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CONFLICTS OF INTEREST BY OFFICERS

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Introduction

There always seem to be new cases raising novel directors' or officers' conflict of interest issues which directors and officers should be aware of.

Duty of Loyalty to the Corporation

It is part of the general duty of undivided loyalty to the corporation that a director's and officer's personal interest and his or her duty to the corporation cannot be brought into conflict.

This is a common law rule that was set down as long ago as 1854 in the English case of *Aberdeen Railways v. Blaikie Bros*[2] Here it was said that no one in the position of conducting a corporation is allowed to enter into engagements in which he or she has, or can have, a personal interest that conflicts with the interest of those whom he or she is bound to protect.

Although most cases addressing this issue have involved directors, officers have the same obligation.

The imposition of fiduciary duties on directors and officers of the corporation is consistent with the origins of the doctrine in trust law. A director or officer of a corporation is in a position of trust.[3]

Waddilove v 1748960 Ontario Limited[4]

In the *Waddilove* case, Tyler Waddilove, a general manager, prepared a form of employment agreement signed by the board of directors of a corporation governed by the Ontario *Business Corporations Act* ("OBCA").

The general manager's employment agreement contained a very favourable severance provision, more favourable to that of other employees. Waddilove prepared the other

[1] The writers wish to thank Hayley Larkin, student-at-law at Minden Gross LLP for her assistance in the preparation of this article.

[2] (1854), 1 Macq. 461 (H.L.).

[3] See Re: *Unique Broadband Systems, Inc.*, 2014 ONCA 5 38 at para 45 and 46 cited by A. K. Mitchell J. in *Waddilove* (see below).

[4] 2018 ONSC 448 (Ont S.C.J.) ("*Waddilove*").

employee contracts without such a provision. Waddilove's contract was approved by the board of directors which consisted of Waddilove's father, his father's friend and another employee. Subsequently his employment was terminated and Waddilove claimed the severance called for in his contract. The corporation refused to pay, claiming, among other things, that "the contract is unenforceable as being unconscionable and void as a result of the existence of a conflict of interest between the parties at the time the contract was entered into".[5]

The Court considered whether the contract violated Section 132 of the OBCA, which provides, in respect of a director or officer:

> (1) Disclosure: conflict of interest. – A director or officer of a corporation who,
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> (a) is a party to a material contract or transaction or proposed material contract or transaction with the corporation ; or
>
> is a director or an officer of, or has a material interest in, any person who is a party to a material contract or transaction or proposed material contractor transaction 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 or her interest...
>
> (3) By officer. – the disclosure required by subsection 1 shall be made, in the case of an officer who is not a director,
>
> (a) Forthwith after the officer becomes aware that the contract or transaction or proposed contract or transaction is to be considered or has been considered at a meeting of directors...
>
> (9) Court setting aside contract. – Subject to subsection (7) and (8), where a director or officer of a corporation fails to disclosure his or her interest in a material contractor transaction in accordance with this section or otherwise fails to comply with this section, the corporation or a shareholder of the corporation... may apply to the court for an order setting aside the contract or transaction and directing that the director or officer account to the Corporation for any profit or gain realized and upon such application the court may so order or make such other orders as it thinks fit.

The Court also referred to Section 134 of the OBCA which requires directors and officers to act in good faith and in the interests of the corporation.

In finding the contract void, the Court stated at para 51:

> It is difficult to imagine a greater situation of conflict than the one created by the plaintiff when he drafted and executed his own employment contract with his father, his father's friend and his father's employee executing the contract on behalf of the defendant. The contract provided that upon termination without cause the plaintiff was entitled to his wages for the balance of the term. By comparison, his fellow employees were entitled only to the minimum statutory requirement.

The judge went on to find Waddilove breached his fiduciary duty to the corporation in failing to disclose his conflict of interest.

Under subsection 132(8) of the OBCA, Waddilove could have sought confirmation of the contract by shareholders but only if he, as an officer, could show he acted "honestly and in good faith" which he probably could not have done.[6]

Material Contract

A number of principles and issues arise from the cases as follows:

1. The interest in the contract must be material. In one case, the judge considered defining material interest and stated that "[p]resumably it is a broad concept. It denotes a financial interest but to be material it must be more than significant. It is a question of fact in each case."[7]
2. If the interest is *de minimis*, it will be ignored.
3. A contract will not be set aside where non-disclosure would have no effect.

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[5] *Waddilove* at para 3.

[6] *The Canada Business Corporations Act* ("CBCA") equivalent to Section 132 of the OBCA is Section 120 which contains much the same wording and subsection 120(7.1) of the CBCA which is comparable to subsection 132(8) of the OBCA.

[7] *Dimo Holdings Ltd. v H. Hager Developments Inc*. (1998), 43 B.L.R. (2d) 123 (Alb. Q.B.).

The judge made no mention of Waddilove's contract being "material" but made his ruling relying on provisions of the OBCA that govern material contracts entered into by directors and officers, and at para 43 noted that the absence of a similar severance clause in the employment agreements for the other employees was a material difference between the contracts.[8]

Conclusion

The director or officer who chooses to try and avoid making full and frank disclosure relating to a material contract with the corporation runs the risk of having the contract voided for breaching his or her fiduciary duty to the corporation or under the conflict sections of the OBCA or CBCA or other similar provincial legislation.

RECENT CASES

Board of Directors Breached Fiduciary Duty in Awarding Excessive Compensation to Directors and Officers out of Proceeds from Sale of Company's Primary Assets

Ontario Superior Court of Justice, June 1, 2017

Look Communications Inc. was a distributor of wireless, internet and cable services. The company sold its primary assets, telecommunications spectrum and a broadcast licence, for net proceeds of $64 million. The company's board of directors approved the payment of $20 million in "contingent restructuring awards" to the company's directors, officers and employees. The directors and officers collectively received $17 million of those awards, consisting of equity cancellation payments and executive compensation payments. The company's shareholders complained immediately when they discovered those payments. The company brought an action against the defendant directors, alleging a breach of fiduciary duty in paying $17 million to the directors and officers. The company alleged that the payments were excessive, not in the company's best interests and preferred the interests of the directors and officers over those of the company. The action was settled, except for the claim against Mr. McGoey and his holding company Jolian Investments Limited ("Jolian"). Mr. McGoey was a director and chief executive officer of the company. Mr. McGoey's contingent restructuring award was in the amount of $5,565,698 and was paid to Jolian.

The action against Mr. McGoey and Jolian was allowed. Corporate directors owed a fiduciary duty to the company, as codified in subsection 122(1) of the *Canada Business Corporations Act*. Directors were required to act honestly and in good faith with a view to the best interests of the company. They also owed a duty of care, which required them to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Here, the actions of the board in paying the contingent restructuring awards were not made in good faith. The board must have known that the amount of contingent restructuring awards paid to the directors and officers was excessive and not in the best interests of the company; they received more than 25% of the net sale proceeds, from a company that had been struggling for years. The board failed to adjust the $0.40 share price for the contingent restructuring awards, when the board knew that the market price was significantly lower. The board failed to make it clear to shareholders in the company's financial statements that most of the $20 million reserved for "restructuring charges" was being paid to the directors and officers. This information was only disclosed to shareholders after the contingent restructuring awards had been paid. The board's decisions were not in the best interests of the company, preferred the interests of the directors and officers over those of the company and were not within a range of reasonable alternatives so as to be protected under the business judgment rule. Mr. McGoey defended the breach of fiduciary duty allegations on the basis that the board relied on legal advice in approving the contingent restructuring awards, but this defence was rejected. The company's lawyer provided general legal advice to the board on its authority to make special payments, the directors' fiduciary duties and obligations and the protection afforded by the business judgment rule, but gave no advice on the valuation of the shares for the equity cancellation payments, the quantum of compensation payments or the allocation of those compensation payments. These were business matters and would not have been the subject of legal opinion or

[8] The claim was for $225,000. The defendant corporation operated a bingo parlour on a native reserve.

advice. Mr. McGoey breached his fiduciary duty as a director of the company in approving the contingent restructuring awards. Restitution was therefore appropriate, and it was ordered that the contingent restructuring award of $5,565,696 paid to Mr. McGoey and Jolian be repaid to the company and that a constructive trust be imposed over the $5,565,696, together with a tracing order for those funds.

Look Communications Inc. v. Cytrynbaum

Claims by Investors for Breach of Duty against Corporate Directors Summarily Dismissed; Duty Owed to Corporation, not Investors

Ontario Divisional Court, June 12, 2018

The plaintiffs and defendants were all investors who purchased securities issued by corporations, limited partnerships and investment funds comprising an interconnected group of entities operating under the umbrella name "First Leaside". One defendant was the founder, controlling shareholder and guiding mind of First Leaside Wealth Management, which provided services to many of the First Leaside entities and was their *de facto* parent company. All of the defendants were directors of corporations in the First Leaside group. All investors in the First Leaside group, including the plaintiffs and defendants, suffered a significant loss in the value of their investments as a result of the insolvency of the group. The plaintiffs instituted proceedings against the defendants, alleging negligence, negligent misrepresentation, fraudulent misrepresentation, breach of fiduciary obligations, breach of statutory obligations and oppression. The defendants brought summary judgment motions for dismissal of the actions against them on the basis there was no genuine issue requiring a trial. The defendants argued that, as directors, they owed no duty of care to the plaintiffs as shareholders or investors. The motions judge found there was no evidence that any of the defendants acted in a manner that had a "separate entity or interest" from that of the corporation "so as to make the act or conduct complained of their own". However, the motions judge found that the question of "what might reasonably be expected of these directors concerning the financial stewardship of these corporations", as it affected the plaintiffs, was a triable issue. The motions judge therefore granted partial summary judgment, dismissing all claims against the defendants except for claims of negligence, breach of fiduciary obligations and breach of statutory duties. The defendants appealed.

The appeal was allowed and all claims against the defendants were summarily dismissed. It was well-established that no duty of care existed in the relationship between directors of a corporation and its shareholders or investors. The statutory duties of good faith, loyalty and care, set out in subsection 134(1) of the Ontario *Business Corporations Act* and section 122 of the *Canada Business Corporations Act*, were owed to the corporation. The directors could not have separate duties of the same nature owing to shareholders, as such parallel duties would create untenable and unrealistic conflicts. The motions judge correctly observed that the defendants owed their duty of care, not to the investors in limited partnerships in the First Leaside group, but to the corporations of which they were directors. He erred, however, in finding that there was a triable issue with respect to the defendants' duty of care in negligence. The "financial stewardship" of a corporation and its affairs was at the heart of a director's duty of care, but this duty was owed to the corporation only. In focusing on what the defendants did or did not do as directors, rather than on the relationship between the defendants as directors and the plaintiffs as shareholders or investors, the motions judge improperly conflated standard of care and duty of care.

McGrail v. Phillips

CEO of Defendant Corporation executed Indemnity Agreement with Plaintiff without Authority to do so, but Agreement Enforceable under Indoor Management Rule whereby Plaintiff Entitled to Rely on Apparent Authority of CEO

Alberta Court of Queen's Bench, May 10, 2018

The plaintiff Intact Insurance Co. ("Intact") was a commercial surety that provided a bonding facility to four entities, including the defendant NCC Dowland Construction Ltd. ("NCC Dowland"). In consideration for provision of the bonding facility, the four entities, including NCC Dowland, entered into an indemnity agreement with Intact. NCC Dowland's CEO executed the indemnity agreement on behalf of NCC Dowland under seal. Intact was provided with a corporate resolution from the CEO, acknowledging that he was authorized by the corporation to execute the indemnity agreement. Intact subsequently brought an action to enforce the indemnity agreement. NCC Dowland claimed that the indemnity agreement was not binding upon it because the CEO did not have authority to enter into the indemnity agreement. There was a unanimous shareholder agreement under which NCC Dowland required the express written consent of two of the other entities before it incurred any liability or entered into any contract. Intact relied on the indoor management rule, set out in section 18 of the *Canada Business Corporations Act* (the "CBCA"), which indicated that an outsider, when dealing with a corporation, did not need to look behind the apparent authority of a person held out by the corporation "to exercise the powers and perform the duties that are customary in the business of the corporation or usual for a director, officer, agent, or mandatary". On an application for summary judgment by Intact, the Master held that the indoor management rule applied and granted judgment to Intact. NCC Dowland appealed.

The appeal was dismissed. The indoor management rule essentially estopped a corporation from asserting against a third party that the corporation had not complied with its internal management requirements. However, subsection 18(2) of the CBCA set out an exception, providing that the indoor management rule did not apply in respect of a person who had, or ought to have had, knowledge of the situation by virtue of their relationship to the corporation. The Master found that NCC Dowland was not entitled to rely on the exception. NCC Dowland argued that there were many "red flags" and inconsistencies that should have caused Intact to make inquiries with respect to the CEO's authority to bind NCC Dowland to the indemnity agreement and that, had Intact made those inquiries, it would have found that NCC Dowland did not have authority to enter into the indemnity agreement. The Master dismissed each of the "red flag" arguments raised by NCC Dowland. Intact knew it was dealing with the CEO. There was no information or indication given to Intact that the CEO did not have the authority to sign the indemnity agreement, especially since it was under corporate seal. Intact also had a corporate resolution, properly signed. This was precisely the purpose of the indoor management rule. Absent something significant that should have alerted Intact to irregularities, Intact was entitled to rely on the apparent authority of the person held out by the corporation to exercise its usual powers and duties. Intact did so with appropriate due diligence and a long relationship with the respective entities and principals.

Intact Insurance Co. v. NCC Dowland Construction Ltd.

Plaintiff 25% Shareholder entitled to Oppression Remedy where Defendant Unilaterally Managed Corporation and Arranged Sale of Corporation's Land to Defendant's own Company

Alberta Court of Queen's Bench, June 21, 2018

1176520 Alberta Ltd. ("117") was incorporated for the purpose of purchasing a parcel of land At the time of incorporation, there were four shareholders and directors, namely Purewal, Panaych, Gill and Toor. Each shareholder invested $200,000. Several years later, the shareholders agreed to sell the land to Harry's Excavating, a company controlled by Purewal. Harry's Excavating provided a deposit of $200,000, which was divided equally among the four shareholders. Prior to closing, the parties decided that, instead of selling the land to Harry's Excavating, shares of 117 would be sold, in order to save money on income tax. Panaych and Gill each sold their shares in 117 to Purewal for $329,000, each agreeing to a deduction of $50,000 as a result of work done on the land by Harry's Excavating over a period of years. However, Toor objected to such a deduction and did not complete the sale of his shares. Purewal filed a Notice of Change of Directors, removing Panaych, Gill and Toor as directors of 117. Purewal filed a builders' lien against the land. Harry's Excavating filed a caveat against the land, claiming to be the purchaser under an agreement. Toor declined an offer from Harry's Excavating to purchase his shares for the same amount paid to Panaych and Gill. Purewal authorized the transfer of title to the land to Harry's Excavating. Counsel for Harry's Excavating wrote to counsel for Toor, advising that title to the land had been transferred, and enclosed a cheque for $329,107.87 representing "total satisfaction of the previous agreement of the parties." It was not accepted by Toor, who remained the owner of 25% of the shares of 117 and a director, although he was prevented from any involvement in 117's business. Toor commenced an action for oppression against 117, Purewal and Harry's Excavating.

The action was allowed. Section 242 of the *Business Corporations Act* (the "BCA") set out the relief available on the ground of oppression or unfairness. Subsection 242(2) provided that the court may rectify matters complained of if it was satisfied that the business or affairs or powers of the directors of a corporation had been conducted in a manner that was oppressive or unfairly prejudicial to or that unfairly disregarded the interests of any security holder, creditor, director or officer. Remedies available under section 242 were numerous and wide-ranging. In his dealings as a director of 117, Purewal engaged in conduct that was oppressive, unfairly prejudicial or unfairly disregarded a relevant interest. Pursuant to section 120 of the BCA, Purewal, as a director of both 117 and Harry's Excavating, could neither vote nor approve a resolution relating to the sale of the land to Harry's Excavating. Purewal did not follow the procedure required under section 190 of the BCA for extraordinary sales when the land was transferred to Harry's Excavating. Paragraph 191(1)(*e*) of the BCA provided that a shareholder could dissent from a sale of substantially all of the property of a corporation, but Toor was unable to dissent because he did not know about the transfer of land before it happened. Purewal's actions in managing 117, including his involvement in approving the sale of land to his own company and removing Toor as a director, were outside the reasonable expectations Toor had as a shareholder of 117. The appropriate remedy was an order that Purewal purchase Toor's shares in 117 for $379,107. Toor had agreed to sell his shares to Purewal for that amount, but he did not agree to the unilateral reduction of money Purewal sought to impose as a deduction for work done by Harry's Excavating. A deduction of $200,000 from the overall purchase price for work done by Harry's Excavating was not justified. Invoices submitted by Purewal were vague and not supported by evidence. Some work was done, however, so the purchase price owed to Toor was reduced by $25,000. Toor was also entitled to punitive damages in the amount of $30,000. Purewal paid no heed to Toor and simply carried on business with the land and the corporation for five years. His actions were a marked departure from ordinary standards of decency.

Toor v. 1176520 Alberta Ltd.

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