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# The Hallmarks of Good Corporate Law: A Performance Evaluation of the Canadian Business Corporations Act

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**The Hallmarks of Good Corporate Law:  
A Performance Evaluation of the  
*Canadian Business Corporations Act***

**Submitted to  
Corporations Canada, Industry Canada**

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## **Executive Summary**

There are four normative models of the corporation: Contractarianism, Shareholder Primacy, Stakeholder Theory, and the Team Production Model. The model of corporate law that one espouses has a tremendous impact on the debate over the optimal mix of mandatory and default rules and the relative importance that one attaches to the five hallmarks of good corporate law.

Legal rules in corporate law can take one of three forms: mandatory rules that corporate actors must comply with and cannot be opted out of; enabling rules that provide legal force to the rules or agreements that are adopted or reached by corporate actors; and default rules that provide standard-form rules that govern the relationships of corporate actors unless they (expressly or impliedly) opt out of them and adopt their own rules.

The five main policy goals and objectives of good corporate law are:

- enhancing economic efficiency;
- ensuring accountability of corporate managers, directors and officers;
- protecting shareholders and other vulnerable parties;
- attracting business to the jurisdiction by inspiring confidence, supporting competitiveness, innovation and growth; and
- responding effectively to the needs of larger widely-held and smaller closely-held businesses.

An evaluation of the *CBCA* reveals that it is effective in meeting and balancing these five policy goals and objectives. The most recent round of amendments to the *CBCA* contained in Bill S-11 were instrumental in furthering the goals of protecting shareholders, inspiring confidence, innovation and growth, and responding to the needs of smaller closely-held businesses.

There remains further room for improvement, however.

- In the context of enhancing economic efficiency, the government's stated goal of minimizing duplication with provincial securities regulation should be revisited. A more logical goal for the *CBCA* should be to determine which aspects of business law regulation are most appropriately contained in a corporate law statute and which aspects are better suited to be left to securities regulators.
- In the context of ensuring accountability of corporate managers, a sub-goal of this policy objective is to clearly articulate the responsibilities and duties of those we wish to hold accountable. As such, directors' duties in the context of take-over bids should be codified into the *CBCA*, the regulations or policy directives issued by the Director.
- In the context of protecting shareholders and other vulnerable parties, it should be made clear that the oppression remedy cannot be used to pursue claims that are

derivative in nature. In addition, in respect of non-shareholders, additional guidance should be provided on who is a proper person to be a complainant to seek relief under the oppression remedy.

- In the context of being responsive to the needs of small closely-held corporations, the definition of unanimous shareholders agreement should be broadened so that it recognizes shareholders agreements that do not transfer board duties to the shareholders.

## **1. Introduction**

The objectives of this research are three fold. First, this research study sets out the policy objectives and criteria for good corporate law. Second, this research study assesses whether the *CBCA*<sup>1</sup> meets those policy objectives and criteria. Third, the report makes preliminary recommendations for reform to the *CBCA*, which may be subject to further research studies.

This research study will assist in the development of a modern and effective corporate law framework that enhances economic efficiency, ensures accountability of corporate managers, directors and officers, affords shareholders and other vulnerable parties sufficient protection, inspires confidence, supports competitiveness, innovation and growth, and is responsive to the needs of both small, closely-held businesses and large, publicly-held corporations.

Part 2 frames the relevant research questions within four competing theoretical models of the corporation, and sets out the five policy goals and objectives of good corporate law. Part 2 also reviews and analyses academic literature on the optimal role of mandatory and default rules in corporate law. This part also identifies three main types of corporations that are present in the Canadian economy: (i) private, closely-held corporations; (ii) large, publicly-held corporations; and (iii) large, public corporations with a controlling (family or foreign) shareholder. This theoretical and policy categorization is relevant to the analysis and assessment of the *CBCA* conducted in the report.

Finally, Part 3 evaluates and assesses the effectiveness of the *CBCA* against the theoretical frameworks developed in Part 2. This part assesses whether or not the *CBCA* strikes an optimal balance between the five hallmarks of good corporate law, and whether or not the *CBCA* consists of an appropriate balance of mandatory and default rules. In so doing, this part also assesses whether or not the *CBCA* meets the needs of the three corporation types identified in Part 2, in particular, the needs of small, closely-held corporations. Based on the entire analysis, this part makes preliminary recommendations for reform to the *CBCA* and provides directions for further study and research.

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<sup>1</sup> R.S.C. 1985 c. C-44. [*“CBCA”*].

## **2. Theoretical Frameworks**

### **A. Normative Models of the Corporation**

This part sets out four normative models of the corporation. The theories underlying each model are analyzed and their underlying assumptions are revealed. The model that one espouses has a tremendous impact on the relative importance that is attached to each of the six policy goals and objects of good corporate law and on the debate over mandatory versus enabling rules.

#### **(i) Contractarianism**

Contractarianism is a theory of corporate law based on the notion that the corporation is a “nexus of contracts.”<sup>2</sup> Under this model, the corporation is not a separate legal entity, but a representation of express and implied contractual relationships and obligations among stakeholders, all of whom provide various inputs that are important to the productive process. For example, shareholders provide equity capital, employees provide labour and debt capital, the board of directors provides monitoring services, senior management provides services to operate the business and oversee more junior management, and so forth. Under this model, for example, limited liability for shareholders represents the bargain shareholders have struck with creditors. Similarly, employees have agreed to be compensated in the form of wages. Acceptance of the contractarianism theory of corporate law has implications for the debate on the optimal mix of mandatory and default rules in corporate law. This model supports the position that corporate law is and ought to be comprised of default provisions to which private parties would themselves have agreed, had they engaged in private bargaining. This model sees little or no scope for mandatory rules of corporate law. Under this model, the government’s role is to provide default rules that the parties would have agreed to themselves and to enforce private contracts.

#### **(ii) Shareholder Primacy**

The shareholder primacy model of corporate law espouses the view that shareholders own the corporation and that in discharging their duty “to act in the best interests of the corporation”, directors and officers ought to act in the interests of shareholders and engage in profit maximization. The shareholder primacy theory takes the view that corporate law does not have a role to play in protecting the interests of non-shareholder stakeholders such as creditors, employees or the local community. The view behind this model is that the interests of these stakeholders can be sufficiently protected through private bargaining and contract law and other areas of regulation such as employment law, health and safety legislation, bankruptcy law, and environmental law.

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<sup>2</sup> Easterbrook and Fishel, *The Economic Structure of Corporate Law* (Cambridge, Mass: Harvard University Press, 1991).

### **(iii) Stakeholder Theory**

The stakeholder model of corporate law is based on the premise that stakeholders other than shareholders have legitimate interests in the corporation. Under this model, the corporation's role and purpose are broader than profit maximization for the exclusive benefit of shareholders. Instead, this theory advocates that the interests of all stakeholders ought to be given due consideration in corporate decision-making, especially given the resources that all such stakeholders have invested in the corporation and the risks associated with their investment.

### **(iv) Team Production Model of Corporate Law**

This model of corporate law is an offshoot of the stakeholder theory. The proponents of this theory argue that legal rules in public widely-held corporations must address the team production problem in which individuals must invest firm-specific resources to produce a non-separable product.<sup>3</sup> In such instances, individuals will have difficulty negotiating and drafting express individual contracts to distribute the fruits of their joint product. As a result, they give up control to the board of directors, which is responsible for representing the team and rewarding its members. The team is comprised of shareholders, all levels of employees, creditors, customers, and the community. Under this model, the goal of corporate law is not the maximization of shareholder profit, but rather, maximization of the overall joint welfare of all team members, a responsibility that is left for the directors to discharge.

### **(v) Reflections of the Normative Models in the CBCA**

The *CBCA* is not the exclusive product of any one of the above-discussed normative models. While the *CBCA* generally reflects a shareholder primacy model, there are particular provisions in the Act that suggest some acknowledgement of the interests of non-shareholder stakeholders. For instance, the definition of "complainant" is broad enough to suggest that the respective provisions in the Act encompass potential claims by non-shareholder stakeholders that have been harmed by corporate decision-making. Also, there are particular provisions in the Act, such as section 42, which protects creditors by imposing a solvency test prior to the declaration or payment of dividends, and section 119, which protects employees by imposing personal liability on directors for six months of back wages, which also acknowledge and protect the interests of non-shareholder stakeholders. However, unlike in many U.S. state corporate law codes that contain "stakeholder statutes", there is currently no general provision in the *CBCA* that explicitly permits directors to consider the interests of non-shareholder stakeholders in corporate decision-making.

Mirroring the general theoretical bent of the *CBCA*, the Canadian judiciary has also endorsed the shareholder primacy model of corporate law. There are two pockets of corporate law where courts have been more responsive to the idea of corporate law

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<sup>3</sup> Margaret M. Blair and Lynn A. Stout, "A Team Production Theory of Corporate Law" (1999) 85:2 *Va L. Rev.* 248.



considering the interests of stakeholders. In the context of defining directors' duties in the face of a hostile takeover bid, the British Columbia Supreme Court stated in *Teck v. Millar*<sup>4</sup> that the directors may have "reasonable regard" for the interests of non-shareholder stakeholders in defending the company against a hostile takeover bid. More recently, the Ontario Court of Appeal stated in *Maple Leaf Foods v. Schneider Corp. et al*<sup>5</sup> that a target company's directors may consider a hostile takeover bidder's historically poor relations with its employees and the effect that a successful bid would have on the target company's employees.

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<sup>4</sup> [1973] 2 W.W.R. 385, 33 D.L.R. (3d) 288

<sup>5</sup> (1998), 42 O.R. (3d) 177 (C.A.)

## **B. The Appropriate Role of Mandatory versus Default Rules**

Legal rules in corporate law can take one of three forms: mandatory rules that corporate actors must comply with and cannot be opted out of; enabling rules that provide legal force to the rules or agreements that are adopted or reached by corporate actors; and default rules that provide standard-form rules that govern the relationships of corporate actors unless they (expressly or impliedly) opt out of them and adopt their own rules.

This section analyzes the optimal mix of the different forms of legal rules in corporate law. One's view on the optimal mix will be influenced by the normative model of corporate law that one espouses, the relative weight that one attaches to the six hallmarks of corporate law, the particular type of corporation at issue (closely-held, public and widely-held, or controlled), and the substantive matter that any particular corporate rule deals with.

There are several arguments in favour of the position that corporate law ought to be comprised entirely or largely of default rules as opposed to mandatory rules. The first is the contractarian view that that optimal corporate law is premised on the notion of freedom of contract, and that the state should not interfere with the process of equal parties freely entering into private economic relations with equal information. In addition, the circumstances under which corporations operate are too diverse and too varied to create a single set of mandatory rules. Default rules afford companies greater flexibility in tailoring rules to meet their particular conditions or circumstances if those provided in the corporate code are not suitable.

There are several opposing arguments that mandatory legal rules ought to be an important core component of a corporate law statute.<sup>6</sup> First, failures in the market necessitate mandatory legal intervention to achieve economic efficiency. The fact is that some mandatory rules are efficient. Second, enhancing economic efficiency is one of six hallmarks of good corporate law and it must be balanced against competing objectives. The introduction of mandatory rules is necessary, for example, to protect vulnerable parties. Third, corporate actors do not always neatly fit into the freedom of contract paradigm of equal bargaining power and equal information such that the law may have to impose mandatory rules on parties in some instances.

The appropriate mix of default and mandatory rules depends in part on the particular type of corporation in question. In the public, widely-held corporation, rules that deal with matters where there may be an inherent conflict between the interests of managers and shareholders ought to be mandatory. In particular, rules that specify managers' duties should be mandatory, such as the duty of directors and officers to act in the best interests of the corporation. This duty should not be a default rule that managers can opt out of so that they can effectively act in their self-interest. Similarly, rules on related party

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<sup>6</sup> M. Eisenberg, "The Structure of Corporation Law" (1989) 89 *Colum. L. Rev.* 1461.

transactions, whether they take the form of prohibition, disclosure, abstinence from voting, or independent valuations, also should be mandatory.

Shareholder remedies and shareholder rights to information about the company and communication with each other also should be mandatory. The shareholder right to appoint an auditor to review financial disclosure and the shareholder right to approve fundamental changes should also be mandatory. Rules that fundamentally affect third parties such as creditors and employees also should be mandatory.

In matters where the managers' self-interest is not inherently pitted against that of shareholders, such as instances where the rights of shareholders as amongst themselves are being determined, default rules that can be opted out of are more appropriate. For example, rules governing the rights attached to shares should be default. Specifically, these rights include the right to dividends, the right to vote, and the right to receive assets upon dissolution or winding up of the corporation, and the default rule that all shares have equal rights unless divided up into different classes or series is appropriate. Pre-emptive rights should also be a default rule.

Similarly, procedural rules about director or shareholder meetings should create some level of minimum standards, but should leave room for corporate actors to modify those standards. Basic elements of corporate governance, such as the number of directors on the board, the proportion of directors that are independent of management, and the qualifications of directors, should also be governed by minimum threshold rules.

In large, publicly-held corporations, the key issue is the accountability of controlling shareholders (as opposed to accountability of management) to public shareholders. The same break up of mandatory and default rules applies, with the addition that fiduciary duties that the controlling shareholder owes to public shareholders should be mandatory.

In private, closely-held corporations there ought to be more room for default rules that allow corporate actors to opt out of the provisions of the Act. This suggestion recognizes that some corporate law rules may be cost-prohibitive while not furthering the goals of corporate law. Also, there are unique circumstances in closely-held corporations that cannot be sufficiently accounted for in a single corporate law statute. Nonetheless, there is a core set of rules that should remain mandatory even in the context of closely-held corporations. This core set of rules includes fiduciary duties, shareholder remedies, and shareholder rights to information. In respect of fiduciary duties, parties should be allowed to carve-out specifically fine exceptions to the general fiduciary duty. In respect of shareholder remedies, parties should not be allowed to agree to a wholesale opting out of a derivative suit or oppression action. However, parties should be able to define their reasonable expectations at the outset of their relationship, which may have an impact on any future litigation claims.

In terms of matters for which default rules are more appropriate than mandatory rules, the issue that follows is how should policy makers and regulators choose as between two or more options in respect of the default rule? The contractarian view is that the default rule

should minimize transaction costs and approximate what the parties would have agreed to. Other scholars argue that given the choice of two or more potential default rules, regulators should adopt the rule that is less favourable to managers so that managers must actively opt out of the default rule.<sup>7</sup>

As a general matter, corporate law statutes do not expressly state whether a provision in a corporate law statute is mandatory, enabling or default. This task is left to the good faith of and interpretation by the contracting parties and the judiciary. Also, in the case of default rules, corporate law statutes generally do not provide whether or not the opting out must be express (oral or written) or implied by a course of dealing. This matter is left to judges to determine depending on the facts of any particular case. While it can be posited that the more central the right being opted out of (i.e. the oppression action or rights to information about the corporation), the more likely that courts will find that the opting out must be express and in writing. However, it would be worthwhile to categorize, for the benefit of corporate law statute users, which provisions are mandatory and which are default.

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<sup>7</sup> Lucian A. Bebchuk, and Assaf Hamdani, “Optimal Defaults for Corporate Law Evolution”, (2002) 96:2 *Northwestern University Law Review* 489.

### **C. Policy Goals and Objectives of Corporate Law**

This section sets out the five policy goals and objectives of corporate law. It is important to note that these policy goals often overlap and conflict with each other, and the relative importance or value placed on each policy goal depends on several factors. The theory of corporate law one espouses will impact the assessment of the weight that ought to be accorded to various policy goals, and the particular aspect of corporate law that is at issue will also affect how the policy goals are balanced.

The five main policy goals and objectives of good corporate law are:

- enhancing economic efficiency;
- ensuring accountability of corporate managers, directors and officers;
- protecting shareholders and other vulnerable parties;
- responding effectively to the needs of larger widely-held and smaller closely-held businesses; and
- attracting business to the jurisdiction by inspiring confidence, supporting competitiveness, innovation and growth.

There are some secondary policy goals worth noting, including improvement of the efficient administration of the statutory framework, and fostering corporate social responsibility which drive, or at the very least, add another rationale for, several of the five primary policy goals.

While this report discusses the interaction between a corporate law statute and the judiciary's role in applying and enforcing the statute, it should be noted that this study focuses primarily on good corporate law from the vantage point of the statutory framework. Consequently, the role of the courts is not analyzed in significant depth.

#### **(i) Enhance Economic Efficiency**

A primary goal of corporate law is to enhance economic efficiency. Economic efficiency is comprised of allocative efficiency and transactional efficiency. Allocative efficiency can refer to Kaldor-Hicks or Pareto efficiency. Kaldor-Hicks efficiency involves a change where those who gain can fully compensate those who lose. Pareto efficiency refers to a state in which one person cannot be made better off without someone else being made worse-off. Transactional efficiency attempts to minimize the transaction costs of entering into productive relationships and arrangements.

In free market economies, corporate law plays an important role in facilitating commerce and maximizing both allocative and transactional efficiency. In respect of allocative efficiency, corporate law (together with securities laws) assists in ensuring that assets are being most productively used and that asset prices reflect their intrinsic value. Good corporate law encourages capital formation and efficient allocation of capital resources.

In respect of transactional efficiency, an effective corporate law framework minimizes the transaction costs associated with using the corporate form. A good corporate law

framework provides default or off-the-rack rules that corporate actors such as shareholders, managers and directors can utilize with ease. These default rules represent the best of what these parties would have agreed to if they had put their minds to the matter, and specifically, the terms of their relationship. In this way, good corporate law helps minimize the organizational costs of doing business.

A good corporate law statute provides default rules on matters that are of central importance to corporate actors including the duties and responsibilities of managers, directors and officers, the division of profits, the rights of shareholders, and so forth. A good corporate law statute is convenient and accessible. It can save corporate actors significant savings in time, effort and professional fees, instead allowing corporate actors to channel their resources to productive activity. Even if corporate actors decide to vary the default provisions available to them in a corporate law code, these default rules nonetheless provide a strong frame of reference from which to make modifications, which can also represent significant savings.

A good corporate law statute also reduces the costs of capital for businesses organized under the corporate form by ensuring that mandatory corporate law requirements are not unduly burdensome and do not add significantly to expenses. Simply put, good corporate law ensures that any mandatory regulation is cost-justified.

A good corporate law framework also allows management to manage the business and make ordinary business decisions in an efficient, time-responsive manner that is not unduly constrained by requirements to obtain shareholder approval. There is of course a delicate balance to be struck between efficient operation of business and shareholder protection.

## **(ii) Ensure Accountability of Corporate Managers and Directors**

Ensuring accountability of corporate managers and directors is a critical purpose of corporate law. The specifics of this function depend on the type of corporation at issue, and each corporation type faces a different set of accountability issues. In type (i) public widely-held corporations, the key issue is accountability of professional managers to public retail shareholders. In contrast, the key issue in type (ii) public corporations with a controlling shareholder is accountability of the controlling shareholders to public retail shareholders. Finally, the key issue in type (iii) closely-held corporations is accountability of the shareholders (who also generally manage the corporation) to each other.

In type (i) public widely-held corporations, a good corporate law statute ensures that:

- management has a legal fiduciary duty to act in the best interests of the corporation;
- shareholders have the right to elect their representatives to oversee the business and affairs of the corporation;

- shareholders have rights of access to information about corporate activity; and
- shareholders have access to cost-effective remedies if they are aggrieved by management.

In type (ii) publicly controlled corporations, a good corporate law statute also ensures that controlling shareholders' duties to the public/minority shareholders are clearly articulated. A good corporate law creates sufficient safeguards to ensure that the controlling shareholder is accountable and acts in good faith and in the best interests of the corporation, which includes the interests of those non-controlling, public shareholders. Historically, corporate law statutes have not expressly stated whether a controlling shareholder owes a fiduciary duty to public or minority shareholders. Consequently, the judiciary has generally been charged with defining the duties that controlling shareholders owe to minority and/or public shareholders.

In type (iii) corporations, the owners generally manage the corporation, there is no separation between ownership and control, and hence there is no issue of accountability of management. A good corporate law statute ensures that controlling shareholders are accountable to the non-controlling shareholders and that there are mechanisms to ensure that the reasonable expectations of all shareholders are recognized.

### **(iii) Protect Shareholders and Other Vulnerable Parties**

A good corporate law statute protects vulnerable parties. One's definition of vulnerable parties is intricately linked to the normative model of corporate law that one espouses. Under the shareholder primacy and contractarian models, vulnerable parties are minority and/or public shareholders. Under the stakeholder and team production models of corporate law, vulnerable parties would include stakeholders such as employees, customers, creditors, the community, and the environment, in addition to shareholders. The goal of protecting vulnerable parties requires, by definition, certain rules that are mandatory and cannot be opted out of.

### **(iv) Respond to the Needs of Large Widely-Held and Small Closely-Held Businesses**

Given that a large part of the Canada's economy is comprised of micro, small and medium sized businesses, a good corporate law statute must be responsive to their needs. To the extent that a jurisdiction does not have separate statutory frameworks for larger and smaller businesses, the single statutory framework must afford sufficient flexibility to allow smaller businesses to opt out of rules that are not suitable for their particular circumstances. It must also ensure mandatory rules actually further the policy goals of good corporate law and are not cost-prohibitive for smaller businesses.

**(v) Attract Business to the Jurisdiction by Inspiring Confidence and Support Competitiveness, Innovation and Growth**

While one might think that it is difficult, in a mature and free market economy, for a corporate law statute to actively attract business to a jurisdiction, a good corporate law statute should not create unnecessary obstacles for businesses to operate in that jurisdiction. In the U.S., for instance, Delaware attracts corporate law incorporation business on the basis that it provides flexible enabling rules that are extremely responsive to the needs of corporate managers and shareholders and a specialized judiciary that has expertise to adjudicate corporate law matters. A good corporate law statute should inspire confidence, support competitiveness, innovation and growth, by allowing for certainty, predictability, and ease of access.

**(vi) Overlap and Conflicts Between Policy Goals**

The five hallmarks of corporate law discussed above overlap and conflict with each other. For example, protection of shareholders overlaps significantly with ensuring accountability of corporate managers. Supporting competitiveness, innovation and growth overlaps with enhancing economic efficiency and being responsive to the needs of smaller businesses. Enhancing economic efficiency often conflicts with protecting shareholders and ensuring accountability of corporate managers.

The five policy goals operate within the general premise of a free market economy that the government should create the necessary infrastructure for the effective operation of the marketplace and subsequently let businesses operate without interference from government. On the basis of this premise, corporate statutes have been self-enforcing and the state has taken a very hands-off approach. This approach has been reflected historically in the passive role of corporate law regulators and heavy reliance on private enforcement by aggrieved parties (cf. securities law statutes and active regulators). The judicial inclination to defer to the business judgment of management is also a reflection of this policy. The general premise of governmental non-interference is intricately linked to and overlaps with goal of economic efficiency and often conflicts with the goals of shareholder protection and accountability of management.



### 3. An Evaluation of the *CBCA*

Using the hallmarks of good corporate law set out in Part 2 of this study, this part analyses whether the *CBCA* meets and appropriately balances these competing policy goals and objectives. This part also analyses whether the *CBCA* contains the optimal mix of mandatory and default rules and addresses the needs of the three corporation types that are most prevalent in the Canadian economy.

#### A. Enhancing Economic Efficiency

The *CBCA*'s primary goal is to enhance economic efficiency, and most provisions of the *CBCA* can be justified on the basis of achieving allocative and transactional cost efficiency.

For example, the default rule of limited liability for shareholders enhances allocative efficiency by encouraging efficient capital formation and efficiently shifting risk to parties who can best bear it.<sup>8</sup> There are, however, some important critiques that the appropriate default rule should be unlimited liability in relation to certain types of creditors, and it is certainly appropriate to question whether the statute should be amended accordingly, or whether the matter of piercing the corporate veil ought to be left to judicial determination.

There are also many examples of the *CBCA* increasing transaction cost efficiency. In respect of reducing the costs of doing business, the *CBCA* provisions that allow for shareholders to appoint proxies and for shareholders to unanimously sign resolutions in lieu of meetings are two of many examples of attempts to minimize transaction costs. Recent amendments to the *CBCA* which allow for electronic participation by shareholders at shareholders meetings and which permit corporate and accounting records to be kept outside of Canada so long as they are accessible electronically and the corporation provides reasonable assistance to parties wishing to access the records also enhance transaction cost efficiency.

A key manner in which a corporate law statute enhances economic efficiency is, as noted above, by providing default provisions that parties themselves would have entered into. Given that almost all of the provisions in the *CBCA* would be justified on the basis of economic efficiency or the balancing of economic efficiency with other goals, the issue of whether particular rules should be mandatory or default is discussed in the sections that follow.<sup>9</sup>

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<sup>8</sup> Easterbrook & Fishel, *supra* note 2.

<sup>9</sup> In addition to engaging in a critical analysis of key provision in the *CBCA* based on the theoretical frameworks set out in the preceding part of the study, it would also be extremely worthwhile to interview stakeholders – corporate managers of large, medium sized and small companies as well as their legal advisors – about the extent to which different types of corporations and their actors find it necessary to vary the rules in the *CBCA* to meet their particular circumstances. The greater the extent to which corporations do not vary the rules, the stronger the evidence that the *CBCA* plays a strong facilitative role in providing the optimal boilerplate contracts.

### Minimizing Duplication with Provincial Securities Laws

A stated goal of Bill S-11 was that of “eliminating duplication, in part by eliminating duplication with provincial securities laws, and reducing costs for business.”<sup>10</sup> This was the explicit policy rationale behind the repeal of the *CBCA*’s takeover bid provisions in Bill S-11.<sup>11</sup>

This goal can reasonably be viewed as one method of realizing the policy objective of enhancing economic efficiency by reducing the transaction costs associated with carrying on business in Canada. The rationale is that a corporation should not be subject to multiple and/or conflicting rules from two or more regulatory frameworks.<sup>12</sup>

The goal of eliminating duplication with securities laws has long-since been an explicitly stated government goal, and was supported by the Dickerson Report, which stated:<sup>13</sup>

There has been far too much attention paid in the past to the supposed differences between corporation legislation and securities legislation. We do not believe that there is a valid distinction, and that a good deal of what is found in provincial securities legislation could just as validly be enacted as corporation legislation.

The Dickerson Committee’s comments raise an important issue about the rational allocation of responsibility between corporate and securities law in Canada. As a response to the crisis of confidence faced by North American capital markets and following the U.S. Congress enactment of the *Sarbanes-Oxley Act of 2002*, Canadian provincial securities regulators have recently expanded the scope of their authority, particularly in the area of corporate governance.<sup>14</sup> For example, the Ontario Securities Commission was recently granted rule-making authority on audit committees, CEO/CFO

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<sup>10</sup> Parliamentary Research Branch, *Bill S-11: An Act to Amend the Canadian Business Corporations Act and the Canada Cooperatives Act and to Amend other Acts* (Legislative Summary) Gérald Lafrenière & Margaret Smith (Ottawa: Library of Parliament, 2001) at 1.

<sup>11</sup> *Ibid.*

<sup>12</sup> It should be noted that the proportionate liability scheme now contained in the *CBCA* is quite different in form and structure than the proportionate liability scheme contained in the *Securities Act* (Ontario) in respect of civil liability for continuous disclosure violations. See Poonam Puri & Stephanie Ben-Ishai, *Proportionate Liability under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?* (2003) 39 C.B.L.J. 36

<sup>13</sup> Information Canada, *Proposal for a New Business Corporations Law For Canada*, Robert W.V. Dickerson et al. (Ottawa: Information Canada, 1971) at 5 [“Dickerson Report”].

<sup>14</sup> See, Poonam Puri & Leslie McCallum, *Canadian Companies Guide to the Sarbanes-Oxley Act* (Toronto: Butterworths, forthcoming December 2003).

certifications of financial disclosure and establishing internal controls and procedures.<sup>15</sup> As a practical matter, if securities regulators are constantly expanding the scope of their authority, the *CBCA* will constantly be narrowing its scope of authority in order to meet its stated goal of avoiding duplication. The more logical goal for the *CBCA* should be to determine which aspects of business law regulation are most appropriately contained in a corporate law statute and which aspects are better suited to be left to securities regulators.

This matter raises a more general issue about harmonization as between federal and provincial corporate law regulators, and coordination with provincial securities regulators. The issue of what matters are most appropriately the domain of corporate law and what are those that are best left in the hands of provincial regulators should be analysed further. This analysis will be affected by the distinct historic Canadian evolution of corporate and securities laws. Given the increasingly global nature of business activity, and the importance of corporate law regulatory framework in ensuring competition and innovation and growth of the Canadian economy, a strong argument can be made that the *CBCA*, as opposed to securities law statutes, ought to be the primary regulatory authority on certain matters such as corporate governance.

## **B. Ensuring Accountability of Corporate Managers and Directors**

While the Dickerson Report recognized that there is no practical way that shareholders of public corporations could be involved in corporate administration,<sup>16</sup> the report does provide that, “this is not to say, however, that directors should not be responsible for their actions and accountable to shareholders and others for what they do. We believe that they should be, and more so than they have been in the past.”<sup>17</sup>

The *CBCA* ensures accountability of management through several means: by imposing a fiduciary duty on them to act in the best interests of the corporation, by imposing personal liability on them in certain circumstances, and by allowing shareholders and other aggrieved parties to access certain remedies.

Bill S-11’s background reports made no explicit mention of ensuring corporate accountability but spoke more narrowly to “clarifying responsibility”<sup>18</sup> as one of its main policy goals. One of the ways in which Bill S-11 attempted to clarify responsibility is through the amendments to the directors’ liability regime. Also, the scope of directors’ duties have been clarified by specifying that directors have the power to choose to delegate the management of the corporation to officers or keep these powers for themselves.<sup>19</sup> However, the *CBCA* could do a better job of clarifying responsibility and

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<sup>15</sup> See Poonam Puri & Jeffrey Larsen, *Corporate Governance and Securities Regulation post-Enron* (Toronto: Butterworths, forthcoming 2004).

<sup>16</sup> Dickerson Report, *supra* note 13 at 3.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Supra* note 10 at 2.

thus allowing for greater certainty and predictability for corporate actors, particularly in the context of fiduciary duties. *CBCA*

In respect of fiduciary duties, the standard that is articulated in the *CBCA* is very broad, open-ended and vague. Questions and issues regarding fiduciary duties emerge within all contexts of corporate decision-making, and historically, the judiciary has been assigned the task of flushing out the obligations of directors and officers in various contexts: defending a hostile takeover-bid, the taking of corporate opportunities and managerial compensation.

The *CBCA* does provide relatively more guidance in the context of related party transactions where section 120 sets out bright line disclosure and abstinence from voting requirements. However, in all other contexts, the duties of directors and officers are subsumed under the general duty of to act in the best interests of the corporation. The body of case law that interprets this duty in various contexts is dense and complicated. Additionally, it is inaccessible to corporate actors, thus limiting its usefulness in providing guidance to directors seeking to understand their fiduciary duties, or to shareholders and other stakeholders who may be considering the pursuit of a claim based on a breach of directors' fiduciary duties. The ambiguity and uncertainty imposes significant costs on corporate actors.

As noted above, an important component of ensuring accountability of corporate managers involves clearly articulating in advance the expectations we have of those who we wish to hold accountable. The *CBCA*, regulations or policy statements should expressly articulate the duties that are expected of directors in various contexts. The most pressing need for this codification is in the context of directors' duties during hostile takeover bids.

These recommendations raise a larger issue of when it is appropriate to codify common law principles into a statute. Put another way, what would be gained by codification of the common law? In this context, codification will allow for concision, certainty and ease of access in respect of areas of corporate law that are extremely important and frequently litigated. Codification will clearly set out the principles that the judiciary has articulated over the years and resolve any inconsistencies.

A related issue that arises in this context is whether the law should be codified in the *CBCA*, the regulations or by way of a policy directive issued by the Director. Codification within the Act has the greatest actual and symbolic force of law. However, given limited parliamentary time, codification in the Act would make it difficult to make amendments in response to changed circumstances, whereas policy directives, followed by regulations would be easier to amend.

Clearly, the remedial actions provided for under the *CBCA* act as mechanisms to ensure accountability of corporate managers and directors. These remedies are also designed to

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<sup>19</sup> See *CBCA*, *supra* note 1 at s. 102(1) & (2).

protect shareholders and other vulnerable parties, and are therefore, discussed in the following section.

### C. Protecting Shareholders and Other Vulnerable Parties

The *CBCA* protects shareholders through the availability of shareholder remedies such as the derivative suit, the oppression action, and the appraisal remedy. Shareholders are also afforded protection by having to approve by a super-majority vote any fundamental changes to the corporation, and access to other rights including the right to information.

The *CBCA* also protects the interests of third parties dealing with a corporation yet to be formed by allocating risk and personal responsibility to the promoter of the corporation prior to the existence of the corporation. The Bill S-11 amendments clarified the confusion that had been created by certain recent judicial decisions.<sup>20</sup> The *CBCA* also protects the interests of third parties dealing with the corporation through the indoor management rule. The *CBCA* specifically protects the interests of creditors by requiring in section 42 that a corporation be solvent when declaring or paying dividends. One of the few instances where the *CBCA* protects employees is by imposing personal liability on corporate directors for six months wages under section 119 of the *CBCA*. Creditors and other stakeholders may also qualify as complainants under the oppression remedy to sue the corporation and/or directors and officers.

#### Oppression Remedy

*Mandatory or Default:* The oppression remedy protects the reasonable expectations of vulnerable parties. Since it is difficult to believe that corporate actors would knowingly contract out in a wholesale manner of their reasonable expectations, and given the drastic ramifications of doing so, this remedy should be mandatory in the closely-held corporation and corporate actors should not be able to opt out of it. In the context of closely-held companies, parties should be allowed to define the parameters of their reasonable expectations by clearly articulating their relationship and arrangements in a shareholders agreement, which effectively narrows the scope of any potential oppression claim.

*Type of Corporation:* The intention of the Dickerson Committee was that the oppression remedy would be of most use to minority shareholders of closely-held corporation.<sup>21</sup> However, that intention is not reflected in the wording of the oppression remedy provisions, which do not actually exclude the oppression action from being instituted in relation to widely-held corporations. As a result, the default rule in the *CBCA* is that the oppression remedy is available in relation to both public and private corporations.

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<sup>20</sup> See Poonam Puri, “The Hope of Certainty in the Law on Pre-Incorporation Contracts” (2001) 80:3 *Can. Bar Rev.* 1051.

<sup>21</sup> See for example, Dickerson Report, *supra* note 13 at 487.

A study that I co-authored with Professor Ben-Ishai indicates that 92% of oppression cases adjudicated by Canadian courts in our sample period were in relation to private closely-held corporations while only 8% were for public widely-held companies.<sup>22</sup> The success rate of an oppression claim was much lower in the case of public companies (2 out of 6 cases for a total of 33 %) compared to 54 % for private companies. The two most recent public company cases involved defeated hostile takeover bidders acting as complainants.<sup>23</sup> In both cases, claims were made which at their core were derivative in nature, and both cases were unsuccessful in making the case for oppression.

In the public company context, the oppression remedy does not assist in protecting shareholders; economic efficiency would be better enhanced by the conservation of judicial and private resources by institution of a default rule that the oppression remedy is not available in public corporations (or not available without leave.)

*Substantive Standard:* The broad wording found in the *CBCA* oppression remedy constitutes the broadest of the Canadian corporate law remedies. The open-ended wording of the statutory oppression remedy has meant that the task of defining the ambit of the remedy has been left to the Canadian judiciary. In the last 25 years that the oppression remedy has been in existence, the courts have articulated a number of factors that are indicative of oppression.<sup>24</sup> It would serve the policy goals of good corporate law by allowing for certainty, predictability and ease of access to codify these factors into the *CBCA*, the regulations or a Director's policy directive.

*The Definition of Complainant:* The wording of Section 238 of the *CBCA* suggests that the oppression remedy is not simply a shareholder remedy, but rather, that it is available to a broader class of applicants including directors and officers, and on a discretionary basis to employees and creditors, among others.

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<sup>22</sup> Poonam Puri & Stephanie Ben-Ishai, *Oppression Remedy Cases Judicially Considered: 1995-2001 (2003 Draft)*, attached as Appendix B.

<sup>23</sup> See *supra* note 5; See also *CW Shareholdings v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755 (SCJ).

<sup>24</sup> Puri & Ben-Ishai (2003), *supra* note 22, observed that the successful applications in their sample were variations of a limited number of themes or conduct that mirror the list provided by Justice Austin in *Arthur v. Signum Communications Ltd.* (1991), 25 A.C.W.S. (3d) 1206 (Ont. Gen. Div.) at 74, varied on other grounds (1992), 16 C.P.C. (3d) 38 (Ont. Gen. Div.), *aff'd* (1993), 42 A.C.W.S. (3d) 332 (Ont. Div. Ct.) as indicia of oppressive conduct:

- a. lack of valid corporate purpose for the transaction;
- b. failure on the part of the corporation and its controlling shareholders to take reasonable steps to simulate an arms' length transaction;
- c. lack of good faith on the part of the directors of the corporation;
- d. discrimination among shareholders with the effect of benefiting the majority shareholder to the exclusion of the minority shareholders;
- e. lack of adequate and appropriate disclosure of material information to minority shareholders;
- and
- f. a plan to eliminate a minority shareholder.

The issue of whether non-shareholder corporate stakeholders are proper complainants to bring an oppression application has come to the forefront of Canadian corporate law, particularly in the context of creditors rights.<sup>25</sup>

The Puri and Ben-Ishai empirical study found that shareholders constituted the largest class of complainants accounting for 80% of all complainants (with a 53% success rate). Of the complainants who were shareholders, minority shareholders constituted 67% of shareholder complainants.

Free-standing employees had no success in qualifying as complainants under the discretionary category under Section 238 of the *CBCA*. However, when employees were also shareholders, they were automatically entitled to status and we saw their representation rise to 13% of all cases, (albeit with only a 2% success rate), following shareholders as the largest complainant group.<sup>26</sup> The low success rate may be explained by the fact that unlike creditors the judiciary has not found other remedial options available to employees to be problematic, and accordingly limited the application of the remedy based on those other remedial options available to employees.

Creditors accounted for only 8% of all complainants, however, with a success rate of 83%. This result can be explained in part by the judiciary taking the view that an oppression action is more appropriate than an action based on breach of fiduciary duty and in part by a growing acceptance by the judiciary of a stakeholder theory of corporate law, at least in respect of creditors. Unlike the employee complainant, the judiciary has likely taken the view that creditor applications are necessary as there are no other legal routes readily available to such aggrieved parties.

In the “other” category of complainants we saw Canadian courts granting complainant status to lessors, licensors, a trustee in bankruptcy, and a widow of a former shareholder in 9 cases (13%) with an overall success rate of 56%.

As the stakeholder and team production models of corporate law suggest, there are good reasons to hold corporations and management to a certain standard of behaviour in dealing with the interests of non-shareholders, but perhaps it is not the same standard as shareholders. It would further the goals of good corporate law to more clearly articulate which stakeholders should have access to the oppression remedy and under what circumstances and standards.

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<sup>25</sup> For example, bondholders of Canadian corporations are becoming more vigilant in asserting their rights in the background of a number of high profile reorganizations of telecommunication companies, such as PSINet and Telus.

<sup>26</sup> This result likely reflects the judiciary’s view that shareholders in a closely-held corporation have a multi-dimensional relationship with the corporation. In almost all cases where the employee/shareholder brought an action, the employee/shareholder was involved in a closely-held corporation where it was difficult to separate the employee aspect of the relationship from the shareholder aspect of the oppression: See Puri & Ben-Ishai (2003), *supra* note 22.

*Derivative Claims as Oppression Actions:* The issue of whether the oppression action should be limited to personal actions has been the subject of much current academic debate. Commentators have grappled with the issue of whether the oppression remedy should embrace actions of a derivative character in addition to those of a purely personal character.<sup>27</sup>

As Professor Jeffrey MacIntosh has written, this author too believes that statutory amendments are warranted to deal with certain supportable and unsupportable differences in procedure, costs, remedies and the substantive standard of liability as between derivative actions and oppression actions.<sup>28</sup> It is also the view of this author that the oppression remedy as it currently stands should not apply to derivative claims.<sup>29</sup>

Other scholars such as Professors Iacobucci and Davis suggest that because the absence of the leave requirement under the oppression action is matched with the absence of the entitlement to indemnification for costs and because the danger of a flood of suits is unlikely to materialize in practise, there are really no good reasons for amending the current oppression remedy or not allowing the oppression remedy to embrace derivative wrongs.<sup>30</sup>

The Puri and Ben-Ishai's empirical results indicate that out of 71 cases, only 16 cases dealt with derivative wrongs, and only one case explicitly discussed the issue of an oppression action brought for a derivative wrong. Out of the 16 cases dealing with derivative wrongs, 9 cases could be classified as both derivative and personal in nature. It would appear that the judiciary has avoided a reasoned discussion of the topic and for the most part allows derivative claims to be brought by litigants as oppression claims. The *CBCA* should be amended so that it expressly defines derivative suits and excludes them from being pursued under the oppression action, at least in the context of public companies, where even the threat of an oppression claim can have significant nuisance value.

### Appraisal/Right to Dissent

Dissent and appraisal protect shareholder interests in ways that other remedies do not. A fundamental change that has been carefully considered by all involved, who have taken into account the interests of those opposing the change but ultimately judged it to be in

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<sup>27</sup> The oppression remedy provision under the *CBCA* does not explicitly include claims made on behalf of the corporation. The *Alberta Corporations Act*, S.A. 1981, c. B-15 [as am.] explicitly provides at Subsection 234(3)(q) that the oppression remedy encompasses claims made on behalf of the corporation.

<sup>28</sup> J. MacIntosh, "The Oppression Remedy: Personal or Derivative?" (1991) 70 Can. Bar. Rev. 29

<sup>29</sup> *Ibid.*

<sup>30</sup> E. Iacobucci and K. Davis, "Reconciling Derivative Claims and the Oppression Remedy" (2000), 12 S.C.L.R. (2d) 86.



the best interests of the corporation, may not trigger the oppression remedy, but will trigger dissent and appraisal.

In a closely-held corporation, there may be no other way for the dissenting shareholder to recoup his/her investment. Without a market in the stock it may not be sold off at fair value. Therefore, for private corporations, the dissent right should not only be available, but also should be mandatory.

A shareholder in a public corporation can sell his/her shares in the market in the face of a fundamental change to the corporation that he/she is not agreeable to. However, a key problem with leaving it to the market is that the announcement of the fundamental change may cause the share price to drop and the dissenting shareholder would not be able to sell before this occurs. While the case for the appraisal remedy is not as strong as in the closely-held corporations, dissent and appraisal should nonetheless be mandatory for public corporations. As the Dickerson Report alluded to, the existence of the appraisal remedy also imposes a certain discipline on management to only bring forth value-enhancing fundamental changes because if enough shareholders dissent, the corporation's cash resources would be tied up to the point where the corporation would not be able to proceed with the transaction.

### The Derivative Action

*The Right to Bring a Derivative Action Should be Mandatory:* Provided that the oppression action cannot be used to remedy a wrong which is derivative in nature, there will be situations in which the only way to recover is through the derivative action. Therefore, contracting out of the right to such a remedy should not be permitted. In situations where corporate management is engaged in self-dealing or taking of corporate opportunities, for example, one cannot expect them to commence a suit against themselves on behalf of the corporation. As a result, corporate actors should not be allowed to opt out of the derivative suit.

*Conditions Precedent:* No further clarification is needed to the conditions precedent. The recent change to 14 days in the notice requirement allows for greater certainty and predictability. As for "good faith" and "in the interests of the corporation" requirements, these are factual matters that are better left to the judiciary and common law than to be defined within the *CBCA*.

It may be worthwhile to mention the judgment of a litigation committee in section 239. A phrase such as "the findings of an independent litigation committee may be considered by the court but shall not be decisive in determining whether an action would be in the best interests of the corporation," not unlike the provision in section 242 in respect of shareholder ratification would be appropriate.

*Contracting Out of Liability for Breaches of Fiduciary Duty:* Some U.S. jurisdictions allow for contracting out of personal liability of directors and officers of the corporation. Delaware's Title 8 s. 102(b)(7) enables shareholders to adopt a charter provision that

“opts out” from the personal liability of directors to the corporation or to stockholders for breach of fiduciary duty. As a related matter, the American Law Institute Corporate Governance Project allows a ceiling on financial liability of officers and directors for negligence.

The contracting out provision likely reflects a greater acceptance of the contractarianism view of the corporation and the U.S. reality of competition for corporate charters. It is the view of this author, that based on a proper balancing of the policy goals of corporate law and the evolution and role of corporate law in Canada, shareholders ought not be allowed to contract out, in a wholesale manner, of the right to sue for breaches of fiduciary duty under the *CBCA*.

### Pre-emptive Rights

Section 28 of the *CBCA* enables a corporation’s articles to provide for a pre-emptive right, but the default provision is that no pre-emptive rights exist. Pre-emptive rights can protect shareholders from dilution, but can also reduce flexibility in making financing decisions. Even in the absence of pre-emptive rights, the oppression remedy provides some measure of protection against dilution, even in their absence. The question is whether the default should be set to have them or not. The Dickerson Report dealt with this issue and was in favour of having default pre-emptive rights. Section 66(1) of the *BCBCA* requires pre-emptive rights unless the articles provide otherwise, but provide an exception for public corporations, for which a pre-emptive right would be needlessly complicated. *CBCA* s. 28 should not be altered because there seems to be little benefit in making a pre-emptive right the default. The authors of the Dickerson Report believed that there were insufficient measures in place to protect shareholders from dilution, but they seem to have underestimated how broad the oppression remedy would become. Balanced with the reduction in flexibility that pre-emptive rights create, it seems that these rights should only be available where shareholders specifically turn their minds to the issue, or where a court determines that such rights were part of the shareholders’ reasonable expectations.

### The Proxy System

A general problem with the proxy system is that it may chill informal communications between shareholders by creating fear that the communications will be construed as a proxy solicitation. This problem has, to a certain extent, been dealt with in the last round of *CBCA* reforms, as a number of specific exceptions to the requirement to distribute a dissident proxy circular were created. The amendments have had a positive effect on the market in respect of management accountability and transparency. For example, Ontario Teachers Pension Plan now discloses on its website how it intends to vote its proxies at upcoming annual general meetings, allowing for meaningful reflection by other shareholders on how they should vote their proxies.<sup>31</sup>

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<sup>31</sup> See <http://www.otpp.com/web/proxyvot.nsf/proxyvotes?openform>.

Notwithstanding the relaxation of proxy rules in Bill S-11, the stricter rules are still in effect under securities law statutes but they are not being enforced. This situation presents a problem of consistency and clarity for shareholders. On the one hand, shareholders are being told by the *CBCA* that certain informal communications will not trigger the proxy solicitation requirements. On the other hand, they are being told by securities laws that the definition of proxy solicitation is extremely broad and does not contain the exemptions that are currently in the *CBCA*. Layered on top of this conflicting regulation is the reality that securities regulators are not currently enforcing the relevant provisions. Where does this situation leave investors? The costs of compliance with multiple and conflicting regulation is ultimately borne by investors and the general public. When investors are unable to distinguish between securities laws on the books and securities laws in practice or action, communications among shareholders will be at a level that is less than optimal, which in turn will negatively affect management accountability. Securities laws that are not being enforced on a rational basis (as opposed to a lack of resources) should be repealed. This issue is worthy of additional detailed analysis, but as a general matter, greater co-ordination between federal and provincial corporate law regulators and provincial securities law regulators ought to be a priority for both levels of government.

### Shareholder Proposals

The rules for shareholder proposals seem to be based on fear of the activist shareholder. In large corporations shareholder participation provides a necessary level of scrutiny. However, participation is naturally discouraged by the fact that it is so much easier to vote with your feet. It seems counterproductive to make it difficult for those who actually do want to participate to do so.

One recommendation for reform that would substantially further the goals of shareholder protection and management accountability is that management should have to justify its refusal to circulate a proposal to an appropriate regulatory authority. In the U.S., management refusal is subject to a formal review by the SEC. In Canada, the shareholder must apply to the court before management's decision receives any sort of review. This makes it less likely that a worthy proposal, having been refused, will be saved and circulated.

While the SEC conducts the review in the U.S., since it is the body that promulgates rules on shareholder proposals, provincial securities regulators in Canada would not have the authority to review proposals that are a part of corporate law statutes. Implementing this recommendation would require review by the Director of the *CBCA*, which would involve a more active role than is currently taken.

There is also a need for a mechanism that ensures that management has followed-up appropriately on proposals that were approved by shareholders at an annual general meeting. Other than shareholder proposals that create, repeal or add bylaws which do not require any further action by management, most other shareholder proposal are advisory only and require management to implement them before they can take effect.

At a minimum, management should be required to report in the following year's proxy materials whether the shareholder proposals that were approved in the previous year were implemented. A reasoned justification should be provided if no follow-up action was taken. Alternatively, management's fails to implement a proposal approved by a majority of the shareholders could trigger a shareholder's right to nominate directors to the board. The SEC is currently seeking comments on this mechanism in relation to its proposed rule to allow shareholders direct proxy access to nominate directors.<sup>32</sup>

### Shareholder Discussion

Section 137(1)(b) implies that the right of discussion is only present at annual meetings. There is no valid reason not to allow discussion at special meetings, therefore, the wording should be changed to specifically allow a right of discussion at special meetings.

### Requisitioning of Meetings

The rules on requisitioning meetings should make it clear that the right under section 143(4) for a shareholder to call a meeting when the directors refuse to do so is dependant on the directors not having a justification under 143(3) to not call the meeting. As the section is currently worded, the possibility exists for the meeting to be justifiably not called by the directors (and therefore, it should not be called at all) and still be called by a shareholder.

### Access to Corporate Records

The rules for access to corporate records should be mandatory. Without access to information shareholders simply are not adequately protected, not knowing whether the directors and officers are doing a good job, or whether or not they should continue their investment.

### Right to Appoint an Auditor

The rules surrounding the auditor and audit committee fall into the category of "adequate information". These rules are a necessary part of financial disclosure, and financial disclosure is necessary to protect investors and promote confidence in the market. Therefore, these rules must be mandatory, at least for publicly traded corporations. In the private, closely-held corporation, shareholders should have the right to opt out of an audit of the financial statements. This issue is discussed in detail below.

## **D. Responding to the Needs of Smaller Closely-Held Businesses**

Most Canadian businesses are micro, small or medium sized enterprises. As early as the Dickerson Report, there has been an express policy of ensuring the *CBCA* is responsive

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<sup>32</sup> Securities and Exchange Commission, Proposed Rule: Security Holder Director Nominations, available at <http://www.sec.gov/rules/proposed/34-48626.htm>

to the needs of the different types of corporations that exist in Canada. For instance, the Dickerson Report led to the legitimization of the unanimous shareholder agreement in the *CBCA*, “improv[ing] the position of those who may wish to have a truly ‘private’ corporation.”<sup>33</sup>

The *CBCA* recognizes that the requirement to prepare audited financial statements may be cost-prohibitive for smaller private businesses. Accordingly non-distributing corporations may dispense with the requirement to appoint an auditor (section 163) with the unanimous consent of all the shareholders, including those otherwise not entitled to vote. The rules on shareholder meetings also accommodate the needs and realities of small businesses by allowing for all shareholders to unanimously sign resolution in lieu of an actual meeting. In Bill S-11, the unanimous shareholder provisions of the *CBCA* were clarified to reflect current practices, revealing a continued concern for ensuring that the *CBCA* can be effectively utilized by closely-held corporations.

This policy goal reflects an important priority area, and further clarification of *CBCA* provisions in respect of the unanimous shareholders agreement should be made. While the *CBCA* defines a unanimous shareholders agreement as an agreement that restricts in whole or in part the powers of the directors to manage the business and affairs of the corporation, the *ABCA*'s<sup>34</sup> definition of unanimous shareholders agreement is not dependent on transferring board powers to the shareholders. Consideration ought to be given to expanding the scope of the definition of a unanimous shareholders agreement to include agreements that do not necessarily transfer board powers to the shareholders. Given that the shareholders assume the liabilities of directors under a unanimous shareholders agreement, clarification also ought to be provided on whether the shareholders have director-like fiduciary duties when voting their shares. As well, further study ought to be conducted on whether the *CBCA* default provisions meet the needs of closely-held businesses.

#### **E. Attracting Business to the Jurisdiction by Inspiring Confidence and Supporting Competitiveness, Innovation and Growth**

It is difficult for a corporate law enabling statute to actively attract business to Canada and to actively make Canadian business more competitive. These policy goals are better achieved by other regulatory frameworks, instruments and tools. However, policymakers can ensure that the *CBCA* does not create unnecessary rules or requirements that make these policy goals more difficult to achieve.

The Canadian residency requirement represents one such obstacle and should be eliminated. The stated rationale for the requirement is that it fosters Canadian participation in corporate decision-making, fosters compliance with and enforcement of legal obligations, promotes Canadian participation in the decision-making of

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<sup>33</sup> Dickerson Report, *supra* note 13 at 11.

<sup>34</sup> RSA 2000 c. B-9.

multinational enterprises, and help foreign firms to understand the economic, political and social environment of Canada.<sup>35</sup> However, these rationales ought to be re-evaluated for their relevance in light of the increasingly globalized economy. In addition, one must question whether there is one Canadian viewpoint, and whether Canadian residency serves as a reliable proxy for Canadian viewpoints.

Reflecting Bill S-11's main goal of improving "the ability of Canadian corporations to compete in the marketplace"<sup>36</sup> enhancing global competitiveness,<sup>37</sup> the Canadian residency requirement for directors was reduced from a majority of the board to 25%. However, the reduction from 50% to 25% is difficult to rationalize. The residency requirement should be abolished entirely from the *CBCA*. Industry specific residency requirements should be maintained or introduced only for those business sectors for which the government believes they are essential.

## F. The Role of the Director

The *CBCA* contains several provisions that pertain to the responsibility of the Director under the Act. The Director can engage in four sets of activities under the *CBCA*:

- The Director can make an application to the court to, for example, have a meeting ordered, to commence a derivative or oppression action, or to dissolve the corporation.<sup>38</sup>
- The Director can effect certain actions or directions without applying to the court.<sup>39</sup> These include directing the corporation to change its name (s.12(2)), requiring the directors to restate the articles (s.180(1)).
- The Director has certain (discretionary and non-discretionary powers) to issue exemptions.<sup>40</sup> These include exemptions for "distributing corporation" status, exemptions for trust indenture, and exemption from the requirement for an audit committee.
- The Director has certain powers (discretionary and non-discretionary) to issue certificates.<sup>41</sup>

These responsibilities have been further defined, and in some cases circumscribed, by the courts and the Director him/herself. In *Sparling et al v. Royal Trustco Ltd. et al.*<sup>42</sup>, the

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<sup>35</sup> *Supra* note 10 at 3-4.

<sup>36</sup> *Supra* note 10.

<sup>37</sup> *Ibid.* at 2.

<sup>38</sup> Table 1, Appendix A.

<sup>39</sup> Table 2, Appendix A.

<sup>40</sup> Table 3, Appendix A.

<sup>41</sup> Table 4, Appendix A.

Director commenced an oppression action alleging that the company and its directors were in breach of the requirements of the *CBCA* by failing to disclose certain information in a director's circulate in response to a takeover bid and that shareholders would be misled as a result. The court held that the Director was entitled to commence an action on behalf of the shareholders and provided the following rationale:<sup>43</sup>

The Canada Business Corporations Act provides for the appointment of a Director, who is given wide powers in corporate affairs [... and that] it is therefore clear that the Director has broad powers of investigation and intervention on behalf of the public in corporate affairs. These broad powers are apparent in the provisions pertaining to takeover bids and those referring to oppressive and unfairly prejudicial acts affecting security holders or creditors of the corporation.

Furthermore, Justice Cory explained that,

The Director, as public protector, should be able to bring an action such as this to remedy the past wrong of non-disclosure. From a practical point of view, it is impossible to conceive of a small shareholder attempting to bring an action in a situation such as presents itself in this case. The legal costs involved might well outweigh his investment, yet he may have suffered what is to him a very substantial loss. Where a statute provides a remedy, its scope should not be unduly restricted.

The Director has also issued certain policy directives in the context of export continuance transactions<sup>44</sup> and arrangements under section 192 of the Act.<sup>45</sup> For the most part, however, the general consensus of stakeholders is that the Director of the *CBCA* historically has taken a relatively passive role in the enforcement and interpretation of the *CBCA*.

To effect some of the recommendations contained in this report, such as review of shareholder proposals by the Director, codification of certain common law rules, greater policy direction in respect of certain areas or corporate law, the Director's office will need to take a more pro-active role in administering the *CBCA*. This will, of course,

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<sup>42</sup> [1984] 45 O.R. (2d) 484, (QL) aff'd [1986] 2 S.C.R. 537 (QL).

<sup>43</sup> *Ibid.*

<sup>44</sup> Director of the Canada Business Corporations Act, *9.3 - Policy of the Director as to "Export" Transactions Under the CBCA* (Policy Statement) (Ottawa: Industry Canada, 1999).

<sup>45</sup> Director of the Canada Business Corporations Act, *15.1 - Policy of the Director Concerning Arrangements Under section 192 of the CBCA* (Policy Statement) (Ottawa: Industry Canada, 1999).

require greater resources in terms of budgeting as well as the hiring of additional specialized staff.

However, this recommendation should not take away from the recommendation that parliament should devote more parliamentary time and resources to the upkeep of the *CBCA*. Historically, the *CBCA* has not received as much parliamentary time or attention as other business law legislation, such as the *Income Tax Act*, the *Competition Act* or the *Copyright Act*. The *CBCA* has only gone through one set of major changes since its inception in 1975. There were also minor amendments in other years, but they were primarily of a cosmetic nature.<sup>46</sup>

The *Income Tax Act* is a clear example of an act that receives a great deal of attention: the act changes every year. While some aspect of the high rate of change of amendments can be attributed to the government's interest in closing up loopholes used by taxpayers and their professional advisors as well as reversing judicial decisions, some aspect of the frequency of amendments is certainly related to the high political priority that tax matters receive.

Comparison of the *CBCA* to the *Competition Act* reveals similar, though less striking, results. From 1935 to 1960, there were several changes to the *Competition Act*, (then called the *Combines Investigation Act*.) In 1966, the federal government began a legislative reform process that took 20 years to complete, with major changes in 1976 and 1986, when the *Competition Act* was enacted. Citing the rapidly changing global economy, the *Competition Act* is amended constantly, on an incremental basis, rather than waiting years to get major overhauls through the legislature. Significant amendments were made in 1999, 2000, and 2002.<sup>47</sup>

A more enabling piece of legislation, more akin to the *CBCA* than the other two legislative frameworks above, is the *Copyright Act*. Enacted in 1924, modernization did not begin until 1988. Since then, there have been significant changes in 1989, 1993, 1994, and 1996. Some of these (1989, 1994, and 1996) were a result of trade agreements, extending copyright protection. The other was an attempt to keep up with development of different forms of transmitting. The pace of change (i.e. frequency of amendments) to the *Copyright Act* has not been as rapid as to the other two mentioned, but is still higher than that of the *CBCA*. As well, there is another round of reforms under way.

Based on a comparison with the above-noted statutes, the rate of change of the *CBCA* has been relatively slow and infrequent. While this may owe in part to the *CBCA*'s role as providing an enabling framework, a commitment from the government to ensure parliamentary time for frequent amendments to the *CBCA* is critical to maintaining its

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<sup>46</sup> Many of these changes were in relation to amendments to other legislation, and had to do with the definitions in section 2 of the *CBCA*. For example, in 2002, with the amendments to the *Yukon Act*, the definition of "court" in s. 2(1) changed to reflect the change in the name of the Yukon court.

<sup>47</sup> See Suzanne Legault and Don Mercer, "Legislative Reform of the Competition Act", on the Competition Bureau website.



effectiveness. The review clause contained in Bill S-11 which requires a committee of the Senate and/or House of Commons to regularly review the provisions and operations of the *CBCA* is laudable and should go some way in ensuring that sufficient parliamentary attention is devoted to the *CBCA* in the future.<sup>48</sup>

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<sup>48</sup> Section 136 of Bill S-11 provides that:

A committee of the Senate, of the House of Commons or of both Houses of Parliament that is designated or established for the purpose shall, within five years after the coming into force of this section, and within every ten years thereafter, undertake a review of the provisions and operations of the *Canada Business Corporations Act*, and shall, within a reasonable period thereafter, cause to be laid before each House of Parliament a report thereon.

#### **4. Conclusion**

An evaluation of the *CBCA* reveals that it is effective in meeting and balancing the six policy goals and objectives of good corporate law set out in this report. The most recent round of amendments to the *CBCA* contained in Bill S-11 were instrumental in furthering the goals of protecting shareholders, inspiring confidence, innovation and growth, and responding to the needs of smaller closely-held businesses. There remains further room for improvement, however.

- In the context of enhancing economic efficiency, the government's stated goal of minimizing duplication with provincial securities regulation should be revisited. A more logical goal for the *CBCA* should be to determine which aspects of business law regulation are most appropriately contained in a corporate law statute and which aspects are better suited to be left to securities regulators.
- In the context of ensuring accountability of corporate managers, a sub-goal of this policy objective is to clearly articulate the responsibilities and duties of those we wish to hold accountable. As such, directors' duties in the context of take-over bids should be codified into the *CBCA*, the regulations or policy directives issued by the Director.
- In the context of protecting shareholders and other vulnerable parties, it should be made clear that the oppression remedy cannot be used to pursue claims that are derivative in nature. In addition, in respect of non-shareholders, additional guidance should be provided on who is a proper person to be a complainant to seek relief under the oppression remedy.
- In the context of being responsive to the needs of small closely-held corporations, the definition of unanimous shareholders agreement should be broadened so that it recognizes shareholders agreements that do not transfer board duties to the shareholders.

## Biography of Author

Poonam Puri is an Associate Professor of Law at Osgoode Hall Law School, York University. She is a graduate of the University of Toronto Faculty of Law (LL.B. Silver Medalist) and Harvard Law School (LL.M.).

Professor Puri's research expertise is in corporate law, securities law, corporate governance, corporate social responsibility, corporate and white-collar crime, bankruptcy law, and law and economics. Professor Puri was recently a Visiting Professor at Cornell Law School and is a recipient of the Osgoode Hall Law School Teaching Award.

Professor Puri is author of numerous books, articles and reports. Her books include:

- *Corporate Governance and Securities Regulation in a Post-Enron Era* (co-edited with Jeffrey Larsen)(Butterworths, forthcoming 2004)
- *Cases and Materials on Partnerships and Canadian Business Corporations* (co-authored with Doug Harris, Ed Iacobucci, Ian Lee, Jeffrey MacIntosh, and Jacob Ziegel)(Carswell, forthcoming 2004).
- *Canadian Companies' Guide to the Sarbanes-Oxley Act* (co-authored with Leslie McCallum)(Butterworths, forthcoming 2004)
- *The Sale of Goods in Canada* (co-authored with Kevin McGuinness)(Butterworths, forthcoming 2004).

Professor Puri's recent articles have appeared in the Cornell Law Review, the Osgoode Hall Law Journal, the Canadian Business Law Journal, the Canadian Bar Association Review, and the Georgetown Journal of Legal Ethics.

Professor Puri recently authored a report for the Ontario Securities Commission entitled *A Cost Benefit Analysis of the Multi-Jurisdictional Disclosure System* (with Anindya Sen). She also recently completed a report for the Federal Wise Persons Committee on Securities Regulation entitled *Local and Regional Capital Interests in the Debate on Optimal Securities Regulatory Structure for Canada*.

**Appendix A - Table 1: Applications Director Can Make to the Court**

<b>CBCA ss.</b>	<b>Subject of Rule</b>	<b>Who Can Apply?</b>	<b>Conditions</b>	<b>Exceptions</b>
144(1)	Meeting called by court (Director can apply to the court to order a meeting of shareholders)	a director, shareholder who is entitled to vote at a meeting of shareholders, or the Director	none	None
154(1)	Restraining order (Director can apply to the court where a proxy contains an untrue statement of a material fact)	an interested person, or the Director	none	None
167(1)	Court appointed auditor	shareholder or the Director	“If a corporation does not have an auditor,” and only “until an auditor is appointed by the shareholders”	“does not apply if the shareholders have resolved under s.163 not to appoint an auditor”
212(1)(b)	Dissolution by Director (by application to court for an order)	Director	none	None
229	Investigation (“application for an order directing an investigation to be made of the corporation and any of its affiliated corporations”)	security holder or the Director	“may apply, <i>ex parte</i> or on such notice as the court may require”  Where a security holder makes such an application, they must give reasonable notice to the Director, who is entitled to appear and be heard in person or by counsel.	None
239	Commencing a derivative action	s. 238 “complainant” includes a registered or beneficial security holder, present or former director or officer of corp., the Director, any other “proper person” (discretion of court)	See “conditions precedent” in s.239(2)	None
241	Application to court re oppression	same as “complainant” for derivative actions	none	None
244	Application for directions	the Director	“may apply to a court for direction in respect of any matter concerning the Director’s duties under this Act”	None
265.1 (4)	Cancellation of articles by Director: application to court	the Director or an “interested person”	if in any of their views, the cancellation would prejudice shareholders or creditors of the corporation	
265(4)	Correction of documents: Application to court	the Director, the corporation, or “any interested person who wishes a correction”	if in any of their views, a correction would prejudice shareholders or creditors of the corporation	None

**Appendix A - Table 2: Actions Director Can Effect Without Applying to the Court**

<b>CBCA ss.</b>	<b>Subject of Rule</b>	<b>Conditions</b>
12(2)	Directing change of name	If the corporation's name contravenes (inadvertently or otherwise) section 12(1), the Director may direct the corporation to change its name.
180(1)	Restated articles	the directors "shall when reasonably so directed by the Director, restate the articles of incorporation."
188(1)	Continuance	In addition to obtaining shareholder approval, the corporation must " <i>establish to the satisfaction of the Director</i> that its proposed continuance in the other jurisdiction will not adversely affect creditors or shareholder of the corporation."
212(1)(a)	Dissolution by Director	"if the corporation" ... see (i) through (iv) – basically the corp. is no longer carrying on business.  Also, "despite anything in this section, the Director may dissolve a corporation...if the required fee for the issuance of a certificate of incorporation has not been paid" 212(3.1).
235(1)	Information respecting ownership and control	"If the Director is satisfied that, for the purposes of Part XI, XIII or XVII, or for the purposes of enforcing any regulation..., there is reason to inquire into the ownership or control of a security of a corporation..."
237	Inquiries	"The Director may make inquiries of any person relating to compliance with this Act" (broad independent investigative powers, in addition to the right to apply to court for an Investigation)
264	Alteration	"the Director may alter a notice or document, other than an affidavit or statutory declaration, if authorized by the person who sent the document or by that person's representative."
265(1)	Corrections at the request of Director	if there is an error in a document, the directors or shareholders of the corporation "shall, on the request of the Director," pass the necessary resolutions, send the documents to the Director and take "such other steps as the Director may reasonably require so that the Director may correct the document."
265(3)	Corrections at the request of the corporation	the Director may "accept a correction" if it is approved by the directors (unless it is an obvious error or was made by the Director) and, the Director is satisfied that the correction wouldn't prejudice any shareholders, and the cancellation reflects the original intention of the corporation or the incorporators"
265.1	Cancellation of articles by Director	"in the prescribed circumstance, the Director may, at the request of a corporation or of any other interested person cancel the articles..." if the cancellation is approved by the directors, and it wouldn't prejudice any shareholders, and the cancellation reflects the original intention of the corporation or the incorporators" 265.1(3).

**Appendix A - Table 3: Director’s Powers (Discretionary & non-Discretionary) to Issue Exemptions**

CBCA ss.	Subject of Rule	Application Procedure	Director’s Discretion
2(6) &(7)	Exemption for “distributing corporation” status	“on the application of a corporation”	Director “ <i>may determine... if the Director is satisfied that the determination would not be prejudicial to the public interest</i> ”
10(2)	Exemption for s.10(1): Name of Corporation	this exemption may apply to a “body corporate continued under this Act”	Director “ <i>may exempt</i> ”
82(3)	Exemption of trust indenture		Director “ <i>may exempt,</i> ” if the trust indenture is subject to equivalent laws of any province or country outside of Canada
151(1)	Exemption (from sending a form of proxy under 149, or soliciting proxies under 150)	“on the application of an interested person”	Director “ <i>may exempt the person, on any terms that the Director thinks fit... which exemption may have retrospective effect</i> ”
156	Exemptions from including items in financial statements &/or publication of financial statements	“on application of the corporation”	“The Director <i>may...authorize</i> ” omissions of items and dispense with publication obligations, “and the Director <i>may, if the Director reasonably believes that the disclosure of the information contained in the statements would be detrimental to the corporation, permit any reasonable conditions that the Director thinks fit.</i> ”
171(2)	Exemption from Audit Committee	“on the application of the corporation”	“The Director <i>may...authorize</i> the corp. to dispense with an audit committee... <i>if satisfied that the shareholders will not be prejudiced,...on any reasonable conditions that the Director thinks fit</i> ”
258.2	Exemption	“In the prescribed circumstance”	“The Director <i>may, on any conditions that the Director considers appropriate, exempt from the application of any provision of this Act requiring notices or documents to be sent to the Director any notices...containing information similar to that contained in notices or documents required to be made public...</i> ”

**Appendix A - Table 4: Director’s Powers (Discretionary & non-Discretionary) to Issue Certificates**

CBCA ss.	Subject of Rule	Application Procedure	Director’s Discretion (Exceptions)
8(2)	Certificate of incorporation	“on receipt of articles of incorporation, the Director shall issue a certificate...”s.8(1)	Exception – failure to comply with the Act: “the Director <i>may refuse</i> to issue the certificate...” in the event of non-compliance with subsection 19(2) or subsection 106(1).
178	Certificate of amendment of articles	“on receipt of articles of amendment”	“Director <i>shall issue</i> a certificate...”(No explicit discretion)
185(4)	Certificate of amalgamation	“on receipt of articles of amalgamation”	“Director <i>shall issue</i> a certificate...” (No explicit discretion) But, note that as per s.185(2), the articles of amalgamation must have declarations from a director or officer that “establish” certain key things “ <i>to the satisfaction of the Director</i> ”
187(4)	Certificate of continuance (import)	Corporation may “ <i>apply to the Director for a certificate</i> ” 187(1), and the articles of continuance must be “ <i>in the form that the Director fixes</i> ” 187(3).  “on receipt of articles of continuance”	“Director <i>shall issue</i> a certificate...” (No explicit discretion) But, it seems that as per subsections (1) and (3), the Director does have discretion over issuing the certificate
187(11)	Where continued reference to par value shares permissible	“on the application of a body corporate”	“ <i>Where the Director determines...</i> the Director <i>may...permit</i> the body corporate to...”
191(5)	Certificate of reorganization	“on receipt of articles of reorganization”	“Director <i>shall issue</i> a certificate...” (No explicit discretion) But, the corporation must already have obtained a court order made under 191(1)
192(7)	Certificate of arrangement	“on receipt of articles of arrangement”	“Director <i>shall issue</i> a certificate...” (No explicit discretion) But, section 192(3) provides that the applicant “shall give the Director notice of the application and the Director is entitled to appear and be heard in person or by counsel” at the court hearing
209	Certificate of revival	“any interested person may apply to the Director” (see def’n of “interested person in 202(6))  “on receipt of articles of revival”	“the Director <i>shall issue</i> a certificate... <i>if</i> (a) the body corporate has fulfilled all conditions that the Director considers reasonable; and (b) there is no valid reason for refusing to issue the certificate.”
211(5)	Certificate of intent to dissolve & certificate of dissolution	“on receipt of statement of intent to dissolve”	“Director <i>shall issue</i> a certificate...” (No explicit discretion), because the corporation may only liquidate or dissolve with shareholder approval (211(3)).
211(11)	Certificate of revocation of Intent to Dissolve	“on receipt of statement of revocation of intent to dissolve”	“at any time after the issue of a certificate of intent to dissolve and before the issue of a certificate of dissolution, <i>a certificate of intent to dissolve may be revoked</i> ” (10) and the “Director <i>shall issue</i> a certificate...” (No explicit discretion), because shareholder approval of the revocation is necessary (211(3)).
263.1	Certificate		Director <i>may</i> provide any person with a certificate. Note: s.263.1(2) explicitly provides that, “for greater certainty, the Director <i>may refuse</i> to issue a certificate described in paragraph (1)(c) [certificate that a corporation exists as of a certain date] “if the corporation is in default of sending required documents or paying a required fee”.

## **Appendix B**