act reveals other types of transactions which, although not specifically listed, would nevertheless also be included in the definition of transaction, including, for example: loans, contracts for services, sale of assets, purchase of assets, and lease of space. The types of transactions captured by the Bank Act regime therefore, appear to be much broader than those financial assistance transactions restricted under the CBCA.

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[72] S.A. 1981, c. B-15.

[73] The CBCA only requires corporations that have to prepare a management proxy circular to disclose the details of financial assistance given since the beginning of their fiscal year. Moreover, disclosure under the CBCA is only required where financial assistance was given (i) to a shareholder who was not a director, officer, or employee of the corporation or one of its affiliates, and any associate of the shareholder, or (ii) to any person, if given to purchase shares. Further, the assistance need only be disclosed if it was material to the corporation, its affiliates or the recipient. See CBCA Regulations, par. 35(i).

[74] First Edmonton Place Ltd v. 315888 Alberta Ltd. (1989), 45 B.L.R. 110.

[49] In contrast, the definition of "related party" in the Bank Act is narrower than the list of parties affected by the CBCA financial assistance restrictions. This is primarily so because the Bank Act looks to factors such as significant interest, substantial investment, and control for determining who is a related party.

[50] Unlike the CBCA, the Bank Act includes an elaborate procedure for the review of related party transactions. The majority of permitted transactions must be pre-approved by the board of directors or the conduct review committee (CRC) which each bank is required to establish. The CRC is responsible for developing procedures for the review of transactions with related parties and must also review certain transactions as required by Part XI of the Bank Act. Some transactions however, require board approval only. The CRC must report to the board which in turn reports annually to the Superintendent of Financial Institutions.

[51] Like the CBCA, the Bank Act sets out the general duty of care for officers and directors. The Bank Act also requires directors and officers to disclose the nature and extent of any interest in a material contract with the bank. This provision is found in the Bank Act's conflict of interest guidelines and is, with two exceptions, virtually identical to s. 120 of the CBCA.

D. SOLVENCY TEST AND STRICT PROHIBITIONS

[52] Unlike the CBCA, the giving of financial assistance by a company under the British Columbia CA is, without exception, subject to a solvency test. The British Columbia CA financial assistance provisions do not however include an assets test. Further, the majority of financial assistance arrangements under the British Columbia CA are also subject to a "best interests of the company" test. With limited exceptions, B.C. companies are not allowed to give financial assistance for the acquisition of shares in their company. The exceptions include loans for the purchase of shares by or for the benefit of bona fide employees and financial assistance to a purchaser who will, after the purchase, own at least 90% of the company. Financial assistance to or by subsidiaries, holding companies and sole members of the company are also not restricted by the prohibition against share acquisition. The British Columbia CA also includes a general duty of care for directors as well as a duty to disclose interest in contracts or transactions with the company. Directors under the British Columbia CA have a duty to account unless specific requirements are met.

E. NOTICE AND SHAREHOLDER APPROVAL; DIRECTOR DUTY TO PREVENT INSOLVENT TRADING

[53] There are a number of provisions in the Australian CA that deal with the issue of a company giving financial assistance. Essentially there are strict rules on the giving of financial assistance both for share purchases and related parties, although in both cases financial assistance

can be granted with notice and shareholder approval.[75] A third rule approaches conflict of interest concerns from another direction by imposing a duty on directors to prevent insolvent trading.

[54] Section 205 of the Australian CA prohibits a company from giving financial assistance to any person in connection with the acquisition of its shares. This provision applies to privately-held (called "proprietary") and publicly-held corporations. Financial assistance is defined to include: loans, guarantees, provision of security, release of an obligation and the forgiving of a debt. There are a number of specific listed exceptions to the general prohibition including the payment of dividends and loans made in the ordinary course of business on commercial terms. Subsection 205(10) also allows a company to give financial assistance for share acquisitions which would otherwise be prohibited by subs. 205(1), so long as the company agrees by special resolution[76] to give the assistance and the company abides by the notice and filing requirements of the section. Where there has been a contravention of this section, it is the officer involved and not the company itself who is guilty of an offence.

[55] Part 3.2A of the Australian CA deals specifically with the giving of financial "benefits" to related parties. This part states that its purpose is: "to protect a public company's resources (in particular, those available to pay the company's creditors); and the interests of its members as members; by requiring that, in general, financial benefits to related parties that could diminish or endanger those resources, or that could adversely affect those interests, be disclosed, and approved by a general meeting, before they are given."[77] Part 3.2A does not apply to proprietary companies. Under Part 3.2A, a public company may not give financial assistance to a related party except as authorized by the Australian CA. Division 4 of Part 3.2A lists seven basic exceptions to the general prohibition including: advances up to a prescribed amount to a director or a director's spouse, financial benefit on arm's length terms, and financial benefit given to a closely-held subsidiary. Division 5 of Part 3.2A lists a further exception that allows the giving of financial benefits if they have been approved by a general meeting of the public company and the administrative and disclosure requirements have been met.

[56] Section 588G of the Australian CA sets out the duty of a director to prevent insolvent trading by a company (proprietary or public). This provision addresses the situation of a company incurring a debt while it is insolvent or a debt which would cause the company to become insolvent, where there are reasonable grounds for suspecting the company is insolvent or would become insolvent. By failing to prevent the company from incurring such a debt, a director will be found in contravention of the provision and subject to the civil and criminal consequences

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[75] These provisions are presently under review by the Australian Corporations Law Simplification Task Force.

[76] Subsection 253(1) - a special resolution requires a majority vote of 3/4 of eligible voters and at least 21 days notice of meeting specifying intent to propose a special resolution.

[77] Section 243A.

found in Part 9.4B of the Australian CA. As part of a civil penalty order, the Australian court may order that the contravening director be prohibited from managing a corporation and/or order that the director pay to the Commonwealth a pecuniary penalty to a maximum of $200,000.[78] Further, the contravening director may also be subject to criminal consequences.[79] The director need not have actual knowledge of the company's circumstances if a reasonable person in a like position would have been aware of the company's financial position. Section 588G sets out a number of defences available to the director including: the director had reasonable grounds to believe that the company was solvent at the time the transaction was entered into and the director took all reasonable steps to prevent the company from incurring the debt.

F. U.K. COMPANIES ACT[80]

[57] The UKCA deals with financial assistance to related parties (s. 330) separately from leveraged buy-out financial assistance (s. 151). Subject to limited exceptions, a public or private U.K. company is prohibited from giving loans, guarantees or security on a loan to a director of the company or its holding company. A public company[81] or a company which is part of a group that contains a public company is further prohibited from giving financial assistance to a person connected with the director.[82] The UKCA also prohibits back-to-back arrangements. For example, where a company agrees to make loans to the director of another company in return for that other company giving loans to its directors.[83] There are eight exceptions to the general restriction on loans to directors and connected persons including: inter-company loans in the same group, loans of small amounts to a director, minor business transactions, transactions with holding company, and home purchase and improvement loans. Where a public or private company is

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[78] Section 1317EA.

[79] Section 1317FA.

[80] U.K. 1985, c. 6.

[81] In the U.K. Companies Act a "public company" may be referred to as a "relevant company". The expression "relevant company" is defined to include: (a) a public company; or (b) a subsidiary of a public company; or (c) a subsidiary of a company which has as another subsidiary a public company; or (d) a company which has a public company as a subsidiary (subs. 331(6)).

[82] A person connected with a director of a company includes: (a) spouse, minor children and step-children; (b) a company with which the director is associated (meaning, the director and the persons connected with the director either have at least a 20% interest in the equity share capital of the company or are entitled to exercise or control of at least 21% of the voting power at a general meeting); (c) a trustee of a trust where a beneficiary is anyone of (a) or (b); (d) a partner of the director or anyone of (a), (b) or (c).

[83] Subsection 330(7).

permitted, because of an exception, to give financial assistance, they are required to disclose information regarding the financial assistance in the company's annual financial statement.[84]

[58] There is also a general prohibition against the giving of financial assistance[85] for the present or future acquisition of shares in the company. Financial assistance given to reduce a liability that has been incurred because of a past acquisition of the company's shares is also prohibited. There are limited exceptions to this rule.[86] However, neither a public nor a private company may avail itself of these exceptions unless it has net assets[87] which will not be reduced by the financial assistance or, to the extent that those assets are thereby reduced, the assistance is provided out of distributable profits.[88] Although these provisions apply to both public and private companies, there is a relaxation of the general rule for private companies.[89] Realistically, the result of the relaxation is that private companies may give financial assistance for the acquisition of its own shares and the shares of its holding company. However, where the holding company is a public company or the private company is part of a group which contains a public company, the general rule still applies.

[59] The UKCA also has wrongful trading and director disqualification provisions. The wrongful trading provisions are found in the Insolvency Act 1986. What is considered wrongful trading is not defined. Instead, the UKCA provides that a director of a company that has gone into insolvent liquidation, and who, prior to the commencement of the winding up, knew or ought to have known that it was not reasonable to expect the company to avoid going into insolvent liquidation, may be liable to contribute to the company's assets.[90] The onus is on the director to show that they took every step they ought to have taken to minimize the potential loss to the company's creditors. Further, the extent to which a director may be liable is not limited to debts

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[84] Section 232.

[85] Financial Assistance is defined to include loans, guarantees, security, indemnity, gifts, or any other agreement (section 152).

[86] Section 153 - There are three groups of exceptions to the general share acquisition rule: (1) Purpose Exception - where either the principle purpose of the assistance is not a share acquisition or if the principle purpose is a share acquisition, the assistance is given as part of a larger purpose of the company. In both cases the assistance must be given in good faith and in the interests of the company; (2) Authorized Transaction Exceptions - These exceptions are based on the nature of the transaction and include - dividends lawfully given, allotment of bonus shares and the redemption or purchase of shares in accordance with Chapter VII of the Act; (3) Ordinary Course of Business Loans and Employee Exceptions - This exception allows the giving of loans where lending is within the ordinary course of business of the company. This section also sets out an employee share acquisition scheme exception.

[87] Net Assets - the aggregate of the company's assets, less the aggregate of its liabilities (subs. 152(2)).

[88] Subsections 154(1) and 155(2).

[89] Section 155.

[90] Insolvency Act, section 214.

incurred after the director knew or ought to have known the precarious financial situation of the company - the courts have unfettered discretion in deciding the amount of contribution. When a director has been found liable to contribute under s. 214 the court may also make a disqualification order against the director. During the period of the order (maximum 15 years), the person affected may not act as a director or directly or indirectly be involved in the promotion, formation or management of a company.

G. OTHER APPROACHES

[60] There are other approaches to this issue. For example, under the New Brunswick Business Corporations Act,[91] related party and share purchase financial assistance transactions are treated separately. Related party financial assistance cannot be given if there are reasonable grounds for believing that the corporation cannot meet the solvency and assets tests. However, the articles of the corporation may otherwise provide. There is a prohibition on share purchase financial assistance, subject to excepted transactions similar to those set out in CBCA subs. 44(2).

V. PROBLEMS\ISSUES RELATING TO SECTION 44

[61] Legal practitioners and others have raised a long list of technical problems with s. 44. While it is not possible to discuss all of them here, they are set out in detail in **Appendix C**. However, it may be useful to review a number of more general problems with the statute.

A. COMPETITIVENESS OF CBCA CORPORATIONS

[62] At a recent conference, a practitioner commented:

> Auditors will not give solvency opinions. Directors are left on their own. Note in particular that there are serious deficiencies in the language of the financial assistance provisions . . . I believe that the impact of the financial assistance provisions of Canadian business corporations acts go so far as to constitute a competitive trading disadvantage for Canadian corporations vis a vis their foreign competitors.[92]

[63] Competitiveness may be affected by the increased cost of capital for corporate groups, particularly those seeking to reorganize. There may be significant legal costs, management time, and sometimes even investment dealer costs, to investigate whether these tests can be met.

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[91] S.N.B. 1981, c. B-9.1, s. 43.

[92] Bruce McNeely, "Directors' Liability - Certain International Considerations" in New Developments in Directors' and Officers' Liability, (Canadian Institute Conference, June 6 and 7, 1995) at p. 14.

Further, it has been suggested that lawyers may spend a great deal of time restructuring transactions, without changing the substance, in order to obtain the benefit of one of the subs. 44(2) exemptions. There may also be a negative impact on competitiveness through loss of opportunities from an inability to obtain financing for certain projects.

[64] It has also been noted to us that:

> A lender with adequate time and opportunity for investigation may be able to determine whether or not the relationships between the corporations involved in a transaction bring the transaction within the scope of section [44]. By sufficient examination and discussion with corporate officers and auditors, the lender may be able to place itself in a position where it has reasonable grounds to believe that the conditions in [paragraphs 44(1)(c) and (d)] are satisfied. This situation, however, is not a desirable one in a lending environment in which commercial transactions must be conducted quickly with reasonable assurance that they will not subsequently be subject to attack.
>
> Furthermore, the provisions may, in many cases, frustrate transactions which are in the overall interest of a group of companies, because of the uncertainty of what constitutes "financial assistance". In work-out situations involving insolvent companies, where it is necessary to effect transfers of assets, often to take advantage of tax loss situations, the technical application of the financial assistance provisions may make a work out plan impossible.[93]

[65] As seen above, some jurisdictions do not have financial assistance restrictions or impose less restrictions than the CBCA. Corporations incorporated under one of these regimes may therefore have a competitive advantage over a CBCA corporation because the s. 44 restrictions would not apply to them.

[66] On the other hand, s. 44 may be important in protecting the capital of the corporation from misuse or diversion by insiders for non-competitive purposes. Financial assistance by definition is the loaning, guaranteeing or securing of funds paid to persons other than the corporation. The additional transactional costs may be money well spent in protecting the corporation's capital from misuse by corporate insiders.

[67] A recent research volume suggested that:

> Canada's is a closely held economy, and dealing with controlling shareholders is consequently the central issue in Canadian corporate governance . . . The high level of share ownership concentration in Canada makes problems between controlling and minority shareholders the crucial axis of agency conflict. The problem is not one of

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[93] Some of the difficulties s. 44 creates in respect of leveraged buy-outs and reorganizations can be seen in some of the caselaw. See for instance, Straight Line Contractors v. Rainbow Oilfield Maintenance Ltd. (1991), 115 A.R. 327 (Alta C.A.), discussed in Appendix C, issue 6.

> managerial fidelity to shareholders, but rather one of fidelity to some shareholders - controllers - at the expense of others . . . controlling shareholders usually make the corporation's managers work harder, but the rub is that the fruits of such effort may not go equally to all shareholders - the controlling shareholder can siphon off a disproportionate share.[94]

[68] Unfortunately, we are unaware of any empirical evidence that might be of assistance in determining the impact of s. 44 (or any of the alternative regimes) on competitiveness of corporations.

B. DIRECTORS' LIABILITIES

[69] As discussed, s. 44 has been criticized for being vague and imprecise. It may be very difficult for directors, even when exercising due caution, to be sure that they have complied with the requirements of the section. They may be unable to obtain opinions from either lawyers or accountants that the requirements of s. 44 have been met. Unpredictable liability is a problem for directors. Clarifying or eliminating s. 44 may reduce unpredictable and therefore unfair liability imposed on the directors.

[70] Further, s. 44 may distract directors and officers from inquiring into whether, in the context of a financial assistance transaction, they are properly performing their fiduciary duties. It has been suggested that some directors and officers believe that if the solvency and assets tests are met they have complied with the law. This would be incorrect as they must still act in the best interests of the corporation as required by s. 122.

[71] On the other hand, eliminating or reducing the statutory rules on financial assistance (and other conflict of interest rules) may lead to greater reliance on the courts to set the standards for proper conduct among directors. One practitioner has noted the difference between Canadian and U.S. rules:

> Now, if one simply looked at all the regulations, legislation [and] requests for comments, one would think that Canadian corporations, public corporations, did nothing but sit around and enter into related-party transactions. There's an inordinate amount of time and effort and intellectual power devoted to this topic in Canada; and in the United States very, very little. It's simply litigated and the courts tell the directors what standards to adhere to and they work out their own rules.[95]

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[94] Randall Morck & Ron Daniels, eds., Corporate Decision Making in Canada (Calgary: University of Calgary Press, 1995) at pp. 674-675.

[95] Stanley Beck, "Related-Party Transactions [:] Conference Proceedings", Bullet-Proofing Your Board of Directors (Toronto, Insight Conference, December 1, 1992), at p. 80.

[72] Therefore, there might be a concern that less focus on these issues in corporate legislation may lead to more litigation to develop standards of conduct.

C. CURRENT RULES PROVIDE LITTLE PROTECTION FOR CREDITORS AND SHAREHOLDERS

[73] Another concern with the section is that while it appears to cause problems for directors and others, the protection it affords creditors and minority shareholders may be questionable. Unlike pre-1975 federal rules there is no absolute prohibition on financial assistance. The statute only requires that the solvency and assets tests be met. In other words, a transaction may severely abuse the shareholders, may result in a clear conflict of interest and may even be a breach of fiduciary duties, and still the transaction might not offend the section.[96] This possible result calls into question the actual protection s. 44 provides to creditors and minority shareholders.

[74] One of the reasons given for removing the current restrictions on the giving of financial assistance is that, under the CBCA, shareholders and creditors have many types of remedies available to them, including the derivative action and oppression remedy.[97]

[75] On the other hand, section 44 may usefully impose a bottom line for directors in respect of creditor and shareholder protection. Directors must take care that these particular financial assistance transactions only be undertaken where there are no reasonable grounds for believing that the corporation is insolvent. And, as we have seen, other corporate and common law regimes impose much greater duties and liabilities on directors.

[76] Moreover, while an action must still be taken against directors for breach of this provision, as would be the case for breach of fiduciary duties and under the oppression remedy, there are two further controls imposed by s. 44. First, where s. 44 is not complied with, the contract of financial assistance may be invalid. Because the threat of a contract being found invalid may be a greater concern to the contracting parties at the time of entering into the contract, this provision may be more of an impetus for contracting parties to ensure that s. 44 is complied with than the abstract possibility of future liability. A second related point is that lenders may find that guarantees/security interests granted to them by the corporation in respect of financial assistance transactions are invalid. Apparently, this concern results in a reluctance on the part of lending institutions to enter into transactions involving financial assistance.[98]

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[96] Of course, the corporation, its shareholders or its creditors may be able to pursue the directors or officers for breach of fiduciary duties or under the oppression remedy.

[97] See for instance, the Alberta LRI Final Report, page 83. However, there may be some issue as to whether creditors are complainants under s. 238 (CBCA) and would have a right to take derivative and oppression remedies. See discussion in the Alberta LRI Final Report, pages 93-94.

[98] See discussion in Appendix C, issue 17.

[77] Indeed, this latter check (appropriate or not) on financial assistance transactions may explain why problems have arisen uniquely with financial assistance even though the same solvency and assets tests are found in many other sections of the statute.[99] Under these other sections, for example on the payment of dividends, the distributions are made from corporate funds and do not depend on contributions from lenders or other third parties. Directors are left with the dilemma of approving the transactions under problematic tests and could suffer liability for their decisions, but there is usually no need to rely on outside funding by third parties.

D. NON-AVAILABILITY OF ACCOUNTANTS OPINIONS

[78] As noted above, since October 1988, the CICA Handbook advises accountant practitioners not to provide an opinion on matters relating to solvency.[100] The reluctance of accountants and lawyers to provide solvency opinions creates problems for both directors and lenders. Since directors can avoid liability for financial assistance made in contravention of s. 44 if they relied in good faith upon a report of an expert. Lenders also can ensure that guarantees and security given by the corporation are enforceable if, in relying on expert opinions, as well as assurances from corporate officers, they act in "good faith without notice of the contravention."

[79] The 1988 CICA guidelines followed a similar action by the American Institute of Certified Public Accountants under an interpretation distributed in February 1988.[101] The CICA gives four reasons for the guideline, primarily based on the lack of clarity in the statute:

(a) Lenders are primarily concerned that the giving of financial assistance does not result in a fraudulent conveyance or transfer. In addition, terms such as "directly or indirectly" and "loan, guarantee or otherwise" are used to determine the applicability of the particular provision. These matters are subject to legal interpretation and, as such, do not fall within the professional expertise of public accountants.

(b) The public accountant is asked to provide assurance on the corporation's ability to pay its liabilities as they become due. No time frame is provided for this assurance and it is unclear whether "liabilities" would include contingent liabilities as may be the case in the giving of a guarantee.

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[99] For example, CBCA ss. 36 and 42 in respect of share redemptions and dividends.

[100] CICA Handbook, note 9.

[101] See Farlinger, "Solvency Letters and Financial Assistance Prohibition" (1989), 3 Banking & F.L.R. 339, at p. 340 referring to an interpretation of AU Section 2010 distributed by the American Institute of Certified Public Accountants in "Responding to Requests for Reports on Matters Relating to Solvency: An Interpretation of Statement on Standards for Attestation Engagements," (New York: American Institute of Certified Public Accountants, February 1988), Journal of Accountancy (May 1988).

(c) The public accountant is asked to provide assurance on the "realizable value" of the corporation's assets. The term "realizable value" is not defined and the value of assets could be determined in a number of different ways.

(d) The public accountant is being requested to provide either positive or negative assurance on matters relating to solvency. Since these matters are not clearly defined in an accounting sense, there are no appropriate criteria to establish the framework within which an accountant can form an opinion.[102]

E. CORPORATE VERSUS SECURITIES LAWS

[80] One question is what role should corporate law play with respect to financial assistance and other related-party transactions of publicly-traded corporations and what is the appropriate interplay between corporate and securities laws. Should corporate law simply impose a minimum standard, applicable (if possible) to both privately-held and publicly-traded corporations, and leave it to securities laws to supplement disclosure and transactional rules necessary in the context of publicly-traded corporations?

[81] Section 44 is applicable to all CBCA corporations, both those publicly-traded and privately-held. This was one of the criticisms in the Alberta LRI Discussion and Final reports, which concluded that at least some aspects of financial assistance should be regulated through securities laws.[103]

[82] As already discussed,[104] publicly-traded CBCA corporations and related parties are subject to regulation by provincial securities laws. These laws supplement or duplicate the disclosure and transactional rules imposed by the CBCA. Some securities law rules, for example OSC Policy 9.1, and some provincial requirements for disclosure of executive compensation, are more far reaching than the corporate law rules.

[83] In 1992, the Ontario Securities Commission issued a Request for Comments on Related Parties:

> Over the past year, the Commission has received submissions expressing varying degrees of concern about on-going relationships between reporting issuers and related parties. While some of the concerns may go beyond the traditional issues of securities law, the Commission has requested that staff undertake an initiative, distinct from its ongoing

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[102] Appendix C proposes a number of clarifications to s. 44, if it is maintained. These clarifications address the concerns raised by the CICA Guideline.

[103] Alberta LRI Final Report recommended at page 5 that Alberta's securities legislation should be amended "to regulate the giving of improper financial assistance by a distributing corporation in the purchase of its shares."

[104] See Part III above.

> monitoring of the application of Policy Statement No. 9.1, to consider whether it is necessary or appropriate to recommend amendments to appropriate statutes, regulations and accounting guidelines to require enhanced disclosure and prescribed minimum standards for the conduct of boards of directors in the context of such relationships. Comments would be welcome on the extent, if any, that market participants should be legally entitled to enhanced disclosure and opportunities for assessment of transactions between related parties in order to ensure a fair and efficient capital market in Ontario . . .
>
> Staff has received comment suggesting that it is not unusual for reporting issuers to enter into transactions with related parties that, while not "material" for the purposes of Policy 9.1, may nonetheless be significant (either alone or in the aggregate) to an issuer and its security holders. Examples of such transactions identified to staff include investments in the securities of a significant shareholder or its affiliates, and transactions involving a significant shareholder or its affiliates, such as asset acquisitions or dispositions, loans, leases, supply arrangements or business operations through joint ventures.
>
> It has been suggested that the existing accounting, corporate and securities law regime may not provide an appropriate framework or sufficient opportunity for the assessment of such transactions. It has also been suggested by some that it is not unusual for related party transactions to be implemented without timely and adequate disclosure to boards of directors, shareholders or the market generally. If this is the case, it is conceivable that directors, shareholders and the market generally are not fully aware of the extent or nature of relationships between certain reporting issuers and related parties.[105]

[84] The Request for Comments goes on to consider the role of the directors, their independence and extent of current public disclosure and asks a number of questions, such as what means should be used to implement any initiatives in this area. The OSC received little written commentary in reply to its Request for Comments but the staff of OSC remains concerned about the issue.

VI. CONSULTATIONS

[85] During spring 1994, Industry Canada officials held preliminary consultations with some CBCA stakeholders across Canada on required amendments to the CBCA. Industry Canada has also received a number of written submissions from practitioners and organizations commenting on s. 44.

[86] A number of people favoured repealing s. 44. Some of the comments were that:

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[105] (1992) 15 O.S.C.B., at p. 3253.

- Section 44 should be reconsidered unless there is a problem that it corrects. Five years ago, accountants and lawyers gave quick advice. Now, transactions are much more expensive.

- Shareholders can be protected by disclosure. If the purpose of s. 44 is to protect creditors, they are protected by other means such as the oppression remedy.

- The section should be eliminated. Creditors look to fraudulent conveyance statutes.

- There is no policy basis/purpose for the current provision. There are already too many technical loopholes to get around the provision for it to serve any useful purpose.

- Section 44, like a number of other provisions, is eccentric and ad hoc. There appears to be no underlying policy.

- The disclosure route is better. Full disclosure should be enough.

[87] Others favoured keeping the section but redrafting it in order to inject elements of predictability, security and regularity in the section's interpretation and application. Some stakeholders sought greater flexibility for the corporation and favoured more permissive legislation. Some of the comments made were that:

- There may be more certainty for directors and their legal advisors under s. 44 than under the oppression remedy and having to litigate where there has been oppression of shareholders/creditors.

- The solvency definition needs clarification.

- A better reliance mechanism for directors is required if you want to maintain the solvency test. Directors have difficulty evaluating their liability.

- One uncertainty is the timing for the purpose of performing the solvency test.

- There is definitional uncertainty in the section with expressions such as "financial assistance" and "realizable value."

- The British Columbia CA contains a number of exceptions to the prohibition of giving financial assistance e.g., ratification by a special majority and dissent rights. This is much easier for private companies than having to search out and pay for legal and financial expertise.

- New Brunswick legislation allows corporations to opt out of similar provisions. Almost 100% of companies opt out.

- **!** The Saskatchewan BCA, which replaces the solvency\assets tests with a disclosure requirement, should be followed.

- **!** The expression "financial assistance" needs to be defined so that the prohibition applies only in circumstances where a corporation makes a loan or provides financial assistance that does not benefit the corporation. The directors of a corporation would have the responsibility of determining whether or not there is a benefit to the corporation.

- **!** All assistance given to affiliates should be exempted by adding an exception in subsection (2).

- **!** The references to "associate" and to indirect transactions should be removed.

VII. OPTIONS, PRELIMINARY CONCLUSIONS AND RECOMMENDATIONS FOR AMENDING OR REPEALING SECTION 44

A. OPTIONS

[88] There are many possible options for addressing the concerns raised about section 44. Ten options, with their advantages and disadvantages, are listed below. Some of these options have been suggested by the business and legal communities. Others have been developed from provincial or foreign legislation. These options are not exhaustive and additional suggestions made during consultations will also be considered.

Option 1: Repeal Section 44

Pros:

- **!** Eliminates solvency/assets tests that cause problems for CBCA corporations, directors, lenders, lawyers and accountants.
- **!** Directors and officers approving financial assistance transactions will still be subject to fiduciary duties to act in the best interests of the corporation.
- **!** Removes a test which may distract directors and officers from inquiring into whether they are properly performing their fiduciary duties.

Cons:

- **!** Financial assistance is a key area of conflict of interest and should be specifically regulated.
- **!** Could be less certainty for directors who may have their actions tested under fiduciary duties/oppression remedy.
- **!** More litigation may arise as a result of reliance on fiduciary duties/oppression remedy and hence greater expense.
- **!** Removes an element of protection that was provided to creditors and minority shareholders.

Option 2: Replace solvency/assets test for both share purchase transactions and related party financial assistance with an express authorization of financial assistance when made in best interests of the corporation

[89] This is the approach taken in the Delaware GCL.

Pros:
- **!** Mirrors fiduciary duties imposed on directors by CBCA s. 122.
- **!** Eliminates problematic solvency/assets tests.

Cons:
- **!** Financial assistance is key area of conflict of interest and should be more specifically regulated.
- **!** Test may be difficult to satisfy in the case of financing transactions among members of a corporate group.[106]

Option 3: Replace solvency/assets tests with disclosure requirement

[90] This is the approach adopted by the Saskatchewan BCA when it was amended in 1992. It requires annual disclosure to shareholders for public corporations and disclosure to shareholders within ninety days for privately-held corporations. Similarly, the Corporate Law Subcommittee of the Canadian Bar Association - Ontario, Business Law Section ("CBA- Ontario") recommended that the financial assistance provision address only the restriction of financial assistance for the purchase of shares. The CBA - Ontario further recommended that disclosure of financial assistance to officers and directors and their associates be dealt with in the disclosure regime for disclosure of interested director and officer contracts (CBCA s. 120) at the meeting of directors.[107]

Pros:
- **!** Directors and officers approving financial assistance transactions will still be subject to fiduciary duties to act in the best interests of the corporation.
- **!** Disclosure of transactions required in respect of all corporations.
- **!** Eliminates problematic solvency/assets tests.
- **!** Removes technical rules that may distract directors and officers from carefully examining their fiduciary obligations when they approve financial assistance.

Cons:
- **!** Disclosure of transactions already now occurs in cases of larger corporations (in the management proxy circular) and disclosure to

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[106] That is, a guarantee or loan may be in the best interests of the group of companies as a whole or the parent corporation but it may be difficult to prove that the transaction is in a particular subsidiary's best interest.

[107] CBA-Ontario redraft of Ontario BCA s. 20 dated November 19, 1985 and redraft of Ontario BCA s. 132 dated March 27, 1986.

shareholders of smaller corporations makes little sense if concern is protection of creditors.

- **!** The 90 day disclosure requirement for financial assistance transactions made by privately-held firms (imposed by the Saskatchewan BCA) may be burdensome and compliance could be difficult to monitor.
- **!** Financial assistance is key area of conflict of interest and should be more specifically regulated.

[91] A variation on this option could require immediate disclosure to the CBCA Director within ten days of the transaction. The advantage of immediate disclosure would be to better ensure access to information by shareholders and creditors. Such immediate disclosure, on the other hand, could be seen as burdensome, intrusive and bureaucratic. The effectiveness of the filing as a means of notifying shareholders and creditors as well as the costs incurred by government for publication may be questionable.

Option 4: Replace solvency/assets test with the requirement of notice and shareholder approval[108] for financial assistance transactions which are "material"

[92] This approach, with different variations, is taken in a number of regimes, including the Australian CA.

Pros:

- **!** Notice and approval may help protect minority shareholders and creditors. As with the Australian CA regime, shareholders and creditors would have the right to apply to a court to oppose a transaction even if approved by a special resolution.
- **!** Eliminates problematic solvency/assets tests.

Cons:

- **!** A shareholder approval requirement might be burdensome in the case of publicly-traded corporations and result in very little protection for creditors in the case of a closely-held corporation (because they are unlikely to have notice of the transaction).
- **!** Shareholder approval requirement seems contrary to general thrust of CBCA to leave business decisions to the management.

Option 5: Maintain and clarify section 44

[93] **Appendix C** reviews nineteen changes that could be made to s. 44 to clarify it. Clarifications could include:

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[108] Shareholder approval could be by ordinary or special resolution. The term "special resolution" is defined in CBCA s. 2(2) to mean a resolution passed by a majority of not-less than two thirds of the votes cast.

- ! Replacing, in the problematic assets test, the term "realizable value" with the clearer term "fair value" and providing a definition of "fair value";
- ! Providing that the solvency and assets tests need only be satisfied at the time of the entering into the contract for financial assistance;
- ! Limit the application of s. 44 to "significant" shareholders, directors and officers of the corporation or of the holding corporation, and to associates of such persons;
- ! Broadening subs. 44(3) to protect (in addition to lenders) creditors and other third parties dealing with the corporation at arm's length to allow them to enforce financial assistance transactions where they have acted in good faith; and
- ! Expressly authorizing a corporation to give financial assistance except as prohibited or restricted.

Pros:

- ! Maintains bottom line protection for creditors and minority shareholders while continuing to allow the corporation and directors very broad discretion to give financial assistance.
- ! Clarifies many of the problems identified with the section.

Cons:

- ! Retains a problematic and burdensome process while only providing a bottom line protection for creditors and minority shareholders.
- ! Addresses major concerns but leaves some problems unanswered.

Option 6: Rationalize section 44 by removing all restrictions on financial assistance for share acquisitions but retaining a solvency test for related party financial assistance

Pros:

- ! Eliminates the most problematic test, the assets test, and maintains the key solvency requirement which is important for creditor protection.
- ! Eliminates restrictions on financing of share acquisitions. The policy behind the current restrictions is not completely clear.

Cons:

- ! Retains a problematic process that is burdensome yet appears to provide little protection for shareholder and creditors.
- ! Addresses major concerns but leaves some problems unanswered.
- ! Allows a corporation to freely traffic in its own shares.

Option 7: Status quo for both share purchase transactions and related party financial assistance

Pros:

- ! Maintains a bottom line protection for creditors and minority shareholders.
- ! CBCA corporations and directors currently have a very broad discretion to give financial assistance.

Cons:
- **!** Retains a regime that causes problems for CBCA corporations, directors, lenders, lawyers and accountants, while only providing a bottom line protection for creditors and minority shareholders.
- **!** If provision is maintained, there appears to be little reason not to make the clarifications set out in Appendix C.

Option 8: Require publicly-traded corporations with a dominant shareholder to establish a committee[109] to approve significant non-arm's-length transactions and contracts

[94] This is the recommendation of a recent research volume. The general editors, Ronald Daniels and Randall Morck, recommend the following:

> We suggest that a special committee of the board monitor and review the corporation's activities with controlling shareholders, other entities controlled by the controlling shareholders, and other insiders (non-shareholder officers and directors) to ensure fairness to minority shareholders. This would permit some institutional experience and memory to be accumulated with respect to non-arms's-length transactions and contracts.
>
> . . . The board of directors of any public Canadian company with a dominant shareholder should be required to establish a conduct review committee to approve significant non-arm's-length transactions and contracts. This committee should be composed entirely of [independent] directors.[110]

One variation on this option would be to require each member of a corporate group, which has one or more publicly-traded companies in the group, to set up a committee.

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[109] This committee need not be a new or separate committee of the board. The required function might be performed be a committee already existing in the corporation such as the audit committee.

[110] Morck and Daniels, note 94, p. 677. The research volume refers to a committee of "outside directors" but it recommends that:

> the definition of an outside director should be tightened considerably. For a firm to characterize a director as an outside director (in accordance with the Canada Business Corporations Act), that director should have no commercial link of any kind with the firm or its controlling shareholder(s). In other words, an outside director should be truly independent of management and owners. The controlling shareholder, the firm's lawyers, its advertising account managers, the executives of firms dependent on it for business, etc. should not be considered outside directors.

In essence, the review should be done by directors who are genuinely "independent" of the corporation. The issue of what would constitute an independent director was also discussed by the TSE Report on Corporate Governance, pages 24-25 and 53.

Pros:
- **!** Focuses on key area of potential abuse for canadian corporations.
- **!** Committee review may be less burdensome than meeting confusing solvency/assets test or obtaining minority shareholder approval.
- **!** Committee rules could be developed such that approval for general types of transactions between related parties would be permitted without requiring specific approval of each transaction by the committee.[111]

Cons:
- **!** Adds another layer of regulation which may be unduly burdensome for some corporations.
- **!** Restriction to publicly-traded corporations with dominant shareholder does little to deal with potential abuses by management in a widely-held corporation.

Option 9: Adopt disclosure, valuation, special committee review and minority approval regime for significant related party transaction of publicly-traded corporations

[95] This is the approach taken by O.S.C. Policy 9.1, [Policy Statement Q-27 of the Q.S.C. and B.C.S.C. Policy XX]

Pros:
- **!** Comprehensive approach allows broad protection for creditors and minority shareholders.

Cons:
- **!** Some of the rules, particularly the valuation and minority approval rules, are seen by some as ineffective and/or burdensome.
- **!** Detailed regime may not be appropriate for all publicly-traded corporations.

Option 10: Adopt a comprehensive regime regulating all related party transactions of publicly-traded corporations

[96] This is the approach adopted by the Bank Act.

Pros:
- **!** Related party transactions, including financial assistance transactions, involve a key area of conflict of interest that should be regulated.
- **!** Comprehensive approach allows broadest protection for minority shareholders and creditors.

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[111] A limit to the general transaction approval could be imposed that would require transactions which involve a certain percentage of the corporations capital (for example, greater than 25%) be specifically approved.

Cons:
- **!** Comprehensive regime, like the Bank Act regime, appears suitable only for the largest of companies and may be unfairly burdensome for many companies.
- **!** Contrary to general thrust of CBCA to leave internal corporate governance structures to be determined by each company.

Option 11: In conjunction with any of the above options, amend CBCA s. 288 to expressly define "complainant" to include a creditor for derivative remedy or derivative and oppression remedies

Pros:
- **!** Largely codifies the case law.[112]
- **!** Ensures creditor protection through access to broad remedies.

Cons:
- **!** Unnecessary as courts currently have a broad discretion which they can exercise to ensure adequate protection.
- **!** Could encourage more litigation.
- **!** Defining "complainant" for derivative action alone could lead to narrow interpretation for the more flexible oppression remedy.

B. PRELIMINARY CONCLUSIONS AND RECOMMENDATIONS

[97] The current provision requires change in order to effectively protect creditors and shareholders. If shareholder protection is a main concern, the solvency and assets tests are not effective. Creditor protection, on the other hand, is clearly balanced into the s. 44 regime by the inclusion of the solvency and assets test. However, the exemptions set out in subs. 44(2), in particular the upstream and downstream financial assistance in corporate groups, could be seen as ignoring creditor protection. On the other hand, the regime may be seen to reflect a balance between creditor protection and the need to permit flexibility in corporate groups.

[98] The exemption in favour of upstream financial assistance seems to partially nullify one of the original goals of the financial assistance provision, namely the prohibition on financial assistance for leveraged buy-outs. However, the provision does provide some protection for minority shareholders in cases where there has been a leveraged buy-out of some but not all the shareholders. Another policy rationale often cited for the restrictions on financial assistance for share purchases, i.e., the common law prohibition on corporations "trafficking" in one's own shares, has been overridden by the CBCA which now expressly allows corporations to purchase their shares. However, solvency and assets tests similar to those in s. 44 must be satisfied. It would therefore appear to be an anomaly to require corporations to follow solvency/assets tests when repurchasing shares themselves, but not to impose the same requirement in respect of financial assistance for share purchases.

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[112] Bank of Montreal v. Dome Petroleum Ltd. (1987), 54 Alta L.R. (2d) 289 (Q.B.), at 298; First Edmonton Place Ltd. v. 315888 Alberta ltd (1989), 40 B.L.R. 28.

[99] We believe that eliminating s. 44 altogether is problematic because it could lead to more litigation and confusion as to whether fiduciary duties permit financial assistance. Although addressing some of s. 44's weaknesses may reduce the problems corporations and others have with the section, the confused policy behind s. 44 would still remain.

[100] The comprehensive Bank Act regime appears attractive from a policy perspective and might be appropriate for the largest CBCA corporations. However, its detailed corporate governance rules and financial limits on loans, etc. may not be practical for the vast majority of CBCA corporations. The disclosure regime enacted by the Saskatchewan BCA is also attractive but we have concerns that the requirement imposed on privately-held firms to disclose within 90 days would be burdensome, largely ignored and difficult to enforce.

[101] We therefore make the following preliminary recommendations:

(1) In respect of share purchase financial assistance, maintain and clarify the s. 44 solvency/assets test requirements.[113] Exempt financial assistance transactions among all members of a wholly-owned corporate group.

(2) In respect of related party financial assistance, amend the CBCA to replace the solvency/assets test with:

(a) an express statutory authorization that a corporation may give financial assistance, as specifically defined,[114] to directors, officers, employees, shareholders and others where three conditions are met:

(i) (A) the financial assistance is in the best interests of the corporation, or

(B) in the case of financial assistance to shareholders or their associates, it is in the best interest of a member of the corporate group and not opposed to the best interests of the corporation;[115]

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[113] See Appendix C for discussion of potential clarifications.

[114] Proposed definition of "financial assistance" in Appendix C, Issue 7.

[115] The requirement that the financial assistance be not opposed to the best interests of the corporation may be seen as too onerous. Delaware, for instance, applies the concept of a "deemed best interest" provision whereby financial assistance to a subsidiary, parent corporation and certain other affiliates is "deemed" to be in the best interests of the contracting corporation (Delaware GCL, subs. 122(13)).

(ii) in the case of material[116] financial assistance transactions with shareholders that have a significant interest,[117] directors and officers of the corporation or the holding corporation and their associates,[118] there has been full disclosure at a board meeting and subsequently at the next annual shareholder meeting; and

(iii) in the case of material financial assistance transactions with shareholders that have a significant interest, directors and officers of the corporation or the holding corporation and their associates, the transaction has been approved by the directors or the shareholders;

(b) an additional requirement for publicly-traded CBCA corporations that all material related-party transaction[119] with significant shareholders, directors and officers of the corporation or the holding corporation and their associates, shall also be reviewed by a committee made up of independent directors.[120]

(c) elimination of exemptions in subs. 44(2) which no longer remain relevant to related party financial assistance, given that the new rule does not include an assets and solvency test but only involves the exercise of the director's traditional fiduciary duties and disclosure;[121]

(3) In respect of both related party financial assistance and share purchase financial assistance:

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[116] The term "material" could be simply used as it is in CBCA s. 120 with respect to material contracts or the statute or regulations could define "material" in either absolute dollar amounts (e.g., transactions involving an amount greater than a certain figure or an amount in relation to the capital of the corporation (as, for example, OSC Policy 9.1 does in s. 18.1).

[117] The Bank Act defines significant interest as ownership of more than 10% of the outstanding shares in a class (s. 8).

[118] See discussion of whether the restrictions placed upon related party financial assistance should be narrowed to include only those persons with power to affect corporate decision-making in Appendix C, issue 8.

[119] Reference here is intentionally made to "transactions" and not just "financial assistance transactions."

[120] The issue of independent directors is discussed above in note 109.

[121] Exemptions under the pre-1975 rules were perhaps essential as there were absolute prohibitions on certain types of financial assistance. Also, since 1975, the burdensome solvency and assets tests also lead to the need for exemptions. If a new rule is adopted based on fiduciary duties and disclosure, the exemptions no longer seem appropriate. However, it might be argued that, in some cases, financing in corporate groups may not be possible (given that the assistance may not be in the best interest of every subsidiary) and that requiring disclosure of all financial assistance transactions may create a paper burden.

(a) directors' liability for financial assistance made in contravention of this section, with the availability of a full due diligence defence;[122] and

(b) enforceability of contracts made in contravention of the section by the corporation and by a lender, creditor and other third party dealing with the corporation at arm's length in good faith without actual notice of the contravention.

VIII. DISCLOSURE OF INTERESTED DIRECTOR CONTRACT (SECTION 120)

Background

[102] Related to section 44 is section 120[123] which requires directors and officers of CBCA corporations to disclose whether they are a party to a material contract with the corporation or have an interest in a person who is a party to a material contract with the corporation.

[103] The Dickerson Report[124] provides the rationale for this provision. The common law, it is explained, was absolutely strict in its treatment of a director having an interest in a contract with the corporation of which he or she was a director. The common law rule, which had remained pretty much unchanged since first expressed by a British court in 1854 in the case of Aberdeen Railway v. Blaikie,[125] was that a contract between an interested director and a corporation of which the person was a director was void and the director had the duty to account to the corporation for any profits received, irrespective of how fair the contract was to the corporation.

[104] At the same time, however, the common law placed very few if any limitations on what the parties could agree to in the articles of association. The articles were generally drafted to: i) waive the obligation of the director to disclose his/her interest, ii) permit a director to vote in respect of a contract in which he/she had an interest and, iii) absolve the director altogether of any duty to account for profits made from such contract. Such articles had become so widespread as to lead to the amendment of the Companies Act in the United Kingdom in 1929. A new provision which focused almost entirely upon disclosure of the interest in the contract was added; however, the sanction to be imposed in the event of non-compliance by an interested director was still found at common law. Section 95 of the Companies Act, 1934 had also been expanded to limit the

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[122] The issue of a due diligence defence is canvassed in the CBCA discussion paper on Directors Liability pages 22-25.

[123] Reproduced in full in Appendix A.

[124] Dickerson Report, note 7, vol. I, par. 226.

[125] (1854) 2 Eq. 1281.

rights of an interested director to vote and to declare when a director is not accountable for profits made on the contract with the company.[126]

[105] The Dickerson Report stated that article 9.17 (s. 120 CBCA) of its draft bill had two objectives:

> first to stipulate the conditions that must be fulfilled by a director having an interest in a contract with the corporation; and second to declare that if the director does fulfil these conditions, the contract is not void and he has no liability to account for any profit he may make under the contract. Particularly noteworthy is the overriding criterion that the contract be "reasonable and fair to the corporation."[127]

[106] The rationale underlying s. 120 is also seen in Rhyolite Resources Inc. v. CanQuest Resource Corp. where Mr. Justice Ryan of the British Columbia Supreme Court, held that:

> This provision is in direct conflict with the equitable rule that such a contract is voidable at the instance of the company unless it has been ratified by the company in general meeting. Clearly, the intention of the legislature was to replace the common law.[128]

Consultations:

[107] Preliminary consultations regarding Phase II amendments to the CBCA produced the following comments:

- Section 120 is unclear with regards to the materiality of a contract.
- There are examples of clear conflicts which need not be disclosed under the CBCA because they don't involve a contract with the corporation eg. voting restrictions which don't require a director to abstain when it's a transaction affecting an affiliate.

[108] It should be added that these consultations were not intended to be exhaustive and that all points of view may not have been expressed.

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[126] Subsection 95(7) of the Companies Act, 1934 (U.K.), 24 & 25 George V, c. 33, provided that nothing "shall impose any liability upon a director in respect of the profit realized by any contract which had been confirmed by the vote of shareholders of the company at a special general meeting called for that purpose."

[127] Dickerson Report, note 7, vol. I, par. 228. Unlike the present version of s. 120, article 9.17 addressed the issue of accountability for profits, hence the reference to no liability to account for profits where certain conditions are met.

[128] Rhyolite Resources Inc. et al. v. Canquest Resource Corporation et al. (1991), 50 B.L.R. 275, at p. 282.

1. **Definition of "contract"** (subs. 120(1))

Issue:

[109] Whether the emphasis on "contract" in subs. 120(1) is too restrictive and, if so, whether shareholders and the public would be better protected if directors and officers were required to disclose their material interests in connection with other "transactions" or "proposed transactions."

Background:

[110] A legal practitioner has advised that:

> The emphasis in section 120 on "material contracts" seems to me unduly narrow. In a recent situation in which I have been involved, a director of A Co. had a substantial personal investment in B Co.; A Co. also had an investment in B Co. and there was no contract relating to the investments between A Co. and its director. In another situation, a director of A Co. is also CEO and a director of B Co. which is suing A Co. in litigation not premised on breach of contract. These are only two examples among many I have encountered that don't fit the statutory scheme but, to my mind, should be addressed.

[111] Subsection 132(1) of the Ontario BCA provides that a director or officer who is a party to a material contract or **transaction** or proposed contract or transaction must disclose the nature and extent of his/her interest. The British Columbia CA also uses the term "transaction" in its provision on conflict of interest.[129] The Civil Code of Québec requires that a director give information about an **acquisition** or a contract with a legal person.[130] These different expressions seem broader than the one used in the CBCA.[131]

[112] Although the Ontario BCA, the British Columbia CA and the Civil Code of Québec do not define the term "transaction" or "acquisition," they seem broader than "contract." The Dictionary of Canadian Law defines transaction "in its ordinary sense . . . to mean the doing or performing of some matter of business between two or more persons."[132] The Bank Act provides that the term

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[129] See subs. 144(1) of the British Columbia CA.

[130] Civil Code of Québec, S.Q., 1991, c. 64, Arts. 325 and 326. A wider obligation to disclose is found in art. 324 of the Civil Code of Québec (based on the common law rule in Aberdeen Ry v. Blaikie Bros. (1854), 1 Macq H.L. 461) which requires the director to disclose to the legal person "any interest he has in an enterprise or association that may place him in a situation of conflict of interest and of any right he may set up against it, indicating their nature and value, where applicable."

[131] Other provincial corporate laws use the term "transaction."

[132] "Contract" is defined as an agreement between two or more persons, recognized by law, which gives rise to obligation, that the courts may enforce (Daphne A. Dukelow & Betsy Nuse, The Dictionary of Canadian Law, 2nd ed. (Toronto: Carswell, 1995)).

"transaction" includes a guarantee, an investment, an assignment of or otherwise acquiring a loan as well as the taking of a security interest.[133]

[113] A further question is whether directors and officers should be required to disclose an interest in a lawsuit by or against the corporation. The policy behind s. 120 is to identify those situations in which a director or officer's ability to consider, fairly and effectively, the corporation's interests may be inhibited by a self-interest. For example, concerns could be raised where a director is voting on whether or not to authorise the corporation to take or defend an action against a body corporate owned by that director.

Recommendation:

[114] It is recommended that directors and officers be required to disclose their interest not only in connection with "contracts" but also their interest in connection with any "transaction" or "proposed transactions."

Option:

[115] The term "contract" could be replaced by the term "transaction" which could be defined to include a contract, guarantee, investment, assignment of or otherwise acquiring a loan as well as the taking of a security interest, and any lawsuit involving the corporation.

2. Extension of Disclosure Requirement to "Any" Contract

Issue:

[116] Whether requiring directors to disclose interests only with respect to material contracts or proposed material contracts provides adequate shareholder protection or whether the disclosure obligation should extend to any contract or proposed contract.

Background:

[117] Initially, article 9.17 of the draft Bill accompanying the Dickerson Report did not qualify that a contract had to be "material", although it did refer to "a material interest" in any person that is a party to a contract or proposed contract with the corporation.[134]

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[133] See subsection 488(1) of Part XI (Self-dealing) of the Bank Act.

[134] Dickerson Report, note 7, vol. II, article 9.17.

[118] However, both Bill C-213[135] and Bill C-29, which was enacted as the CBCA in 1975, included the "material" contract qualification. Therefore, under the current CBCA rules, in order for s. 120 to apply the contract must be somewhat substantial and not merely a token contract.

[119] Referring to the equivalent provision of the British Columbia CA,[136] a 1991 discussion paper prepared on the reform of the British Columbia CA states that:

> Requiring directors to disclose only material interests in material contracts would improve the practical application of this provision. Disclosing contracts and interests which are not material does not protect companies. Immaterial contracts should not be rescinded because of an innocent oversight on the part of an interested director. If there are doubts as to whether an interest or contract is material, then the director should disclose.[137]

Recommendation:

[120] No change is recommended.

3. Ability of Interested Directors to Vote on Material Contracts (subs. 120(5))

Issue:

[121] Whether interested directors should be permitted to vote on all matters enumerated in subs. 120(5).

Background:

[122] CBCA subs. 120(5) provides that

> A director referred to in subsection (1) shall not vote on any resolution to approve the contract unless the contract is
>
> (a) an arrangement by way of security for money lent to or obligations undertaken by him for the benefit of the corporation or an affiliate;

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[135] Bill C-213 was the 1973 precursor to Bill C-29. Bill C-213 was tabled but not enacted.

[136] The equivalent provision in the British Columbia CA does not include the "material" qualification.

[137] British Columbia, Ministry of Finance and Corporate Relations, Company Act (:) Discussion Paper (Victoria: January 1991), at p. 24.

(b) one relating primarily to his remuneration as a director, officer, employee or agent of the corporation or an affiliate;
(c) one for indemnity or insurance under section 124; or
(d) one with an affiliate.

[123] A legal practitioner has argued that:

> The policy basis underlying some of the exceptions in 120(5) eludes me. As to 120(5)(a), I have a preliminary difficulty as to what it means; in my view, the best interpretation is to construe it as if "or obligations undertaken by" were set off by commas, but other interpretations could be put forward. Accepting my interpretation, why should a director be allowed to vote on the security arrangements when the corporation lends him or her money? Or when he or she undertakes an obligation for the benefit of the corporation? And in 120(5)(b), why should the director be allowed to vote on his or her remuneration -- although I recognize the need for some special provision to accommodate voting on the remuneration package for the board as a whole, as distinct from the package for any particular director. Similar questions can be asked as to the other exceptions. . .

[124] With respect to par. 120(5)(a), it does seem that allowing directors to vote on an arrangement for security for money lent to them or obligations undertaken by them could amount to endorsing a conflict of interest situation. However, the contract must be "for the benefit of the corporation or an affiliate."

[125] It would appear that par. 120(5)(a) could be interpreted to mean that a director to whom the corporation has lent money will not be precluded from voting on the approval of the arrangement provided the loan is undertaken "for the benefit of the corporation or an affiliate." One of the difficulties with this provision however, is determining when such a loan is made "for the benefit of the corporation" as opposed to for the benefit of the director.

[126] Further, it can be argued that it is unlikely that the approval of a contract that does not offer any benefit to the corporation would withstand the fiduciary duty test set out in s. 122 which requires directors and officers to act with a "view to the best interests of the corporation." Therefore, in accordance with this fiduciary duty, directors should presumably only make loans which benefit the corporation. If all loans benefit the corporation interested directors would always be entitled to vote on a loan made to them. If a director could always vote what is the necessity of a section which says the director may not vote unless the loan is made for the benefit of the corporation.

[127] The Bank Act provides a regime similar to s. 120 of the CBCA. Although directors under the Bank Act are entitled to vote on a resolution to approve a contract for a loan to them undertaken for the benefit of the bank, the loan would also be subject to the approval requirements for self-dealing under Part XI of the Bank Act. British Columbia CA on the other hand, specifically lists three of the four subs. 120(5) transactions and deems the director not to be

"interested" in the transaction. As a result the interested director provisions, which would otherwise apply, do not, thereby allowing the director, among other things, to vote.[138]

[128] The exception regarding the director's ability to vote where the issue is his/her remuneration (par. 120(5)(b)) is consistent with s. 125 which empowers the directors of the corporation, subject to a corporation's articles, by-laws and unanimous shareholder agreement, to fix the remuneration of the directors, officers and employees of the corporation. However, executive remuneration has become a key issue of corporate governance. Some provincial securities laws have been changed to require individual disclosure of the top executives of publicly traded (distributing) corporations. One might question, therefore, whether the process for approval of such executive remuneration should be looked at.

[129] In Re North Eastern Insurance Co.[139] the English courts have highlighted an important corollary to the voting prohibition placed on the director. The court held that: not only are directors prohibited from voting on any resolution to approve a contract in which they have a material interest but, where two directors have separate but parallel contracts with the corporation, such directors cannot agree to give reciprocal approval of each other's contract.

[130] Further, it seems that, although subs. 120(5) precludes a director from voting to approve a contract in which such director has a material interest, a director would however be entitled to approve actions necessary to implement the contract.[140]

Recommendation:

[131] We recommend that par. 120(5)(a) be repealed.

Option:

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[138] British Columbia C.A, subs. 144(4).

[139] Re North Eastern Insurance Co. (1919), 1 Ch. 198. Where it is proposed that the corporation enter into separate but parallel contracts with two of its directors, one director approving the contract between the corporation and the other director and the other director reciprocating in approving the other contract, the two contracts ought to be regarded as part of one transaction in which both directors are jointly interested. If either of the impugned resolutions were not passed, the agreed upon transaction would not have been implemented. Thus, since both directors are jointly interested in the two resolutions, neither is entitled to vote there on.

[140] Garvie v. Axmith (1962), 31 D.L.R. (2d) 65, at p. 74, the court held that ". . . the requirement for disclosure of interest and refraining from voting did not apply to the passing of this resolution by the directors . . . because the resolution did not deal with a contract in which the directors were interested but simply was a procedural step necessary to carry out the contract and the director's interest in that contract was disclosed when it was approved by the shareholders."

[132] For publicly-traded (distributing) corporations, limit the right of directors to vote on their own executive remuneration to the package of compensation for the whole board. Individual remuneration, such as that received by a director in the capacity of an officer, could not be voted on by that director.

4. Effective Continuing Disclosure (subs. 120(6))

Issue:

[133] Whether the continuing disclosure requirement in subs. 120(6) needs to be clarified.

Background:

[134] Subsection 120(6) provides that:

> For the purposes of this section, a general notice to the directors by the director or officer, declaring that he is a director or officer of or has a material interest in a person and is to be regarded as interested in any contract made with that person, is a sufficient declaration of interest in relation to any contract so made.

[135] A legal practitioner wrote:

> I have trouble with the timing implications of 120(6). As I read it, if I am a director of A Co. and also of B Co. and duly advise each of my relationship with the other, then I need not give further advice when a contract is entered into between them, perhaps years later.

[136] Subsection 120(6) requires initial disclosure by a director. However, it does not require that the director keep the corporation current as to changes in the interest nor does it require the director to periodically inform the corporation of continuing interests.

[137] Unlike the CBCA, the Alberta BCA provides in par. 115(6)(c) that a general notice given by a director or officer is sufficient disclosure provided that "the notice is given within the 12-month period preceding the time at which disclosure would otherwise be required." Therefore, the problem with subs. 120(6) in regard to notice continuing in perpetuity once given, does not exist under the Alberta BCA which, for all intents and purposes, appears to require a renewal of notice every twelve months.

[138] Although requiring periodic disclosure imposes a further administrative burden, the duty to make full disclosure is a fiduciary duty a director owes to the corporation.[141] Even though subs. 120(6) does not require that a director keep the corporation current as to the status of his/her interest, it could be argued that the fiduciary duty imposed by s. 122 does.

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[141] Denman v. Clover Bar Co. (1913), 48 S.C.R. 318.

Recommendations:

[139] **!** Adopt the Alberta requirement that general disclosure be given within the 12-month period preceding the time at which disclosure would otherwise be required; and

! Amend subs. 120(6) so as to provide that a material change in the nature of the interest a director or officer may have in either a material contract or a person with whom the corporation deals must be the object of a new declaration.

Option:

[140] Status quo.

5. Whether Disclosure Should Also be Given to Shareholders

Issue:

[141] Whether disclosure to the other directors is sufficient or should be extended to shareholders.

Background:

[142] Under the present provisions shareholders will only receive disclosure of information regarding director's conflict of interest contracts where it is a case that requires shareholder approval. Where however such ratification is not required the director need only give notice to the corporation. This disclosure has been questioned: "Why is disclosure made only to one's fellow directors if ratification is not involved? Why should not the annual information circular inform shareholders of contracts or transactions in which the directors were interested?"[142]

[143] In 1980 the Alberta Institute of Law Research and Reform questioned whether disclosure to directors alone was sufficient protection or whether disclosure should also be made to shareholders.[143] As Professor Gower has noted, "it hardly seems over-cynical to suggest that

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[142] Jacob S. Ziegel, Ronald L. Daniels, David L. Johnston & Jeffrey G. MacIntosh, Cases and Materials on Partnerships and Canadian Business Corporations, 2nd ed. (Toronto: Carswell, 1989), p. 501.

[143] Alberta, Institute of Law Research & Reform, Proposals for a New Alberta Business Corporations Act, Report No. 36 (Edmonton: August 1980) (1980 Alberta LRI report)

disclosure to one's cronies is a less effective restraint on self-seeking than disclosure to those for whom one is a fiduciary."[144]

[144] Other jurisdictions have addressed this concern and expanded the disclosure requirement to include shareholders. For instance, the Alberta LRI in its 1980 report indicated that the Ghana Code s. 207(7) required that detailed information regarding directors' interest in contracts be compiled in a record available for shareholder scrutiny. Further the report stated that the South African Act required that information regarding contracts to which directors have declared an interest be presented at the annual meeting.[145]

[145] The 1980 Alberta LRI report recommended that "a note of the disclosures made under s. 115 of the [Alberta BCA] be available for inspection at the records office for shareholders." This requirement was made subject to the ability of shareholders to alter it by unanimous shareholder agreement.[146]

[146] Although requiring disclosure be made to shareholders places an extra administrative burden on corporations, in order to make fully informed decisions shareholders should be made aware of interests that their directors have in transactions with the corporation.

Recommendation:

[147] We recommend that subs. 120(6) be amended to require that disclosure required by subs. 120(1) of "material" contracts (transactions) be also given at the next annual shareholder meeting.[147]

6. Reasonable and Fair Standard (subs. 120(7))

Issue:

[148] Whether the standard "reasonable and fair to the corporation" is appropriate and fair to the directors.

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[144] L.C.B. Gower, The Principles of Modern Company Law, 3rd edition (London: Stevens & Sons, 1969), p. 530.

[145] 1980 Alberta LRI Report, note 141, p. 64.

[146] Ibid.

[147] This recommendation corresponds with the recommendation made in Part VII concerning disclosure of financial assistance transactions.

Background:

[149] Along with disclosure and approval, the avoidance standard in subs. 120(7) requires that any conflict of interest contract be "reasonable and fair to the corporation at the time it was approved" before the contract will be rendered non-voidable.

[150] Subsection 120(7) provides the following:

> A material contract between a corporation and one or more of its directors or officers, or between a corporation and another person of which a director or officer of the corporation is a director or officer or in which he has a material interest, is neither void nor voidable by reason only of that relationship or by reason only that a director with an interest in the contract is present at or is counted to determine the presence of a quorum at a meeting of directors or committee of directors that authorized the contract, if the director or officer disclosed his interest in accordance with subsection (2), (3), (4) or (6), as the case may be, and the contract was approved by the directors or the shareholders and it was reasonable and fair to the corporation at the time it was approved [emphasis added].

[151] A legal practitioner has argued that "I think the 'reasonable and fair' standard in the last line of 120(7) is inherently unfair: I read it as introducing an objective test that might be applied years later with the benefit of hindsight. My concerns are only slightly allayed by the 'at the time it was approved' clause."

[152] The Dickerson Report alludes to the purpose behind including the fair and reasonable test in s. 120: "[p]articularly noteworthy is the overriding criterion that the contract be reasonable and fair to the corporation which is necessary to preclude mutual back-scratching by directors who might otherwise tacitly agree to approve one another's contracts with the corporation."[148]

[153] Under the British Columbia CA conflict of interest contracts can be rendered non-voidable in either one of two ways. The first test requires the director to disclose his/her interest. After disclosure the transaction must be approved by the directors and the interested director must abstain from voting on the contract's approval. The second test requires that the contract was reasonable and fair to the corporation at the time it was entered into and after full disclosure of the nature and extent of his/her interest, the contract or transaction was approved by special resolution of the shareholders.

[154] Unlike the CBCA, the British Columbia CA, only applies a "reasonable and fair to the corporation" test to contracts which are made non-voidable by shareholder approval. The authors of a discussion paper on the British Columbia CA argue that:

> While there does not seem to be much justification for only applying the fair and reasonable test to contracts approved by the members, there is an argument against following the other statutes mentioned above [Alberta BCA, Ontario BCA, CBCA]. The

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[148] Dickerson Report, note 7, vol. 1, par. 228.

> uncertainty created by the fact that a contract duly approved may be overturned by the court is a serious drawback. The intention of the test is clearly to ensure that those approving the contract understand their duties to the company. However, that duty is already clear in respect of directors, and the members' interest should be consistent with the interests of the company in those circumstances. Remedies already exist against directors who improperly approve such contracts, and oppression remedies exist if minority members are oppressed by an approval.
>
> In the interests of certainty for innocent third parties involved in contracts where there is a conflict of interest, such contracts should stand if duly approved, even if the approval was inappropriate. Those who improperly approve should bear the burden; not innocent third parties.[149]

[155] As part of the recommendations of the British Columbia discussion paper it was proposed that the reasonable and fair test be removed from the shareholder approval provision.[150]

[156] One alternative to the "reasonable and fair" test might be the test formulated for directors and officers fiduciary duties. Under such a test, the contract would not be voidable if it was "in the best interests of the corporation" at the time it was approved.

Options:

[157] (1) Maintain the present provision with a reasonable and fair test.

[158] (2) Amend the provision by removing the reasonable and fair test and requiring only disclosure and either director or shareholder approval in order to render the contract non-voidable.

[159] (3) Replace the "reasonable and fair" test with a requirement that the contract be "in the best interests of the corporation."

[160] (4) Replace the "reasonable and fair" test with a subjective test such as the board or director was reasonably justified in concluding, at the time the financial assistance was given, that it was in the best interests of the corporation.

7. Duty to Account (subs. 120(7))

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[149] Company Act (:) Discussion Paper, note 135, pp. 25-26.

[150] Ibid., p. 26 - "The court would no longer have the power to set aside a contract once approved by either the members or the directors."

Issue:

[161] Whether subs. 120(7) should be amended to specifically state that a director or officer is not accountable to the corporation for any profit or gain realized from a contract so long as the avoidance standards have been met and the contract is rendered non-voidable.

Background:

[162] According to their fiduciary duties,[151] directors and officers have the obligation in a conflict of interest contract to account to the corporation for any profit they gain.

[163] A legal practitioner has raised concerns that subs. 120(7) of the CBCA does not mention that a director or officer is not accountable to the corporation for any personal profit from a non-voidable contract. In other words, it is not clear if the fiduciary duty to account applies to a contract rendered non-voidable under subs. 120(7).

[164] One author suggests that, because the CBCA is silent on that point, the rule must be that a director or officer whose contract is rendered non-voidable under subs. 120(7) will remain accountable for his/her profits.[152]

[165] The draft Act proposed by the Dickerson Report provided that a director would be liable to account for any profit made on the contract unless the adequate disclosure was made, the contract was approved and was reasonable and fair to the corporation.[153] This element was not adopted when the CBCA was passed in 1975.

[166] The Ontario BCA and several other provincial laws provide for accountability if the conflict of interest contract is voidable.[154] However, the provisions expressly provide that the director will not be accountable if the contract is non-voidable. Subsection 132(7)(a) of the Ontario BCA, like subs. 120(7) of the CBCA, provides that "the director or officer is not accountable to the corporation or its shareholders for any profit or gain realized from the contract or transaction" if disclosure takes place, the contract was approved and it was reasonable and fair to the corporation. The notion of accountability appears to be more detailed in the Ontario BCA than in the CBCA.

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[151] At common law and under articles 325 and 326 of the Civil Code of Québec.

[152] Bruce L. Welling, Corporate Law in Canada (:) The Governing Principles, 2d ed. (Toronto: Butterworths, 1991) at p. 453.

[153] Dickerson Report, note 7, vol. 2, art. 9.17(3).

[154] Subsection 132(7) of the Ontario BCA. See also s. 145 of the British Columbia CA, subs. 115(7) of the Alberta BCA, s. 77 (am. 1983, c. 15, s. 13) of the New Brunswick BCA and art. 326 of the Civil Code of Québec. The New Brunswick provision provides for accountability only and do not mention any method to make contracts non-voidable.

Recommendation:

[167] We recommend that the subs. 120(7) of the CBCA be amended to clarify that a director or officer is only accountable to the corporation for any profit if the conflict of interest contract is voidable.

8. Additional grounds for Court Applications (subs. 120(8))

Issue:

[168] Whether the grounds for a court application to set aside the contract be expanded.

Background:

[169] Currently, CBCA subs. 120(8) provides the following:

> Where a director or officer of a corporation fails to disclose his interest in a material contract in accordance with this section, the court may, on the application of the corporation or a shareholder of the corporation, set aside the contract on such terms as it thinks fit.

[170] This provision only refers to the disclosure requirement placed on directors and officers. It does not provide for an application to court in the case of the two other elements in the avoidance standards, namely where the contract was not approved by directors or shareholders and was not reasonable and fair to the corporation. For example, subs. 120(5) states that a director who caused the voidability problem by his/her conflict of interest must not vote on the approval. It is not clear what will be the result if the director does vote. One author suggests that possibly the director's voting "would invalidate the board resolution, as the taking of the vote would itself be a conflict of interest situation, resulting in an avoidable 'transaction' not covered by the statute and thus falling within the general equitable rule."[155]

[171] Subsection 132(9) of the Ontario BCA allows a court to make any order it sees fit if the director or officer "otherwise fails to comply with this section."

Recommendation:

[172] We recommend that subs. 120(8) be amended to read "Where a director or officer of a corporation fails to disclose his interest in a material contract in accordance with this section, or otherwise fails to comply with this section . . ." We further recommend that

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[155] Welling, note 150, p. 446.

subs. 120(8) be amended to give the courts the power to make an order directing that the director or officer account to the corporation for any profit or gain realized.

9. Clarification of Par. 120(2)(b)

Issue:

[173] Whether par. 120(2)(b) should be clarified by replacing the word "then" with "at the time of the meeting referred to in clause (a)."

Background:

[174] Paragraph 120(2)(b) reads:

> The disclosure required by subsection (1) shall be made, in the case of a director,
>
> (a) at a meeting at which a proposed contract is first considered;
>
> (b) if the director was not then interested in a proposed contract, at the first meeting after he becomes so interested; . . .

[175] Subsection 120(2) addresses the time of disclosure of interest in a material contract for a director. One author suggests that the section is clearly worded and poses no major problems:

> [Subsection 120(2)] appears to be exhaustive, listing as alternatives the time of the first meeting, or where that is not applicable then at the next meeting immediately following the establishment of his interest or the time at which an interested party becomes a director.[156]

[176] It could be argued however that the words "not then interested" do not clearly indicate the timing required for disclosure under par. 120(2)(b). Other jurisdictions have worded their provision differently. Both British Columbia CA and Alberta BCA have use the words "at the time of the meeting referred to in clause (a)."[157]

Recommendations:

[177] Amend par. 120(2)(b) to read:

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[156] Ibid., p. 445.

[157] British Columbia C.A., par. 144(2)(b) and Alberta BCA, par. 115(2)(b).

(b) if the director was not interested in a proposed contract **at the time of the meeting referred to in clause (a)**, at the first meeting after he becomes so interested.

10. Addition of Shareholder Confirmation

Issue:

[178] Whether a provision allowing a voidable contract to be made non-voidable by shareholder confirmation notwithstanding non-compliance with the avoidance standards set-out in subs. 120(7) should be added.

Background:

[179] Under the CBCA a material contract in which a director has an interest will be void or voidable if subs. 120(7) is not complied with. In other words, the contract is non-voidable if the director discloses his/her interest, the contract was properly approved by the directors or shareholders and the contract was fair and reasonable at the time it was entered into.

[180] If any of these three requirements are not met the contract may be void or voidable. The Ontario BCA, in comparison, provides separately for director and shareholder approvals. Subsection 132(7) provides for director approval, which is valid if (1) disclosure to the board is made; (2) the director does not vote on the contract or transaction; and (3) it was reasonable and fair to the corporation. Subsection 132(8) allows for confirmation by special resolution of the shareholders as an alternative method of rendering a contract non-voidable even if the disclosure to the corporation required by subs. 132(1) has not occurred.

[181] Subsection 132(8) of the Ontario BCA provides the following:

> Despite anything in this section, a director or officer, acting honestly and in good faith, is not accountable to the corporation or its shareholders for any profit or gain realized from any such contract or transaction by reason only of his or her holding the office of director or officer, and the contract or transaction, if it was reasonable and fair to the corporation at the time it was approved, is not by reason only of the director's or officer's interest therein void or voidable, where,
>
> (a) the contract or transaction is confirmed or approved by special resolution at a meeting of shareholders duly called for that purpose; and
>
> (b) the nature and extent of the director's or officer's interest in the contract or transaction is disclosed in reasonable detail in the notice calling the meeting or in the information circular required by section 112.

[182] One author has commented that a provision similar to the Ontario BCA's subs. 132(8) is a sensible improvement and "probably ought to be included in future revisions of other Canadian Corporate Statutes."[158]

Recommendation:

[183] We recommend that the CBCA be amended to add a provision similar to Ontario BCA subs. 132(8) and that CBCA subs. 120(7) be amended to remove the reference to shareholder approval. Therefore, subs. 120(7) would provide for director approval and a new subsection would provide for shareholder approval.

IX. CONCLUSION

[184] The purpose of this discussion paper, along with eight others dealing with CBCA reform,[159] is two-fold:

1) to address problems with the existing legislation that have been brought to the attention of Industry Canada, and

2) to provide, where possible, new approaches to advance the field of corporate law in Canada.

[185] The recommendations and options outlined in the paper are not in any sense the final word on the subject. They are ideas that have come about largely through discussions with stakeholders across the country. As such, they are not government or even departmental policy.

[186] This paper is intended to solicit views from those who use the CBCA and others on the regulation of financial assistance transactions and material contracts under CBCA ss. 44 and 120 and, if appropriate, how they can be improved.

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[158] Welling, note 150, p. 454.

[159] The other eight discussion papers deal with:

- Directors' and other Corporate Residency Requirements;
- Shareholder Communications and Proxy Solicitation Rules;
- Going-Private Transactions;
- Technical Amendments;
- Directors' Liability;
- Unanimous Shareholder Agreements;
- Insider Trading; and
- Takeover Bids.

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APPENDIX A

CBCA SECTION 44 AND RELATED SECTIONS

44.(1) [Prohibited loans and guarantees] Subject to subsection (2), a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise

> (a) to any shareholder, director, officer or employee of the corporation or of an affiliated corporation or to an associate of any such person for any purpose, or
>
> (b) to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or affiliated corporation,

where there are reasonable grounds for believing that

> (c) the corporation is or, after giving the financial assistance, would be unable to pay its liabilities as they become due, or
>
> (d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

(2) [Permitted loans and guarantees] A corporation may give financial assistance by means of a loan, guarantee or otherwise

> (a) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation;
>
> (b) to any person on account of expenditures incurred or to be incurred on behalf of the corporation;
>
> (c) to a holding body corporate if the corporation is a wholly-owned subsidiary of the holding body corporate;
>
> (d) to a subsidiary body corporate of the corporation; and
>
> (e) to employees of the corporation or any of its affiliates
>
> > (i) to enable or assist them to purchase or erect living accommodation for their own occupation, or

(ii) in accordance with a plan for the purchase of shares of the corporation or any of its affiliates to be held by a trustee.

(2.1) [Wholly-owned subsidiary] A corporation is a wholly-owned subsidiary of another body corporate for the purposes of paragraph (2)(c) if

(a) all of the issued shares of the corporation are held by

(i) that other body corporate,

(ii) that other body corporate and one or more bodies corporate all of the issued shares of which are held by that other body corporate, or

(iii) two or more bodies corporate all of the issued shares of which are held by that other body corporate; or

(b) it is a wholly-owned subsidiary of a body corporate that is a wholly-owned subsidiary of that other body corporate.

(3) [Enforceability] A contract made by a corporation in contravention of this section may be enforced by the corporation or by a lender for value in good faith without notice of the contravention.

! ! !

120.(1) [Disclosure of interested director contract] A director or officer of a corporation who

(a) is a party to a material contract or proposed material contract with the corporation, or

(b) is a director or an officer of or has a material interest in any person who is a party to a material contract or proposed material contract with the corporation,

shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors the nature and extent of his interest.

(2) [Time of disclosure for director] The disclosure required by subsection (1) shall be made, in the case of a director,

(a) at the meeting at which a proposed contract is first considered;

(b) if the director was not then interested in a proposed contract, at the first meeting after he becomes so interested;

(c) if the director becomes interested after a contract is made, at the first meeting after he becomes so interested; or

(d) if a person who is interested in a contract later becomes a director, at the first meeting after he becomes a director.

(3) [Time of disclosure for officer] The disclosure required by subsection (1) shall be made, in the case of an officer who is not a director,

(a) forthwith after he becomes aware that the contract or proposed contract is to be considered or has been considered at a meeting of directors;

(b) if the officer becomes interested after a contract is made, forthwith after he becomes so interested; or

(c) if a person who is interested in a contract later becomes an officer, forthwith after he becomes an officer.

(4) [Time of disclosure for director or officer] If a material contract or proposed material contract is one that, in the ordinary course of the corporation's business, would not require approval by the directors or shareholders, a director or officer shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors the nature and extent of his interest forthwith after the director or officer becomes aware of the contract or proposed contract.

(5) [Voting] A director referred to in subsection (1) shall not vote on any resolution to approve the contract unless the contract is

(a) an arrangement by way of security for money lent to or obligations undertaken by him for the benefit of the corporation or an affiliate;

(b) one relating primarily to his remuneration as a director, officer, employee or agent of the corporation or an affiliate;

(c) one for indemnity or insurance under section 124; or

(d) one with an affiliate.

(6) [Continuing disclosure] For the purposes of this section, a general notice to the directors by a director or officer, declaring that he is a director or officer of or has a material interest in a person and is to be regarded as interested in any contract made with that person, is a sufficient declaration of interest in relation to any contract so made.

(7) [Avoidance standards] A material contract between a corporation and one or more of its directors or officers, or between a corporation and another person of which a director or officer of the corporation is a director or officer or in which he has a material interest, is neither void nor voidable by reason only of that relationship or by reason only that a director with an interest in the contract is present at or is counted to determine the presence of a quorum at a meeting of directors or committee of directors that authorized the contract, if the director or officer disclosed his interest in accordance with subsection (2), (3), (4) or (6), as the case may be, and the contract was approved by the directors or the shareholders and it was reasonable and fair to the corporation at the time it was approved.

(8) [Application to court] Where a director or officer of a corporation fails to disclose his interest in a material contract in accordance with this section, a court may, on the application of the corporation or a shareholder of the corporation, set aside the contract on such terms as it thinks fit.

APPENDIX B

DETAILED REVIEW OF OTHER CONFLICT OF INTEREST REGIMES

I. The Delaware General Corporation Law (Delaware GCL)

1. Loans to Employees and Officers

Under the Delaware GCL, any corporation may offer financial assistance in the form of loans, guarantees or otherwise to officers, directors or employees of the corporation or its subsidiary whenever in the judgment of the directors, such loan may "reasonably be expected to benefit the corporation."[1] This financial assistance may be with or without interest, secured or unsecured and if secured, any security the board approves is acceptable, including a pledge of the corporation's shares.

In addition, subs. 122(13) of the Delaware GCL provides for the giving of financial assistance to related corporations where it is "necessary or convenient to the conduct promotion or attainment of the business of the contracting corporation." Such financial assistance includes contracts of guaranty and suretyship.

2. Interested Director Contracts:

The Delaware GCL deals with the issue of interested director contracts in s. 144. Under this provision a director's interest in a transaction, attendance at or participation in the meeting which authorizes the transaction or an interested director's vote at the authorization meeting will not cause the transaction to be void or voidable if the following conditions are met:

(1)(a) the director discloses the material facts regarding his/her interest in the transaction, and:

(b) (i) the board of directors or committee[2] in good faith authorizes the transaction by majority vote of disinterested directors; or

(ii) the shareholders entitled to vote, approve the transaction in good faith; or

(2) the transaction is fair to the corporation at the time it is authorized.

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[1] Section 143.

[2] Paragraph 141(c) - The board of directors may, by resolution passed by a majority of the whole board, designate one or more committees, each committee to consist of one or more of the directors of the corporation. See also this section for committee powers.

Further, interested directors may be counted for the purposes of determining quorum at a meeting to authorize such a contract or transaction.[3]

3. Duty of Care

The Delaware GCL has no comparable provision to the CBCA's s. 122. The common law business judgment rule[4] relating to director's duty of care applies to Delaware GCL corporations. Paragraph 102(b)(7) of the Delaware GCL, however, allows corporations to limit the personal liability of directors for breach of fiduciary duty, except in limited instances including when a director derives an improper personal benefit from a transaction.[5]

II. **American Bar Association Model Business Corporation Act (Model BCA)**

1. Permitted Loans and Guarantees:

The ABA's introductory comments regarding subchapter F state that, a loan to a director is simply one form of directors' conflicting interest transaction and therefore subject to the provisions relating to such transactions.[6] Based on this comment, it would appear that financial assistance to related parties is to be governed by subchapter F.

2. Chapter 8, Subchapter F:

(a) To whom does subchapter F apply? Subchapter F applies to directors only. The comments on this provision[7] state that conflict of interest of non-director officers or employees of a corporation are governed by the law of agency and therefore do not need specific legislation.

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[3] Paragraph 144(b).

[4] Directors are protected by the business judgment rule when all five of its elements are met: a business decision, disinterestedness, due care, good faith and no abuse of discretion. The limitation of Directors' Liability: a Proposal for Legislative Reform (1987), 66 Texas Law Review 411, at 416.

[5] Paragraph 102(b)(7) - Delaware corporations may not limit liability (i) for any breach of the director's duty of loyalty to the corporation or its stockholders, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) under section 174 of this Title, or (iv) for any transaction from which the director derived an improper personal benefit.

[6] Introductory comment (2) for section 8.60.

[7] Ibid.

(b) When does a directors' conflicting interest arise? In order for a conflicting interest[8] of a director to arise the director must know of his/her interest at the time the corporation enters into the transaction. Therefore, if a director becomes aware of an interest he/she has in a transaction with the corporation after the transaction has been entered into, there is no conflicting interest.

(c) Definition of Conflicting Interest: A conflicting interest will arise when: a director, a related party of a director, or specific other entities to which a director is economically involved is either a party to, or has a beneficial interest in a transaction, and the financial significance of the transaction is such that it would reasonably be expected to influence the director's judgment if he/she were called upon to vote on the transaction. This definition is found at paragraphs 8.60(1)(i) and (ii). If an interest of a director does not fall within this definition it is not a conflicting interest.[9]

Each subdivision has a different threshold based on the economic significance of the transaction. Subdivision 1(i) deals with transactions between the corporation and the director or related parties of the director, whether or not they are significant enough to go before the board of directors. Subdivision 1(ii) deals with transactions involving specific other entities and only deals with transactions that are of such significance that they are or would normally be brought before the board for approval.

(d) What Is a Transaction? The term transaction is not defined. However, the American Bar Association's comments which follow this section state that a transaction is a "consensual bilateral arrangement between the corporation and another party."[10]

(e) Who Is a Related Person? For the purpose of subdivision 1(i), a related person is defined in subs. 8.60(3) as: "(i) the spouse (or parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director, or an individual having the same home as the director, or a trust or estate of which and individual specified in this clause(i) is a substantial beneficiary; or (ii) a trust, estate, incompetent, conservatee, or minor of which the director is a fiduciary." This list is exclusive: if an individual does not fit this definition such individual is not a related party.

(f) Who Are the Persons Referred to in Subdivision 1(ii)? Subdivision 1(ii) deals with transactions between specific listed persons and the corporation. Those persons are: " (a) an entity (other than the corporation) of which the director is a director, general partner,

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[8] Subsection 8.60(1).

[9] Paragraph 8.61(a).

[10] Introductory comment (2) for section 8.60. Directors Conflicting Interest Transaction (subs. 8.60(2)) - "means a transaction effected or proposed to be effected by the corporation (or by a subsidiary of the corporation or any other entity in which the corporation has a controlling interest)respecting which a director of the corporation has a conflicting interest."

agent, or employee; (b) a person that controls one or more of the entities specified in subclause (a) or an entity that is controlled by, or is under common control with, one or more of the entities specified in subclause (a); or (c) an individual who is a general partner, principal, or employer of the director." This list is also exhaustive.

(g) What is Required Disclosure? The director must disclose the existence and nature of the conflicting interest and facts known to the director regarding the transaction that an ordinarily prudent person would reasonably believe to be material.[11]

(h) What are the available safe harbours? The Model BCA states that a transaction which does not fit the definition of a director's conflict of interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions by reason only that a director or a party related to the director has an interest in the transaction.[12] When the director is involved in a conflicting interest transaction, however, the Act offers three ways to safeguard it from attack by a shareholder or the corporation:[13]

> (i) Directors' Action:[14] A director's conflicting interest transaction may be sanctioned by a vote of a majority of the qualified directors[15] on the board or by a duly appointed committee of the board made up of qualified directors. This action can take place before or after the transaction has been entered into;[16] however, the vote must take place after required disclosure has been made by the interested director. Paragraph 8.62(b) allows for special disclosure where the interested director is under a legal or professional duty of confidentiality in regard to information which would otherwise be required to be disclosed. It is important to note that overriding this safeguard is the condition that the board's actions must comply with the director's duty of care prescribed in par. 8.30(a) (see discussion below).

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[11] Subsection 8.60(4).

[12] Paragraph 8.61(a).

[13] Paragraph 8.61(b).

[14] Section 8.62.

[15] Paragraph 8.62(d) - any director who does not have either (1) a conflicting interest respecting the transaction, or (2) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest respecting the transaction, which relationship would, in the circumstances, reasonably be expected to exert an influence on the first director's judgment when voting on the transaction.

[16] See ABA official comment 1 for par. 8.62(a).

(ii) Shareholders' Action:[17] A director's conflict of interest transaction may also be sanctioned by a majority vote of all qualified shares[18] of the corporation. This vote can only take place after (1) notice is given to the shareholders describing the director's conflict of interest transaction; (2) the interested director has informed the corporation about the number of voting shares of the corporation he/she holds or owns and the number and identity of related persons who own or hold voting shares; and (3) the required disclosure is made. It is interesting to note the absence from this provision of the interested director's right not to disclose information based on confidentiality as given in par. 8.62(b). Thus, where a director does not disclose information on the grounds of confidentiality, the shareholder action safe harbour is not available. Like the director's action, the shareholder's action may be taken before or after the transaction has been entered into.

(iii) Fair to the Corporation: Even where there has been no directors' or shareholders' action, a director's conflict of interest transaction may still be secure from attack if the interested director shows that the transaction was fair to the corporation.[19] The American Bar Association's comments on this section outline three aspects of the issue of fairness: (1) the terms of the transaction must be fair i.e. market price is paid; (2) the transaction must benefit the corporation, in that it is likely to result in a profit or other favourable outcome; and (3) the process of making the decision to enter into the transaction was fair. Thus, if the director's actions during the decision making process were in someway inappropriate the courts may still condemn the transaction even where the terms were fair by market standards and the corporation made a profit.

3. Duty of Care: Paragraph 8.30(a) of the Model BCA states that a director shall act in good faith, with the care of an ordinarily prudent person and in a manner which he/she reasonably believes to be in the best interests of the corporation when discharging his/her duties as a director.[20] Further, the Model Act specifically states that if a director complies with par. 8.30(a), he/she may rely on the reports, opinions etc. of certain listed people. However, if a director knows of some reason why he/she should not rely on the report but does so anyway the director is not acting in good faith. If the director complies with s. 8.30 he/she is not liable for any action taken as a director.

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[17] Section 8.63.

[18] Paragraph 8.63(b) - any shares entitled to vote with respect to the director's conflicting interest transaction except shares that, to the knowledge, before the vote, of the secretary (or other officer or agent of the corporation authorized to tabulate votes), are beneficially owned (or the voting of which is controlled) by a director who has a conflicting interest respecting the transaction or by a related person of the director, or both.

[19] Paragraph 8.61(b)(3).

[20] Section 8.30.

The duty of care for officers under the Model BCA is similar to s. 8.30; however, there are fewer people on whose reports an officer may rely.

III. **The Business Corporation Act of Saskatchewan (Saskatchewan BCA)**

1. Permitted Loans and Guarantees:

The Saskatchewan BCA states that a corporation may give financial assistance to related parties if the corporation discloses the giving of the financial assistance in accordance with the act.[21] There is neither a requirement of solvency nor the application of an assets test. Further, except for the disclosure requirement, there is no restriction on financial assistance for the acquisition of the corporation's shares.

2. Related Parties:

The requirement to disclose applies to the giving of financial assistance to shareholders, directors, officers, and employees of the corporation or an affiliate and associates of these people.[22] The disclosure requirement also applies to financial assistance given to any person for the purchase of shares in the corporation or an affiliate.[23]

3. Time for Disclosure:

(a) Non-distributing Corporations: must give notice to all shareholders within 90 days after giving the financial assistance.[24]

(b) Distributing Corporations: must place a financial statement before shareholders at the annual meeting, unless disclosure is made otherwise. The financial statement must deal with financial assistance given in the period to which the financial statement relates as well as financial assistance given in previous years but still outstanding.[25]

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[21] Subsection 42(1).

[22] Paragraph 42(2)(a).

[23] Paragraph 42(2)(b).

[24] Subsection 42(3).

[25] Subsection 42(4).

4. Extent of Disclosure:

Both distributing and non-distributing corporations must disclose the same information:[26]

(a) identity of borrower;
(b) nature of financial assistance given;
(c) terms on which the financial assistance is given;
(d) amount; and
(e) amount of financial assistance that remains outstanding.

5. Enforcement:

A contract made in contravention of the financial assistance provisions of the Saskatchewan BCA is enforceable by the corporation or a lender for value in good faith without notice.[27] This provision is the same as section 44(3) of the CBCA.

6. Duty of Care:

Section 117 of the Saskatchewan BCA sets out the duty of care of directors. This section is identical to section 122 of the CBCA.

7. Disclosure of Interested Director Contracts:

The Saskatchewan BCA's interest in material contracts provisions are identical to the CBCA, with two interesting exceptions. First, the shareholders of a corporation may, by Unanimous Shareholder Agreement (USA), opt out of the application of the material contract provisions.[28] The shareholders, by USA, may also set out conditions in addition to or in lieu of these provisions.[29] Second, if a USA is employed to exclude the application of the material contract provisions, the rules of common law and equity will also not apply to the disclosure of interest in material contracts and directors voting on those contracts.[30]

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[26] Subsection 42(5).

[27] Subsection 42(6).

[28] Paragraph 115(9)(a).

[29] Paragraph 115(9)(b).

[30] Subsection 115(10).

IV. **The Business Corporations Act of Alberta (Alberta BCA)**

1. Prohibited Financial Assistance by a Corporation:

The Alberta BCA is identical to the CBCA with one addition. The Alberta BCA requires that a corporation disclose the giving of the financial assistance in its annual financial statement to shareholders.[31] The statement must include information on financial assistance given during the year to which the financial statement relates, and financial assistance given in previous years but still outstanding. The statement must list the identity of the recipient, the nature of the assistance, the terms on which the assistance was given and the amount. Unlike the Saskatchewan BCA, there is no distinction made between distributing and non-distributing corporations with regard to the disclosure requirements.

2. Interests in Material Contracts:

The Alberta BCA deals with the issue of director interest in material contracts in section 115 and is different in four respects from the CBCA. First, the section indicates how notice is to be given by an interested director when the material contract is dealt with by way of resolution and not at a meeting.[32] Second, the Alberta BCA has a more elaborate scheme that must be followed in order for a director's notice of interest to be considered continuing disclosure:[33]

(a) the notice must state that the director or officer has a material interest in a contract and state the nature and extent of the interest;
(b) at the time disclosure regarding a subsequent contract would be required, the nature and extent of the interest initially disclosed must not have increased; and
(c) the initial notice must have been given within the 12-month period proceeding a subsequent contract for which notice would otherwise have to be given.

Third, the Alberta BCA states that a director or officer has no duty to account if the provisions dealing with interests in material contracts are followed.[34] Fourth, the entire material interest in contract provision is subject to any unanimous shareholder agreement of the corporation.[35]

3. Duty of Care:

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[31] Subsection 42(4).

[32] Subsection 115(2.1).

[33] Subsection 115(6).

[34] Paragraph 115(7)(b).

[35] Subsection 115(9).

The duty of care of a director or officer of an Alberta corporation is the same as that of a director or officer of a federal corporation; however, there is one notable difference. When a director or officer is deciding whether a transaction is in the best interests of the corporation, he or she may give special, but not exclusive, consideration to the interest of the group that elected or appointed him or her.

V. **The Bank Act** (BA)

1. Prohibition:

The BA's self-dealing provisions apply the blanket prohibition that a bank shall not enter into any transaction with a related party, either directly or indirectly, except as specifically provided for in Part XI of the BA.[36]

2. Definition of Terms:

The BA specifically defines many of the terms used in Part XI. The key defined terms are: related party, transaction, loan, significant interest, acting in concert, entity, substantial investment and control. These definitions however, are not exclusive.

(a) Related parties include persons that have a significant interest in a class of shares in the bank, directors and officers, entities in which the directors or officers have a significant investment, entities in which a person who controls the bank has a significant investment and entities controlled by any of the previously mentioned parties. Spouses and minor children of these parties also fall within the definition. Further, the Superintendent of Financial Institutions has the authority to designate as related parties certain people who may, because of their relationship with the bank, be able to affect the exercise of the best judgment of the bank in regard to a transaction.[37]

Significant interest, substantial investment and control are the three key criteria used to determine who is a related party. This definition therefore, would not capture shareholders holding less than 10% of outstanding shares of a class.[38]

(b) Transactions which are subject to the Part XI of the BA prohibition include: guarantees on behalf of a related party, investment in securities of a related party,

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[36] Subsection 189(1).

[37] Subsection 486(3).

[38] Ibid.

taking an assignment of or acquiring a loan made by a third party to the related party and taking a security interest in the securities of a related party. The definition of transaction is not exhaustive. A review of the list of permitted transactions is helpful in determining what other types of arrangements would also be included in the definition.

The BA also allows for statutorily prescribed transactions which would be permitted and not reviewable by the Conduct Review Committee (CRC).[39]

3. Permitted Transactions:

Part XI of the Bank Act lists a limited number of transactions that banks are allowed to enter into with related parties.

(a) Transactions with a nominal value. This value is determined by criteria which would be established by the conduct review committee and approved by the Superintendent of Financial Institutions.[40]
(b) Loans to and guarantees made on behalf of a related party that are fully guaranteed by the government of Canada. This section also permits loans to related parties secured by mortgage against the related party's principle residence.[41]
(c) A bank may make deposits with a related party if that related party is a direct clearer or a member of a clearing group and the deposit is made for clearing purposes.[42]
(d) A bank may borrow money, take deposits from or issue debt obligations to a related party.[43]
(e) A bank may purchase, sell or lease certain assets of a related party.[44]
(f) A bank may enter into specific types of service contracts with related parties including contracts for services normally used by the bank or offered to the public by the bank in the ordinary course of business.[45]
(g) A bank may make loans to directors, officers, their spouses and minor children as well as entities the directors and officers control or have a substantial investment in

[39] Section 500, subs. 502(4), see an example reg SOR/92-309. For definition of Conduct Review Committee see section 4 below.

[40] Section 490.

[41] Section 491.

[42] Section 492.

[43] Section 493.

[44] Section 494.

[45] Section 495.

so long as the required board or conduct review committee approval is obtained.[46] However, the aggregate amount of loans to full time officers must not exceed the greater of twice their annual salary or $100,000.

4. Conduct Review Committee:

The bank is required under par. 157(2)(b), to establish a CRC. This committee must establish procedures to review related party transactions and must review these transactions as required by Part XI. The CRC must also ensure that transactions with related parties that may have a material effect on the stability or solvency of the bank are identified. The committee reports to the bank's board of directors. The board of directors in turn must report to the Superintendent within 90 days of the end of their financial year regarding all transactions and other matters reviewed by the conduct review committee during the year.

What transactions must the CRC approve?

(a) all transactions with related parties to ensure that the transactions are done on terms at least as favourable to the bank as market terms[47] (except as provided below and except nominal transactions or transactions where board approval is required);[48]
(b) preferred terms given on all loans to an officer (other than margin loans);[49]
(c) preferred terms given on all loans to an officer's spouse secured by mortgage on the principle residence;[50]
(d) preferred terms on financial services, other than loans or guarantees, offered to an officer of the bank or their spouse and minor children;[51]
(e) all transactions with persons who have ceased to be related parties, during the 12 month period after they have ceased to be a related party.[52]

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[46] Sections 496 and 497.

[47] Subsection 502(1).

[48] Subsection 502(4).

[49] Subsection 496(4).

[50] Subsection 496(5).

[51] Subsection 496(6).

[52] Section 503.

5. Board Approval:

The board must approve certain transactions with directors, officers, their spouses and minor children as well as entities the directors and officers control or have a substantial investment in. Without board approval, the bank shall not make a loan, acquire a loan, make a guarantee or make an investment in the securities of a related party if the aggregate of the outstanding loans, guarantees and value of the securities to that related party exceeds 2% of the bank's regulatory capital. Further, the bank is prohibited from entering into any such related party transaction, where the aggregate of the outstanding loans, guarantees and value of investments with all related parties exceeds 50% of the bank's regulatory capital.[53]

6. Duty of Care:

In addition to the guidelines provided in Part XI, every officer and director has a duty of care to the bank.[54] In wording very similar the CBCA, every officer and director must act in the best interests of the bank and must exercise the care, diligence and skill of a reasonably prudent person when exercising the powers and discharging the duties of a director or officer.

7. Disclosure of Interest in Material Contracts:

The BA has disclosure of interest in material contracts provisions identical to the CBCA, with two exceptions.[55] Directors and officers of banks are required to disclose any interest they may have in a material contract with the bank. Further, if a director knowingly contravenes this provision they automatically cease to hold office as a director and are ineligible to be a director for a period of 5 years after the date of the contravention.[56]

8. Conclusion:

The BA approaches the issue of financial assistance to related parties with an outright prohibition, with exceptions as specifically authorized by the statute. If a transaction is not listed as a permitted transaction or prescribed by regulation it is prohibited. Further, any permitted transaction must be approved by either the CRC or the Board. For directors and officers who are also related parties to whom financial assistance is given, the provisions regarding the duty of care and disclosure of interest in a material contract provisions must also be adhered to.

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[53] Subsection 497(2).

[54] Section 158.

[55] Sections 202 - 206.

[56] Subsection 203(2).

VI. **The British Columbia Company Act (British Columbia CA)**

1. Solvency Test:

The British Columbia CA prohibits financial assistance when a company is insolvent or where the company would become insolvent as a result of giving financial assistance.[57] There is no exception to this test. The British Columbia CA does not however require that an assets test be met. Further, under this section a director may apply to the court for a declaration that a company is insolvent or that the proposed financial assistance would render the company insolvent.

2. Best Interests of the Company Test:

The British Columbia CA also imposes a "best interests of the company" test for any financial assistance. There are however, exceptions to this rule.[58] To meet this test there must be reasonable grounds for believing, that the giving of the loan would be in the best interests of the company.[59]

3. Financial Assistance for the Acquisition of Shares:

Subsection 127(1) of the British Columbia CA prohibits financial assistance for the purchase of or subscription for shares of the company or any debt obligation of the company that has a right of conversion into or exchange for shares.[60] This section also prohibits financial assistance where the security given is a pledge of, or charge on, shares of the company.[61]

4. Exceptions to the Share Acquisition Rule:

The British Columbia CA allows three exceptions to the prohibition against financial assistance for share acquisition:

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[57] Section 126.

[58] Subsection 127(3).

[59] Paragraph 127(1)(c).

[60] Paragraph 127(1)(a).

[61] Paragraph 127(1)(b).

(a) Employee Share Acquisitions:

The company may provide money to trustees in order to purchase shares for the beneficial interest of bona fide employees.[62] This purchase however, must be in accordance with a scheme in force at the time of the purchase. This exception also allows the company to give financial assistance to a bona fide employee to purchase or subscribe to shares which would be held beneficially by that employee.[63] In both instances the best interests of the company test, as well as the solvency test must be met.

(b) Greater than 90% Ownership of all shares:

A second exception to the share acquisition prohibition allows a company to give financial assistance to a person who would own at least 90% of all the shares of the company after the acquisition.[64] To fall under this exception the deal must be authorized by a special resolution of the company before the financial assistance is given and the company must not be a reporting company. The best interests of the company test does not have to be met, but the solvency test would still apply.

(c) Subsidiaries, Holding Companies and Sole Members:

Under this exception, notwithstanding the prohibition against giving financial assistance for share acquisitions, a holding company may give financial assistance to its wholly owned subsidiary, the wholly-owned subsidiary may give to its holding company, two wholly owned subsidiaries of the same holding company may give to each other and the company may give financial assistance to its sole member.[65] In these instances the best interests of the company test need not be met, but again the solvency test applies.

7. Definitions:

(a) Person: the British Columbia CA does not specifically list those people a company is restricted from giving financial assistance to, the act merely states "to a person." Person is not defined nor has it been judicially considered in the context of the British Columbia CA.

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[62] Paragraph 127(2)(a).

[63] Paragraph 127(2)(b).

[64] Subsection 127(3).

[65] Subsection 127(5).

(b) Financial Assistance: the British Columbia CA definition of financial assistance is similar to that of the CBCA. The only difference is that the British Columbia CA expressly includes "the provision of security" as a form of financial assistance. Like the CBCA, the British Columbia CA ends its definition with "or otherwise."

(c) Member: means a subscriber of the memorandum of a company (shareholder).

8. Duty of Care:

The British Columbia CA duty of care of directors is similar to that under the CBCA.[66] However, the British Columbia CA specifically states that this duty of care is in addition to, and not in derogation of, any rule of law or equity relating to the duties of directors of a company.

9. Interests in Material Contracts:

The British Columbia CA deals with the issue of directors' interest in material contracts in ss. 144 - 148. Although these sections are similar to the CBCA, there are some notable differences. Directors must disclose any direct or indirect interest in any proposed contract with the company. There is no "material contract" limitation as in the CBCA. Further, directors have a duty to account for profits unless the following requirements are met:

- there is disclosure,
- approval by the directors, and
- the interested director does not vote on the approval; or unless
- the contract was fair and reasonable, and
- it is approved by special resolution of members.

The British Columbia CA allows the company or an interested party to apply to the court for an order to set aside the contract, enjoin the company from entering into the contract or make any other appropriate order. Unlike subs. 120(8) of the CBCA however, the grounds for requesting such an order under the British Columbia CA are not limited to failure to disclose, but also include failure to comply with the duty to account requirements. Further, there are four specific situations where directors are deemed not to be interested parties: (1) a director guarantees a loan to the company; (2) a contract with an affiliate for which the director is also a director; (3) a contract to indemnify the director; and (4) a contract relating to remuneration of the director.

[66] Subsection 142(1).

10. Enforceability:

A contract made in contravention of the financial assistance provisions of the British Columbia CA is enforceable by the company or a bona fide lender for value without notice.[67] This provision is the same as subs. 44(3) of the CBCA.

VII. **The Australian Corporations Act (Australia CA)**

1. Company Financing Dealings in its Shares (s. 205):

Subsection 205(1) prohibits a company from giving any financial assistance for the purpose of, or in connection with, the acquisition or proposed acquisition of its shares or the shares of its holding company by any person, or to lend money to any person on the security of its shares. This provision is presently under review by the Australian Corporations Law Simplification Task Force. Financial assistance is defined in this section to include loans, guarantees, provision of security, release of obligations, forgiving of a debt or otherwise. There is a knowledge requirement to this prohibition:[68] in order for a company to be found to have given financial assistance in connection with a prohibited acquisition, the company must have been aware, at the time the financial assistance was given, that the assistance would be used for the purchase of the company's shares, or if already purchased, that the money would go toward the payment of an unpaid amount of the subscription. It is those officers of a company involved in a prohibited transaction, and not the company itself, who may be found guilty of an offence.

Subsections 205(8) and 205(9) provide a number of exemptions from the prohibition of subs. 205(1). Subsection 205(8) lists eight dealings not prohibited and includes the payment of a dividend, the purchase by a company of its own shares pursuant to a court order, and entering into an agreement allowing a subscriber for shares to make payments in instalments. Subsection 205(9) lists exempt commercial transactions and is meant to catch commercial transactions done in the ordinary course of the company's business, ie. loans made on ordinary commercial terms where the company's business includes lending money, and employee share acquisition schemes. Subsection 205(10) allows a company to give financial assistance for share acquisitions which would otherwise be prohibited by subs. 205(1), so long as the company agrees by special resolution to give the assistance and the company abides by the notice and filing requirements of the section. There are a number of parties, including shareholders and creditors, who can apply to

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[67] Section 128.

[68] Subsection 205(4).

court to oppose a special resolution that has authorized the giving of financial assistance.[69] Further, a special resolution does not relieve a director of his/her duties owed to the company under s. 232 of the Australia CA.[70]

2. Financial Benefits to related Parties of Public Companies (s. 243):

(a) Definitions:

(i) Related Parties:[71] The definition of related party under the Australian CA includes directors of the public company, directors of a body corporate that is a parent entity and persons that constitute an entity[72] that is a parent of the public company. Parents, spouses and children of these parties are also captured by this definition, as well as entities controlled by any of the previously mentioned parties. Parent and sibling entities are also related parties. Further, this definition catches parties that were related parties within the previous 6 months. Entities that may at some future date become related parties and entities acting in concert with a related party in respect of the giving of or proposed giving of a financial benefit (associates)[73] are also captured by this definition.

(ii) Giving a financial benefit:[74] The Act lists a number of examples of giving a financial benefit and includes: loans, guarantees, providing security, forgiving a debt, neglecting to enforce an obligation, assuming an obligation, buying, selling or leasing an asset, acquiring or supplying services, issuing securities or granting an option and giving money or property.[75] A benefit that is non-monetary will also be considered a financial benefit if it confers a financial advantage.[76]

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[69] Subsection 205(12).

[70] Section 232 requires an officer or director of a corporation to act honestly and to exercise the care and diligence of a reasonable person in a like position.

[71] Section 243F.

[72] Subsection 243C(1) - Each of the following is an entity: (a) a body corporate; (b) a partnership; (c) an unincorporated body; (d) an individual; (e) a trustee of a trust that has only one trustee.

[73] Subsection 243F(5).

[74] Section 243G.

[75] Subsection 243G(4).

[76] Subsection 243G(3).

(b) Prohibition: Neither an Australian public company nor a child entity of a public company[77] may give a financial benefit to a related party unless permitted by the Act.[78] It is important to note that this prohibition does not apply to proprietary companies.[79]

(c) General Exceptions: There are seven general exceptions to the prohibition against giving a financial benefit:[80] (1) financial benefits made under contract before section 243H came into force; (2) remuneration of officers; (3) advances of not more than $2,000 (or a greater amount if prescribed) to directors or directors' spouses; (4) financial benefit given to or by a closely held subsidiary;[81] (5) financial benefit on arm's length terms; (6) financial benefit given to the company's shareholders so long as it does not unfairly discriminate in favour of one or more related parties; and (7) financial benefit pursuant to a court order.

(d) Financial benefits approved by general meeting of public company: Sections 243Q-243ZD and 243ZF deal with another exception to the general prohibition against the giving of a financial benefit to a related party - a financial benefit permitted by resolution of shareholders. This exception requires approval by shareholder resolution passed within 15 months before the benefit is given. There are also a number of administrative provisions which must be adhered to in order for a financial benefit given to a related party to fall under this exception. The company must lodge with the Commission and provide to its shareholders a proposed notice of meeting, an explanatory statement, and any other document that can reasonably be expected to be material to a shareholder in deciding how to vote on the proposed resolution.[82] The explanatory statement must set out: (1) the related party to whom the proposed benefit is to be given; (2) the nature of the benefit; (3) recommendation and reasons from each director of the company; (4) disclosure of director interest; and (5) all other information that is known to the company or any of its directors that would reasonably be required by the shareholders in order to decide whether the proposed

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[77] Many of the terms used in this part of the Australian CA are defined at ss. 243C-243G - child entity - subs. 243D(1) - an entity is a child entity of another entity if the other is its parent entity, or is one of its parent entities.

[78] Section 243H.

[79] Section 116 - Proprietary Company: A company having a share capital (other than a no liability company) may be incorporated as a proprietary company if a provision of its constitution restricts the right to transfer shares, restricts the number of members to 50 or less, prohibits invitation to the public to subscribe for the shares and prohibits any invitation to the public to deposit money with the company for fixed periods or payable at call.

[80] Sections 243J - 243PB.

[81] Subsection 243M(3) - a body corporate is a closely-held subsidiary of another body corporate, if, and only if, no member of the first-mentioned body is a person other than: (a) the other body; or (b) a nominee of the other body; or (c) a body corporate that is a closely-held subsidiary of the other body corporate because of any other application or applications of this subsection; or (d) a nominee of such a body.

[82] Section 243U.

resolution is in the company's interests.[83] The Commission may give the company written comments on the documents it lodges, but may not comment on whether the proposed resolution is in the company's best interests.[84]

Section 243ZF prohibits voting by or on behalf of the related party who would receive a financial benefit if the resolution passed. Associates of that related party are also prohibited from voting. If the affected related party or an associate of that related party votes on a proposed resolution, the resolution is still valid so long as the resolution would still pass with their votes disregarded.[85]

Like s. 205, where there has been a contravention of these provisions, it is not the company or child entity itself which is guilty of an offence. It is the people who are involved in,[86] or directly or indirectly recklessly concerned in, or a party to a contravention, who contravenes s. 243 and face possible civil penalties pursuant to Part 9.4B which sets out the civil and criminal consequences of contravening civil penalty provisions.

A person who has been implicated in the giving of a financial benefit in contravention of s. 243 has a defence if he/she can prove that he/she was unaware of a fact or circumstance essential to the contravention of subs. 243H(1) or (2).[87] Further, a contravention of s. 243H does not invalidate the transaction.[88]

3. Director's duty to prevent insolvent trading by company (s. 588G):

Subsection 588G(1) of the Australian CA deals with the situation where a company incurs a debt while it is insolvent or becomes insolvent by incurring the debt.[89] A director of the company at the time the debt is incurred, contravenes this section if he/she was aware, or a reasonable person would have been aware, of grounds for suspecting that the company was insolvent at the time of incurring the debt.[90] This section provides four defences: (1) the director had reasonable grounds to expect, and did expect, that the company was solvent and would remain solvent even if the debt was incurred; (2) the director had reasonable grounds to rely on information provided by a

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[83] Section 243V.

[84] Section 243W.

[85] Sections 243ZF and 243 ZB.

[86] Defined in s. 79.

[87] Subsection 243ZE(6).

[88] Section 103.

[89] Subsection 95A: (1) solvency - a person is solvent if, and only if, the person is able to pay all the person's debts, as and when they become due and payable; (2) insolvent - a person who is not solvent is insolvent.

[90] Subsection 588G(2).

competent and reliable person regarding the solvency of the company and expected, based on this information, that the company would remain solvent even if the debt was incurred; (3) the director, because of illness or some other good reason, was not participating in the management of the company at the time the debt was incurred ; and (4) the director took all reasonable steps to prevent the company from incurring the debt. There are a number of provisions which allow a court to order a director who contravenes this section to pay compensation to the company equal to the amount of loss or damage suffered by the creditors as a result of the transaction.

VIII **U.K. Companies Act 1985 (UKCA)**

1. General Restriction on Loans to Directors and Persons Connected With Them:

Subject to limited exceptions, a U.K. company[91] is prohibited under s. 330 from giving loans, guarantees or security on a loan to a director of the company or its holding company. A company is also prohibited from assuming any rights, obligations or liabilities under a transaction which, had it been entered into originally by the company, would have violated section 330. Public companies are further prohibited from making quasi-loans[92] to directors of the company or its holding company, from giving loans, quasi-loans, guarantees or security on a loan to a person connected with the director[93] or entering into a credit transaction[94] as creditor or guarantor for

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[91] Company - includes public and private companies. Where the Act refers to a "related company" it includes: (a) a public company; or (b) a subsidiary of a public company; or (c) a subsidiary of a company which has another subsidiary a public company; or (d) a company which has a public company as a subsidiary (subs. 331(6))

[92] A quasi-loan is an indirect form of a loan where the corporation pays money to a party who as lent money to a director. The Act defines a quasi-loan as: a transaction under which one party ("the creditor") agrees to pay, or pays otherwise than in pursuance of an agreement, a sum for another ("the borrower") or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement, expenditure incurred by another party for another ("the borrower") on terms that the borrower will reimburse the creditor; or in circumstances giving rise to a liability on the borrower to reimburse the creditor (subs. 331(3)).

[93] A person connected with a director of a company includes: (a) spouse, minor children and step-children; (b) a company with which the director is associated (meaning, the director and the persons connected with the director either have at least a 20% interest in the equity share capital of the company or are entitled to exercise or control of at least 21% of the voting power at a general meeting); (c) a trustee of a trust where a beneficiary is anyone of (a) or (b); (d) a partner of the director or anyone of (a), (b) or (c).

[94] I.e. hire purchase, conditional sale, lease and other deferred payment plans (subs. 331(7)).

such a director or a person connected with the director.[95] The UKCA also prohibits back-to-back arrangements.[96]

(a) Exceptions to the General Restriction on Loans to Directors and Connected Persons: There are 8 exceptions to the general restriction:[97] (i) short-term quasi-loans; (ii) inter-company loans in the same group; (iii) loans of small amounts to a director; (iv) minor business transactions;[98] (v) transactions with holding company; (vi) funding of director's expenditure; (vii) loans by money-lending companies;[99] and (viii) home purchase and improvement loans.[100]

(b) Enforceability: A transaction which violates section 330 is voidable by the company unless restitution is no longer possible, the company has been indemnified or a person has acquired rights bona fide for value without notice of the contravention.[101] Further, the director and any person connected with the director in whose favour a transaction is made, is liable to account for any gain made directly or indirectly by the transaction and they are jointly and severally liable to indemnify the company for any loss or damage that may have resulted from the transaction. The UKCA also provides for criminal penalties for breach of s. 330.[102]

(c) Disclosure: A company is required to disclose information regarding loans, quasi-loans and other dealings in favour of directors and connected persons in the companies annual financial statement.[103]

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[95] Subsections 330(3) and (4).

[96] I.e. where a company agrees to make loans to the director of another company in return for that other company giving loans to its directors (subs. 330(7)).

[97] Sections 332-338.

[98] Transaction is not defined, however this an exception to subs. 330(4) which deals with credit transactions, ie. hire purchase, conditional sale, lease and other deferred payment plans.

[99] Test - neither the amount of the loan nor the terms given may be more favourable than those which it is reasonable to expect that company to have offered to a person with the same financial standing but unconnected to the company

[100] This type of loan may be given on terms preferable to an arms length loan if it is the company's policy to make these loans

[101] Section 341.

[102] Section 342.

[103] Section 232.

2. Financial Assistance by a Company for Acquisition of its Own Shares:[104]

There is a general prohibition against financial assistance for the present or future acquisition of a company's shares. A company is also prohibited from giving financial assistance to reduce a liability that has been incurred in connection with a past acquisition of its' shares. Although these provisions apply to both public and private companies, there is a relaxation of the general rule for private companies.[105] Paradoxically, despite the general prohibition of financial assistance, the result of the section 155 is that private companies may give financial assistance for the acquisition of its own shares and the shares of its holding company. However, where the holding company is a public company or the private company is part of a group which contains a public company, the general rule still applies. Financial assistance is defined to include loans, guarantees, security, indemnity,[106] gifts, or any other agreement.[107]

(a) Exceptions to the general share acquisition rule: There are three main exceptions to the general share acquisition rule:

(i) Purpose Exception:[108] This is really two exceptions : (1) where the principal purpose of the assistance is not a share acquisition, or (2) where the principal purpose of the assistance is a share acquisition but it is given as part of a larger purpose of the company. In both cases, the assistance must be given in good faith and be in the interests of the company.

(ii) Authorized Transaction Exceptions:[109] These exceptions are based on the nature of the transaction and include: dividends lawfully given, allotment of bonus shares and the redemption or purchase of shares done in accordance with Chapter VII of the Act.

(iii) Ordinary Course of Business Loans and Employee Exceptions:[110] This exception allows the giving of loans where lending is within the ordinary course of business of the company. This section also sets out an employee share acquisition

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[104] Section 151.

[105] Section 155.

[106] However, a company can insure itself against its own neglect or default (par. 152(1)(a)(ii)).

[107] Section 152.

[108] Subsections 153(1) and (2).

[109] Subsection 153(3).

[110] Subsection 153(4).

scheme exception. It is no longer a requirement of the Act that employee share acquisition schemes be administered by a Trustee.[111]

(b) Special restrictions for public companies:[112] This exception requires that a public company has net assets[113] which will not be reduced by the financial assistance or, to the extent that those assets are thereby reduced, the assistance is provided out of distributable profits.

(c) Relaxation of general rule for private companies: A private company may give financial assistance for the acquisition of its own shares or the shares of its holding company where the holding company is also a private company. Here, as is the case of public companies, financial assistance may not be given unless the company has net assets which are not reduced by the giving of the assistance and, to the extent they are reduced, it is through the use of distributable profits. Except in the case of a wholly-owned subsidiary, financial assistance must be approved by special resolution[114] of the company and by the holding company where the company is proposing to give financial assistance for the acquisition of shares in the holding company. The Act requires that the directors of the company make a statutory declaration stating the particulars of the financial assistance,[115] including a statement of their opinion regarding the solvency of the company.[116] The director's statement must be annexed to a report of the company's auditor supporting the director's solvency opinion.[117] This report, together with a copy of the special resolution, must be filed with the registrar of companies.

3. Wrongful and Fraudulent Trading:

The UKCA includes a provision on fraudulent trading which makes a person liable for carrying on business with the intent to defraud creditors.[118] The wrongful trading provisions are found in the Insolvency Act 1986. Under section 214 of the UKCA, a person who is or has been a director

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[111] The 1948 Act required that share schemes be administered by Trustees, this was amended by F.S.A. 1986, s. 196.

[112] Section 154.

[113] Net Assets - the aggregate of the company's assets, less the aggregate of its liabilities (subs. 152(2)).

[114] Requires a minimum 3/4 vote of entitled voters and at least 21 days notice of the intent to propose a resolution as a special resolution.

[115] Subsection 156(1).

[116] Subsection 156(2).

[117] The Act does not provide a penalty for an auditor who breaches this obligation.

[118] Section 458 UKCA.

may be liable to make contribution to a company's assets if: (1) the company has gone into insolvent liquidation, (2) the director, prior to the commencement of the winding up of the company, knew or ought to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and (3) the person was a director at that time. The director may defend him/herself by showing that he/she took every step he/she ought to have taken to minimize the potential loss to the company's creditors.

This provision does not include a definition of wrongful trading, but according to Palmer's Company Law "the essence of the activity consists of the company's continuing to trade, and to incur liabilities, after the time when it was known, or ought to have been realised, by the directors, that an insolvent liquidation was inevitable, or at least, would appear to be probable to a reasonable person in the place of the director sought to be held liable."[119] Further, the provision states that a director may be held liable to contribute to the company's assets, and it does not restrict this liability to the debts incurred after the director knew or ought to have realized the company's precarious financial situation. The director therefore could be held responsible for any debts of the company, whenever they occurred.

Under the Company Directors Disqualification Act 1986, where a director has been found liable to make a contribution to the company's assets by reason of section 214 of the Insolvency Act 1986, the court may also make a disqualification order against the director. The maximum period of the disqualification is 15 years. A person against whom a disqualification order is made shall not, without leave of the court, be a director of a company or, in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of a company.

[119] F.B. Palmer, C.M. Schmitthoff, Palmer's Company Law, 24th ed. (London: Stevens, 1987) p. 15209.

APPENDIX C

POSSIBLE CLARIFICATIONS OF SECTION 44

Legal practitioners and others have raised a long list of technical problems with section 44. These problems are discussed in this appendix. If section 44 is maintained and clarified as put forward in Option 5 in the discussion paper,[1] the following discussion could form the basis for updating the section.

The following review begins with the most complicated matter, the confusing assets test found in paragraph (d) of subs. 44(1) (see issues 1-5). Issue 6 then consider a number of timing considerations, followed by issues 7-13 on definitional questions. Issues 14 to 16 look at the exemptions provided for in subs. 44(2) and issues 17 and 18 examine the protection offered by subs. 44(3) for lenders and creditors. Finally, issue 19 deals with the general focus of section 44.

I. ASSETS TEST

Issue 1: Whether the expression "realizable value" of the corporation's assets found in par. 44(1)(d) should be replaced with the more well-used expression "fair value" or otherwise clarified.

Background:

The assets test portion of s. 44 prohibits financial assistance transactions where there are reasonable grounds for believing that "the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less that the aggregate of the corporation's liabilities and stated capital of all classes." Legal and accounting practitioners have a number of problems with this test.

The first problem is with the expression "realizable value". One author has written:

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[1] Some of the following possible clarifications might be also applicable if some of the other Options set out in the paper are adopted. For example, the breadth of a disclosure requirement set out in Option 3 of the discussion paper could be affected by clarifications as to the type of insiders and the type of financial assistance transactions which must be disclosed.

> The meaning of "realizable value of the corporation's assets" is difficult. It would appear to raise the question of whether or not the present fair saleable value of the assets of the corporation is less than the amount that will be required to pay the corporation's probable liabilities on its existing debt (contingent and actual) as they become absolute and mature, including the liability under the guarantee.[2]

One difficulty for directors is that "realizable value" is forward looking and not the historical book value generally used in the corporation's financial statements.[3] Directors are therefore left in the position of not being able to adequately rely on the corporation's financial statements to make their decision on whether or not s. 44 is complied with. On the other hand, the use of historical book value accounting does not reflect the current value of the corporation and would hinder protection of shareholders and creditors.

Another problem is that, until recently, there has been little case law interpreting the phrase "realizable value." However, a 1992 Ontario court decision defined "realizable value" to mean the price to which a willing and knowledgeable vendor and purchaser, neither acting under compulsion, would agree at the time financial assistance is given. This price can be considered to be the fair market value. Distress liquidation values would only come into play if there were storm clouds on the horizon -- years of losses with no hope of a turnaround or major creditors in a pressing mode with no white knight in the wings.[4]

In another judgment dealing with the equivalent section of the Alberta Business Corporations Act[5] (Alberta BCA), a court held that "the 'realizable value' of the assets refers to the fair market value on either a going-concern or piece-meal basis, whichever is greater."[6]

The Canadian Institute of Chartered Accountants Handbook uses the expression "fair value" as part of Generally Accepted Accounting Principles (GAAP) in areas such as related party transactions. "Fair value" is defined as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties, who are under no compulsion to act."[7]

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[2] Belcher and Lewarne, "Corporate Guarantees as a Form of Financial Assistance: The Banker's View" (1989) 5 Banking and Finance Law Review, p. 10.

[3] Ibid.

[4] Clarke v. Technical Marketing Associates Ltd. Estate (1992), 8 O.R. (3d) 734 (Gen. Div.) pp. 750-1.

[5] S.A. 1981, c. B-15, s. 42.

[6] Dassen Gold Resources Ltd. v. Royal Bank of Canada [1994] A.J. No. 685 (Q.B.), September 14, 1994, par. 193.

[7] CICA Handbook, section 3840.

One option would be to amend the CBCA to replace the expression "realizable value" with the CICA Handbook's expression "fair value" and to adopt a definition of fair value. Advantages of this option include more certainty both for accountants asked to give opinions and for directors. One disadvantage is that the case law that has now interpreted the phrase "realizable value" is less useful, although the CICA Handbook definition seems to closely track the language adopted by the case law.

Recommendation:

Amend par. 44(1)(d) to replace the expression "realizable value" with the CICA Handbook's expression "fair value" and add a definition of it in s. 44.

Issue 2: What assets should be excluded under the assets test where the financial assistance is in the form of assets pledged or encumbered to secure a guarantee.

Background:

Another problem has been identified with the par. 44(1)(d) assets test. The test seems to indicate that, where a guarantee is secured by an assets pledge or encumbrance of assets, all such assets must be excluded from definition of "realizable value of the corporation's assets." This causes problems for corporations and lenders, particularly where there is a debenture placing a floating charge on all of a corporation's assets. In such a case, all assets of the corporation would then have to be excluded in making the solvency calculation and few such financial assistance transactions would meet the test.

Some commentators have suggested that a reasonable interpretation is that assets should be excluded only to the extent necessary to cover the liability under the guarantee.[8] It could also be argued that the full potential amount guaranteed should not be deducted from the assets side of the equation. Instead, an amount reflecting the cost of the guarantee, if for example born by a third party, should be deducted. However, because such financial assistance occurs in a potential conflict of interest situation, it can be argued that the full amount guaranteed, the full potential liability, at a minimum be excluded from the value of the assets.

Recommendation:

Clarify that, where the financial assistance is in the form of assets pledged or encumbered to secure a guarantee, the amount excluded from the realizable value of the corporation's assets

[8] See for example Sedgwick, "Guarantees, Security and the Giving of 'Financial Assistance' by Corporations" (Insight Conference, 1986), at p. 38.

for the purpose of the assets test in par. 44(1)(d) is the lesser of the value of the assets or the full amount of the liability secured by the pledge or guarantee.

Issue 3: Whether clarification of s. 44 is required in respect of: (1) guarantees as liabilities, (2) off-setting of indemnifications received from other parties, and (3) double counting.

Background:

Three other problems with the pars. 44(1)(c) and (d) solvency and assets test have been identified in relation to calculating the liabilities/assets. First, it is not clear whether "liabilities" should include contingent liabilities, particularly guarantees. One commentator has noted:

> With respect to the test in s. 42(1)(d),[9] it is perhaps simple to apply where the financial assistance is in the form of a loan, but we suggest this test is ambiguous if the financial assistance consists of a guarantee. Does the word "liabilities" include contingent liabilities? When does a guarantee become "due", especially where many forms of guarantees do not require any actual demand but make the guarantor liable concurrently with the primary debtor? How is one to determine whether or not the corporation would be able to pay such a liability on becoming "due"?[10]

It can be argued that the contingent liability under a guarantee should be included among the guarantor's liabilities to the extent that there are reasonable grounds for believing that within the reasonably foreseeable future it will become an actual liability. Perhaps a time limit needs to be placed on this projection. National Policy Statement No. 48, which deals with future-oriented financial information in disclosure documents, provides for a maximum of 24 months (the end of the next financial year).

A second and related problem is how off-setting indemnifications/guarantees should be treated. Corporations are not generally entitled to offset a contingent liability by a contingent asset for the purposes of calculating this test. The contingent asset is represented by the value of the corporation's right of subrogation against the party whose debts are guaranteed and the right, if any, to contribution from other parties joining in the contract of assistance, such as co-guarantors. GAAP requires all contingent losses and gains to be disclosed in notes to the financial statement. Should the CBCA be amended to allow for the inclusion of "contingent assets" in the

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[9] Of the Alberta BCA, the equivalent of CBCA par. 44(1)(c).

[10] Karvellas & Daniel, "Limitations On The Power Of An Alberta Corporation To Provide Guarantees And Other Financial Assistance: Section 42 Of The (Alberta) Business Corporations Act" 23 (1985) Alta L.R. 479 at p. 484.

calculation of assets to offset contingent liabilities which are included in determining existing debt?

A third and last problem is that par. 44(1)(d) may require a double counting of a secured guarantee. GAAP may require that the guarantee itself be shown as a contingent liability on the balance sheet. In addition to that monetary liability being shown, the statute requires that the realizable value of the security be deducted from the assets of the corporation. This constitutes a double counting of the amount of the financial assistance if, as would normally be the case, the creditor takes security equal to the value of the guarantee.

Another aspect of double counting has also been noted:

> It should be noted that this test can be extremely onerous since it is arguable that there is a form of double counting as far as the corporation is concerned, e.g., if a corporation makes a loan to a shareholder which is permitted by [subsection 44(1)], the source of which loan was a share issuance, the loan must be excluded in calculating realizable value even though the stated capital which gave rise to such loan must be included in the test.[11]

This second double counting issue is more complex than the first issue because, in addition to paying the loan, the corporation is now subject to certain new obligations in respect of the newly issued shares. The problem does not appear to be one so much as double counting but the rights of the new shareholder while the loan is outstanding.

Recommendations:

(A) Define the term "liabilities" under par. 44(1)(d) to include a contingent liability under a guarantee where there are reasonable grounds for believing that it will become an actual liability within the current or next financial year.

(B) Amend s. 44 to provide that where a contingent liability under a guarantee is considered to be a liability under par. 44(1)(d), any valid off-setting guarantee or indemnity may be included in the determination of the corporation's assets.

(C) Amend s. 44 to provide that where a contingent liability under a guarantee is considered to be a liability under par. 44(1)(d), the assets secured by the guarantee do not need to be excluded from the calculation of value of the assets.

Issue 4: Whether previous financial assistance should be excluded in calculating the value of a corporations assets.

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[11] Jonathan Levin, "Financial Assistance" (Canadian Bar Association -- Ontario, Continuing Legal Education, Basic Corporate Practice, April 27, 1985), at p. 9.

Background:

In par. 44(1)(d), it is not clear whether the amount of the financial assistance which must be excluded from the corporations assets includes previous financial assistance or only that involved in the particular transaction. Some commentators state that only the immediate amount of financial assistance need be excluded. Others argue that the "safe" route is to exclude all previous financial assistance. Indeed, the real picture of a corporation's financial situation may not be shown without taking into account all the financial assistance that has been granted.

The French version of par. 44(1)(d) suggests that only the particular financial assistance need be deducted because the term used is singular ("l'aide consentie"), as opposed to the English version which refers to "any financial assistance."

Recommendation:

Exclude from the definition of "assets"

(i) all amounts of financial assistance given by the corporation at any time in the form of loans,

(ii) all amounts of financial assistance given by the corporation in the form of assets pledged or encumbered to secure a guarantee, and

(iii) all amounts of financial assistance provided by the corporation in the form of security given over some or all of its assets in order to secure payment of the borrower's obligations at the time the financial commitment is made by the corporation and at the time or times the corporation is called upon to fulfil its obligations.

Issue 5: Whether the taxes payable and transaction costs associated with the disposition of assets should be taken into account in calculating the assets test (par. 44(1)(d)).

Background:

In determining the value of the assets under par. 44(1)(d), a question arises whether the taxes payable and transactions costs associated with the disposition of assets should be deducted. On the one hand, "realizable" [fair] value implies an amount realized as cash in the hands of the corporation, that is, net of taxes or other selling expenses. It might also be argued that the CBCA should err on the side of caution, in order to protect creditors and minority shareholders.

On the other hand, the solvency test which is already seen to be onerous would be made even more difficult to satisfy. Income and capital gains tax liability is difficult to quantify and could vary significantly depending on the disposal method used. Indeed, a sale of assets could give rise to a capital loss, and should the amount of the loss be included as an asset (from a tax perspective)?

Recommendation:

No change is proposed.

II. TIMING

Issue 6: Whether s. 44 should be clarified to determine when the solvency and assets tests need to be met -- at the time a contract is made or each time an advance or payment under the contract is made.

Background:

The timing required by section 44 is not completely clear. Both the solvency and assets tests use the conditional tense. For example, the solvency test in par. 44(1)(c) reads that a corporation shall not give financial assistance where there are reasonable grounds for believing that "the corporation is or, after giving the financial assistance, would be unable to pay its liabilities as they become due." The use of the conditional tense ("would") and the words "after giving the financial assistance" seems to suggest that the test is future looking.

It appears that at least some legal practitioners have taken the view that the solvency tests need not be met each time an advance or payment is made under an intra-group loan agreement, or each time an advance is made under a loan agreement secured by a guarantee. The loan, guarantee or other assistance is measured against the solvency tests only at the time the documents are executed and the financial assistance becomes a legal commitment.[12]

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[12] See, for example, Stewart, "Financial Assistance by Corporations -- Statutory Prohibitions" (Oct. 1988) 7 Can. Banking Newsletter 65, at p. 67:

> The most practical interpretation is that the tests must be met at the point in time at which the guarantee or other form of financial assistance is provided to the lender. An alternative interpretation would require the tests to be met on each occasion that a payment was made by the provider of the financial assistance. The obvious problem with the second interpretation is that there would never be any certainty of the enforceability of the financial assistance because the tests could be met at one point in time and failed at a later date.

The case law is not completely clear on this point. No decision appears to have been made directly on point, although some cases deal with related issues.

Two cases have looked at the timing of the financial assistance section from the perspective of whether an exemption applies. In determining whether a corporation was a subsidiary of another corporation and therefore whether an exemption applied, the British Columbia Court of Appeal held in Noren v. Brownie's Franchises Ltd. that:

> The number of shares owned when the transaction is first conceived is, in my opinion, irrelevant. The relevant times are when the transaction becomes a binding legal commitment and when the financial assistance is actually given.[13]

In a second judgment, Straight Line Contractors v. Rainbow Oilfield Maintenance Ltd., the Alberta Court of Appeal relied on the Noren decision in interpreting the equivalent financial assistance provision under the Alberta BCA. Again, in that case, the court had to determine if a corporation was a wholly owned subsidiary and if an exemption applied.

> To the extent that the Noren decision concludes that two of the factors to be considered in determining whether the exemption applies are firstly the ownership situation as it existed at the time the legal commitment to assist is given and secondly whether that 100% ownership persisted during the period of giving the financial assistance, I am in complete agreement. However, I would respectfully disagree to the extent that the decision may be interpreted to mean that if, at any time during the period of assistance, the 100% ownership should end, that would have the effect of leaving the subject transactions open for successful attack on the basis that the exemption would then be inapplicable.
>
> Such a result would lead inevitably to continuous uncertainty and indeed potentially unfair interference in the planning and conduct of sound business practices. This result is particularly evident when one considers, for example, a case involving financial assistance given by way of a mortgage or debenture calling for a long-term payout. The company and its shareholders would be severely restricted in its activities pending the completion of the pay back. This type of restriction would surely not be within the intent of the legislature.
>
> In my view, the test as to whether the exception applies to the subject transaction must relate to the various circumstances surrounding the transaction. These would include, as in Noren, a consideration of whether the relationships of 100% ownership as allowed in the exemption, existed at the time the legal commitment to give financial assistance was

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[13] (1987), 37 D.L.R.(4th) 1, at p. 5 (B.C.C.A.), 13 B.C.L.R. (2d) 73, 36 B.L.R. 85. In this case, the corporation was not a subsidiary "when the whole purchase scheme was initially conceived," although the corporation became a subsidiary at the time the financial assistance was executed and became a legal commitment, binding on the corporation (page 4).

> given. Another and major consideration must be whether the ownership forming the basis for the exemption claimed is one of substance.[14]

While these decisions are not directly on point, in that they consider the applicability of an exemption, similar considerations[15] appear relevant to the issue of the timing of the solvency and assets tests.

In a third case, Nelson v. Rentown Enterprises Inc.,[16] the Alberta Queen's Bench considered the interpretation of CBCA s. 34, which places restrictions on the acquisition by a corporation of its own shares. This section contains solvency and assets tests comparable to those found in s. 44. The court was of the view that the solvency test should be applied both when the contract is made and when it is performed. In its decision, the court noted that:

> In the United States, however, the position has generally been that, if the shareholder's contract concerns instalment payments, the test is applied at the time of each payment and not simply at the moment the contract is entered into . . .[17]

The court maintained that the policy behind s. 34, which acts to limit a corporation's power to purchase its own shares, was "intended to ensure that one or more shareholders in a corporation do not recoup their investments to the detriment of creditors and other shareholders".[18] Application of the test at different points in time helps to ensure creditors and minority shareholders are protected from the action of a major shareholder.

The court in Nelson distinguished the Straight Line decision on the basis that the two sections (34 and 44) use different wording and that CBCA s. 40 establishes a priority regime for share purchase contracts. The court ultimately weighed "business uncertainty" against "protection of minority shareholders and creditors":

> Even to the extent that the "business uncertainty" argument may be persuasive, one must consider the paramount purpose of Parliament in enacting s. 34. Undoubtedly Parliament did not want to encourage uncertainty for business. On the other hand, as I have said earlier, the main thrust of s. 34 and its companion provisions is the protection of creditors and other shareholders from share purchase arrangements that may prefer one or more shareholders in a situation of insolvency. The interpretation of s. 34 proposed by the

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[14] (1991), 115 A.R. 327 (Alta C.A.) at pp. 332-3.

[15] For example, "conduct of sound business practices" and "certainty of the enforceability of the financial assistance."

[16] Nelson v. Rentown Enterprises Inc. (1993), 2 W.W.R. 71 (Alta. Q.B.). On appeal, the Alberta Court of Appeal unanimously agreed with and adopted the judgment of the Queen's Bench (1994) 109 D.L.R. (4th) 608 (Alta C.A.).

[17] Ibid., p. 73.

[18] Ibid., p. 74.

> plaintiff could create many opportunities for abuse of the position of one shareholder. Consider a situation where the primary asset of a corporation is a piece of land. A share purchase arrangement could be entered into at a time when the financial future of the corporation is unpredictable. An agreement could be made to extend the performance date well into the future, by which time the corporation's prospects are more obvious. If the solvency test is applied only at the execution date and not when the contract is actually to be performed, the shareholder could be given the right to strip the corporation of its main asset, far into the future, to detriment of other shareholders and creditors.[19]

The objective of protecting creditors and other shareholders is an important issue for both corporate share purchase and financial assistance transactions. In the case of share redemptions, one is always dealing with parties related to the corporation (i.e., the shareholders). With financial assistance transactions, third parties, for example lenders, may be involved which may tilt the balance of consideration towards concerns about certainty of transactions. While it may make sense to subject each payment under an instalment loan, made by the corporation to a director or shareholder over a period of months or years, to the solvency and assets tests, it appears less reasonable to impose such a requirement in respect of transactions involving third parties dealing with the corporation at arm's length, such as a lender in good faith.

The same concerns about ambiguities in the timing of the test discussed above concerning advances or payments under the contract are relevant with respect to guarantees. Paragraphs 44 (1)(c) and (d) provide that the solvency and assets tests are to be applied or analyzed at the point of time "after giving the financial assistance." In the context of a guarantee, it is not clear whether this type of financial assistance is "given" when it is entered into or when (or if) the guarantee is actually called upon. The same concerns of "business uncertainty" versus "protection of minority shareholders and creditors" is relevant.

Recommendation:

Amend s. 44 to clarify that the tests need only be satisfied at the time of the entering into the contract for financial assistance.[20]

Option:

Amend s. 44 to clarify that, only with respect to a lender or another third party dealing with the corporation at arm's length and in good faith, the tests need only be satisfied at the time of the entering into the contract for financial assistance. As with the rule for share purchases,

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[19] Ibid., p. 78.

[20] For example, pars. 44 (1)(c) and (d) could be amended by replacing the words "after giving the financial assistance" with the expression "immediately upon the giving of the financial assistance."

contracts directly with related parties, must be satisfied at each time financial assistance is advanced under the financial assistance contract.[21]

III. DEFINITIONS

Issue 7: Whether the expression "financial assistance" should be defined and broadened and/or whether s. 44 should only apply to "material" financial assistance transactions.

Background:

Section 44 restricts the corporation from giving "directly or indirectly" "financial assistance by means of a loan, guarantee or otherwise." The words "indirectly" and "otherwise" give subs. 44(1) an extremely broad application which, although perhaps intended, creates some unusual problems. For example, suppose Y and Z are partially owned subsidiaries of X. If Y and Z enter into a joint and several obligation and each provides collateral security, does this constitute indirect financial assistance which would fit into the "otherwise" category? The breadth of the type of transaction is made further problematic because the class of persons caught by par. 44(1)(a) is also broad.[22]

A commentator made the following review of the types of financial assistance that might be captured by the current section:

> You should consider whether financial assistance is being given whenever you encounter a situation in which a party is taking on an obligation or giving security to a lender, but the proceeds of the loan are going wholly or mostly to another party.
>
> The commonest forms of financial assistance are loans and guarantees, but it is important to remember that such assistance can take other forms.
>
> A mortgage or other security interest given by one party as security for the borrowing of another, whether or not it is "non-recourse" and whether or not there is a formal guarantee is financial assistance to the borrower . . .
>
> Financial assistance might also take the form of a "comfort letter" (even though it falls short of a formal guarantee), forgiveness or liberalization of an obligation, subordination of security or postponement of payment, early payment of a debt, or an agreement to

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[21] Another issue that involves timing questions is stepped transactions, discussed below in issue 14.

[22] See discussion below in issue 8.

indemnify. It could even take the form of entering into a transaction which benefits the other party, especially if it lets the other party "off the hook", such as buying its excess inventory or renting unoccupied space in its building.[23]

Under Part XI (entitled "Self-Dealing") of the Bank Act,[24] banks are prohibited from entering into any "transaction" with a related party unless the transaction is authorized by that Act.[25] The term "transaction" is broadly defined to include guarantees on behalf of a related party, investment in securities of a related party, taking an assignment of or acquiring a loan made by a third party to the related party and taking a security interest in the securities of a related party.[26] The definition of transaction is not exhaustive and includes loans to related parties.[27]

The Australian Corporations Act[28] (Australian CA) also adopts a broad approach to the type of transactions subject to restrictions. Section 205 prohibits a company from giving financial assistance to any person in connection with the acquisition of its shares. Financial assistance is defined to include: loans, guarantees, provision of security, release of an obligation and the forgiving of a debt.

Part 3.2A of the Australian CA restricts the giving of a "financial benefit" to related parties of publicly-trade companies.[29] Neither an Australian public company nor any subsidiary may give a financial benefit to a related party unless permitted by the Act.[30] The Act lists a number of examples of giving a financial benefit including: loans, guarantees, providing security, forgiving a debt, neglecting to enforce an obligation, assuming an obligation, buying, selling or leasing an asset, acquiring or supplying services, issuing securities or granting an option and giving money or

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[23] Brian Keith, "Guarantees, Financial Assistance and Independent Legal Advice" in LSUC, Opinions in Lending Transactions, January 24, 1990, at pp. 3-4.

[24] S.C. 1991, c. 46.

[25] Section 489.

[26] Section 488.

[27] Loans to related parties are not specifically listed as transactions. However, as loans to related parties are specifically included as permitted related party transactions, the term "transaction" should be interpreted as also including loans to related parties. A review of the permitted transactions sections of the Bank Act reveals other types of transactions which, although not specifically listed, would nevertheless also be subject to regulation under the Bank Act related party rules, for example: contracts for services, sale of assets, purchase of assets, and lease of space.

[28] The Corporations Act, No. 109, 1989.

[29] Section 243A.

[30] Section 243H.

property.[31] A benefit that is non-monetary will also be considered a financial benefit if it confers a financial advantage.[32]

Some regulations of conflict of interest try to regulate only material financial assistance. For example, only "material contracts" are currently regulated in respect of directors and officers in section 120 of the CBCA. OSC Policy 9.1 in regulating related party transactions focuses on transactions that would be a material change.[33] The approach of targeting only material transactions is attractive in ensuring that key transactions are regulated but avoiding unduly burdensome regulation on regular business activity of corporations. However, there might be some concern that regulating only major transactions allows for a great deal of self-dealing.[34] An all encompassing regime with specific exceptions (for minor transactions) allows the regime to establish what is material and what is not.

Recommendations:

(A) Amend s. 44 to add a definition of the phrase "financial assistance" which would include a broader range of specific transactions and delete the word "otherwise." The definition of "financial assistance" would include the following transactions:

- loan to a related party,
- guarantee on behalf of a related party,
- provision of security,
- release of an obligation,
- investment in securities of a related party,
- taking an assignment of or acquiring a loan made by a third party to the related party,
- provision of a "comfort letter",
- forgiveness or liberalization of an obligation,
- subordination of security or postponement of payment,
- early payment of a debt, and
- an agreement to indemnify.

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[31] Subsection 243G(4).

[32] Subsection 243G(3).

[33] See s. 17.1 of Policy 9.1.

[34] For example, see Ontario Securities Commission Request for Comments on Related Parties published at (1992) 15 O.S.C.B. 3253 and examined in Part V(e) of the discussion paper.

(B) As a corollary to broadening the definition, amend subs. 44(1) to make it only applicable to financial assistance transactions that are "material."[35]

Issue 8: Whether the restrictions placed upon related party financial assistance should be narrowed to apply only to those persons with power to affect corporate decision-making.

Background:

Currently, the restrictions on financial assistance apply to a broad range of persons, including all shareholders and employees. However, many shareholders and employees of publicly-traded as well as privately-held corporations are not in a position to significantly influence the decision-making of the firm. Many conflict of interest regimes only apply to officers, directors and shareholders who own a significant interest in the corporation and persons associated with such director, officer or shareholder.[36] Other employees and shareholders with a minor interest are not caught by such regimes. If the purpose of the regime is to deal with conflict of interest in the corporate form by focusing on a key area of conflict (financial assistance to insiders), then it appears sensible to restrict the regime to real insiders who can influence firm decisions.

The current regime also applies to any shareholder, director, officer or shareholder of an affiliated corporation. Affiliated corporations include subsidiaries, parent (holding) corporations and sister corporations.[37] Again, in terms of influencing the corporate decision making, the parent corporation and its principals can influence the subsidiaries decisions but a subsidiary presumably has no influence over the decision making of the parent corporation.[38] On the other hand, there may be concerns about intra-corporate group financial dealings and therefore a downstream financial assistance restrictions should also be applied. Currently, however, par. 44(2)(d) expressly authorizes financial assistance to subsidiaries.

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[35] The term "material" could be simply used as it is in CBCA s. 120 with respect to material contracts or the statute or regulations could define "material" in either absolute dollar amounts (e.g., transactions involving an amount greater than a certain figure (say $2,000)) or an amount in relation to the capital of the corporation (as, for example, OSC Policy 9.1 does in s. 18.1).

[36] See for example, ss. 8 & 186(1)(a) and the definition of "significant interest" and s. 2 of the Bank Act.

[37] See CBCA, subs. 2(2).

[38] Again, the Bank Act provisions on related parties apply only in respect of significant shareholders and not subsidiaries (upstream, not downstream).

Recommendation:

Amend s. 44 to limit its applicability to only financial assistance granted to significant shareholders, directors and officers of the corporation or of the holding corporation, and to associates[39] of any such person.[40]

Issue 9: Whether the word "shareholder" should be clarified to include a beneficial owner of shares.

Background:

Until relatively recently, shareholders were generally individuals who had in their possession actual share certificates. Now, however, fewer shareholders of publicly-traded corporations actually hold registered shares. Instead, most are held by nominees, typically brokers, financial institutions, and other intermediaries.

There appears to be no policy reason why beneficial shareholders should benefit from special rules when it comes to financial assistance transactions. The purpose of s. 44 appears to be to protect the corporation's creditors and minority shareholders from unfair financial assistance given to corporate insiders, and this appears to apply equally to beneficial shareholders.

Recommendation:

Amend the CBCA to clarify that section 44 imposes the same restrictions on financial assistance given to beneficial shareholders as to registered shareholders.[41]

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[39] The extension of the restrictions on granting financial assistance under s. 44 to "associates" of the related parties also leads to a broad net being cast. However, by restricting financial assistance to the "associates," which includes partners, spouses, children and corporations in which the related party has a significant interest, the CBCA attempts to address concerns about avoidance of s. 44 through transactions that clearly benefit the related party.

[40] It also appears that the exemption provided in par. 44(2)(d) for financial assistance to subsidiaries would no longer be required.

[41] One option might be to define the phrases "beneficial shareholder" and "registered shareholder" in s. 2. Paragraph 44(1)(a) could then refer to "beneficial shareholder."

Issue 10: Whether the restrictions on financial assistance to "associates" of the related parties should be expanded to include a "common law spouse" in addition to a "spouse".

Background:

The current definition of "associate" found in CBCA subs. 2(1) does not include a common-law spouse. However, the purpose of restricting financial assistance to associates of shareholders, directors and officers is to prevent avoidance of the financial assistance restrictions. This policy would seem to be applicable in respect of common law spouses.

Recommendation:

Broaden the meaning of "spouse" in the definition of "associate" in subs. 2(1) of the CBCA to include common-law spouse.[42]

Issue 11: Whether term "share" should be more clearly defined.

Background:

Paragraph 44(1)(b) restricts direct or indirect assistance by a corporation or its affiliate for the purchase of its or its affiliate's shares.[43] The provision therefore applies equally to voting and non-voting shares. It does not apply to a corporation providing direct or indirect assistance for purchasers of its convertible debt securities. One of the original purposes of the restriction on share purchase financial assistance transactions was to deal with leveraged buy-outs. If this is the only policy basis for the section, there does not seem any reason to apply the provision to non-voting shares nor to expand it to apply to debt securities generally. However, debt instruments convertible into shares could be used to effect a leveraged buy-out.

Another basis given for the adoption of the share purchase financial assistance transaction restrictions was to confirm the common law prohibition on a corporation trafficking in its own shares. This common law rule has been expressly overridden by the CBCA which permits a corporation to purchase its shares (s. 34). However, the corporation and its directors must comply with similar solvency/assets tests.

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[42] The definition of spouse found in par. 252(4)(a) of the Income Tax Act, R.S.C. (5th Supp.) c. 1, as amended, could be used.

[43] The term share is not defined in the statute although its characteristics, etc. are carefully set out in CBCA sections 24 and following.

Currently, subs. 126(1) defines "share" for the purpose of the insider trading provisions in Part XI as "carrying voting rights under all circumstances . . . including . . . (a) a security currently convertible into such a share, and (b) currently exercisable options and rights to acquire such a share or such a convertible security."

Recommendation:

Amend s. 44 to include a definition of "share" that includes voting and non-voting shares, securities currently convertible into shares and currently exercisable options and rights to acquire shares or convertible securities.

Issue 12: Whether the term "acquisition" should replace "purchase" in paragraphs 44(1)(b) and (2)(e).

Background:

Section 44 uses of the word "purchase" in relation to the restrictions on financial assistance and exemptions thereto. The word "acquisition" might be more appropriate since it would include subscriptions and transfers of shares for consideration other than cash. Other statutes use this broader term.[44]

Recommendation:

Replace the term "purchase" with the term "acquisition" in paragraphs 44(1)(b) and (2)(e).

Issue 13: Whether the definition of "wholly-owned subsidiary" in subsection 44(2.1) needs to be clarified to include all members of a corporate group and whether financial assistance should be available between sister corporations within a wholly-owned corporate group.

Background:

A legal practitioner advises that the definition of "wholly-owned subsidiary" in CBCA subs. 44(2.1) does not include all junior corporations in a corporate group where there is a

[44] See the U.K. Companies Act, subsections 151(1) and (2). The issue of the "purchase" of shares is also discussed in Royal Bank v. Stewart (1979) 8 B.L.R. 77 (B.C.S.C.) at pp. 84-5.

complex shareholding structure. For instance, consider the case where a parent corporation X owns all of subsidiary X1, fifty percent of subsidiary X2, and one third of subsidiary X3; subsidiary X1 owns fifty percent of subsidiary X2 and one third of subsidiary X3; and lastly subsidiary X2 owns one third of subsidiary X3. In these circumstances, the practitioner points out that subsidiary X3, which is owned partly by X, X1 and X2, would not be a wholly-owned subsidiary of X under subs. 44(2.1) "notwithstanding all of its outstanding shares are held within the corporate group."

The practitioner recommends that the definition in subs. 44(2.1) be amended along the lines of the following language:

> A corporation is a wholly-owned subsidiary of another body corporate for the purposes of paragraph (2)(c) if none of the issued shares of the corporation are held by any person or body corporate other than:
>
> (a) the other body corporate, or
>
> (b) that other body corporate and one or more wholly-owned subsidiaries of that body corporate.

While the current definition does appear to be limited, the suggested language may not solve the problem in that the definition may be circular because "wholly-owned subsidiary" appears in the definition (par. (b)). One option might be to define wholly-owned corporate group and allow financial assistance from any member of the group to the ultimate holding corporation.

Another issue is whether sister corporations, within a wholly-owned corporate group, should be able to provide financial assistance to each other. From a policy perspective, there does not appear to be any reason to disallow financial assistance between sister corporations when upstream and downstream financial assistance are both permitted.

Recommendation:

Amend subs. 44(2.1) to redefine the expression "wholly-owned subsidiaries" to include all members of a corporate group owned ultimately by a holding corporation and to amend subs. 44(2) to permit financial assistance among wholly-owned subsidiaries.

Option:

Define a new term in s. 44 for wholly-owned corporate group and amend subs. 44(2) to permit financial assistance among all members of the group.

IV. EXEMPTED TRANSACTIONS

Issue 14: Whether it is appropriate to amend section 44 to expressly permit or prohibit financial assistance in the case of stepped[45] transactions.

Background:

As seen from the sections of the discussion paper on the origin and purpose of s. 44,[46] one of the original purposes of the prohibition on financial assistance for share purchases was to address problems associated with leveraged buy-outs. However, one important change in 1975 was that the CBCA expressly permitted a corporation to give financial assistance to a holding (parent) corporation "if the corporation is a wholly-owned subsidiary of the holding body corporate." The explanation given for this change in the 1975 Senate Briefing Book was that: "Paragraph [44(2)](c) has been added to facilitate the borrowing arrangements that are commonly made in today's business world."

This change appears to allow a corporation that purchases all the shares of another corporation to then obtain financial assistance from that wholly-owned subsidiary, including financial assistance for any debt acquired to purchase the subsidiary. In other words, this exception adopted in 1975 seems to expressly permit one type of transaction, the leveraged buy-out, that the provisions was originally designed to prohibit.[47] However, a partial leveraged buy-out (whereby the purchaser only acquires some of the corporations shares) or a leveraged buy-out by an individual would still be subject to the requirements.

In one legal article, it was noted:

> The structure of the prohibition and exemption to the prohibition in . . . section 44 of the CBCA cause practitioners difficulties in structured transactions under which the availability of the exemption to the prohibition upon financial assistance is dependent upon corporations becoming subsidiaries at the time the transaction is completed. A good example is the structuring involved in takeover situations such as leveraged or management buy-outs when the proposed bank financing of the acquisition contemplates the giving of a secured guarantee by the target company. The timing of the giving of such

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[45] By stepped transaction, it is meant the purchase of all of the shares (or a controlling position) of a corporation, followed by another transaction, namely the giving of financial assistance from the corporation to the purchaser.

[46] See Parts II(b) and II(c) of the discussion paper.

[47] At least in respect of a corporation. An individual who takes over a company would not be entitled to benefit from the upstream financial assistance exemption which is only available in respect of one corporation owning another corporation. The issue below analyzes a recommendation of one stakeholder that the exemption be expanded to include natural persons.

> guarantee is critical and can lead to some concerns that the transaction is a stepped transaction. The concern is that the Court will ignore the very carefully orchestrated sequence of events and simply focus on the substance of the transaction to find that the transaction was prohibited . . .
>
> In a leveraged buy-out situation, the investment banker usually sets out a financing plan involving sequential steps to complete the takeover including the granting of security. In a friendly takeover transaction, the steps are sometimes even set out in agreements or documents called "heads of agreement." In any event, the banking syndicate is often involved in structuring the transaction. The methods and timing of giving of security are often agreed upon in advance of the takeover even being launched. A guarantee to support the purchase of shares is only permissible if the target is a subsidiary of the acquiror because usually the solvency tests cannot be met . . .
>
> Nevertheless, in leveraged buy-out transactions, the issue of the target company's guarantee arises strictly in cases where a shell company purchaser of shares and the target company do not undergo a statutory amalgamation immediately following the completion of the transaction. Banks, however, usually require the statutory amalgamation approach. This is because of the difficulties with and potential voiding of prohibited guarantees.[48]

This article also discusses the issue of creditor protection. If the policy goal of the financial assistance transaction rules is only to protect minority shareholders, there is no concern about the stepped transaction because the corporation must be wholly-owned. However, the article notes that "it is not inconceivable that the courts would seek to protect creditors' interests as well" and points out that courts in the United States will invalidate guarantees given in the circumstances of a leveraged buy-out if the creditors are prejudiced.[49]

Two cases can be interpreted as permitting financial assistance in the case of stepped transactions, where, at the time the binding legal commitment is made and the financial assistance is given, the corporation giving the financial assistance is a wholly-owned subsidiary. These cases, Noren v. Brownie's Franchises Ltd.[50] and Straight Line Contractors v. Rainbow Oilfield Maintenance Ltd.,[51] are discussed in detail above.[52]

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[48] Belcher and Lewarne, note 2, pages 14-6.

[49] Ibid., pp. 15 and 26-7.

[50] (1987), 37 D.L.R.(4th) 1, at page 5 (B.C.C.A.), 13 B.C.L.R.(2d) 73, 36 B.L.R. 85. In this case, the corporation was not a subsidiary "when the whole purchase scheme was initially conceived," although the corporation became a subsidiary at the time the financial assistance was executed and became a legal commitment, binding on the corporation (page 4).

[51] (1991), 115 A.R. 327 (Alta C.A.) at pp. 332-3.

[52] See issue 6.

It has been suggested that, even if the exemption in par. 44(2)(c) were removed, it would not likely affect the ability of acquirors to obtain secured financing for leveraged buy-out transactions, for instance through the use of an amalgamation. However, in order to amalgamate, the acquisition vehicle and the target must satisfy the solvency and realizable asset tests in par. 185(2)(c) of the CBCA.

Whether to expressly permit stepped transactions depends on the analysis of whether leveraged buy-outs should continue to be permitted.[53] Part of the problem of analysing this issue may be that the regulation of leveraged buy-outs might be better considered in the context of the take-over bid regime established by the CBCA. The take-over bid rules are the subject of a separate discussion paper where this issue is canvassed.

Recommendation:

Maintain exemption for wholly-owned subsidiaries to provide financial assistance to parent corporations and clarify that stepped transactions are permitted. Continue to make partially-owned subsidiaries subject to solvency and assets tests in order to protect the creditors.

Option 1:

Amend s. 44 to clearly prohibit stepped transactions (which are used for leveraged buy-outs). One option to implement this proposal would be to make the upstream exemption granted in par. 44(2)(c) inapplicable in the case of share purchases.

Option 2:

Amend par. 44(2)(c) to require that when a corporation makes a leveraged buy-out take-over bid, the corporation or a director of the corporation shall prepare and circulate with the bid a statutory declaration (similar to the declaration required in respect of amalgamations).

[53] As apparently they were in 1975, despite the original policy of the section to prohibit leveraged buy-outs.

Issue 15: Whether the upstream financial assistance exemption granted for parent corporations of "wholly-owned subsidiary" corporations should be expanded to allow financial assistance to a natural person.

Background:

A legal practitioner raises the following point:

> We wonder about the appropriateness, under subparagraph [sic] 44(2)(d),[54] of making a corporation's right to give financial assistance without a solvency test to a shareholder subject to the restriction that the shareholder must be its holding body corporate of which it is a wholly-owned subsidiary. Could the rule not be extended to any shareholder by whom the corporation is wholly owned, whether or not the shareholder is a body corporate?

As is noted above, the only rationale given for the adoption of the upstream financial assistance exemption when it was adopted in 1975 was that it would "facilitate the borrowing arrangements that are commonly made in today's business world." If the policy behind s. 44 is merely to protect minority shareholders, then the exemption should be available where there is one shareholder, whether the shareholder is a corporation or a natural person. However, if the policy is, as it appears to be from the existence of the solvency test, to also seek to protect creditors, then expanding the exemption to apply to natural persons does not make sense.

Essentially, the justification for the par. 44(2)(c) exemption appears to be the inter-corporate group financial arrangements are common and necessary in today's business world, and this justification does not seem to extend to individuals who wholly-own a corporation.

Recommendation:

No amendment is recommended.

Issue 16: Whether the words "to be held by a trustee," currently found in clause 44(2)(e)(ii), should be removed.

Background:

One of the exemptions provided in subs. 44(2) (from the applicability of the solvency/assets tests) is for financial assistance given to employees "in accordance with a plan for

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[54] Although the reference is to paragraph (44)(2)(d), the discussion appears to relate to paragraph 44(2)(c).

the purchase of shares of the corporation or any its affiliates to be held by a trustee" (clause 44(2)(e)(ii)). The restriction that shares purchased under a plan must be held by a trustee might be seen as a unreasonable restriction on the exemption. The exemption appears to be designed to allow for financial assistance in the case of employee share purchase plans, a common financial reward for employees. Share purchase plans can further corporate governance by aligning the interests of officers and employees with that of the shareholders.

Under the Ontario BCA, there is no requirement that the shares be held by a trustee. The U.K. Companies Act 1985 removed a similar condition which had been introduced in 1948.[55]

On the other hand, it can be argued that the trustee requirement should be kept because without the requirement, it might be easy to fabricate an artificial share purchase plan to simply use the exemption.[56]

Alternatively, a requirement that share purchase plans be approved by a Canadian stock exchange or securities commission could be imposed.

Recommendation:

Remove the words "to be held by a trustee" from clause 44(2)(e)(ii).

Option:

Replace the requirement that shares be held by a trustee with a requirement that a share purchase plan be approved by a Canadian stock exchange or securities commission.

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[55] U.K. Companies Act, 1985, 1985, c. 6, par. 153(4)(b).

[56] One author argues that under the Ontario BCA "the plan must genuinely exist and cannot be a fiction created simply for purposes of relying upon the exemption". See Levin, note 11, p. 14.

V. LENDER IN GOOD FAITH

Issue 17: Whether subs. 44(3) needs to be amended to better protect lenders.

Background:

As noted above,[57] s. 44 attempts to balance competing concerns about "business uncertainty" and "protection of minority shareholders and creditors." Subsection 44(3) addresses these concerns by allowing the corporations and "a lender for value in good faith without notice of the contravention" to enforce a financial assistance contract made in contravention of s. 44. It was clearly the intention of the drafters of s. 44 to protect lenders. The Dickerson Report stated:

> Section 5.16(6) [s. 44(3)] is new and is added to make it clear that the corporation and a bona fide lender will not be barred from enforcing a loan contract made in breach of s. 5.16.[58]

However, there remains some uncertainty in the lending community as to how far this section actually protects lenders. There are complaints that the whole process is very costly and time-consuming and that it acts to discourage `legitimate' transactions by making conservative lending institutions and their advisors even more cautious.[59]

Part of the confusion may flow from the fact that the U.K. regime specifically uses invalidity of loan guarantees as a means to ensure compliance with the financial assistance prohibition.[60] Some confusion[61] also appears to have arisen in respect of the judgment in Royal

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[57] See issue 6 above.

[58] R.W.V. Dickerson, J.L. Howard, L. Getz, Proposals for a New Corporations Law for Canada (Ottawa: Information Canada, 1971), vol. 1, par. 147.

[59] The problems for banks arising out of s. 44 type provisions are canvassed by Sedgwick, note 8.

[60] See Alberta, Institute of Law Research and Reform, Financial Assistance by a Corporation: Section 42, The Business Corporations Act (Alberta), Report for discussion No. 5 (Edmonton: August 1989), at page 112:

> It has been a deliberate policy of English company law to put the third party or lender at risk as one of the most effective sanctions to ensure compliance with the section. There is no question that it is an effective sanction but it is achieved at the cost of enormous expense of time and effort and at the further cost of discouraging legitimate transactions through the understandable caution of lending institutions and their advisors. If there is any doubt at all that the provisions of section [44] may be infringed, any lender will think very carefully before entering into the transaction and usually will not do so.

[61] See for example, Sedgewick, note 8, at p. 43.

Bank v. Stewart[62] which found that a bank could not enforce a guarantee and security given by a corporation in respect of a purchase of shares. The bank knew that the purpose of the loan was for the purchase of shares. Similarly, in The Central and Eastern Trust Co. v. Irving Oil Limited and Stonehouse Motel and Restaurant Limited, the Supreme Court of Canada invalidated a mortgage on the a corporation's assets used to secure funds advanced for the purchase of the shares of the corporation. The bank was aware of the purpose of the loan.[63]

However, it should be noted that, under the corporate laws of British Columbia and Nova Scotia applicable in the above two cases, financial assistance for share purchases is forbidden,[64] whereas under the CBCA, financial assistance is only prohibited where there are reasonable grounds for believing that the corporation cannot meet the insolvency/assets tests. Under CBCA s. 44 therefore, mere knowledge that the purpose of the loan is for the purchase of shares would not invalidate the guarantee/security as it would under the B.C. legislation.

In Petro-Canada v. Cojef Ltd.,[65] a case dealing with the equivalent of CBCA s. 44 in the Manitoba Corporations Act,[66] the Manitoba Court of Appeal upheld the right of a "lender" to rely on the exemption provision where there was no actual knowledge or suspicion that the corporation was in financial difficulties:

> In this case there was no evidence of actual knowledge by Petro-Canada of Mid-City's finances; there was a finding by the motion judge, supported by the evidence, that no reasonable grounds exist to infer that knowledge to Petro-Canada; and there was no evidence of suspicious circumstances at the time the guarantee was received which should have put Petro-Canada on its guard regarding Mid-City's state of financial health.[67]

Despite the fact that it was a sophisticated lender aware of the hazards of guarantees, the court held that Petro-Canada was "entitled to the benefit of what has become known as the 'safe harbour' provision."[68]

Recommendation:

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[62] (1979), 8 B.L.R. 77 (B.C.S.C.).

[63] [1980] 2 S.C.R. 29, 110 D.L.R. (3d) 257.

[64] B.C. Companies Act, R.S.B.C. c. 59, s. 126 and N.S. Companies Act, R.S.N.S. 1967, c. 42, subs. 96(5).

[65] [1993] 3 W.W.R. 79 (Man. C.A.).

[66] L.R.M. 1987, c. C225, s. 42.

[67] Petro-Canada, note 65, p. 82.

[68] Ibid., p. 80.

Broaden the protection for lenders under subs. 44(3) by requiring "actual" notice of the contravention by the lender.

Option:

Amend subs. 44(3) to codify the case law and provide that a lender can enforce a contract in contravention of s. 44 where (a) the lender has no knowledge of the contravention, and (b) there are no reasonable grounds for suspicion on the part of the lender.

Issue 18: Whether the term "lender" used in subs. 44(3) should be broadened to include creditors and other third parties.

Background:

Subsection 44(3) refers only to "lenders" even though other third parties such as creditors, including suppliers, may be parties to prohibited financial assistance transactions. The term "lender" might be narrowly read to be limited to a person that has actually advanced funds. In the case Petro-Canada v. Cojef Ltd., discussed above, Petro-Canada supplied Cojef Ltd. with petroleum products. An affiliate of Cojef Ltd., Mid-City Concrete Ltd., guaranteed the payment of Cojef's debt to Petro-Canada. The court noted:

> In its written submission, Mid-City argued that Petro-Canada was not a "lender" under s. 42(3) while Petro-Canada responded by noting that it extended credit to Cojef on the strength of the Mid-City guarantee, and by so doing it became a lender as that word is used in the context of s. 42(3). At the time of the oral hearing, counsel for Mid-City did not press the point further . . . .[69]

Recommendation:

Amend subs. 44(3) to refer to "a lender, creditor or other third party dealing with the corporation at arm's length for value in good faith . . ."

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[69] Petro-Canada, note 65, p. 78.

VI. GENERAL

Issue 19: Whether the focus of s. 44 should be changed to what financial assistance is permitted from the current focus on what is <u>not</u> permitted.

<u>Background</u>:

In addition to the more specific issues addressed above, a more general question is whether the whole focus of s. 44 needs to be changed. Currently, subs. 44(1) prohibits a corporation from entering into related party and leveraged buy-out financial assistance where there are reasonable grounds for believing that the corporation is insolvent or can not meet the assets test. The only transactions that are expressly permitted are the exempted transactions (with subsidiaries, etc) set out in subs. 44(2).

However, from the discussion in the paper on the origin of s. 44,[70] there may be some concerns about the validity of certain financial assistance transactions, particularly those involving the corporations shares, under the common law. Redrafting the provision to clearly state that a corporation may give financial assistance, except where prohibited, might be appropriate given general concerns about financial assistance transactions and the effect of the common law upon them.

<u>Recommendation</u>:

Amend subs. 44(1) to provide that a corporation may give financial assistance except as prohibited or restricted.

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[70] See Part II(b) of the discussion paper.