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RECENT DEVELOPMENTS IN CORPORATE COMMERCIAL LAW

By J.A. Levin and David Ferris of
Fasken Martineau DuMoulin LLP*
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Corporate governance issues continue to dominate in Canada through amendments to the *Criminal Code* ("Code"), recent litigation pursuant to Ontario securities law and the *Canadian Business Corporations Act* ("CBCA"), as well as a move towards implementing mandatory rules.

Expansion of Corporate Criminal Liability

Amendments to the Code brought into force on March 31, 2004 have expanded the laws relating to: (i) who qualifies as the directing mind of the corporation, (ii) what is required to establish the necessary intent of the corporation, (iii) what constitutes negligent conduct of a corporation and (iv) possible sentencing options.

(i) The directing mind of the corporation

To establish the necessary intent by a corporation, it was previously necessary to determine that the "directing mind" or "alter ego" of the corporation possessed the required state of mind. Determination of who qualified as the necessary individual was evaluated on a case-by-case basis, but typically it required that the person had sufficient authority to determine policy rather than merely manage the affairs of the corporation.

The definition of a "senior officer" under section 2 of the Code has been changed to include not only individuals responsible for setting policy, but also those responsible for the management of an important part of the corporation's activities. This prevents corporations from avoiding liability by suggesting that wrongdoers simply had a management function in relation to the corporation or one of its divisions and did not set policy.

(ii) Offences requiring proof of intent of the corporation

Section 22.2 of the Code was amended to address the requirements necessary to find an organization guilty of an intent-based offence. An organization will be held criminally liable:

- If a senior officer acts within the scope of his or her authority and is a party to the offence;

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- If a senior officer has the mental state required to be a party to the offence and acts within the scope of his or her authority, and directs the work of other representatives of the organization so that they do the act or make the omission specified in the offence; or

- If a senior officer knows that a representative of the organization is or is about to be a party to the offence, and fails to take all reasonable measures to stop hi or her from being a party to the offence.

These changes do not alter the requirement that the organization benefit at least in part from the actions of the senior officer. However, it is no longer necessary that the intent and the guilty act of a criminal offence reside in the same person. Further, senior officers are now under a positive obligation to act when they have knowledge that an offence has been or will be committed; failure to act will result in corporate criminal liability.

(iii) Negligent conduct of corporations

The amendments to the Code have also expanded negligence based offences for corporations. Section 22.1 establishes that an organization will be held negligently responsible:

- If acting within the scope of their authority (i) one of its representatives is a party to the offence, or (ii) two or more of its representatives engage in conduct, whether by act or omission, such that, if it had been the conduct of only one representative, that representative would have been a party to the offence; and

- The senior officer who is responsible for the aspect of the organization's activities that is relevant to the offence departs -- or the senior officers, collectively, depart -- markedly from the standard of care that, in the circumstances, could reasonably be expected to prevent a representative of the organization from being a party to the offence.

These changes broaden negligence offences by allowing the combined conduct of two individuals, who although individually may not be acting in a manner that is careless or reckless, to constitute the necessary elements of the crime in order to hold the corporation responsible.

(iv) Sentencing options

Other amendments to the Code provide for stiffer penalties and corporate probation orders. A less serious summary conviction may result in a fine up to $100,000, an increase from the $25,000 level previously set for corporations, and fines for more serious indictable offences remain with no prescribed limits.

The purpose of corporate probation is to allow the court to oversee and regulate an organization’s efforts to reform. A judge may impose certain conditions, most notably (i) restitution to a person for any loss or damage suffered as a result of the offence, and (ii) notice to the public of the offence committed, the sentence imposed and any measures that the organization has undertaken to reduce the likelihood of committing future offences.

Insider Trading Reforms to the Criminal Code

On September 15, 2004 two new amendments to the Code concerning insider trading and whistle-blower protection came into force.

(i) Insider Trading

The legislation prohibits two forms of conduct relating to insider information: insider trading and tipping. For the purpose of the offences, “inside information” includes information not generally disclosed, relating to an issuer of a security to the public, which could reasonably be expected to affect the security’s market price or value.

A person will be found guilty of insider trading under s. 382.1(1) of the Code if such person, directly or indirectly, buys or sells a security, knowingly using inside information which they possess:

- as a shareholder of the issuer of that security;
- through a professional relationship with that issuer;
- as a result of a proposed takeover, merger or reorganization with that issuer;
- by virtue of, or obtained in the course of, their employment, office, duties or occupation with that issuer or with a person referred to above; or
- obtained from a person who possesses or obtained the information in a manner referred to above.

Although insider trading is already an offence under provincial securities law and the CBCA, the Code offence of insider trading differs in that it is more difficult to establish. In addition to requiring that the individual charged was in possession of insider information when he or she bought or sold securities, the Code requires that the individual *knowingly* used the inside information in this course of action. Although more onerous to establish, if found guilty of insider trading under these provisions, an individual may be sentenced up to 10 years in prison.

The second offence of tipping is created under s. 382.1(2). A person will be guilty of tipping if he or she knowingly conveys inside information to another person, knowing that there is a risk that the person will use the information to buy or sell, directly or indirectly, a security to which the information relates or that he or she may convey the information to another person who may buy or sell the same security. Similar to the offence of insider trading, establishing tipping requires proof that the accused had knowledge that the person to whom the information was communicated may have used the information to deal with the securities as described above. The penalty for such an offence is up to five years in prison, and there is a saving provision that protects an accused if such information was offered in the ordinary course of business.

(ii) Whistleblower Protection

Corporate governance standards were also improved through the protection of employees who are willing to disclose information about unlawful conduct within the workplace. On September 15, 2004 the Canadian government enacted s. 425.1 of the Code, which resembles the U.S. efforts under the *Sarbanes-Oxley Act* ("SOX") to prevent employers from threatening or retaliating against these employees. Employers are prevented from taking, or threatening to take, disciplinary measures against an employee with the intent of compelling the employee to abstain from providing information respecting an offence that the employee believes has been committed by an employer or the directors of a corporation. It is also an offence if the employer takes such actions with the intention to retaliate against an employee after such employee has disclosed such information. If found guilty, there is a maximum penalty of up to five years imprisonment.

Although the above areas are currently regulated at the provincial and federal levels under securities law and the CBCA respectively, these amendments to the Code are to provide an alternative avenue of enforcement for the most serious cases that, according to the Department of Justice, "threaten the national interest in the integrity of the capital markets." One potential advantage of this federal legislation, as compared with provincial statutes, is that it applies to all organizations regardless of the provincial law governing the organization and provides an overarching mechanism to attack inappropriate conduct.

Provisions dealing with the jurisdictional issues of prosecution of these offences have not come into force as of yet. These amendments under the Code give the Attorney General of Canada concurrent jurisdiction with provincial Attorney Generals to prosecute capital market frauds cases; the federal government has indicated that a prosecution protocol is in the works to provide guidance as to the appropriate way to deal with the overlap.

Liability for Misrepresentation of Forecasts

Douglas Kerr et al v. Danier Leather Inc. et al is the trial decision of a class action brought under the *Securities Act* (Ontario) (the "Act"). The plaintiffs were investors who purchased Danier Leather Inc. ("Danier") shares pursuant to the company's 1998 initial public offering ("IPO"). The case dealt with the issue of forward-looking information and the nature of the duty to disclose subsequent changes to such information.

Background

The plaintiffs sued Danier, its President/CEO and its CFO under the section of the Act dealing with liability for a misrepresentation in a prospectus in relation to a financial forecast contained in the IPO final prospectus dated May 6, 1998 (the "Prospectus").

Pursuant to the Act, a "misrepresentation" is a) an untrue statement of material fact, or b) an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

The Prospectus contained a forecast for the fourth quarter and the 1998 fiscal year (the "Original Forecast"). The IPO closed approximately seven and one half weeks into the fourth quarter. The CFO reviewed the intra-Q4 financial results prior to closing. Despite a reduction in revenue and an estimated loss rather than a profit over the first seven weeks, the CEO and CFO remained of the view that the Original Forecast was achievable. Continuing poor sales prompted the CEO and CFO to engage in a further examination of Danier's financial situation. They concluded that unseasonably hot weather across most of Canada caused the sales decline. Danier informed the underwriters shortly after closing that the company may not meet the Original Forecast. Management then consulted legal counsel. Approximately two weeks after closing, Danier announced revisions to the Original Forecast. The revised forecast included a 28% reduction in quarterly revenues, and a threefold increase of net loss for the quarter. Notwithstanding the revised forecast, Danier substantially achieved the results of the Original Forecast by the end of the fourth quarter. Danier, its CEO and its CFO were found liable for misrepresentations.

Conclusion

The case sets an exacting standard of continuing scrutiny of the accuracy of forecasts. As well, the case's principles could have broader application. The case demonstrates how disclosure obligations can be expanded through the "omitted facts as misleading" branch of the Act's misrepresentation definition.

The case should encourage a higher level of caution by issuers and senior management, particularly in the context of using forward-looking information. If included in a prospectus, such information must be accurate as of the date of the IPO closing. Accordingly, senior management must give continuing attention to any subsequent facts that emerge prior to the date of closing and seek the appropriate consultation with professional advisors. Danier management's failure to inform, and consult with, counsel, the auditors and the underwriters (and the company's board of directors) appears to have weighed heavily against meeting a reasonable prudence standard..

Court Ordered Investigation under the CBCA's Oppression Remedy

Catalyst v. Hollinger Inc. involved an August 27, 2004 application under s. 229 of the CBCA by Catalyst Fund General Partner I Inc. ("Catalyst") to have an inspector appointed by the court to look into the affairs of Hollinger Inc. ("Hollinger") and its dealings with related parties. This request was sought because of the failure of Hollinger to take meaningful steps to address issues raised by independent directors and auditor of the corporation in the fall of 2003; they had resigned subsequent to raising such issues.

Although an ongoing Ontario Securities Commission investigation was underway at the time of the application and a forensic accountant had been hired by Hollinger in July 2004, Catalyst's application was granted. The court appointed an inspector to investigate and provide a report concerning the related party transactions involving Hollinger.

Where the conduct of the corporation or powers of the directors appears to the court to have been exercised in a prejudicial or oppressive manner that disregards a security-holder's interest, a court appointed inspector may provide meaningful information for minority shareholders and may facilitate their bringing a law suit with substantial factual disclosure gathered at the company's expense.. .

An appointed inspector is an officer of the court. If the corporation under investigation fails to co-operate with the inspector, the corporation may be found in contempt of court. A further benefit of a court ordered investigation is that the resulting report will be protected by privilege and will therefore not give rise to any potential defamation concern. In comparison, it is noteworthy that an investigation conducted at the instigation of the board of Hollinger's US subsidiary, Hollinger International, has spawned a defamation action due to the lack of privilege.

Given the broad range of investigatory powers a court may grant to an inspector, the report will provide a comprehensive examination of the relevant information and documents relating to the conduct in question. For a stakeholder looking to further exercise rights by pursuing a class-action suit against the corporation, this provides an independent evidentiary foundation to which a court will attach substantial weight in subsequent proceedings.

Corporate Governance Standards: Shifting to a U.S. Approach

In seeking to establish appropriate standards for corporate governance, Canada has reacted through a series of measures implemented by securities regulators, government and self-regulated bodies that attempt to provide a balanced approach to enhancing investor confidence while maintaining market efficiency.

CSA Proposal: Mandatory Disclosure of Corporate Governance Practices

On March 30, 2004, three rules intended to promote investor confidence came into effect dealing with (i) personal certification by CEOs and CFOs of annual and interim filings, (ii) the role and composition of audit committees and (iii) the oversight of auditors. The first and second requirements are comparable to similar provisions of SOX in the U.S., and the third requirement reflects the need for an auditor to be a firm recognized by the board responsible for overseeing the independence of the auditing process. These rules are mandatory for all publicly-traded companies reporting in all provinces and territories in Canada, with the exception of British Columbia who opted out of the certification and composition of audit committee requirements; this opting out will have only narrow application due to the fact that British Columbia public companies with listings on one of Canada's two stock exchanges will have to comply with Ontario securities law requirements and Ontario has not opted out.

In addition to implementing the above rules, the CSA also released a two part corporate governance proposal concerning (1) a policy outlining 18 recommended best practices for effective corporate governance and (2) a mandatory disclosure requirement of the actual corporate governance practices of the corporation. Once finalized, these guidelines will likely supersede similar Toronto Stock Exchange ("TSX") guidelines and mandatory disclosure requirements. The best practices are outlined in Proposed Multilateral Policy 58-201, and represent guidelines that have been compiled with the assistance of various capital markets participants, the listing standards at the New York Stock Exchange and the TSX corporate governance guidelines.

In conjunction with the recommended best practices, Proposed Multilateral Instrument 58-101 requires that an issuer disclose the corporate governance practices it has adopted, allowing for a comparison between the recommended and the implemented practices.

Proposed Amendments to the CBCA

The federal government took a further step towards a rules-based approach to corporate governance, releasing a consultation paper on May 13, 2004 that consisted of a series of proposed mandatory best corporate governance practices. These rules will only apply to publicly-traded corporations incorporated under the CBCA and are aimed at codifying certain best practices necessary to provide high standards to corporate governance. The proposals consist of the following:

- A majority of directors must be independent
- The functions of Board Chair and CEO are required to be separated, or alternatively, corporations must provide an independent lead director
- Audit committees must consist only of independent directors
- Audit committees are required to recommend the auditor to the board of directors prior to the board's approval of the proxy circular
- Nominating and compensation committees must be independent
- Implementation of a broader definition of "independent" to capture directors serving on the boards of the corporations
- An auditor is required to be a participating firm in the Canadian Public Accountability Board (CPAB), the entity responsible for promoting the independence and transparency of the auditing process

Shifting to a U.S. approach

The combined rules and guidelines proposed by the CSA are intended to represent a middle of the road approach to corporate governance. Although adherence to the guidelines remains voluntary, required disclosure of the standards implemented allows market participants to determine whether non-compliance may be justified. This represents a shift from the traditional Canadian approach towards a more U.S. based approach with implementation of certain rules to provide a greater degree of certainty to capital markets.

A further move towards a U.S. approach is signified by the proposed amendments to the CBCA. Although the government does suggest reliance on mandatory disclosure may be adequate for certain requirements, the proposed codification of these rules represents a move away from the traditional voluntary guideline approach of Canada.

Enforcement of International Civil Judgements obtained in Default

The Supreme Court of Canada's decision in *Beals v. Saldanha* ("*Beal*") in December 2003 has serious implications for Canadian businesses sued internationally, as it represents a shift from the traditional requirements for jurisdiction of an international court to a "real and substantial connection" test.

The issue in this case was whether a default judgement obtained in a Florida court could be enforced against Ontario defendants. The defendants were held responsible for making misrepresentations to the Beals in connection with property sold to the plaintiffs in a 1984 purchase of $8,000 (US) worth of residential property. The defendants chose not to defend the charges, were found to be in default, and a $260,000 (US) judgement was awarded by the jury. When the Supreme Court heard this case, the value of the judgement was approximately $800,000 with interest.

The enforcement of foreign judgements by Canadian courts traditionally necessitated the defendant's presence in the foreign jurisdiction when served or submission by the defendant to the foreign country's jurisdiction. If the Court had applied this test, the decision of the Florida court would not have been enforceable. However, the Court decided that the "real and substantial connection" test to determine enforceability of judgements applicable to inter-provincial judgements also applied to international judgements: the jurisdiction of the foreign court will have been properly exercised if there is a real and substantial connection with either the defendant or the subject matter of the action. Given that the real estate transaction at issue dealt with property situated in Florida, all nine judges of the Supreme Court held that the revised test had been met.

The application of the real and substantial connection test to enforcement of international judgements raises many concerns for Canadian businesses. The potential liability that may now arise from default judgements in foreign jurisdictions requires a business to seriously consider the appropriate course of action when faced with foreign suits. It is no longer a wise decision for defendants to undertake a strictly economic decision of whether defending in a foreign jurisdiction is cost effective based on present factors since future liability can be enormous. Instead, the *Beal* decision increases the need to prevent default judgements and the potential for unanticipated liability by addressing these international claims head on.