ALBERTA LAW REFORM INSTITUTE

EDMONTON, ALBERTA

# FINANCIAL ASSISTANCE BY A CORPORATION:

# SECTION 42, THE BUSINESS CORPORATIONS ACT (ALBERTA)

Report No. 54

August 1989

ISSN 037-1604
ISBN 0-8886-4155-9

## ALBERTA LAW REFORM INSTITUTE

The Alberta Law Reform Institute was established January 1, 1968, by the Government of Alberta, the University of Alberta and the Law Society of Alberta for the purposes, among others, of conducting legal research and recommending reforms in the law. Funding of the Institute's operations is provided by the Government of Alberta, the University of Alberta and the Alberta Law Foundation.

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## ACKNOWLEDGMENTS

We have had much help in forming our opinions and developing the position presented in this report. We have not invariably followed the advice received, and the Board of Directors of the Institute assumes sole responsibility for the form which the recommendations in the report have taken.

The counsel in charge of this project is Janice Henderson-Lypkie, who took on the project in mid course when she joined the Institute in late 1988. We are grateful for her industry and ability to shepherd this final report to completion.

## How to read this report

We make the recommendations contained in this report against the backdrop of research in two areas: remedies under the Business Corporations Act and under the fraudulent conveyances and preferences legislation. Both of those reseach memoranda are included in the appendices to the report in order to provide a comprehensive collection of the research in this area. We have also drawn on the research into the liability of corporate directors which was published as Research Paper No. 17. The results of this research is succinctly summarised in the body of the report.

You will receive a flavour of the recommendations by reference to the executive summary at page 1. The policy of the recommendations is set out in the body of the report. For a more comprehensive review of the remedies which are extant, if our recommendations are followed, the reader should consult the research memoranda.

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# TABLE OF ABBREVIATED REFERENCES

| | Reference | Abbreviation |
|---|---|---|
| 1. | Business Corporations Act, S.A. 1981, c. B-15 as am. | **ABCA** |
| 2. | Canada Business Corporations Act, R.S.C. 1985, c. C-44 | **CBCA** |
| 3. | Company Act, R.S.B.C. 1979, c. 59 as am. | **BCCA** |
| 4. | The Corporations Act, R.S.M. 1987, c. C-225 as am. | **MCA** |
| 5. | Business Corporations Act, 1982 S.O. 1982, c. 4 as am. | **OBCA** |
| 6. | The Business Corporations Act, R.S.S. 1978, c. B-10 as am. | **SBCA** |

# PART I - SUMMARY OF THE REPORT

## Introduction

Since its enactment in 1981, both practitioners and lenders have had difficulties with Section 42 of the Alberta Business Corporations Act (ABCA). Section 42 was intended to protect shareholders and creditors by preventing the directors of corporations from using corporate funds for personal profit. To accomplish this, Section 42 prohibits a corporation from giving financial assistance to its shareholders or directors or those of its affiliates, or to the associates of such persons, when the corporation cannot satisfy the two-part solvency test set out therein. Section 42 also prohibits financial assistance by a corporation in the purchase of its shares or those of an affiliate, again when it cannot satisfy the two-part solvency test.

Major complaints arose from the unusual two-part solvency test and the failure of Section 42 to differentiate between distributing and non-distributing corporations. Directors and their advisors had difficulty determining whether the corporation could satisfy the two-part solvency test. In addition, while most of the financial assistance prohibited in Section 42 harms the corporation granting it, there are some situations where giving financial assistance is of benefit to the corporation and in its interest. Section 42 prevented corporations in these instances from using proper financing arrangements necessary for their survival. In August 1987, the Institute issued its Report for Discussion No. 5 analyzing the practical problems raised by Section 42. In that report the Institute proposed the enactment of a new section that would specifically address these problems.

In the present report, the Institute questioned whether the stated purposes of Section 42 could be achieved by other means. It concluded that most of the intended protection for shareholders and creditors already exists in the personal and derivative actions and remedies in the ABCA, and in trust law and the law of fraudulent conveyance and fraudulent preference. The Institute recommends that Section 42 be repealed after minor modifications are made to the ABCA. It further recommends that financial assistance by a distributing corporation in the purchase of its shares be regulated under Alberta's securities legislation.

## The Analysis

The Institute tested whether Section 42 could be repealed by examining the personal oppression remedies in the ABCA, the derivative action and its procedures, and the relevant cases. It then reviewed the law of fraudulent conveyance and fraudulent preference. Finally, it tested its conclusions using common fact situations. In the process the Institute examined the potential liability of the party receiving financial assistance, directors who support the giving of financial assistance, and third-party lenders.

### (a) Actions and Remedies Available

If Section 42 were repealed, shareholders and creditors would continue to have remedies against directors who authorize financial assistance that is not in the corporation's interest. Shareholders and creditors will have no remedy where the financial assistance is in the interest of the corporation, such as when it is necessary to ensure the survival of the corporation.

#### (i) Derivative Actions

When the directors of a corporation approve giving financial assistance which is not in the interest of the corporation, they breach their fiduciary duty to the corporation. The corporation, therefore, has a cause of action against the directors. To protect the corporation, the ABCA allows "complainants" to bring a derivative action on behalf of the corporation against the directors for breach of fiduciary duty. "Complainants" include shareholders and such other persons as the courts decide are proper persons to bring an action on behalf of the corporation. Shareholders, therefore, have an express right to seek leave to bring a derivative action on behalf of the corporation against the directors for breach of fiduciary duty.

Creditors are not expressly listed as complainants in the ABCA but might be included in the general category of "proper person". In *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* (1987) 54 Alta. L.R. (2d) 289 (Q.B.), Justice McDonald concluded that to be a complainant who can bring a derivative action, the creditor must prove himself to be a person who could be reasonably entrusted with the responsibility of advancing the interests of the corporation. Once he has established his status as a complainant, the creditor, like the shareholder, can then seek leave from the court to bring an action on behalf of the corporation against the directors for breach of their fiduciary duties. The Institute agrees with this conclusion and recommends, should the *First Edmonton Place Ltd.* decision be overturned, that the ABCA be amended to expressly include a creditor as a complainant capable of bringing a derivative action (<u>but not a personal oppression action</u>).

(ii) <u>Personal Actions</u>

In many situations now prohibited by section 42, the giving of financial assistance is oppressive or unfairly prejudicial of the shareholders. The shareholders have a personal action against the corporation under section 234 of the ABCA to remedy oppressive or unfairly prejudicial treatment. The oppression remedy is of little use to creditors who will be limited to the more procedurally difficult derivative action on behalf of the corporation. In some very limited situations creditors can also use the law of fraudulent preference and fraudulent conveyance.

(b) <u>Liability of Lenders</u>

Repealing Section 42 would improve the position of lenders but would not eliminate their liability in all financial assistance situations. Repeal would remove the present impediments to debt restructuring within a corporate group. Such restructuring would become possible where it is in the corporation's interest to give financial assistance to the corporate group. However, lenders must differentiate between the interest of the corporation giving the security and the interest of the corporate group. Often these interests are the same; occasionally they differ. Where the lender knows that the financial assistance is of no benefit to the corporation granting it, the lender will be liable as a constructive trustee for the proceeds collected by the lender upon enforcement of the security given contrary to the interests of the corporation. Shareholders and creditors could obtain leave to bring a derivative action on behalf of the corporation against the lender.

(c) Disclosure

If they are to act, complainants must know that financial assistance has been given by the corporation contrary to its interest. The Institute recommends that the ABCA compel non-distributing corporations to give notice within 90 days to all shareholders of a grant of financial assistance to its shareholders or directors or those of its affiliates, or their associates. The report further recommends that Section 149 of the ABCA be amended to compel distributing corporations to make full disclosure of financial assistance to directors and shareholders. Because creditors can learn of financial assistance from public registries, or can compel such information from the debtor corporation before giving credit, the Institute did not think it necessary to require notice to creditors by either distributing or non-distributing corporations.

Financial Assistance by a Distributing Corporation in the Purchase of Its Shares

The Institute concluded that financial assistance by a distributing corporation in the purchase of its shares, or the shares of an affiliate, should be regulated under securities legislation. Such financial assistance most often arises in takeover situations, which are better supervised by securities specialists than by shareholders or creditors. However, until the necessary regulations are in place, Section 42(1)(c) must remain in force.

Recommendations

The Institute recommends that Section 42 be repealed in conjunction with:

(a) the incorporation into Section 149 of the disclosure requirements now in Section 42(4);

(b) a requirement that non-distributing corporations give notice within 90 days to all shareholders of financial assistance to shareholders and directors of the corporation and its affiliates or to their associates;

(c) the amendment of Alberta's securities legislation to regulate the giving of improper financial assistance by a distributing corporation in the purchase of its shares; and

(d) if the decision in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* is overturned, the amendment of Section 231 to include a creditor as a complainant capable of bringing a derivative action on behalf of the corporation.

# PART II - FINAL REPORT

## CHAPTER 1 - INTRODUCTION

### A. The History of the Project

In 1980 the Alberta Law Reform Institute[1] ("the Institute") issued Report No. 36, *Proposals for a New Alberta Business Corporations Act* (2 vols.). Subject to some relatively minor modifications, the Institute's draft Act was enacted as the ABCA.

As it was expected that amendments to legislation of this complexity would be necessary, the Institute and the Alberta Department of Corporate and Consumer Affairs monitored the application of the ABCA. Throughout 1986 the Institute and the Department canvassed with the bar and other interested parties several proposed amendments of the ABCA. This consultation resulted in the enactment of the Business Corporations Amendment Act, 1987, S.A. 1987, c. 15 which came into force on October 16, 1987.

The Institute and the Alberta Department of Consumer and Corporate Affairs were aware that section 42 of the ABCA was creating problems for practitioners and lenders. However, the Business Corporations Amendments Act, 1987 did not include amendments to section 42. The Institute was to undertake a more detailed analysis of these problems. This analysis resulted in Report for Discussion No. 5, *Financial Assistance by a Corporation: Section 42, The Business Corporations Act (Alberta)* ("the Discussion Report"). This was issued in August, 1987.

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1 The Alberta Law Reform Institute was formerly known as the Institute of Law Research and Reform.

## B. Summary of the Discussion Report

It is useful to summarize briefly the contents of the Discussion Report as follows.

### (1) Section 42 of the ABCA

Section 42 of the ABCA came into force on February 1st, 1982. This section was modelled after section 42 of the Canada Business Corporations Act, S.C. 1974-75-76, c. 33, as amended in 1978-79, now section 44 of the CBCA. These sections were designed to prevent the personal enrichment of directors of a corporation by the "siphoning off" of corporate funds through loans to themselves and certain unconscionable take-over practices exhibited in the 1920s and 1930s. The policy underlying both these sections is that the solvency prerequisite will provide sufficient protection for creditors and minority shareholders.

Section 42 of the ABCA applies to all corporations. The section regulates two classes of transactions. They are:

1. Financial assistance by a corporation by means of a loan, guarantee or charge on the assets of the corporation to a prohibited class. The prohibited class includes shareholders of the corporation, directors of the corporation, shareholders of an affiliated corporation, directors of an affiliated corporation, associates of shareholders of a corporation, associates of directors of a corporation, associates of shareholders of affiliated corporations and associates of directors of affiliated corporations.

2. Financial assistance provided by the corporation in connection with transactions involving a purchase of its shares by any person.

Subject to the exceptions set out in section 42(2), the section prohibits the two classes of transactions unless the corporation is solvent. In this context, solvency is of a dual nature and is defined in terms of current liquidity [section 42(1)(d)] and underlying assets [section 42(1)(e)]. The current liquidity test ensures that the corporation must be able both before and after giving the financial assistance to pay its liabilities as they become due. The underlying assets test ensures that the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan or in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, cannot be less than the aggregate of the corporation's liabilities and stated capital of all classes.

Yet even if a corporation is insolvent, it can enter into any of the six excepted transactions set out in section 42(2) which are:

> 42(2) A corporation may give financial assistance by means of a loan, guarantee or otherwise
>
> (a) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation,
>
> (b) to any person on account of expenditures incurred or to be incurred on behalf of the corporation,
>
> (c) to a holding body corporate if the corporation is a wholly owned subsidiary of the holding body corporate,
>
> (d) to a subsidiary body corporate of the corporation, or
>
> (e) to employees of the corporation or any of its affiliates
>
> (i) to enable or assist them to purchase or erect living accommodation for their own occupation, or
>
> (ii) in accordance with a plan for the purchase of shares of the corporation or any of its affiliates to be held by a trustee.

(2) Problems Arising From Section 42

(a) Failure to make a distinction between distributing and non-distributing corporations

The ABCA distinguishes between distributing corporations and non-distributing corporations. Distributing corporation is defined in section 1(i) of the ABCA. Briefly a distributing corporation is one that has distributed any of its shares to the public and has over 15 shareholders. A non-distributing corporation is not defined in the ABCA. The purpose of the ABCA in making the distinction is to divide corporations on a functional basis. It was thought a distributing corporation would have a division between management and ownership. A non-distributing corporation will not usually have such a division as the owners generally manage the corporation.

Problems arise because section 42 imposes the same prohibitions on distributing corporations and non-distributing corporations. The characteristics of the two types of corporations, the problems faced by each and the likelihood of transactions prohibited by section 42 affecting various persons concerned are substantially different. The result has been that in particular situations the prohibitions have made no sense. Therefore the differences between the two types of corporations should be taken into account.

(b) Difficulty of applying the solvency test

The dual nature of the solvency test contained in section 42 is the major source of problems associated with that section. The current liquidity test has not caused too many concerns. Modern accounting has accepted accounting techniques to determine if the test is met. The problems arise in determining if the underlying asset test has been met. The underlying asset test uses the concept "realizable value". "Realizable value" means that current value is looked at instead of historical value. Yet the financial statements prepared in accordance with generally accepted accounting principles as contained in the *Canadian Institute of Chartered Accountants Handbook* reflect historical value. The result is that directors cannot rely on financial statements without making some adjustment to determine the current value of assets. Further problems arise in determining how one evaluates "realizable value". Is it on the basis of the sale of assets for cash or on the basis of sale of a business as a going concern?

There is no doubt that the application of the solvency test has proven difficult and introduced uncertainty and expense into this area of the law. Also, the section has inhibited legitimate commercial transactions.

(c) Effect of infringing section 42

The precise effect of a transaction being in breach of a statutory provision such as section 42 has been the subject of some debate. It appears the position is that the transaction is entirely void.[2]

The protection afforded to lenders by section 42(3) has been put into doubt because of the British Columbia Supreme Court decision in *Royal Bank* v. *Stewart et al.*[3] In that case the Royal Bank lent three shareholders $62,000 to buy all the shares of a fourth shareholder. The bank insisted that the company guarantee repayment of the loan and provide a collateral mortgage for that guarantee. The court held that the guarantee fell within the ambit of prohibited financial assistance set out in the BCCA and was therefore unenforceable. The court further refused to afford the bank protection of a section similar to our section 42(3) because the bank knew the purpose of the loan was to buy shares. Therefore, the bank was not without notice of contravention of the statute which prohibited a company from giving financial assistance to anyone buying shares of the company. The result was that the bank could not recover on the guarantee granted by the corporation.

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2 *Central and Eastern Trust Company* v. *Irving Oil Ltd.* [1980] 2 S.C.R. 29.

3 (1980) 8 B.C.L.R. 77.

It was the intention that section 42(3) and similar sections would protect the third party and lenders from this result. Yet if the reasoning in *Royal Bank* v. *Stewart*[4] is applied, it is unlikely it will do so. Few banks lend money without knowing the purpose of the loan and the financial position of the corporation giving security for the loan.

(3) Recommendations Made to Restructure Section 42

The Discussion Report suggested that section 42 of the ABCA should be repealed and replaced with more workable legislation providing some degree of regulation in this area.

The Discussion Report stated that the problems of section 42 were more easily analyzed and the proposals for change more easily understood if a distinction was drawn between distributing and non-distributing corporations. It further suggested that in respect of each type of corporation, one must also analyze separately financial assistance given in connection with the purchase of shares of the corporation and financial assistance to directors and others. The recommendations of the Discussion Report were made in accordance with this scheme.

The recommendations of the Discussion Report are succinctly summarized at pages 5-6 of the Discussion Report as follows:

> a) Financial assistance to directors and other persons with respect to distributing corporations should be absolutely prohibited, but subject to certain specific exceptions. The general prohibition is appropriate because "other people's money" is at issue. These exceptions are relatively narrow, and include certain activities which may be said to be fairly incidental to the proper activities of the corporation. We also recommend some alterations to the present law as to what is meant by "other persons" - that is, persons who have some degree of association with directors.
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> b) Financial assistance to directors and other persons with respect to non-distributing corporations should not be absolutely prohibited. Corporations

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4 *Supra* n. 3.

of this kind are, in general, more akin to incorporated partnerships. Such assistance should however not be permitted save where the corporation is solvent in the sense of being able to pay its liabilities as they fall due and, for a specified period thereafter. The reason for this requirement is to protect the interests of trade creditors.

c) As to financial assistance with respect to the purchase of shares in a distributing corporation, we have tentatively recommended a distinct change in the law. The abuses in this area have historically arisen with respect to corporate takeovers and reconstructions, and routinely in corporations having some relation to each other. The traditional proscription came into being prior to the inception of modern securities regulation, and we are tentatively of the view that *any* proscriptions in this area should be removed from the corporations statute and dealt with (so far as they may be thought to need regulation) in the Alberta Securities Act. That Act is presently under review in Alberta, and we think the question of what, if any, prohibitions there ought to be could usefully be undertaken as part of that exercise, or at some future time.

d) As to financial assistance with respect to the purchase of shares in a non-distributing corporation, the traditional formula endeavours to afford protection to trade creditors. There is a substantial issue as to whether the law should continue to reflect that policy. We tentatively recommend that it should. There is then a question as to how that policy might best be given effect to. We have tentatively recommended that the directors of the company be required to restore to the company the amount of any financial assistance improperly advanced, where the company was not solvent at the time the transaction was entered into. Certain other alternative solutions are suggested, should this solution be thought inappropriate.

## C. The Consultation Process

After the Discussion Report was issued, the Institute sought the opinions of certain lawyers in respect of the application of section 42 and the recommendations contained in the Discussion Report. The lawyers were polarized into two camps: those who wanted repeal of section 42 and those that wanted it retained as it is. Few lawyers supported the middle ground position taken by the Institute in its Discussion Report.

Lenders and their lawyers see section 42 as inhibiting legitimate commercial transactions. Their concerns are with the scope of the prohibition of financial assistance and the application of the solvency test.

Lenders contend that in today's world, a business enterprise is often operated through several corporations. To secure a loan made to a business enterprise, the lender wants security from all members of the corporate group. Yet, in certain circumstances, section 42 prevents the lender from taking security from each member. Another criticism of section 42 is that it has prevented the financial restructuring of a corporate group even when it is to the benefit of the shareholders and unsecured creditors of each member of the corporate group that the restructuring take place.

It is the second prong of the solvency test, namely the underlying asset test, which causes lenders most concern. This is especially the case in the area of contingent liabilities. Section 42(1)(e) provides that the amount of any financial assistance in the form of assets pledged or encumbered to secure a guarantee must be excluded in determining the realizable value of a corporation's assets. This presents a problem where the guarantee is secured by a floating charge debenture. By the wording of section 42(1)(e) the court would be required to exclude all the corporation's assets when it determines the realizable value of the assets of the corporation. This would make many security arrangements technically in violation of section 42 and may deprive the lender of any rights to enforce the security.

Those favouring the repeal of section 42 do not advocate that persons affected by the transactions prohibited by section 42 be without remedy. They claim there are other areas of the law now in existence such as fraudulent preference legislation and the fiduciary duty of directors which will control the abuses that section 42 was aimed at without inhibiting legitimate business transactions.

Lawyers who represent creditors say there is a need for some regulation to ensure that directors of a corporation do not choose to siphon off the assets of the corporation to the very real detriment of the creditors. Their experience shows that too often it is the unsecured creditor who suffers in these situations.

## D. Current Position of the Institute

After considering the comments received in the consultation process, the Institute reviewed the remedies which would be available to aggrieved persons if section 42 was repealed. As a result of the review, the Institute now is of the opinion that section 42 can be repealed. Adequate remedies now exist which would give aggrieved parties protection against the most serious abuses that section 42 was designed to deal with. This Final Report will summarize this review and detail the Institute's new recommendations.

## E. Scope of the Report

As is discussed and supported at pages 50-60 of the Discussion Report, the Institute is of the opinion that:

(a) If an Alberta corporation is not incorporated for a specific object the doctrine of *ultra vires* is no longer applicable because section 15 of the ABCA gives a corporation the capacity, rights, powers and privileges of a natural person.

(b) *Trevor* v. *Witworth*[5] has not been extended by analogy to prohibit the granting of financial assistance by a corporation to aid a person in purchase of a corporation's shares, since no reduction in capital is involved.

Therefore, if section 42 were repealed these two doctrines would not limit the corporation's ability to grant financial assistance.

Starting from this viewpoint, our research focused on remedies available under the ABCA and the general law of fraudulent conveyances and fraudulent preferences. We did not review bankruptcy law because many creditors do not avail themselves of

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5 (1887) 12 A.C. 409 (H.L.).

this legislation because of the prohibitive costs involved. Chapters 2 and 3 contain summaries of the research undertaken. A more detailed review of the law is found in the research memorandums attached as Appendices 8 and 11.

For this report the term "prohibited financial assistance" will be defined as financial assistance which is currently prohibited by section 42.

## F. Form of the Report

The Discussion Report suggests that the distinction between distributing and non-distributing corporations is necessary when discussing prohibited financial assistance. We shall use the distinction in this report. The distinction shall be made for the two types of financial assistance regulated by section 42. This analysis will lead us to discuss four situations: financial assistance by a non-distributing corporation to directors and other persons; financial assistance by a non-distributing corporation in connection with the purchase of the corporation's shares; financial assistance by a distributing corporation to directors and others; financial assistance by a distributing corporation in connection with the purchase of the corporation's shares.

# CHAPTER 2 - REMEDIES UNDER THE BUSINESS CORPORATIONS ACT - PERSONAL REMEDIES AND DERIVATIVE ACTIONS

## A. Introduction

The ABCA has created a powerful arsenal of remedies for the shareholders and creditors of a corporation faced with a board of directors that is conducting the corporation's business in a manner that is harmful to the corporation, the shareholders or creditors. Some of these remedies are found in Part 19 of the ABCA, sections 231 to 235.[6] Section 232 allows complainants to seek leave to bring a derivative action on behalf of the corporation. Section 234 creates a personal remedy for complainants who have been oppressed, unfairly prejudiced or had their interests unfairly disregarded.

In this chapter we shall discuss the scope of the new remedies found in Part 19 of the ABCA. Subsequent chapters will address the issue of whether these new remedies are sufficiently broad to give protection to shareholders and creditors harmed by prohibited financial assistance.

## B. Complainant

### (1) Is a Shareholder a Complainant?

Only a complainant as defined in section 231 of the ABCA can avail himself of the personal remedies created by section 234 and obtain leave pursuant to section 232 to bring a derivative action on behalf of the corporation.

Section 231(b) reads as follows:

> (b) "complainant" means

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6 *See* Appendix 2.

(i) a registered holder or beneficial owner, or a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates.

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates, or

(iii) any other person who, in the discretion of the Court, is a proper person to make an application under this Part.

"Security" as defined in section 1 of the ABCA is a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation. Therefore a shareholder would be a registered holder of a security and is a complainant within the meaning of section 231(b)(i). There are many cases in which a shareholder has sought leave to bring a derivative action on behalf of the corporation. Also many shareholders have brought a personal action under section 234 or an equivalent section in another act.

(2) Can a Creditor be a Complainant?

(a) Secured creditors

A registered holder of a security as used in section 231(b)(i) has been interpreted to include secured creditors who hold security of the type which is capable of being registered under section 88.2(2) and section 88.2(5) with the Registrar of Corporations. Therefore a creditor who is a mortgagee or a holder of a debenture creating a charge is a complainant within the meaning of section 231(b)(i) . An unsecured creditor such as a landlord is not a registered holder of a security.[7]

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7 *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* (1988) 60 Alta. L. R. (2d) 122 (Alta. Q.B.). This case is under appeal.

The case of *Bank of Montreal* v. *Dome Petroleum Ltd and Amoco Canada Petroleum Company Ltd.*[8] is an example of a secured creditor bringing an action under section 234. Although the Bank of Montreal was unsuccessful in proving its case, it clearly had the right to bring such an action.

(b) Unsecured creditors

When preparing the draft Business Corporations Act, it was not the Institute's intention to give unsecured creditors the right to be complainants. In fact the Institute was wary of extending the definition of complainant to include secured creditors. The Institute's concern was that creditors might use section 234 to belittle the concept of limited liability of the shareholders of a corporation. Section 231(b)(iii) was included primarily to ensure uniformity with the CBCA and with the belief that the courts would rarely, if ever, have occasion to make use of its discretion under section 231(b)(iii). The reference in section 234 to creditors was intended only to ensure that a shareholder oppressed in his capacity as creditor would still have a remedy. It was not intended that all creditors be allowed to avail themselves of section 234.

Notwithstanding the intention of the Institute, in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*,[9] Justice McDonald held that an unsecured creditor can be a complainant if the creditor is a person who, in the discretion of the court, is a proper person to make an application under Part 19. Whether an unsecured creditor is such a person, depends on the nature of the remedy he seeks.

To be considered a complainant who can bring a derivative action, an unsecured creditor must be a person who could reasonably be entrusted with the responsibility of advancing the interest of the corporation by seeking a remedy to right the wrong allegedly done to the corporation. To be considered a complainant who can bring an

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8 (1987) 54 Alta L. R. (2d) 289 (Alta. Q.B.).

9 *Supra* n. 7.

action under section 234, the unsecured creditor must show there was some oppression or unfair prejudice or unfair disregard of his interest as a creditor. An unsecured creditor would be a proper person to bring a section 234 action in two situations. First, where the act of management of the corporation constituted using the corporation as a vehicle for committing fraud upon the creditor. Secondly, where the act or conduct of management of the corporation constituted a breach of the underlying expectation of the creditor arising from the circumstances in which the creditor's relationship with the corporation arose.

Justice McDonald stated that the goal of the court is to balance protection of the creditor's interest against the policy of preserving the freedom of action for management and the right of the corporation to deal with a creditor in a way which might be to the prejudice of the interest of the creditor or that may disregard those interests so long as the prejudice or disregard is NOT UNFAIR.

The Institute is not opposed to allowing a creditor to be a complainant who can bring a derivative action on behalf of a corporation to enforce a right or duty owed to the corporation. It is more concerned that a liberal interpretation of section 234 would abrogate the concept of limited liability of the shareholders of a corporation. Yet, Justice McDonald has taken a restrictive view of what is unfair prejudice or unfair disregard of a creditor's interest. This has alleviated the Institute's concerns in this regard.

## C. Personal Remedies

### (1) Legislative History

Section 234 of the ABCA and section 241 of the CBCA[10] have their roots in section 210 of the United Kingdom Companies Act, 1948. Section 210 created an

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10 See Appendix 3.

alternative remedy to winding up in cases of oppression. To obtain a remedy under this section, a shareholder had to establish several points. First, that the company's affairs were being conducted in a manner oppressive to some of the shareholders, including himself. Next, that the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up. Finally, that to wind up the company would unfairly prejudice the oppressed shareholders. If all this was shown, the court could with a view to bringing an end to the matters complained of, make such order as it thought fit.

The 1962 Company Law Report ("Jenkins Report") recommended expansion of the remedy created by section 210. The Jenkins Report's main concern was to avoid a restrictive interpretation of oppression. The Report recommended that the remedy cover conduct that was oppressive and those affairs that were being conducted in a manner unfairly prejudicial to the interests of certain members. The Report also thought the requirement that the facts must justify a winding-up order was unduly onerous and unnecessary. It further recommended that section 210 apply not merely to oppressive conduct, but to isolated oppressive acts.

The 1971 Proposals for a New Business Corporations Law for Canada ("Dickerson Report") noted that section 234 of the draft CBCA (which is now section 241 of the CBCA) was derived from section 210 of the United Kingdom Companies Act, 1948 and modified in accordance with the recommendations of the Jenkins Report.

The Dickerson Report quoted Lord Cooper in *Elder* v. *Elder*[11] at page 55 to sum up the standard set out in section 234 of the draft CBCA.

> [T]he essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealings, and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely.

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*11* [1952] A.C. 49.

Legislation based on section 241 of the CBCA is found in Alberta, Manitoba,[12] New Brunswick, Newfoundland, Ontario[13] and Saskatchewan.[14] Section 241 of the CBCA and legislation based on it are broader than legislation merely enacted to implement the recommendations of the Jenkins Report. The CBCA contains an extended definition of complainant which includes parties other than shareholders. Also, there is the addition of the term "unfairly disregards the interest" as a basis of remedy. The drafters of the CBCA wanted to make it clear that section 241 applies where the impugned conduct is wrongful, but not illegal.

The oppression remedy found in section 224 of the BCCA[15] was enacted to implement the recommendations of the Jenkins Report. It is not as broad as that found in the CBCA and other similar legislation.

(2) Interpretation of Section 234

(a) General principles

The introduction of section 234 was a deliberate departure from the policy of judicial non-intervention in corporate affairs. It is not a codification of the common law. Section 234 ought to be broadly and liberally interpreted to implement the legislature's intention to ensure settlement of intra-corporate disputes on equitable principles as opposed to adherence to legal rights.[16]

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12 *See* Appendix 5.

13 *See* Appendix 6.

14 *See* Appendix 7.

15 *See* Appendix 4.

16 *Keho Holdings Ltd and Oliver* v. *Noble*, (1987) 52 Alta. L.R. (2d) 195 (Alta. C.A.) and *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski, supra* n. 7.

Section 234 has been drafted to allow the court to look at isolated acts, the conduct as a whole or both to determine if the conduct complained of was oppressive, unfairly prejudicial or unfairly disregarded the interest of the complainant.

(b) Key terms

(i) Oppression

In *Scottish Co-op Wholesale Soc. Ltd.* v. *Meyer*[17] "oppression" is defined as conduct that is burdensome, harsh and wrongful or conduct that suggests a lack of probity and fair dealing in the affairs of a company to the prejudice of some portion of its members. Numerous cases have adopted this definition.

(ii) Unfair prejudice

The leading case on unfair prejudice with respect to the rights, position or interest of a shareholder is *Diligenti* v. *R.W.M.D. Operations Kelowna Ltd. et al.*[18] This was a case decided under the Companies Act, 1973, (B.C.) c. 18, section 221, the predecessor to section 224 of the ABCA. Section 221 provides relief only where there was oppression or unfair prejudice to the rights, position or interests of an applicant as shareholder. The section does not protect the rights, position or interests of an applicant as creditor, director, officer or employee.

In deciding what unfairly prejudicial meant, Justice Fulton looked at the dictionary definitions of the words "prejudice", "prejudicial" and "unfair". He held that these definitions supported his instinctive reaction that what is unjust and inequitable is obviously also unfairly prejudicial.

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17 [1959] A.C. 324, [1958] 3 W.L.R. 404, [1958] 3 All E.R. 66.

18 (1976) 1 B.C.L.R. 36 (B.C.S.C.).

(iii) Unfairly disregards the interest

In *Stech* v. *Davies and D.J.S. Music Services Ltd.*[19] Justice Egbert defined unfair disregard as to unjustly or without cause pay no attention to, ignore or treat as of no importance the interest of security holders, creditors, directors and officers of the corporation.

(3) When is the Personal Remedy Available to a Shareholder?

(a) Review of cases

The courts are willing to use section 234 to remedy situations where majority shareholders deplete the corporate assets for their benefit and to the detriment of the minority shareholders. These cases fall into three distinct fact situations: loans, financial assistance and misappropriation of corporate assets.

(i) Loans

*Jackman* v. *Jackets Enterprises Ltd.*[20] was a case involving as application under section 221 of The Companies Act, 1973 (B.C.) c. 18, as amended in 1976, c. 12 section 44. Section 221 creates a remedy for oppression and unfair prejudice. The wording of section 221 is very similar to section 224 of the BCCA.

The petitioner was the minority shareholder in Jackets Enterprise Ltd. ("Jackets") and Etsekson was the majority shareholder. Also Etsekson was the sole shareholder of Ben's Truck Parts of Canada Ltd. ("Ben's"). Jackets had been incorporated to buy land and build a building which was to be rented to Ben's. This was made possible by the assistance of Ben's in obtaining financing.

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19 (1987) 53 Alta. L.R. (2d) 373 (Alta. Q.B.).

20 (1977) 4 B.C.L.R. 358.

After the petitioner's husband was dismissed from the employ of Jackets, Etsekson ran Jackets as if it was his own company. He did not consult with the petitioner. Etsekson caused Jackets to borrow $450,000 at 12% interest. The loan was secured by a mortgage on the lands and building owned by Jackets. Jackets used the money to pay off $210,000 owing on an existing mortgage which carried interest at 10%, to pay off a debt owed to Ben's, and to lend $214,000 to Ben's. The net effect was that Jackets was paying a 2% higher interest charge on the $210,000 and there was an impairment of equity represented by the loan to Ben's which was not secured. The financial statements of Ben's did not indicate that it would be able to pay the debt owed to Jackets when the mortgage matured. The court held that the channelling of money to the benefit of Etsekson's company, Ben's, was conduct oppressive or unfairly prejudicial to the petitioner. Her equity is diminished or prejudiced proportionately by the extra borrowing from which she derives no benefit.

With the consent of Etsekson, the court ordered that Etsekson personally guarantee the payment of the loan made by Jackets to Ben's. Also the court ordered Etsekson to pay, or cause to be paid to Jackets the extra interest charges incurred on the $210,000. The court said it was empowered to order Etsekson to guarantee the payment of the loan by the general wording of section 221. This section gives the court the power, with the view to bringing an end to the matters complained of, to grant any interim or final order it considers appropriate.

In *Low and Anderson* v. *Ascot Jockey Club Limited et al.*,[21] the British Columbia Supreme Court dealt with a dispute between shareholders of a company which operated the Vancouver race track. Needless to say this company was very profitable. In settlement of a long-standing dispute among family members, the petitioners became minority shareholders in the company. After they became involved in the company they complained that the controlling shareholder paid himself a yearly management fee and bonuses of $480,000 as he had done in the past. He did this without approval of the

[21] (1986) 1 B.C.L.R. (2d) 123.

board of directors. The petitioners also impugned the company's failure to require interest to be paid on loans previously made to relatives of the majority shareholder and companies controlled by the majority shareholder or his son.

The court held that payment of the $480,000 was oppression of the petitioners because the board of directors had not fixed the remuneration. It said it was not called on to decide if such a payment would have been oppressive if the board of directors had approved it. Failure of the company to insist on receiving interest on all loans was oppressive because it had the effect of conferring a benefit upon one branch of the family to the exclusion of the others.

The court ordered the majority shareholder to repay the $480,000 to the company. It also ordered the board of directors to meet and decide two issues. First, to determine the appropriate salary and bonuses to be paid to the controlling shareholder. Secondly, to decide what steps the company should take to have the loans repaid or to collect interest at a fair rate on the loans.

In *Keho Holdings Ltd. and Oliver* v. *Noble et al.*[22] the minority shareholders of Keho Holdings Ltd. ("Keho") had obtained an order under section 207(1)(a) of the ABCA for liquidation and dissolution of Keho. The order was given because the conduct of Oliver was oppressive, unfairly prejudicial or unfairly disregarded the interests of the minority shareholder. Oliver appealed this decision. Oliver was a director of Keho and had managed the affairs of Keho successfully for over 20 years. He also exercised control over the majority of shares.

The court held that Oliver's exercise of his control of the voting power to prevent election of the minorities nominee as director was not oppressive in these circumstances. There was no underlying obligation that the minority shareholders participate in the management of the corporation. Yet, Oliver's exercise of this control of voting power to

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22 Supra n. 16.

cause the corporation to grant him a stock option for shares at one-half their fair value was oppressive and unfairly prejudicial.

Oliver had also, without reference to the board of directors, arranged for Keho to borrow $258,000 from its bank and lend this money at a higher interest rate to Gyron Petroleum Ltd. This was a corporation wholly owned by Oliver. Gyron Petroleum Ltd. did not provide security for the loan. The court held that Oliver was treating Keho as his personal domain and this conduct was prejudicial to Keho and its shareholders.

The court said that a corporation should not be wound up under section 207 if equity could be achieved by use of other remedies available under section 234. The court set aside the order for dissolution of Keho. Instead, it restrained Oliver from exercising the stock option. Also, it ordered Keho and Oliver to repay the loan within 30 days or provide security for payment therefore.

(ii) Financial assistance

One case that is of particular interest is *Westmore and Enchant Resources Ltd.* v. *Old MacDonald's Farms Ltd. and McAfee.*[23] This was an application brought under section 224 of the BCCA.[24] In 1978 Enchant Resources Ltd. ("Enchant") bought 20 shares of the capital stock of Old MacDonald's Farms Ltd. ("the Company") and made a shareholder's loan to the Company in the amount of $144,000. Later, Enchant transferred the 20 shares to Westmore, the controlling shareholder of Enchant. On April 30, 1980 Westmore transferred the 20 shares to the Company pursuant to a purchase agreement and escrow agreement.

It was a key issue in this case whether "payment of the Company's debt due to Enchant was part of the consideration for the sale to the company of Westmore's 20

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23 (1986) 70 B.C.L.R. 332 (B.C.S.C.).

24 See Appendix 4.

shares under written agreements between the parties executed as of 30th April 1980 (the purchase agreement and the escrow agreement) or whether those agreements constitute a completed sale of the shares and then a pledge or equitable mortgage thereof as security for repayment of the shareholder's loan due to Enchant . . .".[25] The court held that Westmore had not intended to transfer the 20 shares to the Company until the Company paid the debt it owed to Enchant. This was part of the consideration for purchase of the shares. Therefore Westmore was a shareholder at the time of the conduct complained of. As a shareholder, he could bring an action for relief against conduct which was oppressive or unfairly prejudicial to himself as a shareholder.

On April 1, 1982 the Company sold all of its assets for $1,500,000. The purchaser assumed payments under a debenture granted by the Company, transferred assets and cash to the Company worth $370,000 and granted a debenture to the Company to secure payment of $550,000.

The conduct complained of related to the declaration of dividends and the granting of financial assistance. On December 20, 1982 and July 2, 1983 the directors authorized the Company to pay dividends on issued and outstanding shares. A total of $270,000 was paid on shares owned by controlling shareholder, McAfee Enterprises Ltd. Dividends were not paid on the shares of Westmore. The dividends were set off against the debt McAfee Enterprises Ltd. owed to the Company. Also impugned was the transaction whereby the second debenture was discharged and the purchaser of the Company assets replaced it with two debentures. One was for the principal amount of $325,000 and the other for the principal amount of $225,000. The $325,000 debenture was granted priority over the other debenture. The debenture with priority was assigned by the Company to a bank to secure the personal indebtedness of John and Brenda McAfee, directors of the Company. John McAfee was the only shareholder in McAfee Enterprises Ltd., the controlling shareholder of the Company.

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25 *Supra* n. 23 at 335.

The Company was solvent when it declared the dividends and when the debenture was split and assigned. At that time there was no indication that the purchaser of the Company's assets would default on payment under the two debentures. John McAfee honestly thought that the $225,000 debenture would be paid and that the Company would use this money to repay the debt owed to Enchant. It happened that the purchaser did default on payments under both debentures. The assignee enforced the $325,000 debenture to satisfy payment of the personal debts of John and Brenda McAfee. There were no assets left to satisfy the debt of $225,000 owed to the Company and secured by the second debenture.

The court viewed the declaration of the $270,000 dividend to McAfee Enterprises Ltd. as reducing the Company's ability to pay the debt it owed to Enchant. Against the background of the declaration of the dividends, the transaction involving the splitting of the debenture and assignment of the debenture with priority was conduct which was unfairly prejudicial and oppressive to Westmore as shareholder. The court was willing to say that even if the Company owed Westmore money for repayment of a shareholders loan made by Westmore, non-payment of the shareholders loan in these circumstances would be oppression of the shareholder in his capacity as shareholder and not just in his capacity as creditor. He viewed the shareholders loan as an investment on behalf of a creditor that cannot be distinguished from share capital.

Since the Company had no assets, the court ordered the Company and John and Brenda McAfee to complete the Company's purchase of Westmore's shares. They were ordered to pay to Westmore, in trust for Enchant, the balance owing on Enchant's shareholder loan with interest. The court justified the making of such an order on the basis that John and Brenda McAfee received the benefit of the assignment of the debenture for their personal use without consideration of any kind flowing to the Company.

The company argued that this was really an issue of whether a preference had been made and this should be dealt with in an appropriate action. The court rejected this argument on the grounds that where the Company was not affluent and the stakes are not high the Court should make an order which reduces litigation, not encourages it.

Section 234 of the ABCA is broader than section 224 of the BCCA. The result is that a shareholder who is oppressed in his capacity as creditor and not in his capacity as shareholder would still be able to seek a remedy under section 234 of the ABCA. The problems the court had in finding oppression of Westmore in his capacity as creditor would not arise in Alberta.

(iii) Misappropriation of corporate assets

There are many cases where controlling shareholders or directors have misappropriated corporate assets for their personal use. Minority shareholders have successfully challenged such conduct on the basis that it was oppressive or unfairly prejudicial to the minority shareholders. See the cases discussed at pages 177-181 of Appendix 8.

(4) When is the Personal Remedy Available to a Creditor?

*First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*[26] is the only case where a court has carefully considered when, if ever, a creditor can avail itself of section 234 of the ABCA. Therefore, it is useful to review this decision in detail.

The applicant was the owner of a downtown office building. The three individual respondents were lawyers who were associated together. In 1984 the applicant and the lawyers negotiated a 10 year lease. The lease was taken in the name of the corporate respondent, of which the lawyers were the only shareholders and directors. The lawyers were not called upon to give personal guarantees. As an incentive to the lawyers agreeing to lease the premises, the applicant agreed that the corporate respondent would

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26 *Supra* n. 7.

pay no rent for the first 18 months of the term. The applicant also paid to the corporate respondent a cash payment of $140,000. After the lease was executed, the lawyers occupied the premises without entering into a formal sublease with the corporate respondent. The $140,000 was paid to the three lawyers for their personal use. The lawyers occupied the premises for 21 months and then departed. The corporate respondent paid rent for the last three months.

The applicant sought leave to bring a derivative action on behalf of the company and in the alternative sought relief under section 234.

As earlier discussed, Justice McDonald held that a section 234 remedy is available to creditors where the corporation has acted in a manner that is oppressive or unfairly prejudicial to or in unfair disregard of the interests of the creditor. At pages 145 and 146, Justice McDonald stated:

> The s. 234 remedy would be available if the act or conduct of the directors or management of the corporation which is complained of amounted to using the corporation as a vehicle for committing fraud upon a creditor.
>
> Assuming the absence of fraud, in what other circumstances would a remedy under s. 234 be available? In deciding what is unfair, the history and nature of the corporation, the essential nature of the relationship between the corporation and the creditor, the type of rights affected and general commercial practice should all be material. More concretely, the test of unfair prejudice or unfair disregard should encompass the following considerations: the protection of the underlying expectation of a creditor in its arrangement with the corporation, the extent to which the acts complained of were unforeseeable or the creditor could reasonably have protected itself from such acts, and the detriment to the interests of the creditor. The elements of the formula and the list of considerations as I have stated them should not be regarded as exhaustive. Other elements and considerations may be relevant, based upon the facts of a particular case.

Later on in his decision, Justice McDonald applied these principles to the facts in question. He decided that this was not a case in which the conduct of the directors or management of the corporation constituted using the corporation as a vehicle for committing a fraud *upon the applicant*. However, he suggested the conduct of the directors may constitute fraud against the corporation. In deciding whether the corporation had acted in a manner that was unfairly prejudicial to or in unfair disregard of the landlord, he held at page 152:

> Second, the court might hold that the applicant is a "proper person to make an application" for an order under s. 234 if the act or conduct of the directors or management of the corporation, which is complained of, constituted a breach of the underlying expectation of the applicant arising from the circumstances in which the applicant's relationship with the corporation arose. For example, where the applicant is a creditor of the corporation, did the circumstances, which gave rise to the granting of credit, include some element which prevented the creditor from taking adequate steps when he or it entered into the agreement, to protect his or its interests against the occurrence of which he or it now complains? Did the creditor entertain an expectation that, assuming fair dealing, its chances of repayment would not be frustrated by the kind of conduct which subsequently was engaged in by the management of the corporation? Assuming that the evidence established the existence of such an expectation, the next question would be whether that expectation was, objectively, a reasonable one.
>
> Thus, in the present case, an inquiry would properly be directed at trial toward whether the lessor, First Edmonton Place, at the time of entering into the lease, consciously and intentionally decided to contract only with the numbered company, and not to obtain personal guarantees from the three lawyers. A further proper inquiry would be into whether the lessor entered into the lease fully aware that it was not protecting itself against the possibility that the corporation might pay out the cash advance to the lawyers, leaving no other assets in the corporation, and that the corporation might permit the lawyers to occupy the space without entering into a sub-lease either for ten years or for any lesser period.

Justice McDonald dismissed the landlord's application to bring a section 234 action on the ground that it was not a complainant within section 231(b)(iii) because there was no evidence before him to suggest unfair prejudice or unfair disregard.

He also held that even if the landlord was a complainant, the landlord could not avail itself of section 234 because it was not a creditor at the time of the action complained of. At that time the corporate respondent paid the $140,000 to the lawyers, there was no rent owing under the terms of the lease.

### (5) What Effect Does Shareholder Approval Have?

Section 235(1) provides that the court may take shareholder approval into account when making an order under section 234. However, the court cannot stay or dismiss the action for that reason only. The weight given by the court to shareholder approval will depend on the circumstances. If the wrongdoers are also the shareholders who approve the conduct, little or no weight will be given to the shareholder approval. If the shareholders approving the conduct are in the same position as the complainant and gave consent with full knowledge of the facts, then such approval would be an indication that those shareholders condoned the conduct on the basis that is was a mere error in judgment.

In *Redekop* v. *Robco Construction Ltd.*[27] a director of Robco Construction Ltd. ("Robco") bought shares in C.F.R. Properties Ltd. ("C.F.R."). Then, Robco and C.F.R. entered into a contract which was profitable to the director. A minority shareholder of Robco said this conduct was oppressive within the meaning of section 221 of the Companies Act, 1973 (B.C.) c. 18. The court held that it was even though Ramsey, another minority shareholder of Robco had no objection to the contract between Robco and C.F.R. The court did not see this as significant because Ramsey was an employee of Credit Foncier, the controlling shareholder of C.F.R.

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27 (1978) 89 D.L.R. (3d) 507 (B.C.S.C.).

(6) Powers of the Court Under Section 234

Section 234(3) creates an impressive arsenal of remedies available to the court to redress conduct that is oppressive, unfairly prejudicial to or in unfair disregard of the complainant's interest. A copy of this section is found in Appendix 2.

In most of the cases involving misappropriation of corporate assets, the court has ordered the corporation or the majority shareholders to purchase the shares of the minority shareholders. This is one of the specified remedies listed in section 234(3). Yet the court is not limited to giving the specific remedies outlined in section 234. The court has a broad power to give any interim or final order it thinks fit in order to remedy the matters complained of.

In exercise of their broad power to give any interim or final order they think fit to remedy the matters complained of, the courts have given the following orders:

(a) *Keho Holdings Ltd. and Oliver* v. *Noble et al.*[28] The Alberta Court of Appeal enjoined Oliver from exercising the share option and Keho from accepting the option. It also held that if Keho and Oliver were to avoid liquidation of Keho, the loan must be repaid within 30 days or Keho and Oliver must secure the loan.

(b) *Jackman* v. *Jackets Enterprises Ltd.*[29] The court ordered the majority shareholder of Jackets to guarantee a loan made by Jackets to Ben's. Ben's was another company owned by the majority shareholder. Also the majority shareholder was required to pay, or cause to be paid, to Jackets the extra interest charges incurred or to be incurred by Jackets on the original borrowing of $210,000.

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28 *Supra* n. 16.

29 *Supra* n. 20.

(c) *Low and Anderson* v. *Ascot Jockey Club et al.*[30] The court ordered the majority shareholder to repay to the company the $480,000 improperly paid to him as salary and bonuses. The court also ordered the board of directors to meet and determine two issues. What amounts are proper as a salary and bonus? What steps should the company take to receive immediate payment of the loans or interest on the loans?

(d) *Westmore and Enchant Resources Ltd.* v. *Old MacDonald's Farms Ltd et al.*[31] The corporate assets were depleted for the benefit of the individuals and this prevented the Company from performing the contract. The court ordered the Company and two individuals to perform the contract entered into by the Company.

These cases show that the courts, in certain circumstances, will order the persons benefiting from the impugned conduct to remedy the loss suffered by the minority shareholders. This is important because in situations where section 42 of the ABCA is contravened the corporation is insolvent.

Under section 234(3)(l) the court has the power to grant an order compensating an aggrieved person. In the Institute's Report No. 36, *Proposals for a New Alberta Business Corporations Act*, V. 2, p. 329, the Institute said that it was unclear if this section created a new cause of action for damages against another person for oppression. It appears to do so, but the courts may interpret it as a procedural means of enforcing one which would arise under the present law. If section 234(3)(l) is not seen as creating a new cause of action for damages for oppression or if the courts will not make such an order under their general power created by section 234, then the personal remedy will be of limited use when the directors strip the corporation of its assets.

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30 *Supra* n. 21.

31 *Supra* n. 23.

Consider the case of *Liu et al.* v. *Sung et al.*[32] which involved an application under section 224 of the BCCA.[33] The plaintiff claimed against the directors of Worldview Television Limited ("Worldview"), and the trustee in bankruptcy of Worldview for an order pursuant to section 224 of the BCCA. The plaintiff alleged that the affairs of Worldview had been conducted or the powers of the directors had been exercised in a manner oppressive to the plaintiffs. In the alternative, the plaintiff alleged that some act of Worldview had been done that was unfairly prejudicial to the plaintiff. From the facts plead the court concluded that the predominant motive of the directors was to gain control of Worldview's assets. The court held that this created a cause of action for the company, but not for the shareholders, unless some rights were available under section 224(2). The court concluded that section 224 was of no help to the plaintiffs. The court's rationale is set out at page 241:

> Although some of the cases under s. 224(2) refer to an award of "damages", they really deal with fixing a notional price for the sale of the oppressed member's shares. The statutory remedies set out in that section are remedies directed against the company, or involving its shares, record or actions. I see no authority in the section for awarding damages simpliciter against individuals in the circumstances and manner requested here.

One may be able to distinguish this case on the basis that remedies created by section 234 are broader than those created by section 224. Yet, if the reasoning in this decision is followed, it severely limits the use of the oppression remedy where the result of the director's oppressive conduct is to leave the corporation penniless. Even if the court is unwilling to make an order against defendants who are not directors, there is no reason why directors stripping the company of its assets cannot be held responsible. The court could order those directors to buy the shares of the applicant. The value of the shares would be determined on the basis that the assets of the corporation and its

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32 (1988) 39 B.L.R. 236 (B.C.S.C.).

33 *See* Appendix 4.

opportunities were not removed by the directors' elaborate scheme. It could also order the directors to return the assets to the corporation or the value thereof.

## D. Derivative Actions: Section 232

### (1) Relationship Between Derivative and Personal Actions

A derivative action is one where the shareholder is the self appointed representative of the corporation, suing to enforce a right the corporation has and doing so for the corporation's benefit. If the action is successful, the result is a judgment in favour the corporation against the named defendants. The shareholder would receive nothing more than his expenses. Before the enactment of section 232 the action was brought in the name of the shareholder suing on behalf of himself and all other shareholders except the wrongdoers. The other shareholders were named as plaintiffs to ensure that the judgment bound them. The corporation was named as a defendant so judgment could be given in its favour. Section 232 now provides that such actions be brought in the name of the corporation. The remedy typically sought in such an action is damages for breach of the directors' fiduciary duty to the corporation.[34]

A personal action is an action brought by a shareholder to enforce a personal right of the shareholder against the corporation. Traditionally, the most common personal rights of a shareholder were the right to receive timely and informative notice of company meetings, the right to vote at such meetings, the right to have a properly executed proxy accepted and the right to inspect certain of the company records.[35] The remedy typically sought in this type of action was a declaration or injunction.

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34 Institute of Law Research and Reform, Report No. 36, *Proposals for a New Alberta Business Corporations Act* (1980) 138.

35 Stanley M. Beck, "The Shareholders' Derivative Action" (1974) 52 *Can. Bar Rev.* 159 at 169-70.

A shareholder can bring a personal action on behalf of himself and other shareholders with the same interest. This is known as a class action. It is still a personal action, not a derivative action.

There is confusion between derivative actions and personal actions because some acts or omissions may inflict a wrong upon both the corporation and the shareholder. In some situations the same conduct will create a derivative cause of action and a personal cause of action. In other situations only a derivative cause of action will arise. One must differentiate between the two because a derivative action cannot be brought without leave of the court under section 232.[36] A personal action is brought as of right.

In *Goldex Mines Ltd.* v. *Revill et al.*[37] the Ontario Court of Appeal dealt with the distinction between a derivative action and a personal action. The court held that an individual cause of action exists if the injury does not arise simply because the corporation itself has been damaged and as a consequence of the damage to it, its shareholders have been injured. If the shareholder has been injured by a wrong done to the corporation which causes a decrease in the value of shares held by the shareholder, the shareholder does not have a personal action. The court held that the holding of annual meetings and election of directors after the sending of a misleading information circular by the directors was a breach of the directors' fiduciary duty to the corporation and a breach of the duty owed to the shareholders. The shareholders are entitled to adequate information from which they can make intelligent business decisions. Therefore the court held that part of the writ would support a personal action. However, claims for relief that were personal and derivative were inextricably woven together and leave to bring the derivative action had not been obtained. Therefore the

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36 Authority for this statement is given at p. 40 of this report.

37 (1974) 54 D.L.R. (3d) 672.

court struck out the entire writ. In this case the limitation period to bring the actions had not expired.[38]

(2) Is Leave of the Court a Prerequisite to all Derivative Actions or Does the Rule in *Foss* v. *Harbottle* still have some Application?

(a) The rule in *Foss* v. *Harbottle*

In *Foss* v. *Harbottle*[39], it was held that only the company itself could sue to remedy a wrong done to the company. If the shareholders in a general meeting could affirm a director's breach of fiduciary duty, individual shareholders could not bring an action to enforce the company's rights. This was so even if such a general meeting had not been held.

The rule in *Foss* v. *Harbottle* gave effect to the principles of corporate personality and majority rule. The principle of corporate personality dictates that a company is a legal entity, separate from the individuals involved in its operation. Under the principle of majority rule, the majority must determine when the corporation will bring an action to remedy a wrong. Later cases extended the rule to prevent the court from interfering with decisions arrived at irregularly, but where the subject matter of the decision still fell within the scope of the corporate powers.

To give some relief in situations where the wrongdoers were the persons controlling the corporation, the courts developed four exceptions to the rule in *Foss* v. *Harbottle*. The exceptions are:

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38 This case was decided under companies legislation that did not create a remedy for oppression or unfair prejudice. This remedy was not enacted in Ontario until the OBCA came into force. Under the oppression remedy, shareholders are now obtaining personal remedies in some situations where such relief was historically denied. See the discussion at p. 195 of Appendix 8.

39 (1843) 2 Hare 461.

(1) where a company acts or proposes to act beyond its powers.

(2) where a company acts in a way that requires the as yet unobtained authority of more than a simple majority

(3) fraud on the minority

(4) where the personal rights of the shareholder are infringed

In these situations the shareholders could bring an action in their own name. Category (4) is really a situation where the rule is inapplicable because the shareholder is bringing a personal action. The other three categories are situations where the shareholders would be able to bring representative actions on behalf of the corporation.

(b) Has section 232 abolished the rule in *Foss* v. *Harbottle*?

The ABCA does not specifically repeal the rule in *Foss* v. *Harbottle* because the Institute thought that this should be a matter left up to the courts. To date an Alberta court has not made a ruling on this issue. However, in other provinces this issue has been addressed. The courts have held that sections similar to section 232 of the ABCA abrogate the rule in *Foss* v. *Harbottle.* See *Farnham et al.* v. *Fingold et al.*[40], *Goldex Mines Ltd.* v. *Revill et al.*[41] and *Shield Development Company* v. *Snyder et al. and Western Mines Limited.*[42] It is submitted that the reasoning applied in *Farnham et al.* v. *Fingold et al.* and *Shield Development Company* is applicable. Therefore in Alberta a complainant wishing to bring a derivative action must get leave of the court to do so.

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40 (1973) 33 D.L.R. (3d) 156 (Ont. C.A.).

41 *Supra* n. 37.

42 [1976] 3 W.W.R. 44 (B.C.Q.B.).

(3) <u>When Will the Court Grant Leave for the Complainant to Commence a Derivative Action?</u>

(a) <u>Section 232 of the ABCA</u>

Section 232 of the ABCA[43] provides that a complainant may apply to the Court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries. Leave cannot be granted unless the court is satisfied that:

> (a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the Court under subsection (1) if the directors of the corporation or its subsidiary do not bring the action,
>
> (b) the complainant is acting in good faith,and
>
> (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought.

(b) <u>Principles governing the exercise of the court's discretion</u>

Even though a shareholder or creditor establishes that he is a complainant within the meaning of section 231, he must still obtain leave of the court under section 232 to commence a derivative action on behalf of the corporation. The general attitude of the courts is to grant leave where all the statutory prerequisites have been met.[44] Yet even where the prerequisites of the statute are met, the court can still refuse to grant leave. It may refuse to grant leave when the statute provides a more appropriate remedy elsewhere or where the personal and derivative claims are insufficiently distinguished.[45]

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43 See Appendix 2

44 *See Re Marc-Jay Investments Inc. and Levy et al.* (1974) 50 D.L.R. (3d) 45 (Ont. H.C.) and *Armstrong* v. *Gardener* (1978) 20 O.R. (2d) 648 (Ont. H.C.).

45 *See Johnson* v. *Meyer* (1985) 57 Sask. R. 161 (Sask. Q.B.) and Welling, *Corporate Law in Canada*, p. 511.

At page 47 of *Re Marc-Jay Investments Ltd. and Levy et al.*[46] the court explained when it would give leave to a complainant to bring a derivative action:

> It is obvious that a Judge hearing an application for leave to commence an action, cannot try the action. I believe it is my function to deny the application if it appears that the intended action is frivolous or vexatious or is bound to be unsuccessful. Where the applicant is acting in good faith and otherwise has the status to commence the action, and where the intended action does not appear frivolous or vexatious and could reasonably succeed; and where such action is in the interest of the shareholders, then leave to bring the action should be given.

(4) <u>What is the Effect of Shareholders' Approval of the Directors Actions?</u>

Under the rule in *Foss* v. *Harbottle* the possibility that the shareholders might approve the conduct of the directors was, with exceptions, a bar to an action by a shareholder alleging breach of duty owed to the corporation. Section 235(1) was enacted to abolish this part of the rule. Section 235(1) provides that an application under Part 19 shall not be dismissed by reason only that it is shown the alleged breach of a right or duty owed to the corporation has been or may be approved by the shareholders. However, evidence of the approval of the shareholders may be taken into account by the court.

When preparing section 235(1) of the proposed ABCA, the Institute contemplated that the ratification of the breach of a right or duty owed to the corporation would be relevant to the issue of whether it appears to be in the interest of the corporation that the derivative action be brought. If the misconduct was ratified by the wrongdoers casting their votes as shareholders, evidence of shareholder ratification would carry little weight. Yet if disinterested shareholders ratify the conduct of the directors it is some indication that they thought the conduct could be dismissed as a

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46 *Supra* n. 44.

mere error of business judgment. Therefore it may not be in the interest of the corporation that the action be brought.

The following cases have taken this approach: *Re Northwest Forest Products Ltd.*,[47] *Bellman et al.* v. *Western Approaches Limited et al.*[48] and *LeDrew* v. *LeDrew Lumber Company Limited.*[49]

(5) Duties Owed by Directors to the Corporation

(a) Duty of care, diligence and skill

(i) At common law

The leading authority on the common law duty of care, diligence and skill owed by a director to the corporation is the case of *Re City Equitable Fire Ins. Co.*.[50] At pages 428-29 Romer J. set out the duties of directors as follows:

> (1.) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience . . ..
>
> (2.) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.

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47 [1975] 4 W.W.R. 724 (B.C.S.C.).

48 (1981) 17 B.L.R. 117 (B.C.C.A.).

49 (Nfld. S.C. T.D.), Sept. 23, 1988 unreported to date.

50 [1925] 1 Ch. 407 (C.A.).

> (3.) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director, is, in an absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

### (ii) Statutory duty

Recognizing the inadequacy of the common law duty of care, diligence and skill, the modern corporation acts have included sections which change the test from a subjective one to an objective one. A representative example of such a statutory duty is found in section 117(1)(b) of the ABCA. This section provides that every director and officer of a corporation in exercising his powers and discharging his duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.[51]

In *Grindrod & District Credit Union et al.* v. *Cumis Insurance Society, Inc.*[52] the court had cause to interpret The Credit Union Act (B.C.). This Act provides "that every director, in exercising his powers and performing his functions, shall exercise the care, diligence and skill of a reasonably prudent person". The court compared the statutory standard to the three propositions set out in *Re City Equitable Fire Ins. Co.* which are quoted above. It concluded that the statutory standard is more stringent than proposition one. The test created by the statute is an objective one. The court said, ". . . in determining what degree of skill is required of a director, the Court must use the standard of the reasonable man with no reference to the knowledge and experience of the board of directors in this particular case".[53] The court still considered the third proposition to apply under the statute. Therefore if the directors do not have skill in operating a credit union they can rely on expert officials. The directors can rely on the

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51 For a more detailed review of this area see Institute of Law Research & Reform, *Corporate Directors' Liability*, Research Paper No. 17 (February 1989).

52 (1983) 4 C.C.L.I. 47 (B.C.S.C.).

53 *Ibid.* at 59.

official to carry out his responsibilities honestly, provided there is no prior misconduct on the part of the official.

(b) Fiduciary duties

(i) The common law

We shall now broadly outline the common law fiduciary duties owed by a director or senior officer to the corporation. These duties were developed by the Courts of Equity over several hundred years. This outline is based on a review of Ellis, *Fiduciary Duties in Canada*, (1989), Waters, *Law of Trusts in Canada*, (1974) and Welling, *Corporate Law in Canada*, (1984).

A director or senior officer owes a duty to the corporation of utmost good faith and heightened loyalty which compels the fiduciary to always act in the best interest of the corporation. In evaluating whether there has been a breach of fiduciary duty, any act of the director or senior officer will be evaluated on the basis of whether the act was in the best interests of the corporation. It is this departure from the adherence to the best interests of the corporation that constitute breach of the fiduciary duty. The motive of the director is irrelevant. Therefore even though a director has acted honestly, he will still be liable for breach of his fiduciary duty. Absence of malice will not validate a breach of fiduciary duty.[54]

A breach of fiduciary duty can arise in an infinite variety of situations. The most common breaches are management manipulation for the advantage of the directors or senior officers and the making of secret profit, that is, profit not approved by the shareholders. When the directors manipulate the management of the corporation to achieve personal benefit, they have breached their fiduciary duty because they are not acting in the best interests of the corporation. This argument is often made when the

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54 *Regal (Hastings) Ltd.* v. *Gulliver* [1942] 1 All E.R. 378 at 381.

directors issue shares in face of an unwanted takeover bid. Any profit enuring to the benefit of the director from an opportunity presented to him as a result - and only as a result - of his being a director must be disgorged to his corporation, unless there is a contrary agreement ratified by the shareholders with respect to the specific transaction. Absent such an agreement, any personal profit is repugnant to the best interests of the corporation. Such conduct can only be ratified by the shareholders after complete disclosure. This liability to account arises because a director is strictly prohibited from putting himself in a position of conflict between his personal interest and his duty to the corporation. In such a situation the presence or absence of good faith is irrelevant. Also the fact that the corporation cannot avail itself of the business opportunity will not relieve the director of his liability to account.

(ii) Statutory duties

The fiduciary duties imposed upon directors by equitable principles have been set out in the new business corporation legislation enacted in several provinces in Canada. Section 117 of the ABCA enacts:

> 117(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation.

This and similar legislation is seen as a codification of the fiduciary duties created by the courts. It is submitted that the principles dealing with fiduciary duties of directors and officers which were developed by the courts will still be applicable under the application of section 117.

The problem of directors having a personal interest in material contracts made with the corporation has been addressed specifically in section 115 of the ABCA. This section requires a director who is a party to a proposed material contract or has a material interest in any person who is a party to a proposed material contract to disclose in writing to the corporation the nature and extent of his interest. Subject to certain exceptions, the interested director cannot vote on any resolution to approve the contract. If the director discloses the nature and extent of his interest in accordance with the Act, the contract is not void or voidable by reason only of the relationship as long as the directors or the shareholders approved the contract and the contract was fair and reasonable to the corporation. If the director fails to disclose his interest in a material contract, the court may on application of the corporation or a shareholder set aside the contract on any terms it thinks fit.

This section substantially reflects the common law position. However it contemplates approval by the "directors or shareholders" as opposed to common law requirement of shareholder approval.

(iii) Remedies

The breach of the duty of care, diligence and skill creates a cause of action in the corporation for negligence. However, as the common law duty of care was very subjective directors were rarely found liable for negligence. The new objective standard created by section 117 may make this a more useful remedy to corporations complaining of the negligence of directors.

When a director acquires a profit by reason of his office as director, he must account to the corporation for the profit. There is a divergence of opinion as to whether the director holds such profit on trust for the corporation.

If a director uses corporate assets to generate profit for himself, he holds the profits in trust for the corporation. Corporate property under the control of directors must be applied for the specified purposes of the corporation. The directors are trustees of the corporate assets and like any other trustee are liable for breach of trust in respect of the assets.[55] Therefore when the director uses corporate assets to make himself a profit, he is in breach of trust. The profit is attributable to the use of corporate assets and is the property of the corporation itself. The director holds the profits in trust for the corporation.[56]

A director can misapply corporate assets in breach of his fiduciary duty and thereby cause loss to the corporation. Even if he does not gain personally, he is liable for his breach of trust because he is a trustee of the property. The director must reimburse the corporation for its loss.[57]

There are also situations where the director breaches his fiduciary duty without misapplying corporate assets. The corporation suffers harm but the director does not gain personally. Historically the equitable remedy of compensation would be granted against a trustee or other fiduciary to compel restitution for the loss suffered because of his breach of duty. Yet in practice this remedy and the common law remedy of damages are often not distinguished. There may be no useful purpose in keeping them distinct.[58] In *Guerin* v. *The Queen*[59] Chief Justice Dickson and three other judges awarded damages for breach of a fiduciary duty. The quantum of damages was determined by analogy to trust laws and was assessed on the basis of a breach of a trust of a trustee.

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55 *Selangor United Rubber Estates, Ltd.* v. *Craddock and Others (No. 3)* [1968] 2 All E.R. 1073 (Ch. D.) and *Angus* v. *R. Angus Alberta Limited et al.* (1988) 50 D.L.R. (4th) 439 (Alta. C.A.), but see the conflicting authority of *J.L.O. Ranch Ltd.* v. *Logan (estate) and Logan* (1987) 54 Alta. L.R. (2d) 130 (Alta. Q.B.).

56 B.L. Welling, *Corporate Law in Canada* (1984) 408.

57 *Selangor United Rubber Estates, Ltd.* v. *Craddock and Others (No. 3), supra* n. 55 and *Angus* v. *R. Angus Alberta Limited et al., supra* n. 55.

58 L.C.B. Gower, *Gower's Principles of Modern Company Law* (4th ed. 1979) 607.

59 [1984] 2 S.C.R. 335.

Will the nature of the remedies change now that the fiduciary duty has become a statutory duty? We believe this will not happen. However it may now be described as damages for breach of statute as it was in *Beamish* v. *Solnick*.[60]

(6) Restrictions on Powers of Directors to Authorize the Corporation to Grant Financial Assistance

(a) General analysis

Subject to a unanimous shareholder agreement, the power to authorize the corporation to grant financial assistance lies with the directors.[61] Restrictions on the exercise of this power are found in the ABCA. Restrictions may also be found in a unanimous shareholder agreement or the articles and by-laws. For the purpose of this discussion we shall assume that there are no restrictions on the directors powers contained in any unanimous shareholder agreement, or the articles and by-laws.

What restrictions are now imposed by the ABCA on the directors power to authorize the corporation to grant financial assistance? The first such restriction is created by section 42 itself. Subject to the exceptions created by section 42(2), if a corporation cannot meet the solvency tests established by section 42, it cannot give the financial assistance contemplated by section 42. The recipients of funds or property transferred in contravention of section 42 must restore the funds or property to the corporation. Directors who authorize prohibited financial assistance are liable under section 113 to restore to the corporation the money paid by the corporation in contravention of section 42.

If the corporation satisfies the solvency tests of section 42, are there any restrictions upon the directors power to authorize the corporation to grant financial

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60 (1980) 10 B.L.R. 224 (Ont. H.C.).

61 Sections 97 and 98.1 of the ABCA.

assistance? At first blush one might say no, but this is not the case. Section 117(1)(a) provides that *every director when exercising his powers must always act with a view to the best interests of the corporation.* This duty governs the directors in the exercise of their powers under section 97(1) and section 98.1(1). Furthermore section 234 indicates that the powers of the directors should not be exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of the shareholders or creditors.

As long as they get paid, creditors of a solvent corporation will not complain if financial assistance is given by a corporation. Yet shareholders may challenge the directors who authorize financial assistance. The challenge may take the form of a derivative action for breach of fiduciary duty or it could be a personal action under section 234 or an application for dissolution of the company under section 207. See for example *Keho Holdings and Oliver* v. *Noble*[62] where minority shareholders complained, among other things, of a managing director who had the corporation make a loan to another corporation controlled by the managing director. Relief was granted under section 207 of the ABCA.

If section 42 is repealed the only restrictions on the powers of directors to authorize the corporation to grant financial assistance will be imposed by the fiduciary duty the directors owe to the corporation and by section 234. The directors should not authorize the corporation to grant financial assistance unless it is in the corporation's interests to do so. They should not exercise their powers in a manner that is oppressive or is unfairly prejudicial to or that unfairly disregards the interest of shareholders and creditors. The fact of solvency or insolvency will be only one factor the court will consider in determining if the directors' have breached their fiduciary duty owed to the corporation or if the directors' conduct gives the shareholders some personal remedy under section 234 or justifies the dissolution of the corporation or some other remedy

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62 Supra n. 16.

under section 207. Repeal of section 42 will *not* mean that the directors can, in every situation, authorize financial assistance formerly prohibited by section 42.

The repeal of section 42 will make the solvency tests set out in section 42(1)(d) and (e) no longer applicable. Yet in determining whether the granting of financial assistance was in the best interests of the corporation or is oppressive or unfairly prejudicial to shareholders or creditors, the fact of the solvency or insolvency will still be an important factor. It is submitted that the courts will fall back on the definitions of "insolvency" used in the general area of fraudulent conveyances and fraudulent preferences. See for example, *Robinson* v. *Countrywide Factors Ltd.*[63] where the Supreme Court of Canada held that a person in insolvent circumstances within the meaning of the Fraudulent Preference Act of Saskatchewan, R.S.S. 1965, c. 39, is one unable to pay his debts in the ordinary course of business as they become due or one who does not have the means of paying his creditors in full out of assets which could be realized upon sale for cash or its equivalent. These tests are very similar to those now contained in section 42(1)(d) and (e) with the exception that in determining the realizable value of the assets, the corporation does not have to subtract the amount of the loan or the value of the assets pledged as security for a guarantee. The result is that the repeal of section 42 would allow a corporation to give a guarantee secured by a floating charge debenture but only when it is in the interests of the corporation to do so. Also, subject to section 36, a corporation can make a loan out of stated capital if it is in the interests of the corporation to do so.

When considering if a corporation should grant financial assistance the directors must determine if the granting of the financial assistance is in the interests of the corporation.[64] In making this decision the directors must consider the following issues. Is the financial assistance reasonably incidental to the carrying on of the corporation's

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63 [1978] 1 S.C.R. 753.

64 See the discussion at pages 576-580 in L.C.B. Gower, *Gower's Principles of Modern Company Law* (4th Ed. 1979) on what it means to act in the interests of the company.

business? Does it serve a corporate purpose? Will the corporation gain from the giving of the financial assistance? Is the corporation insolvent or on the verge of insolvency? Does the granting of the financial assistance threaten the continued existence of the corporation? Will the position of present and future creditors be threatened?

In our opinion, it is not in the interests of a solvent or insolvent corporation to give financial assistance to anyone when the directors do not perceive that some benefit would accrue to the corporation as a result of the giving of the financial assistance. In this context we use the term "benefit" broadly and it is not limited to monetary gain. Any director who authorizes such financial assistance will be in breach of his fiduciary duty because he has not acted in the interests of the corporation.

For example, it is generally accepted that employees of a distributing corporation perform better if they participate directly in the corporation through share ownership. A guarantee of a loan made to an employee to enable him to purchase the corporation's shares would be of benefit to a distributing corporation. The directors have not breached their fiduciary duty by authorizing the financial assistance. Also, a director could authorize a corporation to give financial assistance for the purchase of its shares if the financial assistance was a necessary part of a scheme designed to overcome a management deadlock.[65] Yet if a director of a non-distributing corporation wishes to borrow money to start another business, it would not be in the interest of the corporation to guarantee such a loan. The corporation will not receive any benefit and

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65 In *Brady* v. *Brady* [1988] 2 All E.R. 617 the House of Lords reviewed a complex scheme for reorganization of a group of companies owned by two brothers. The scheme had been devised to overcome a management deadlock existing because of a disagreement between the two brothers. Part of the scheme required that one company give financial assistance for purchase of its shares. One of the issues was whether the financial assistance was given in good faith in the interests of the corporation as required by s. 153(2)(b) of the Companies Act, 1985 (U.K.). The House of Lords held that the financial assistance was in the company's interest because it advanced the company's corporate and commercial interests and the interest of its employees and it did not jeopardize the interests of creditors.

only runs the risk of losing its assets. The directors authorizing the corporation to grant such a guarantee would be in breach of the fiduciary duty they owe to the corporation.

Many non-distributing corporations routinely give financial assistance to directors, shareholders and others when it is clear no benefit will accrue to the corporation. Does this fact support an argument that the directors are not breaching their fiduciary duty owed to the corporation? In our opinion it does not. These are just situations where no one has complained of the breach of fiduciary duty. As long as the creditors are paid and all the shareholders agree to the transaction, there is no one to complain about the breach of fiduciary duty. Yet, if at the time the financial assistance is given the corporation is insolvent or near insolvency or if the corporation becomes insolvent by reason of giving such financial assistance, the directors must be accountable for their breach of fiduciary duty. In Chapters 4 and 5 of this report, we shall discuss how a shareholder and creditor can make such a director accountable in these circumstances.

(b) Case law

As seen by a review of the case law, the courts have in several circumstances held that the granting of financial assistance to directors, shareholders or their corporations is not in the interests of the corporation granting the assistance. Consider:

1. *Saskatchewan Land and Homestead Co.* v. *Moore et al.*[66] The managing director of the plaintiff had made the plaintiff liable for two of his personal debts and had received payment of remuneration above what he was entitled to. The court ordered the director to repay these sums to the plaintiff of the ground the managing director had appropriated the corporate funds to his own purpose in breach of his duty as managing director.

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66 (1914) 26 O.W.R. 160, aff'd 8 O.W.N. 525 (Ont. S.C.,A.D.).

2. *Hughes* v. *Northern Electric & Manufacturing Co.*[67] The operation of a mining company was made possible by loans of $43,000 made by its three shareholders. In time the three shareholders became deadlocked. The deadlock was broken and the continuance of the mining operations secured by an agreement entered into by the shareholders and the company. The agreement provided that two of the shareholders sell their shares to a trustee who would hold the shares in trust for the third shareholder. The sale of the shares was secured by a mortgage granted by the company. The third shareholder covenanted to pay $3000 per month to the company for its development. The Ontario Companies Act did not prohibit the company from granting financial assistance in connection with the purchase of shares of the company. A creditor of the company sought a declaration that the mortgage was void because *ultra vires* the company.

It was not argued that, in the absence of special circumstances, the company had the power to mortgage its property for the purpose of securing the payment of the purchase price of shares bought by one of its shareholders for his own benefit. Yet the court held that in these special circumstances it was within the power of the company to grant the mortgage. The transaction was necessary for the survival of the company's operations. There was nothing in the Companies Act prohibiting such a transaction and the court was not willing to imply such a prohibition.

3. *Export Brewing & Malting Co.* v. *Dominion Bank.*[68] This case involved Export Brewing & Malting Co. ("the Old Company") which owned a brewery operation used to supply bootleg liquor to the United States during prohibition. The three directors and their wives were shareholders of the Old Company. The directors had extensive real estate investments. In 1927 the Old Company sold all its undertaking and assets to Carling Breweries Limited. After the sale, the Old Company owned shares in the new company and $400,000 in savings bonds. The savings bonds were deposited

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67 (1915) 21 D.L.R. 358 (S.C.C.).

68 [1937] 2 W.W.R. 568 (P.C.).

with the Dominion Bank as security for payment of any judgment for taxes the Crown might obtain against the Old Company in an ongoing action. When personal loans made to the directors were in default, the Dominion Bank sought security for payment of the personal loans. The bank insisted the directors authorize the Old Company to assign its interest in the savings bonds, subject to the claim of the Crown, to the bank as security for payment of the personal loans.

The court assumed that the assignment of the company's interest in the savings bonds was *intra vires* the company. It then determined if the directors had the power to authorize the assignment. The court said at page 584:

> But, further, their Lordships are of opinion that it is impossible by the application of any proper test to affirm that this transaction was for the old company's advantage or benefit. Its interest in the bonds was its principal, if not its only free, asset, available for the purpose of raising funds which would enable it to conduct to its end the litigation with the Crown. The suggestion that it was beneficial to the old company to deprive itself of its means of securing to itself the surplus value of that asset, in order that surplus value should be applied for the purpose of discharging the private debts of its directors, is a suggestion to which their Lordships cannot accede. They view the transaction as one wholly detrimental to the interests of the old company.
>
> Moreover, even if (contrary to their Lordships' opinion) some benefit did accrue to the old company from the transaction, the overriding fact remains that the old company (acting through its directors and not by its shareholders in general meeting ) purported to apply its property for the benefit of those directors. In such a case it is well settled that the Court will treat the transaction as unenforceable, and refuse even to inquire whether the company has derived any benefit from it: and that on the ground that the company has not received the protection to which it is entitled.

The court deprived the bank of its security because the bank had not satisfied itself that the security was a binding charge on the company. This was not a case where the bank had no notice of anything extraordinary being done. As the court noted at page 586: "It was a plain case of directors using their powers as directors to cause a limited company to apply its property for the benefit of those directors as debtors to the bank." The court ordered the bank to account to the Old Company for the balance of cash which remained to the credit of the Old Company in respect of the savings bonds.

4. *Keho Holdings and Oliver* v. *Noble et al.*[69] In this case the Alberta Court of Appeal characterized the loan made by Keho Holdings to a corporation controlled by the managing director of Keho as prejudicial to Keho. The court objected to the fact that the loan was made without security for repayment.

Other cases are discussed in the research memorandum found in Appendix 8 at pages 220-228. Also, see *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation and Others*[70] which is discussed at pages 63 to 65 of this report.

E. Remedies Available Against Third Parties Dealing with Unfaithful Fiduciaries

(1) When Will a Stranger to a Trust Become Liable as a Constructive Trustee?

The law in this area has developed from the decision in *Barnes* v. *Addy*.[71] Barnes was the husband of the beneficiary of an express trust created by will. He was appointed as sole trustee. Barnes misappropriated the assets of the trust for use in his business which later failed. His children sued the former trustee who appointed Barnes as trustee and the solicitors engaged in respect of the appointment of Barnes as trustee.

At page 251 Lord Selbourne discussed the liability of agents of trustees as follows:

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69 *Supra* n. 16.

70 [1985] 3 All E.R. 52 (C.A.).

71 (1874) 9 L.R. Ch.App. 244.

> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the *cestui que trust*. But, on the other hand, strangers are not to be made constructive trustees merely because they act as agents of trustees in transactions within their legal powers, transactions which perhaps a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on part of the trustees.

The test propounded by Lord Selbourne was adopted in the leading case of *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3)*.[72] This was a case where the cash of Selangor United Rubber Estates Ltd. "(Selangor") was ultimately applied in paying for the acquisition of some 79% of Selangor's shares which were bought on behalf of Craddock. Selangor sued its directors, Craddock and several other parties through whose hands the funds flowed, including Selangor's bank. The Companies Act, 1948 (U.K.) prohibited a company from granting financial assistance for the purchase of the company's shares.

The court held that money of the company under the control of the directors is held by them on trust for the company and is to be applied for the company in accordance with its purpose. The directors of the company had misapplied the corporate funds by using the funds to buy shares on behalf of Craddock and therefore had breached the trust. They were liable to repay the company for the lost funds.

The court then considered when a stranger to a trust could become liable as a constructive trustee in respect of a breach of trust. The court at page 1095 discussed two types of constructive trusts:

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72 Supra n. 55.

> It is essential at the outset to distinguish two very different kinds of so-called constructive trustees. (i) Those who, though not appointed trustees, take on themselves to act as such and to possess and administer trust property for the beneficiaries, such as trustees de son tort. Distinguishing features for present purposes are (a) they do not claim to act in their own right but for the beneficiaries, and (b) their assumption to act is not of itself a ground of liability (save in the sense of course of liability to account and for any failure in the duty so assumed), and so their status as trustees precedes the occurrence which may be the subject of claim against them. (ii) Those whom a court of equity will treat as trustees by reason of their actions, of which complaint is made. Distinguishing features are (a) that such trustees claim to act in their own right and not for the beneficiaries, and (b) no trusteeship arises before, but only by reason of, the action complained of.

Except for the directors, the case brought against all the defendants was based exclusively on the argument that the second type of constructive trust should be imposed on them.

In determining when the courts will impose the second type of constructive trust upon strangers to a trust, the court adopted *Barnes* v. *Addy*. On this authority, a constructive trust will be imposed upon strangers where there is "assistance with knowledge in a dishonest and fraudulent design on the part of the trustees". At page 1104 the court discussed the type of knowledge required:

> The knowledge required to hold a stranger liable as constructive trustee in a dishonest and fraudulent design, is knowledge of circumstances which would indicate to an honest, reasonable man that such a design was being committed or would put him on enquiry, which the stranger failed to make, whether it was being committed. Acts in the circumstances normal in the honest conduct of affairs do not indicate such a misapplication, though compatible with it; and answers to enquiries are prima facie to be presumed to be honest,. . . .

At pages 1098 and 1104, the court also gave some guidance on what is a "dishonest and fraudulent design". The court said that trusteeship and constructive trusteeships are equitable conceptions. Therefore whether a misapplication of company funds for the purchase of shares occasions the imposition of liability as constructive trustees depends on equity and its principles. It does not depend upon statutory provision making it a criminal offence, or on statute or criminal law, or common law. The court rejected the argument that this was not a case of dishonest and fraudulent design because it did not amount to a crime. The court did not wish to define the term "dishonest and fraudulent design", but concluded that it at least included conduct which is morally reprehensible.

The court held Selangor's bank liable as constructive trustee because the bank honoured a cheque drawn on the company's account in circumstances where a reasonable banker would have known that the funds were being used to finance the purchase by Craddock of shares in Selangor. Here the bank manager and assistant manager did not have such actual knowledge.

It is submitted that the statutory prohibition of financial assistance in these circumstances did not trigger the imposition of the constructive trust. Equity was offended by the use of company funds for personal interests of Craddock and not for company purposes. This is more forcefully stated by the court in *Karak Rubber Co Ltd.* v. *Burden (No. 3)*[73] which dealt with a similar factual situation:

> Karak was once a wealthy concern and became insolvent. It was, so it is said, the victim of a species of take-over fraud, whereby those seeking to buy a controlling interest in a company put their fingers in company's till and steal the money in order to pay for the purchase. The bank was the unconscious tool which aided this process. The fact that the theft involves a breach of section 54 of the Companies Act, 1948 is purely incidental and of no fundamental importance in my view.

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73 [1972] 1 All E.R. 1210 (Ch.D.) at p. 1214.

(2) Extension of Principles

This area of law developed from the case of *Barnes* v. *Addy*.[74] In that case there had been a breach of trust by a trustee appointed under terms of a will. The court was dealing with the issue of liability of agents of the trustee. One must consider if the principles set out in the *Barnes* v. *Addy* and the *Selangor* cases are applicable in situations where there has been a breach of fiduciary duty and not a breach of trust. In *MacMillan Bloedel Ltd.* v. *Binstead*[75] the British Columbia Supreme Court extended the principles to cover situations of breach of fiduciary duty. This is the only case which has extended the principles to this extent.

(3) Cases

There are many English and Canadian cases which have followed the principles set out in the *Barnes* v. *Addy* and *Selangor* cases. We discuss these cases at pages 234 to 245 of the research memorandum found in Appendix 8. However it is useful to discuss two English cases in which these principles have been applied in factual situations involving financial assistance by a corporation.

1. *Belmont Finance Corporation* v. *Williams Furniture Ltd. and Others (No. 2)*.[76] Mr. Grosscurth sold the shares of Maximum Finance Ltd. ("Maximum") to Belmont Finance Corporation ("Belmont") for £500,000. Mr. Grosscurth used this money to buy shares in Belmont from the sole shareholder, City Industrial Finance Ltd. ("City"). At the time of the sale, no one obtained a valuation of the worth of Maximum. A subsequent evaluation suggested that at the time of the sale the shares of Maximum were worth £60,069, not £500,000. Mr. James, the Chairman of the Board of directors

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74 *Supra* n. 71.

75 (1983) 22 B.L.R. 255 (B.C.S.C.).

76 [1980] 1 All E.R. 393 (C.A.).

of City and Belmont, negotiated the agreement on behalf of Belmont and City. The trial judge found as a fact that Mr. James honestly believed that the purchase of the Maximum shares by Belmont, was in the interests of Belmont because Belmont was buying Mr. Grosscurth's ability to make money, such as it was!

The Court of Appeal held that the transaction contravened section 54 of the Companies Act, 1948, U.K. This section prohibited a company from granting financial assistance in respect of the purchase of its shares. Belmont did not attack the transaction as *ultra vires* the company and therefore void. Instead it successfully argued that the defendants had conspired together to effect an unlawful purpose resulting in damage to Belmont.

Belmont also argued that City should be liable as constructive trustee in these circumstances. At page 405, Buckley L.J. held:

> I now come to the constructive trust point. If a stranger to a trust (a) receives and becomes chargeable with some part of the trust fund or (b) assists the trustees of a trust with knowledge of the facts in a dishonest design on the part of the trustees to misapply some part of a trust fund, he is liable as a constructive trustee (*Barnes* v. *Addy* per Lord Selborned LC).
>
> A limited company is of course not a trustee of its own funds: it is their beneficial owner; but in consequence of the fiduciary character of their duties the directors of a limited company are treated as if they were trustees of those funds of the company which are in their hands or under their control, and if they misapply them they commit a breach of trust (*Re Lands Allotment Co.*, per Lindley and Kay LJ). So, if the directors of a company in breach of their fiduciary duty misapply the funds of their company so that they come into the hands of some stranger to the trust who receives them with knowledge (actual or constructive) of the breach, he cannot conscientiously retain those funds against the company unless he has some better equity. He becomes a constructive trustee for the company of the misapplied funds. This is stated very clearly by Jessel MR in *Russell* v. *Wakefield Waterworks Co.*, where he said:

> "In this Court the money of the company is a trust fund, because it is applicable only to the special purposes of the company in the hands of the agents of the company, and it is in that sense a trust fund applicable by them to those special purposes: and a person taking it from them with notice that it is being applied to other purposes cannot in this court say that his is not a constructive trustee."
>
> In the present case, the payment of the £500,000 by Belmont to Mr. Grosscurth, being an unlawful contravention of s. 54, was a misapplication of Belmont's money and was in breach of the duties of the directors of Belmont. £489,000 of the £500,000 so misapplied found their way into the hands of City with City's knowledge of the whole circumstances of the transaction. It must follow, in my opinion that City is accountable to Belmont as constructive trustee of the £489,000 under the first of Lord Selborned LC's two heads.

Buckley J. did not hold that City was liable as constructive trustee under Lord Selbourne's second head because Belmont directors were not guilty of dishonesty in buying the shares of Maximum, only guilty of misfeasance. The trial judges finding that Mr. James honestly believed that the transaction was in Belmont's interest made it impossible to hold that there was any dishonesty about the proceedings of the Belmont board.

Goff L.J. agreed with Buckley J. and gave further reasons. In respect of the issue of constructive trust, he held that payment of the £500,000 was a breach of trust for two reasons. First, the agreement was unlawful and secondly it was a misfeasance for the following reasons. Belmont paid far more than the shares were worth. There was not an independent board capable of considering the transaction from Belmont's point of view since Mr. James in fact controlled the board of Belmont. There was a conflict of duty and interest between the position of Mr. James as Chairman of the Board of Belmont and his position as Chairman of the Board of City. City wanted to sell Belmont and get a high price for the goodwill. Belmont wanted to keep the price of purchasing Maximum's shares as low as possible. Yet City knew Grosscurth would use the money from the sale of Maximum shares to pay for the Belmont shares. Goff L.J. held that City was a constructive trustee under the first head of constructive trusteeship. For the same reasons given by Buckley J.C., Goff L.J. also held City was not a constructive trustee under the second head.

2. *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation and Others.*[77] This case involved dealings of two companies, Rolled Steel Products (Holdings) Ltd. ("RSP") and Scottish Steel Sheet Ltd. ("SSS"). Shenkman ("S") owned SSS and he also had a 51% interest in RSP. The other 49% of the shares of RSP were held in trust for S's children. S and his father were directors of RSP.

SSS owed £820,000 to Colvilles Ltd. ("Colvilles"). Colvilles obtained a guarantee from S in respect of this debt. In time Colvilles became aware that SSS was insolvent and it worried that S had insufficient assets to satisfy the indebtedness. The following arrangement was made by Colvilles, SSS, S and RSP. Colvilles agreed to lend RSP sufficient money for RSP to pay the £400,000 debt it owed to SSS. On the same day RSP paid the £400,000 to SSS, SSS transferred the £400,000 to Colvilles in reduction of its £820,000 debt. RSP gave a guarantee for the balance of the SSS debt owed to Colvilles in consideration of Colvilles not demanding repayment of all sums due to it by SSS. If certain land owned by RSP was not sold by a certain date, RSP was to give Colvilles a debenture payable with interest at 1% above prime. The trustees of the RSP shares were aware that the transaction was an unwarranted depletion of trust assets. Therefore the trustees agreed to the transaction on the basis that they would be compensated for an otherwise unwarranted depreciation in the value of the trust asset. This compensation did not materialize.

In time Colvilles made demand for payment of the full amount secured by the debenture and a receiver-manager was appointed under the debenture. British Steel

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77 *Supra* n. 70.

Corp. ("BSC") succeeded to all assets and obligations of Colvilles. After the debt to Colvilles was paid there were insufficient funds to pay the unsecured creditors of RSP.

The court held that there was clear evidence to support the trial judge's finding of fact that everyone on the RSP side understood the transaction proposed was not for the purposes of or in the interests of RSP and would be positively injurious to it.

The court rejected the defendants' argument that they thought the transaction beneficial to RSP and thought RSP's lawyer would not permit it to do anything improper or unlawful. The defendants had notice that advice had been given to S's lawyer that the granting of the guarantee for the amount above the £400,000 would be a gross misfeasance on the part of the directors of RSP.

Based on an interpretation of the memorandum of association, the court concluded that the transactions were not beyond the corporate capacity of RSP and therefore were not *ultra vires*. Entering the guarantee and, to the extent of the sum guaranteed, the debenture, was beyond the authority of the directors, because they were entered into for purposes not authorized by RSP's memorandum. Despite this lack of authority, directors would have been capable of conferring rights of Colvilles if Colvilles did not know of the lack of authority. Yet here Colvilles knew of the lack of authority and so acquired no rights under the transaction.

The court held the debenture and guarantee were not duly authorized by RSP because of a lack of quorum at the directors' meeting which passed the resolution providing for the financial assistance.

The court also held that BSC and the receiver-manager were constructive trustees of RSP. The court adopted the principles set out by Buckley J. in the *Belmont Finance Corp.* v. *Williams Furniture Ltd. (No. 2)* case. The court stated at page 88:

> The *Belmont* principle thus provides a legal route by which a company may recover its assets in a case where its

> directors have abused their fiduciary duties and a person receiving assets as a result of such abuse is on notice that they have been misapplied. The principle is not linked in any way to the capacity of the company: it is capable of applying whether or not the company had the capacity to do the acts in question.
>
> Furthermore, the *Belmont* principle must, in my opinion, be equally capable of applying in a case where the relevant misapplication of the company's assets by the directors has consisted either (a) of an application for purposes not authorized by its memorandum or (b) an application in breach of the company's articles of association (eg. pursuant to a board resolution passed at an inquorate meeting of the directors).
>
> From the findings of fact of the judge, with which I see no reason to disagree for reasons already stated, I think it is clear that (a) the directors of RSP were acting in breach of RSP's articles of association and of their fiduciary duties to RSP in purporting to authorise and in executing the guarantee and debenture, and (b) BCS and Mr. Cooper had notice of these facts when they respectively received the relevant assets.

This case is particularly important because the granting of the financial assistance was not prohibited by statute. The court still found that the granting of the guarantee and debenture was a breach of the director's fiduciary duties because the transaction proposed was not for the purposes of, or in the interests of RSP and was in fact injurious to it.

## F. <u>Conclusion</u>

The full scope of the remedies created by sections 232 and 234 will not be known for some time because the law is still being developed by the courts. Nonetheless, even at this early stage it is clear that these sections are being used by shareholders to obtain remedies when directors abuse their powers and benefit themselves at the expense of the corporation. It is also clear that Justice McDonald has opened the door for creditors to make use of these remedies.

# CHAPTER 3 - FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES

## A. Introduction

The law of fraudulent conveyances and fraudulent preferences is another potential tool for controlling prohibited financial assistance by a corporation. Therefore this chapter will summarily review this area of the law. For a more detailed review of the law, refer to Appendix 11. Chapter 4 will analyze whether this area can be used by a creditor to remedy prohibited financial assistance.

At the outset it is important to define the terms "fraudulent conveyance" and "fraudulent preference". A fraudulent conveyance is a transfer of property made generally to someone other than a creditor with the intent to delay, hinder or defraud creditors. A fraudulent preference is a transfer of property by a debtor to one or more, but not all, of his creditors with the intent to prefer those creditors receiving the transfer.[78]

## B. Fraudulent Conveyances

### (1) Applicable Legislation

In Alberta, creditors can attack fraudulent conveyances under The Statute of Fraudulent Conveyances, 13 Eliz. c. 5, 1571[79] ("Statute of Elizabeth")[80] and under

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78 Ontario Law Commission, *The Enforcement of Judgment Debts and Related Matters - Part IV*, p. 125.

79 The Statute of Elizabeth is in force in Alberta: *Goyan* v. *Kinash* (1945) 1 W.W.R. 291, *Arnold* v. *Fleming et al.* (1923) 1 W.W.R. 706 and *Connors* v. *Egli et al.* (1924) 1 W.W.R. 1050.

80 This Act is found in Appendix 9.

section 1 of the Fraudulent Preferences Act, R.S.A. 1980 c. F-18[81] ("Fraudulent Preferences Act").

Section II of the Statute of Elizabeth and section 1 of the Fraudulent Preferences Act are similar. However, proof of insolvency of the debtor at the time of the transfer of property is not required under the Statute of Elizabeth. It is under the Fraudulent Preferences Act. The other difference between the two statutes is that the Statute of Elizabeth protects "creditors and others". Only persons who are creditors at the time of the fraudulent conveyance can avail themselves of the Fraudulent Preferences Act.

(2) Transactions that are Fraudulent Conveyances

The Statute of Elizabeth is broadly worded and has been liberally interpreted to suppress fraud. It applies to every feoffment, gift, grant, alienation, bargain and conveyance of property made to delay, hinder or defraud creditors and others of their rightful payment. A transfer of land, a granting of a land mortgage and the giving of a loan are all transactions which have fallen within the scope of this Act or similar acts.[82]

(3) Financial Status of Debtor

When attacking conveyances under the Statute of Elizabeth, the creditors do not have to prove that the debtor was insolvent at the time he conveyed the property.[83] Yet when applying under the Fraudulent Preferences Act the creditors must prove that the conveyance was made by the debtor at a time when he was in insolvent circumstances or unable to pay his debts in full or knew that he was on the eve of insolvency.

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[81] This Act is found in Appendix 10.

[82] See the discussion at pp. 254-55 of Appendix 11 and the authorities cited therein.

[83] *Gillespie* v. *Grover* (1852) 3 Gr. 558 (Ont. C.A.).

(4) Fraudulent Intent

Under the Statute of Elizabeth the creditor must prove that the debtor transferred the property with the intent to delay, hinder, or defraud creditors. If a conveyance is attacked under section 1 of the Fraudulent Preferences Act it must be shown the debtor transferred the property with the intent to defeat, hinder, delay or prejudice his creditors. No practical difference arises because of the different terminology used.

It is rare indeed when a creditor can prove the fraudulent intent of the debtor by direct evidence. Debtors do not often admit to their fraudulent intent. Yet courts will infer fraudulent intent from the circumstances surrounding the transaction and the effect it had on the parties to it and on their creditors. The courts make use of the presumption that one intends the natural consequences of the transaction, badges of fraud and the doctrine of close connection when determining if the necessary fraudulent intent exists.[84]

(5) Transactions Protected by Section VI of the Statute of Elizabeth

Section VI of the Statute of Elizabeth protects conveyances made upon "good consideration and *bona fide* lawfully conveyed" to persons not having at the time of such conveyance "any manner of notice or knowledge of such covin, fraud or collusion as is aforesaid".

(a) Voluntary conveyances

Voluntary conveyances or conveyances for nominal consideration do not fall within the protection of section VI of the Statute of Elizabeth because they are not made for "good consideration". When a voluntary conveyance is attacked as fraudulent

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[84] See discussion at pp. 257-61 of Appendix 11.

it is necessary only to determine if the debtor intended to delay, hinder or defraud his creditors by such a conveyance. The transferee's intent is irrelevant.[85]

(b) Conveyances upon good consideration and *bona fide* lawfully conveyed

(i) *Bona fide* conveyances

There is authority to support three different interpretations of *bona fide* as used in section VI of the Statute of Elizabeth. The most sensible interpretation is that a *bona fide* transaction is one which is not a mere cloak for retaining a benefit to the grantor.[86]

(ii) Good and valuable consideration

"Good consideration" as used in section VI of the Statute of Elizabeth has been interpreted to mean valuable consideration. It is not enough that the transferee supplied consideration which would be sufficient in a simple contract case.

The Trial Division decision in *Union Bank* v. *Murdock*[87] contains one of the clearest statements of law on this point. The decision was reversed by the Manitoba Court of Appeal on other grounds. At page 114, the trial judge said that:

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85 *Oliver* v. *McLaughlin* (1893) 24 O.R. 41 (Q.B. Div.); *Gauthier* v. *Woollatt* (1940) 1 D.L.R. 275 (Ont. H.C. of Justice); *Union Bank of Canada* v. *Murdock* [1917] 3 W.W.R. 820 (Man. C.A.); *Banque d'Hochelaga* v. *Potvin* [1924] 1 D.L.R. 678; *Cromwell* v. *Comeau* (1957) 8 D.L.R. (2d) 676; and *Traders Group Ltd.* v. *Mason* (1973) 43 D.L.R. (3d) 76 (N.S. S.C. Trial Div.) varied 1974 53 D.L.R. (3d) 103 (N.S. S.C. App. Div.).

86 See discussion at p. 262 of Appendix 11.

87 [1917] 2 W.W.R. 112.

> To avoid the statute, a conveyance must be for good (i.e., valuable) consideration and *bona fide*.
>
> There must be a real consideration paid, or a fair interchange of interests, for though mere inadequacy of price is not in general a circumstance which will of itself make an assignment void, yet, if the inadequacy is very great, at least if it is so palpable that it must be taken to have been a fraudulent contrivance between the parties, the transaction will be void, especially if what little consideration consisted of an existing debt.

It is unnecessary to show that there exists a one to one correspondence between the fair market value of the property transferred and the consideration applied. In the Alberta Supreme Court Appellate Division decision of *Banque d'Hochelaga* v. *Potvin* the court adopted the following statement:[88]

> "Where it is found that the transaction at issue is, on the whole, fair and honourable, and not induced by fraudulent intention of defeating the creditors, the court is not very particular as to the amount of the consideration, if it is valuable, and not so entirely inadequate as, from its insufficiency, to induce the presumption of fraud, it is enough. The smallness of the consideration is not a matter that the court will go into except so far as it evidences that the transaction is a sham." May on Fraudulent Conveyances (3d ed.) pp. 194-5.

Two cases of note are *Lee* v. *Glenval Holdings Ltd.*[89] and *Jack Cewe Ltd.* v. *Irving.*[90] In *Lee* v. *Glenval Holdings Ltd.*, the two directors of *Glenval Holdings Ltd.* owed $229,000 to the Bank of Nova Scotia. Glenval Holdings executed an instrument guaranteeing the existing personal debt of its directors. The company gave a land mortgage to the bank as collateral security for this guarantee. Creditors of the corporation attacked the mortgage as a fraudulent conveyance.

88 [1924] 1 D.L.R. 678 at 681.

89 (1988) 85 A.R. 394 (Alta. Q.B.).

90 (1978) 26 C.B.R. N.S. 142 (B.C.S.C.).

The bank argued that where the conveyance is made for valuable consideration, the plaintiff must prove both parties to the conveyance had the intent to defraud or delay creditors. They argued that the plaintiff had not proven that the bank had such intent. Justice Sinclair said that it was only necessary to prove that the corporation and the bank intended to delay, hinder or defraud the creditors of the corporation *if* the conveyance was made for valuable consideration. If it was a voluntary conveyance the intention of the bank is irrelevant. Justice Sinclair was of the view that the key issue was whether any consideration passed through the company for the granting of the guarantee. He was unwilling to decide this issue at that stage and directed a trial of the issue. Settlement between the parties has precluded a judicial determination of the issue.

In *Jack Cewe Ltd.* v. *Irving and CIBC*[91] a mortgage was given by Mr. Irving to secure a guarantee he had given to the CIBC two years earlier. Creditors of Irving attacked the mortgage as a fraudulent conveyance or a fraudulent preference under legislation very similar to the Statute of Elizabeth and the Fraudulent Preferences Act. The mortgage was given in consideration of the bank agreeing not to sue on the guarantee. The court held that the mortgage was not a fraudulent conveyance because a transaction was protected by a section equivalent to our section VI of the Statute of Elizabeth. The mortgage was *bona fide* because the bank had no knowledge of the mortgagor's insolvency. The mortgage was given for the bank's forbearance to sue on the guarantee and this was valuable consideration within the meaning of the legislation.

The court held that the transaction was not a fraudulent preference because it was protected by legislation similar to section 6(b) of the Fraudulent Preferences Act. The court held "transfer of property by way of security for any present actual *bona fide* advance of money" did not mean that the advance must be contemporaneous with the granting of the mortgage. The term "present actual *bona fide* advance of money" includes a past advance of money now being secured. On this point, the case conflicts

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91 *Ibid.*

with the law in Alberta set out in *Smith* v. *Sugarman*[92] and *Trusts and Guarantee Co. Ltd.* v. *R.J. Whitlaw Co. Ltd.*[93]

### (c) Transferee's notice or knowledge

The literal interpretation of section VI of the Statute of Elizabeth suggests mere notice of the debtor's fraudulent intent is enough to make a transaction for value void. Nonetheless, the courts have generally not interpreted the section literally, although there are some cases which take this position. As long ago as 1880 the court in *Re Johnson*[94] stated that if mere notice or knowledge of the fraudulent intent of the debtor was sufficient to avoid the transaction then it would overthrow all the plain dealing between businessmen.

In *Meeker Cedar Products Ltd.* v. *Edge et al.*,[95] the British Columbia Court of Appeal had occasion to interpret a section in the Fraudulent Conveyances Act of that province which is very similar to section VI of the Statute of Elizabeth. This decision was later affirmed by the Supreme Court of Canada without reasons. At page 299 of his decision, Justice MacFarlane J.A. of the Court of Appeal held:

> I think it is clear as a matter of interpretation of the statute as a whole and upon authority that where a sale is made for good and valuable consideration the transaction will not be void by reason of the purchasers having notice or knowledge of the vendor's intent to delay, hinder or defraud creditors and others unless it be proved that the purchaser was actually privy to the fraud, i.e., a party to carrying out the fraudulent intention and purpose.

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92 (1909) 2 A.L.R. 442.

93 (1914) 6 W.W.R. 42.

94 (1880) 20 Ch. D. 389.

95 (1968) 68 D.L.R. (2d) 294.

The test set out by MacFarlane in this case is known as the concurrent intent test.

### (6) Remedies

The Statute of Elizabeth provides that the conveyance is void against creditors of the grantor and that the penalty for participation in such a fraud is forfeiture of the value of the goods. One-half of the value of the goods goes to the Crown and the other one-half goes to those prejudiced by the fraudulent conduct of the recipient. The penalty clause in the Statute of Elizabeth is not in force in Alberta. Therefore in Alberta a creditor cannot sue for one-half the value of the goods.[96]

There is a line of old cases that holds that under the Statute of Elizabeth and equivalent statutes, a creditor cannot attach the sale proceeds of property fraudulently conveyed and later resold. An illustration of one of these earlier cases is found in *Davis* v. *Wickson* where the court held:[97]

> The right of the plaintiff in this class of cases is to have any impediment removed or declared invalid which intercepts the action of his writ of execution. So long as the property of his execution debtor remains distinguishable and so long as no purchaser for value without notice intervenes, so long may the court award relief against that property in the hands of the fraudulent or voluntary holders. But where, as here, the first holder sells the property obtained from the debtor and receives the proceeds in a shape that cannot be earmarked, there is no jurisdiction to go beyond the further remedy which the Statute of Elizabeth prescribes, namely that all parties to fraudulent conveyances alienating or assigning thereunder shall forfeit a year's value of lands and the whole value of goods, whereof one-half goes to the Crown and one-half to the party aggrieved.

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96 See *Goyan* v. *Kinash* [1945] 1 W.W.R. 291 (Alta. S.C.T.D.) and *Connors* v. *Egli et al.* (1924) 1 W.W.R. 1050 (Alta. S.C.A.D.).

97 (1882) 1 O.R. 369 at 374.

The injustice created by this line of cases has been overcome in Manitoba and Ontario. In *John Deere Limited* v. *Paddock et ux*,[98] the Manitoba Court of Appeal held that section 49(1) of the Assignments Act[99] applies to all transactions that in law are invalid against the creditors. As the transfer in question was invalid against the creditors by reason of the Fraudulent Conveyances Act, the transaction is invalid in law and within the meaning of section 49(1) of the Assignments Act. The result was that the court ordered that the judgment creditor of the husband recover from the wife the sum of $2,000 being the sale proceeds of land which was conveyed to the wife with the intent to delay, hinder or defraud creditors.

In *Westinghouse Canada Ltd.* v. *Buchar et al.*[100] the Ontario Court of Appeal held that the tracing provisions of section 12 of the Assignments and Preferences Act should be available where a conveyance is void under the Fraudulent Conveyances Act. That section is similar to the Manitoba section 49(1) except in Ontario the wording is "which is invalid against creditors" and in Manitoba the wording is "that in law is invalid against creditors". Notwithstanding the different wording, the court was willing to follow the decision in *John Deere Limited* v. *Paddock et ux*. It specifically overruled the case of *Grey* v. *Quinn*[101] that said that the words "which is invalid against creditors" applies only to transactions invalidated by the Assignment and Preferences Act.

There are no Alberta decisions dealing with this issue. In view of the similarity between section 11 of the Fraudulent Preferences Act of Alberta and section 49(1) of the Assignments Act of Manitoba the reasoning in *John Deere Limited* v. *Paddock et ux* is applicable. Section 11 of the Fraudulent Preferences Act should apply to transfers which are void under the Statute of Elizabeth. This would allow the creditor to follow

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98 (1973) 2 W.W.R. 116.

99 S. 49(1) of the Assignments Act of Manitoba is very similar to our section 11 of the Fraudulent Preferences Act.

100 (1975) 9 O.R. (2d) 137.

101 (1922) 22 O.W.N. 325.

sale proceeds into the hands of a fraudulent transferee and to require that transferee to account for the sale proceeds even where the transferee has spent them for his personal use.

## C. Fraudulent Preferences

### (1) Applicable Legislation

In Alberta, a fraudulent preference can be attacked under sections 2 and 3 of the Fraudulent Preferences Act.

### (2) Financial Status of Debtor

When attacking a transaction as a fraudulent preference the creditor must prove that the transaction was made by his debtor when the debtor was in insolvent circumstances or was unable to pay his debts in full or knew that he was on the eve of insolvency. There is no requirement that all three conditions be proven.[102]

### (3) Fraudulent Intent

#### (a) Intent of debtor

Pursuant to section 2 of the Fraudulent Preferences Act, if a debtor in insolvent circumstances conveys property to or for a creditor with intent to give that creditor preference over other creditors, the transaction is void. By section 3 of the Fraudulent Preferences Act, if an insolvent debtor transfers property to or for a creditor and the transfer has the effect of giving a creditor a preference, the transaction is void if action is brought within one year after the transfer. Under section 3, the actual intent of the debtor is irrelevant because section 4 deems the preferential effect to govern

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[102] See discussion at pp. 256-57 of Appendix 11.

"independently of the intent with which the transaction was entered into and of whether it was entered into voluntarily or under pressure".

(b) Unilateral or concurrent intent

Section 2 of the Fraudulent Preferences Act does not require the concurrent intent of a preferred creditor. However, judicial interpretation has created such a requirement. Therefore in an action brought under section 2 of the Fraudulent Preferences Act, the plaintiff must prove that the debtor had the intent to give one creditor preference over other creditors and the preferred creditor had the intent to receive this preference over the other creditors.[103]

By virtue of section 4 of the Fraudulent Preferences Act, intent of the creditor is irrelevant when a preference is attacked within one year under section 3 of the Act. Only the preferential effect of the transfer and the insolvency of the debtor are in issue. Yet if the creditor receiving the preference can show he entered the transaction in good faith, then the creditor will be protected if he can come within any of the transactions listed in section 6 of the Fraudulent Preferences Act. A creditor is acting in good faith if he did not know of the insolvency of the debtor and did not know or share in the fraudulent intent of the debtor.[104]

(c) Proving concurrent intent

When proving concurrent intent of the creditor to accept a preference, knowledge of the debtor's insolvency is very important. As stated in *Johnson* v. *Hope*,[105] a *bona*

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103 W.R.P. Parker, *Frauds on Creditors and Assignments for the Benefit of Creditors*, (1903) 163; *Re Barnett* (1983) 43 A.R. 215 (Alta. Q.B.); Law Reform Commission of British Columbia, *Report on Fraudulent Conveyances and Preferences*, 1988, 44.

104 Law Reform Commission of British Columbia, *Report on Fraudulent Conveyances and Fraudulent Preferences*, 1988, 45-50.

105 (1890) 17 O.A.R. 10.

*fide* creditor who at the time of dealings has no knowledge or notice of the insolvency of the debtor is safe from the consequences of legislation such as section 2 of the Fraudulent Preferences Act. The existence of knowledge of the debtor's insolvency is necessary to give rise to an inference that the creditor, in taking the security, intended to except the preference over other creditors of the debtor.[106] Yet, where the debtor had no intent to give a preference, knowledge by the creditor of the debtor's insolvency is not sufficient in itself to cause a transfer to be set aside as a fraudulent preference.[107]

Parker in *Frauds on Creditors and Assignments for the Benefit of Creditors* discusses the relevancy of notice of insolvency at page 167:

> **Notice of "Insolvency."**--If the creditor then had notice or knowledge of *insolvency*, but acted in good faith, receiving his preference without any participation in the intent of the debtor, the transaction will in Ontario be considered valid. If the creditor has assisted in bringing about the transfer by pressing the debtor, it is clear that he might well be acting and taking the security in good faith. But if the creditor received a preference from a debtor whom he had not pressed for payment or security, and of whose insolvency he had notice or knowledge, one would think that he must be taken to know or perceive the debtor's intent to prefer him, and that under such circumstances knowledge of insolvency would be almost tantamount to knowledge of intent. Or to put it another way, if the creditor had notice or knowledge of the insolvency he must have known the security voluntarily offered him would have the effect of giving him a preference and so he could not reasonably be acting in good faith in accepting it.

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106 *Gulf and Fraser Fishermen's Credit Union* v. *W.R. Menchions & Company*, (1965) 55 W.W.R. 191 (B.C.C.A.).

107 *Fisher* v. *Kowslowski*, (1913) 5 W.W.R. 91 (Man. K.B.).

(4) Doctrine of Pressure

A transfer of property to a creditor is only a preference if made with the intent that "one creditor steal a march on the other creditors".[108] A transfer of property is not a preference where the transfer was made as a result of legitimate commercial pressure applied by the creditor. In this situation the transfer of property is in response to pressure and not given with intent to prefer creditors.[109]

The doctrine of pressure will not validate a transaction that results in a preference when the transaction is attacked within one year.[110]

(5) Protected Transactions

(a) *Bona fide* transactions

Section 6 protects from the operation of the Act the following transactions:

1) *bona fide* sale or payment made in the ordinary course of trade or calling to innocent purchasers or parties

2) the payment of money to a creditor

3) a transfer of property made in consideration of a present actual *bona fide* sale

4) a transfer of property made in consideration of delivery of goods or other property

5) a transfer of property made in consideration of a *bona fide* payment in money

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108 Law Reform Commission of British Columbia, *Report on Fraudulent Conveyances and Preferences* (1988) 43.

109 *The Molson's Bank* v. *Halter* (1890) 18 S.C.R. 88 at 122, *Stephens* v. *McArthur* (1891) 19 S.C.R. 446 at 453.

110 S. 4(2) of the Fraudulent Preferences Act.

6) a transfer of property by way of security for a present actual *bona fide* advance of money.

All the transactions in section 6 are protected only if the money paid or the goods or other property sold or delivered bears a fair and reasonable relative value to the consideration therefore.

To show that the transaction was not *bona fide*, onus is on the plaintiff to prove that the creditor knew of the debtor's insolvency or should have known at the time he accepted the challenged conveyance and that the creditor participated in the fraud in the sense that he knowingly and willingly accepted the preference over his fellow creditors. Proof of knowledge of insolvency was made easier by the decision in *National Bank of Australia* v. *Morris* where the court said:[111]

> Their Lordships conceive that if the creditor who receives payment has knowledge of circumstances from which ordinary men of business would conclude that the debtor is unable to meet his liabilities, he knows, within the meaning of the Act that the debtor is insolvent.

This test was adopted in *Gulf & Fraser Fishermen's Credit Union* v. *W.R. Menchions & Co.*[112] Yet knowledge of insolvent circumstances will not be imputed even where the creditor fails to make reasonable inquiries.[113]

(b) <u>Payment of money</u>

Section 6(b) of the Fraudulent Preferences Act provides that the Act does not apply to any payment of money to a creditor. Therefore any payment by an insolvent debtor of an existing debt by way of cash or cheque cannot be impeached no matter

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[111] [1892] A.C. 289 at 290.

[112] Supra n. 106.

[113] *Jack Cewe Ltd.* v. *Irving and C.I.B.C.* supra n. 90.

what the intention of the parties thereto was.[114] Section 6(b) does not require that the payment be *bona fides*.

(c) Security for existing debt

When an insolvent debtor grants security for an existing debt, the security will be void if attacked within 1 year of the transaction. The intent of the debtor and creditor is irrelevant. Section 6 of the Fraudulent Preferences Act does not protect such a security because the security was not given for a present actual *bona fide* advance of money or for a present *bona fide* delivery of goods.

If the transaction is not attacked within the 1 year period, the plaintiff must prove the insolvent debtor had the intent to give a preference and the creditor had an intent to receive a preference. If the creditor had no such intent the preference is not fraudulent.[115] This is not a situation where section 6 of the Fraudulent Preferences Act protects a transaction, but where the judicial gloss of "concurrent intent" saves the transaction.

The policy of the court is best expressed in *Johnson* v. *Hope*[116] as follows:

> But then the word *bona fide* is used throughout, and it would seem to follow that the legislature did not intend to involve persons having neither knowledge or notice, in the disabling and penal consequences of the Act thereby forbidden. It would paralyze trade and mercantile business altogether, if transactions entered into in all honesty and good faith, and for valuable consideration, with persons apparently solvent and prosperous, were liable to be undone upon its being

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114 *Re Cohens and Lyons*; *Canadian Credit Men's Trust Association* v. *Spivak* [1927] 1 D.L.R. 577 (Alta. S.C.A.D.).

115 *Smith* v. *Sugarman*, *supra* n. 92 and *Trusts and Guarantee Company Ltd.* v. *R.J. Whitlaw Company Limited*, *supra* n. 93.

116 *Supra* n. 105.

afterwards discovered and proved that such persons were at the time in embarrassed circumstances or unable to pay their debts in full. Such a construction of the Act would make it a trap and a snare instead of an enactment salutary and beneficial to the mercantile community. It has always been the policy of law to protect, as far as possible, persons acting *bona fide*, and without notice of fraud or other wrongdoing, and so I think a person who deals *bona fide* with an embarrassed debtor, and who at the time of the dealing has no knowledge or notice of his embarrassed condition, is safe from all the consequences enacted by the statute. It is hard to imagine how a transaction can be otherwise than *bona fide*, with reference to what is forbidden in the statute, if it has been entered into without knowledge or notice of the embarrassments of the debtor.

## CHAPTER 4 - FINANCIAL ASSISTANCE BY NON-DISTRIBUTING CORPORATIONS

### A. Introduction

Section 42 has two purposes. First, to prevent the stripping of corporate assets for the personal benefit of the directors, shareholders and others. Secondly, to prevent certain unconscionable takeover practices. The problem with section 42 is that it is difficult to apply and in some situations prohibits legitimate business transactions. Can the purposes of section 42 be accomplished by other means? This question will be answered by analyzing several factual situations involving prohibited financial assistance. The analysis will set out the alternative remedies available to those affected by the prohibited financial assistance and examine the scope of those remedies. If the alternative remedies are adequate, we can recommend repeal of section 42.

The factual situations discussed in this chapter will involve a non-distributing corporation called Wonder Corp. Mr. and Mrs. Smith and their son and daughter each own twenty percent of the issued shares. Mr. Jones owns the remaining twenty percent of the shares. Each shareholder is a director of Wonder Corp. This corporation has negligible stated capital and no retained earnings. The realizable value of its assets equals or is less than its liabilities. Also it cannot pay its liabilities as they become due.

### B. Financial Assistance by a Non-Distributing Corporation to its Directors and Shareholders

#### (1) The Affected Classes

When a non-distributing corporation makes a loan or gives a guarantee or charges on its assets for the benefit of a director or shareholder, the persons affected are the shareholders and creditors of the corporation.[117]

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[117] Discussion Report, pp. 76 - 78.

(2) Remedies Available to Shareholders

(a) Loans to directors and shareholders

Assume that the directors pass a resolution authorizing Wonder Corp. to make an unsecured loan to Mr. Smith. Mrs. Smith and her daughter and son vote in favour of the resolution. Mr. Jones votes against the resolution. Mr. Smith abstains from voting. In the circumstances, no benefit accrues to the corporation other that the receipt of interest on the loan.[118] At a meeting of shareholders, Mr. and Mrs. Smith and their children vote to ratify the directors conduct.

Mr. Jones objects to the loan being made and wishes to obtain a remedy. All shareholders are complainants by virtue of section 231(b)(i). Therefore Mr. Jones could bring a personal action under section 234 or seek leave to bring a derivative action on behalf of the corporation under section 232.

(i) Personal action: section 234 ABCA

For relief to be given under section 234, Mr. Jones must prove that the granting of the loan was oppressive or unfairly prejudicial or that it unfairly disregarded his interest as shareholder. *Jackman* v. *Jackets Enterprises*,[119] *Low and Anderson* v. *Ascot Jockey Club*,[120] and *Keho Holdings Ltd. and Oliver* v. *Noble*[121] support the proposition that an unsecured or interest free loan made by a *solvent* corporation to a director or his corporation is oppressive or unfairly prejudicial to the shareholder when the loan is

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[118] In most cases, the granting of an adequately secured interest bearing loan will not harm the shareholders or creditors of the corporation. Therefore, such a situation will not be analyzed.

[119] *Supra* n. 20.

[120] *Supra* n. 21.

[121] *Supra* n. 16.

made for the exclusive benefit of the director or his corporation. If a solvent corporation cannot give such a loan, surely an insolvent corporation cannot.

Under section 234 the Court may make an order to rectify the matters complained of. The court must recognize that any order given against Wonder Corp. is of no practical value. The court must order Mr. Smith to cause the loan to be repaid or to provide security for the loan. An order for immediate repayment of the loan to Wonder Corp. would be the most effective because it would provide the corporation with needed liquidity.

It is not clear if the courts will exercise their broad powers under section 234 to order Mrs. Smith and her daughter and son to repay the loan. They approved the loan but did not benefit financially thereby. In the *Jackman* case and the *Keho Holdings Ltd.* case, the recipient of the loan was a corporation owned by the director approving the loan. The courts had no problem in ordering the director who authorized the loan and who received the benefit of the loan to provide for repayment of the loan or provide security for the loan. We are unaware of any case in which the courts have made such an order in respect of a director who approved the loan, but did not benefit personally thereby. If the courts will not do so, an action under section 234 will not be effective if Mr. Smith is insolvent.

(ii) <u>Derivative action: section 232 ABCA</u>

If recovery from the directors authorizing the prohibited financial assistance is sought, Mr. Jones should seek leave to bring a derivative action on behalf of Wonder Corp.

(A) <u>Does the corporation have a cause of action?</u>

It is submitted that in this situation Mrs. Smith and her daughter and son did not exercise the care, diligence and skill that a reasonably prudent person would exercise in deciding to make the loan. If Wonder Corp. requires money to pay its debts or operate its business, the corporation should not make loans to directors for non-business purposes. Wonder Corp. would have an action in damages for negligence against the directors authorizing the loan.

Wonder Corp. also has a cause of action against Mrs. Smith and her children for breach of fiduciary duty. Directors are fiduciaries of the corporation. As fiduciaries they must act in good faith and with a view to the best interests of the corporation.[122] In this situation the corporation is strapped financially and needs the funds to operate its own business. The making of the unsecured loan is not in the interest of Wonder Corp. Even if the loan is repaid with interest, it harms the corporation by diverting funds needed immediately for the operation of the corporation. In these circumstances, the granting of the loan is a breach of fiduciary duty. The directors authorizing the loan must reimburse the corporation for its loss, which in this case is loss of needed cash flow. The directors should be ordered to repay the money lent.

Directors hold the moneys of Wonder Corp. in trust for the corporation.[123] They should apply the moneys only for the purposes of the corporation.[124] If moneys of Wonder Corp. in the hands or under the control of the directors are not applied for corporate purposes, it is to misapply the funds. This is a breach of trust.[125] Mrs. Smith and her daughter and son made moneys of Wonder Corp. available to Mr. Smith when it was not in the corporation's interest to do so. They did not apply the corporate funds for the purposes of Wonder Corp. They have misapplied the corporate funds and are in breach of trust.

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122 Section 117(1)(a) ABCA.

123 *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3), supra* n. 55 and *Angus* v. *Angus Limited, supra* n. 55.

124 *Ibid.*

125 *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3), supra* n. 55.

A director must avoid a conflict between his duty to the corporation and his personal interests. Mr. Smith has an obvious conflict of interest between his fiduciary duty to the corporation and his personal interests. By obtaining the loan from the corporation in these circumstances he has breached his fiduciary duty to the corporation. He must repay the loan immediately. Even if he met the requirements of section 115 of the ABCA, he is still liable for breach of fiduciary duty. Mr. Smith is not protected by section 115 because the loan was not reasonable and fair to the corporation at the time it was approved.

### (B) Will the court grant leave for the shareholder to bring a derivative action?

Before Mr. Jones can bring a derivative action, he must obtain leave of the court to do so under section 232. Leave will not be granted unless Mr. Jones has met the prerequisites contained in section 232. He must give adequate notice to the directors of his intention to bring the action if the directors fail to do so. He must also establish his good faith. Mr. Jones can do this if he can show the loan is of a significant amount and that his real purpose is not to pursue a private vendetta. There should be no difficulty in showing that the action is in the interests of Wonder Corp. The corporation has a cause of action for recovery of the loan amount. If the loan amount is not recovered, the corporation will fail for it has insufficient funds to pay its liabilities as they become due.

### (C) Will ratification preclude the action?

The approval by the majority of shareholders of a breach of a right or duty owed to Wonder Corp. will not automatically be a bar to commencement of a derivative action. However, the court can take such approval into consideration.[126] The court gives little weight to shareholder approval when the approval is given by shareholders benefitting from the financial assistance or those committing the breach of fiduciary

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[126] Section 235(1).

duty. Therefore if Mr. Smith and his family, voting as shareholders, condone the breach this will not be a bar to the action.

(b) Guarantee or collateral security for the personal debt of the director and shareholder

Assume that Wonder Corp. gives to a bank collateral security for the personal debt of Mr. and Mrs. Smith. Their son and daughter voted in favour of the resolution authorizing the financial assistance. Mr. Jones opposed the resolution. Mr. and Mrs. Smith did not vote on the resolution. No benefit accrues to the corporation as a result of the granting of the financial assistance. The financial assistance given is a guarantee, a charge on corporate assets or both.

(i) Personal action: section 234 ABCA

Wonder Corp. has charged its assets as security for the personal debt of Mr. and Mrs. Smith. In our opinion this is conduct which is oppressive of the minority shareholder, Mr. Jones. The equity of the company and therefore the value of his shares, will be reduced by enforcement of the security and the corporation and Mr. Jones will have received no benefit. Even if the shares are of no value when the security is given, Mr. Jones is still oppressed because the chances of the corporation becoming financially viable are reduced if not eliminated.

Consider *Westmore and Enchant Resources Ltd.* v. *Old MacDonald's Farms Ltd. and McAfee.*[127] In that case a bank sought security for the directors' personal debt from the directors' company. The company provided the security by assigning to the bank a debenture the company held. The directors did not anticipate that the company's other assets would be insufficient to satisfy the company's debts. This is what did happen. Still, the Court held that the assignment of the debenture was unfairly prejudicial and oppressive to Westmore as minority shareholder. This case suggests that it is not the

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127 *Supra* n. 23.

foreseeability of the corporation's inability to meet its debts because of the assignment of the assets that is the key to the finding of oppression or unfair prejudice. It is the use of the corporate assets for the personal benefit of the directors that is the key.

It is submitted that financial assistance in the form of collateral security is just another form of misappropriation of corporate assets. Here misappropriation of corporate assets means the use of corporate assets for non-corporate purposes, such as for the personal benefit of the directors. There is no difference between directors taking director's fees for which they are not entitled to and directors having the corporation pay for their debts. Therefore when arguing his case, the shareholder can rely on the many cases that have held that misappropriation of corporate assets is oppressive of or unfairly prejudicial to the minority shareholder.[128]

When remedying the conduct complained of the court must, as it did in the *Old McDonald's Farms Ltd.* case, recognize that a judgment against an insolvent corporation is of no value. In that case the court did not order the directors to repay the value of the assets assigned for their benefit. It ordered the directors and the company to pay Westmore, in trust for Enchant, the $144,000 owed on the shareholder's loan. This was all Westmore was entitled to by agreement. In absence of such a peculiar fact situation, the directors receiving the benefit of the security should be ordered to repay the value of the corporate assets lost upon enforcement of the security.

This peculiar fact situation does not exist for Wonder Corp. Therefore Mr. and Mrs. Smith should repay to the corporation the value of the assets lost upon enforcement of the security. Query whether under section 234 the court will order all directors approving the financial assistance to repay the value of lost corporate assets.

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128 See discussion of cases at pp. 177-81 of Appendix 8.

(ii) Derivative actions: section 232 ABCA

(A) Does the corporation have a cause of action?

The corporation has a cause of action against the son and daughter in negligence. As directors they were negligent in granting the collateral security when the realizable value of the assets of Wonder Corp. were less that its liabilities. The loss suffered by the corporation is the value of the assets lost when the bank enforced the guarantee and collateral security.

The son and daughter are also liable for breach of fiduciary duty owed to Wonder Corp. As directors, they have a duty to act with a view to the best interests of Wonder Corp.[129] Applying the corporate assets for the personal use of Mr. and Mrs. Smith when the corporation does not benefit is not acting in the best interests of the corporation.[130] The son and daughter have breached their fiduciary duty. They are jointly and severally liable to repay to Wonder Corp. the value of the assets lost upon enforcement of the collateral security.

The corporation can also allege breach of trust by the son and daughter. As directors they hold the assets of Wonder Corp. that are under their control on trust. They are to apply the assets for the corporation in accordance with its purposes.[131] The directors have breached this trust applying corporate funds for the benefit of their parents and to the detriment of Wonder Corp. They are liable to repay Wonder Corp. for the lost funds.

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129 Section 117(1)(a) ABCA.

130 *Plain Ltd.* v. *Kenley & Royal Trust*, [1931] 2 D.L.R. 801 (Ont. S.C.A.D.), *Export Brewing & Malting Company* v. *Dominion Bank*, *supra* n. 68, and *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation and Others*, *supra* n. 70.

131 *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3)*, *supra* n. 55.

Mr. and Mrs. Smith are in a conflict of interest situation. Their duty as director conflicts with their personal interest. They would have to repay to Wonder Corp. the value of the assets transferred to the bank on their behalf. The law of suretyship would also bring about this result.

### (B) Remedies against third parties

Will the bank be deprived of the collateral security? This will depend on whether directors hold assets of the corporation on trust to be used for corporate purposes. If the court does not see directors as holding the corporate assets on such a trust, the issue will be whether the principles in the *Selangor* case will be extended to cover situations of breach of fiduciary duty.

The argument to be made against the bank receiving the benefit of the financial assistance is as follows. The directors of Wonder Corp. are trustees of corporate funds and assets under their control and they hold them on trust for the corporation in accordance with its purposes.[132] To allow corporate assets to be used to satisfy the personal debts of a director is a breach of the trust to apply corporate funds and assets for corporate purposes. This is morally reprehensible for several reasons. First, it reduces the corporation's ability to satisfy its debts. Secondly, it benefits one director at the expense of all the shareholders. Thirdly, it allows the principle of limited liability to shield directors who rob the corporation for their own purposes. Therefore the granting of the financial assistance is a dishonest and fraudulent design on the part of the directors.

The bank took the guarantee and collateral security knowing the directors were under a fiduciary duty as trustee to use the assets in the best interests of Wonder Corp. The bank knew the guarantee and security was not for any purpose of Wonder Corp., but was a gratuitous disposition of property of the corporation for the benefit of Mr. and

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132 *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3), supra* n. 55 and *Angus et al.* v. *R. Angus Limited et al., supra* n. 55.

Mrs. Smith. The bank knew Wonder Corp. derived no benefit from the granting of the guarantee and collateral security. Therefore the bank knew the son and daughter were in breach of trust when they voted for the resolution authorizing the granting of the guarantee and collateral security. A constructive trust should be imposed upon the bank on two grounds. First, the bank received property of the corporation conveyed to it with the knowledge that this was a breach of trust. Secondly, the bank was a stranger to a trust who gave "assistance with knowledge in a dishonest and fraudulent design on the part of the trustees". The fraudulent design was to use corporate assets to pay for the directors' personal debt. The bank assisted the trustees by accepting the guarantee and security. As a constructive trustee, the bank is liable for the loss caused by the breach of trust. It must repay to Wonder Corp. the amount realized in enforcement of the guarantee and collateral security.

Even if the directors are not held to be trustees of corporate assets, the *Selangor* principles may have been extended to apply to situations of assistance by a stranger with knowledge of a dishonest and fraudulent design on the part of the fiduciary.[133]

### (C) Will the court grant leave for the shareholder to bring a derivative action?

The analysis is the same as that set out for the loan fact situation discussed at page 87.

### (D) Will ratification preclude the action?

The analysis is the same as that set out for the loan fact situation discussed at page 87.

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[133] *MacMillan Bloedel Ltd.* v. *Binstead*, *supra* n. 75.

### (3) Remedies Available to Creditors

#### (a) Loans to directors and shareholders

Let us return to the fact situation in which Wonder Corp. made an unsecured loan to Mr. Smith. Assume Mr. Jones opposed the resolution approving the loan, but he did not do anything further. Mr. Smith defaults in payments on the loan. The corporation is unwilling or unable to enforce payment. A creditor obtains judgment and learns that the loan was made.

Garnishment is an effective method of attaching the loan payments as long as Mr. Smith is solvent. If Mr. Smith is insolvent, do the creditors have any recourse against Mrs. Smith and her daughter and son because they authorized the loan? This question can be answered by analyzing this situation from the view point of sections 232 and 234.

##### (i) Personal action: section 234 ABCA

Only a complainant can avail itself of section 234. By Justice McDonald's analysis in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski,*[134] a creditor is not a complainant within the meaning of section 231(b)(i) or (ii). Therefore a creditor can only be a complainant if he comes within section 231(b)(iii). He must be a person who, in the discretion of the court is a proper person to make an application under section 234.

A creditor is a proper person to make an application under section 234 if the creditor shows that the granting of the loan constituted a fraud upon the creditors. It would be fraud upon the creditors to camouflage a gift to Mr. Smith as a loan. Absent fraud upon the creditors, the creditor must show there was a breach of the underlying expectation of the creditor arising from the circumstances in which the credit was

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134 *Supra* n. 7.

granted. To do this, the creditor would have to establish several things. First, that he expected Wonder Corp. would pay the creditor's account before it lent funds to Mr. Smith for his personal use. Secondly, that this expectation is reasonable. Thirdly, there was something in the circumstances giving rise to the extension of credit that prevented the creditor from protecting himself from Wonder Corp. making the loan to Mr. Smith.

The difficulty a creditor has in availing himself of section 234 is that the creditor can usually always protect himself by taking security for the debt owed. However, taking security is not practical in all situations because of the cost of the security, the delay it causes and trade practice. For these reasons most creditors just do not ask for security. Rarely do the circumstances themselves prevent the creditor from protecting his interests. The result is that section 234 is of no use to a creditor harmed by prohibited financial assistance.

Even if section 234 was available to the creditor, it is unclear if the courts would use their powers under this section to order the directors authorizing the loan to repay the loan.

### (ii) Derivative action: section 232 ABCA

#### (A) Does the corporation have a cause of action?

This fact situation is the same as the loan fact scenario discussed under remedies for shareholders. Wonder Corp. will have the same causes of action. These are discussed at pages 85 to 87.

#### (B) Will the court grant leave to a creditor to bring a derivative action?

A creditor must first convince the court that he is a "proper person" to bring the action. Then he must obtain leave of the court to commence the action. A creditor will be seen as a "proper person", if the creditor is a person who "could reasonably be entrusted with the responsibility of advancing the interests of the corporation by seeking a remedy to right a wrong allegedly done to the corporation".[135] Therefore creditors who can afford the costs of the action could be complainants.

Once the creditor establishes himself as a complainant, he will seek leave of the court under section 232 to bring the action. The Court will not grant leave unless the prerequisites of section 232 are met. The creditor must give adequate notice to the directors of his intention to bring the action against Mr. and Mrs. Smith and their two children if the directors fail to do so. The creditor must also establish his good faith by showing that he seeks to recover funds that would be available to pay corporate debts. The creditor should have no difficulty in showing that the action is in the interests of Wonder Corp. The action is likely to succeed. If the loan amount is not recovered, the corporation will fail. It has insufficient funds to pay its liabilities as they become due.

### (C) Will ratification preclude the action?

Section 235(1) of the ABCA provides that the approval by the shareholders of a breach of a right or duty owed to the corporation will not automatically be a bar to commencement of a derivative action. However, the court can take such approval into consideration.

Ratification will be more of a problem for creditors than shareholders. It will depend on the view of the court. The court may see the corporation as separate from the interests of the shareholders and as a legal entity that should be responsible for its debts. If it takes this view, ratification by the shareholders should carry little weight.[136] Yet if the court identifies "the interest of the corporation" as being only "the interests of the shareholders" then ratification may be given more weight. We hope that subsequent

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[135] *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*, *supra* n. 7 at p. 151.

[136] See the decision of Templeman L.J. in *Re Horsley & Weight Ltd.* [1982] 3 All E.R. 1045 at 1056.

decisions will adopt Justice McDonald's view that section 232 should be used by creditors and shareholders to remedy unethical corporate conduct.

(iii) Fraudulent conveyances and fraudulent preferences

A creditor can challenge the loan made to Mr. Smith as a fraudulent conveyance under the Statute of Elizabeth. The creditor must establish that Wonder Corp. made the loan with the intent to delay, hinder or defraud creditors and section VI of the Statute of Elizabeth does not protect the transaction.

To prove that Wonder Corp. had the necessary intent, the creditor will rely on the presumption that one intends the natural consequences of one's acts. At the time the loan was made, the corporation was unable to pay its liabilities as they became due. Therefore, the court should infer that Wonder Corp. had the intent to delay or hinder its creditors by making the loan. The more absurd the terms of repayment are, the stronger this argument will be. Consider the case of *Carew* v. *Power and Melvin.*[137] The debtor lent $15,200 to his common law spouse. No interest was payable on the principle. The principle was to be repaid at the staggering rate of $5 per month for 25 years and the unpaid balance would then be due and owing. The court willingly inferred the existence of fraudulent intent in these circumstances.

In the fact situation we have set out, we have assumed that the loan has no business purpose. The existence of such a business purpose would refute the inference of fraudulent intent. An example of such a situation is a loan made by the parent corporation to its subsidiary. Dividends would flow from the subsidiary to the parent. Therefore the corporation does not intend to defeat its creditors but to support a business investment.

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137 (1984) 50 C.B.R. 275 (Nfld. D.C.).

Section VI of the Statue of Elizabeth protects a conveyance if it is *bona fide* and given for valuable consideration and if Mr. Smith did not participate in the corporation's intent to delay, hinder or defraud creditors of the corporation. Even, if the loan transaction was *bona fide* and valuable consideration was given for the loan, it is still a fraudulent conveyance if the recipient of the loan had the concurrent intent to delay, hinder or defraud the creditors of the corporation.[138] When a corporation makes a loan to a director or shareholder, it is easier to prove concurrent intent because often the person receiving the loan is the governing mind of the corporation. Therefore, the intent of the corporation and the recipient of the loan are the same.

In this situation it is likely the wife and the children acted upon Mr. Smith's direction. If they knew of the financial position of Wonder Corp. at the time the loan was made, they must have had the intent to delay creditors of Wonder Corp. from receiving payment. They would know that the money was needed to pay debts that had accrued due. Mr. Smith would also have this knowledge.

Assume Mr. Smith used the loan proceeds to buy a boat or paid a personal debt. Will a challenge under the Statute of Elizabeth allow the creditor to attach the boat or have recourse against Mr. Smith? We believe that the reasoning in *John Deere Limited* v. *Paddock et ux.*[139] and *Westinghouse Canada Ltd.* v. *Buchar et al.*[140] is applicable. By this reasoning section 11 of the Fraudulent Preferences Act applies to transfers which are void under the Statute of Elizabeth. By virtue of section 11 of the Fraudulent Preferences Act, a creditor can seize the boat to satisfy the corporation's debt. If Mr. Smith used the loan proceeds to satisfy a personal debt, Mr. Smith must account for the money to a judgment creditor of the corporation.

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138 *Ibid.*

139 *Supra* n. 98.

140 *Supra* n. 100.

The loan could also be impugned under section 1 of the Fraudulent Preferences Act. The analysis is the same under the Fraudulent Preferences Act, with the additional requirement that the creditor prove that at the time the loan was made Wonder Corp. was insolvent, unable to pay its debts as they become due or on the eve of insolvency.

### (b) Guarantee and collateral security for the benefit of directors and shareholders

Let us return to the fact situation in which Wonder Corp. gave to a bank a collateral security for the personal debt of Mr. and Mrs. Smith. Mr. Jones opposed the resolution authorizing Wonder Corp. to grant the financial assistance. He did nothing further. No benefit accrues to the corporation as a result of the granting of the financial assistance. The financial assistance given is a guarantee, a charge on corporate assets or both. The bank enforces the collateral security leaving no assets to satisfy trade debts. What remedies do the trade creditors have?

#### (i) Personal action: section 234

The creditor must show that he is a proper person to bring an action under section 234 in these circumstances. First, he must show he was a creditor when the corporation gave the security. Next, he must show the granting of the guarantee and collateral security was oppressive, unfairly prejudicial or was in unfair disregard of his interest as creditor. The argument will be the same as made by a creditor complaining of a loan made by Wonder Corp. to its directors. The problems the creditor will have in showing oppression, unfair prejudice and unfair disregard are the same.

#### (ii) Derivative actions: section 232

For the causes of action which the corporation has in this situation, see the discussion at pages 90 to 92.

The analysis on whether the court will give the creditor leave to bring the derivative action and what effect, if any, ratification will have is the same as that discussed in the loan fact situation at pages 94 to 96.

(iii) Fraudulent conveyances and fraudulent preferences

If Wonder Corp. gave the security and collateral guarantee at the time the loan was made, the corporation's creditors cannot impugn the transaction. It will not be seen as a fraudulent preference because Section 6 of the Fraudulent Preferences Act says the Act is not to apply to such a situation.[141] It is not a fraudulent conveyance because the bank will not have the concurrent intent to delay, hinder or defraud the corporation's creditors. The bank's intent is only to obtain security for its loan.

If Wonder Corp. gave the guarantee and collateral security after the loan was made, the collateral security may be impugned as a fraudulent conveyance and possibly as a fraudulent preference.

To successfully challenge the collateral security as a fraudulent conveyance, Wonder Corp. must have intended to delay, hinder or defraud its creditors when it gave the security. If the corporation gave as security its sole asset, knowing it would become insolvent if the security was enforced, it could be argued that the fraudulent intent existed. This was the case in *Lee* v. *Glenval Holdings Ltd.*[142] where the court held that there was sufficient evidence to direct a trial of an issue on whether the security was a fraudulent conveyance under the Statute of Elizabeth.

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141 Some authorities do not view this as a preference at all. They argue that a preference can only be made to a creditor. At the time the loan was made the bank was not a creditor of the corporation. Only upon default in loan payments does the corporation become indebted to the bank. See *Lee* v. *Glenval Holdings Ltd., supra* n. 89 and *Westinghouse Canada Limited* v. *Caldwell* (1980) 31 C.B.R. (N.S.) 276.

142 *Supra* n. 89.

The key issue will be whether the bank gave any valuable consideration for the guarantee and security. Does forbearance to sue the director constitute valuable consideration given to the corporation? If it does not, the transaction will be seen as a voluntary one. A voluntary transaction can be impugned if Wonder Corp. had the necessary fraudulent intent. The banks intent will have no bearing on the issue. If the bank gave valuable consideration, section VI is applicable. Then it must be proven that the bank had the concurrent intent to "delay, hinder or defraud" creditors. Mere knowledge of the corporation's fraudulent intent or insolvency is not enough to establish concurrent intent. The bank must be privy to the fraud. In most situations this will not be the case.

There is conflicting authority on whether the granting of the security is or is not a preference. Compare *Lee* v. *Glenval Holdings Ltd.* and *Gulf & Fraser Fishermen's Credit Union* v. *W.R. Menchions & Co. Ltd.*[143] However if one does attack it as a fraudulent preference, it will be essential to prove the bank knew of the corporation's insolvent position at the time the guarantee and security was given. This is necessary to prove that the bank intended to accept a preference over the other creditors of the corporation.[144]

## C. Financial Assistance by Non-Distributing Corporations in Respect of the Purchase of its Shares

### (1) The Affected Classes

It is the creditors of a corporation which are most likely to be adversely affected when a non-distributing corporation gives prohibited financial assistance in respect of the purchase of it shares.[145]

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143 *Supra* n. 106.

144 See discussion at p. 76 of this report.

145 Discussion Report, pp. 83-5 and 171-77.

(2) Remedies Available to Creditors

There are many ways in which Wonder Corp. can provide prohibited financial assistance in respect of the purchase of its shares. The corporation can loan money to X who will use the loan proceeds to pay for shares of the corporation.[146] The corporation may provide security to the shareholder selling his shares or to the bank providing a loan for purchase of shares. In each case the corporation is making its assets available for the benefit of some other party.

As was seen in *Hughes* v. *Northern Electric & Manufacturing Co.*,[147] there are situations in which such financial assistance is necessary for the survival of the corporation's operations. In such special circumstances the creditor of the corporation will have no remedy. He has not been oppressed or unfairly prejudiced and the granting of the financial assistance is not a breach of fiduciary duty on the part of the directors and is not negligent. There is no fraudulent intent to delay, hinder or defraud creditors.

Absent such circumstances, the scenario is the same as where a corporation provides financial assistance for the benefit of a shareholder or director where no benefit accrues to the corporation. The creditor has the same remedies against the

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146 This is the type of situation dealt with in *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3)* and *Karak Rubber Co. Ltd.* v. *Burden (No. 3)*. Those cases were decided under company statutes which prohibited financial assistance by a corporation for the purchase of its shares. Yet comments in the latter case would indicate that even if there were no such prohibitions in the Companies Act, equity would see this as a situation where X is stealing from the company in order to pay for his purchase of shares and therefore equity would arrive at the same findings. Both cases held that the directors authorizing the transfer of funds were in breach of their fiduciary duty to the corporation and were liable to repay the corporation the moneys "stolen" from it. Also, other parties participating in the chain of events who knew the money was to be applied for the purpose of buying the shares were held liable as constructive trustees. It is submitted that this is also a situation which would be seen as oppression of shareholders and creditors for it is really a fraudulent scheme.

147 *Supra* n. 67.

directors and bank as are available in the situation of financial assistance to directors and shareholders.

D. Financial Assistance that Benefits the Corporation

Each of the factual situations discussed in this chapter assumed that no benefit accrued to the corporation as a result of the giving of the financial assistance. What is the result if some benefit does accrue to the corporation? In those circumstances the corporation can grant the financial assistance, notwithstanding its poor financial condition. If the financial assistance benefits the corporation, it is not a breach of duty for the directors to authorize it. Also it will not be oppressive or unfairly prejudicial to shareholders or creditors. There is no intent to defraud creditors.

This is not a radical departure from the present law. Presently a corporation which cannot meet the solvency tests created by section 42(1) can *still* grant prohibited financial assistance in the circumstances set out in section 42(2). The circumstances listed in section 42(2) are generally circumstances where the granting of financial assistance is of some benefit to the corporation. For example it is of benefit for a parent company to give financial assistance to its subsidiary. The repeal of section 42 will mean that corporations can give financial assistance in some situations in which it is presently prohibited. The touchstone will be that the financial assistance must be in the interest of the corporation granting the financial assistance.

E. Conclusion

The analysis of alternative remedies contained in this chapter reveals that the repeal of section 42 would not adversely affect shareholders of a corporation. Shareholders can make use of the personal remedy created by section 234 or bring a derivative action under section 232. In most cases a derivative action will bring about the results sections 42 and 113 now provide.

Repeal of section 42 is of more consequence to creditors. The personal remedy of section 234 is of no help to creditors faced with prohibited financial assistance. The law of fraudulent conveyances and fraudulent preferences provides remedies in certain cases of prohibited financial assistance, but not all. However, if a creditor will be allowed to bring a derivative action on behalf of a corporation against directors who breach their fiduciary duty in granting financial assistance, the repeal of section 42 will not adversely affect creditors either.

# CHAPTER 5 - FINANCIAL ASSISTANCE BY DISTRIBUTING CORPORATIONS

## A. Introduction

In this chapter we shall analyze the alternative remedies available to those adversely affected by the granting of prohibited financial assistance by a distributing corporation.

## B. Financial Assistance by a Distributing Corporation to its Directors and Shareholders

### (1) The Affected Classes

Generally speaking, when a distributing corporation gives financial assistance to one of its directors or shareholders, the creditors of the corporation are not affected. The shareholders are affected by these actions, because the recipient of the financial assistance is benefitting at the expense of the shareholders.[148] Therefore, in the context of financial assistance by a distributing corporation to its directors and shareholders, we shall focus on remedies available to shareholders.

### (2) Remedies Available to Shareholders

A shareholder of a distributing corporation who is adversely affected by financial assistance granted by the corporation to a director or shareholder can protect his interests. He can bring a personal action under section 232 or a derivative action under section 234. The remedies available to a shareholder of a distributing corporation in this situation are the same as those available to a shareholder of a non-distributing corporation faced with the same problem. These remedies are discussed in Chapter Four. We will not repeat the analysis in this chapter.

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148 Discussion Report, pp. 84 and 147.

## C. Financial Assistance by a Distributing Corporation in Respect of the Purchase of its Shares

### (1) The Affected Classes

The problems associated with financial assistance by a distributing corporation in respect of the purchase of its shares arise in connection with take-over bids or an issuer bid by a distributing corporation to purchase its own shares. It is the shareholders and not generally the creditors who are affected by such transactions.[149]

### (2) Remedies Available to Shareholders

The regulation of take-over bids is a complicated matter and is one which is best done by Security Commissions and the administrators of Canada's various stock exchanges. Therefore, the ABCA should not contain any provision relating to regulation of financial assistance by a distributing corporation in connection with a purchase of its shares. Any regulation considered necessary by the Alberta Securities Commission and the Department of Consumer & Corporate Affairs should be found in the appropriate Alberta securities legislation.[150]

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[149] Discussion Report, pp. 165-166.

[150] For a more complete discussion of this topic, see pp. 165 - 168 of the Discussion Report.

## CHAPTER 6 - DISCLOSURE

### A. Introduction

In Chapters 2 and 3 we reviewed areas of the law which create remedies for shareholders and creditors harmed when a corporation grants prohibited financial assistance. The existence of such remedies is of no benefit to a creditor or shareholder unless they have some knowledge that the corporation has granted financial assistance. Therefore, we believe shareholders and creditors must have some means of obtaining this knowledge. In this chapter we will examine how shareholders and creditors presently learn that a corporation has given financial assistance. Then we will analyze if these methods are adequate.

### B. Section 42(4)

Sub-section 42(4) requires disclosure to shareholders of the transactions regulated by section 42, whether they are in contravention of the section or not. Unless disclosure is otherwise made by a corporation, the financial statement presented to the annual meeting of shareholders must disclose the financial assistance. The financial statement must contain the identity of the person to whom the financial assistance was given, the nature of the financial assistance given, the terms on which the financial assistance is given and the amount of the financial assistance initially given and the amount, if any, outstanding.

The effect of section 149 and the regulations enacted under that section is very similar to the effect of section 42(4). Sections 149 and the regulations require that the financial statements be prepared in accordance with the CICA Handbook. Section 3840 of the Handbook deals with related party transactions. The transactions regulated by section 42 are related party transactions. Section 3840.13 requires disclosure in the annual financial statement of the nature and extent of the transaction, a description of their relationship and amounts due to or from a related party, and, if not otherwise apparent, the terms of settlement.

The only difference between section 42(4) and section 3840.13 is that section 42(4) requires disclosure of the identity of person receiving the financial assistance. Section 3840.13 requires the financial statement to disclose the relationship only.

## C. Disclosure by Non-Distributing Corporations

### (1) To Shareholders

It is important that the shareholders of a non-distributing corporation know if and to whom the corporation gives financial assistance. In most non-distributing corporations the shareholders will be aware of any financial assistance given by a corporation. Yet to ensure that no shareholder remains uninformed, disclosure of the financial assistance should be required.

Is a statutory disclosure requirement necessary? If section 42(4) were repealed, generally accepted accounting principles would still require that the financial statements disclose related party transactions. However, the corporation would not have to disclose the identity of the person receiving the financial assistance. In the case of a non-distributing corporation, the identity of the person receiving the assistance is of prime importance. Therefore corporations should be required to disclose the information set out in section 42(4).

When dealing with section 42, the Institute was concerned that shareholders would not get timely notice even if the section 42(4) was satisfied. If disclosure is made in the financial statements presented at the annual meeting of shareholders, it is possible these financial statements may not be seen by the shareholder until 15 months after the financial assistance was given. It may be longer if the shareholder must compel the corporation to provide financial assistance. An action brought under section 113 must be brought within two years of the date of the directors resolution authorizing the granting of the financial assistance given in contravention of section 42. This two year limitation period could leave the shareholder with very little time to commence his action. Therefore the Discussion Report recommended that non-distributing corporations disclose to all of its shareholders the details of any financial assistance given by the corporation to its directors within 90 days of the transaction.[151] The same recommendation was made for financial assistance given for purchase of the corporation's shares.[152]

If section 42 is repealed, a derivative action for breach of fiduciary duty and an action under section 234 will be the primary remedies available to shareholders. The current applicable limitation period for these actions is 6 years. The discoverability principle in *Central and Eastern Trust Company* v. *Rafuse*[153] may create additional protection for the shareholders. If this principle is applicable, the limitation period may not arise until the shareholder learns the directors had the corporation give financial assistance. Even if the limitation period arises on the day the directors pass the resolution authorizing the corporation to grant the financial assistance, the six year limitation period will not bar an action brought by a shareholder.

Even with a longer limitation period, a lengthy delay in learning of the financial assistance is still of concern to a shareholder. By the time the shareholder learns of the financial assistance the damage to the corporation may be irrevocable. Therefore, it is still our recommendation that a non-distributing corporation give to all of its shareholders notice of the financial assistance within 90 days of the transaction. This will allow the shareholder to seek timely remedies. It is not a great burden on the non-distributing corporation for there are not too many shareholders.

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[151] Discussion Report, p. 162.

[152] Discussion Report, p. 184.

[153] [1986] 2 S.C.R. 147.

(2) To Creditors

In the Discussion report we made Recommendation 18 to elicit discussion. Recommendation 18 suggested that in any case in which a non-distributing corporation has granted financial assistance in connection with a purchase of its shares, corporations be required to notify all of its unsecured creditors that it has done so within 90 days of the date of the transaction. The practical benefit of such disclosure was that a creditor could refuse to grant further credit.

The lawyers that did comment on this recommendation thought that it was impractical. In their opinion notice to creditors would raise often needless alarm and would be difficult to carry out. They did not think the disclosure would be of much help to an existing creditor.

Another reason that disclosure may not be necessary is that creditors can learn of the financial assistance in other ways. For example, most collateral security given for a guarantee must be registered in some government registry. Creditors can search these registries. Also, there is nothing stopping a creditor from seeking information from the corporation before it grants credit. This is commonly done when large amounts of credit are extended. Also, a creditor has access to information once he obtains judgment and conducts an examination in aid of execution. This is often a frustrating process because it may mean several appearances before the court to obtain an order compelling the corporate officers attendance. However, if one is patient and persistent it does provide information.

For these reasons we do not recommend that a non-distributing corporation be required to notify its creditors of the details of any financial assistance it gives to directors or shareholders or in respect of the purchase of its shares.

## D. Disclosure by Distributing Corporations

### (1) To Shareholders

Financial statements of a distributing corporation prepared according to the CICA Handbook would disclose related party transactions. The financial statements would not reveal the identity of the director or shareholder receiving the assistance. The requirement to disclose the name of the individual does discourage such transactions. Therefore we believe there should be a statutory requirement that distributing corporations disclose financial assistance given directors and shareholders.

As discussed in Chapter 5, we believe that financial assistance by a distributing corporation in connection with purchase of its shares should be regulated in the Securities Act. However, until this matter can be reviewed by the Securities Commission, the disclosure requirements should be retained in the ABCA.

### (2) To Creditors

It is not usually the creditors of a distributing corporation who are or will be adversely affected if a distributing corporation gives financial assistance to a director or shareholder.[154] Distributing corporations under the umbrella of the Alberta Securities Act must file quarterly statements. These are available to creditors directly or through credit reporting agencies. Therefore, creditors have the opportunity to review current financial statements to assist in estimating the risk of granting credit. Also most distributing corporations have a substantial amount of stated capital to which a creditor can look for payment. Therefore we do not believe there is a need to have disclosure to creditors.

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[154] See Discussion Report, pp. 120-21 and 147.

## E. Recommendations

We recommend that a non-distributing corporation disclose to all of its shareholders financial assistance given by way of loan, guarantee or otherwise to a certain class of persons within 90 days of the transaction. The class includes shareholder or director of the corporation or of an affiliated corporation, an associate of a shareholder or director of the corporation or of an affiliated corporation, or to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or an affiliated corporation.

We also recommend that the disclosure requirements imposed upon distributing corporations by section 42(4) be incorporated into section 149.

## CHAPTER 7 - RECOMMENDATIONS FOR REFORM

### A. Consequences of Repeal of Section 42

Whenever repeal of existing legislation is contemplated, the adage of "Look before you leap" should come to mind. Although some lawyers and bankers see section 42 as an affliction, will the cure be worse? In this chapter, we shall discuss the criticisms of section 42 and analyze if repeal of section 42 will alleviate these concerns. We will also discuss concerns that arise if section 42 is repealed. A comparison of the affliction and the cure will determine if the Institute should recommend repeal of section 42.

#### (1) Criticisms of Section 42

Section 42 creates problems for bankers and lawyers. In their experience the section is difficult to apply and is a hindrance to legitimate commercial transactions.

Before the enactment of section 42, section 14 of the Alberta Companies Act, R.S.A. 1980, C-20 prohibited a public company from making loans to directors or shareholders. The section also prohibited a public company from giving financial assistance to anyone in connection with purchase of shares in the company. Section 14 had no application to private companies. Section 42 applies to a much broader range of transactions. All corporations, not just distributing corporations, are affected by the section. The prohibited class includes shareholders and directors of a corporation, the associates of shareholders and directors of a corporation, shareholders and directors of affiliated corporations, and associates of shareholders and directors of affiliated corporations.

The extension of the scope of prohibited transactions has increased the complexity of section 42. A lender needs sufficient time and opportunity for investigation to determine if the transaction falls within the scope of section 42. In debt restructuring situations, the lender does not always have the time or opportunity for investigation.

If the transaction falls within the scope of section 42, the lender must satisfy himself that the liquidity test of section 42(1)(d) and the underlying asset test of section 42(1)(e) are met. The application of the underlying asset test is the most troublesome. The underlying asset test uses realizable value as opposed to historical value. The financial statements reflect historical value. Therefore no one can rely on the financial statements in determining realizable value. Appraisals are necessary to determine realizable values. Yet, there is uncertainty as to how one measures realizable value.

The lenders main concern with section 42 is that it prevents lenders from taking security from a corporate group. This is a recurring problem because today many business enterprises are operated through several related corporations. When making a loan to the business enterprise, the lender will want security for repayment of the loan from each member of the corporate group. This removes the temptation to transfer property to another member of the corporate group to avoid payment of the loan. Unfortunately, section 42 has prohibited certain corporate debt restructuring when the transaction was in the interest of each member of the corporate group and the corporations' creditors.

Another consequence of section 42 is that it prohibits a common lending practice. Corporations often give a floating charge debenture as security for a loan. However, a corporation cannot give a floating charge debenture in any situation regulated by section 42. The corporation cannot satisfy the underlying solvency test if it grants a floating charge on all its assets.

The consequences of contravening section 42 are severe for a lender. Security given to a bank in contravention of section is unenforceable, unless the bank is protected by section 42(3). A lender will not be afforded the protection of section 42(3) if the bank knew the security it was granted was in contravention of section 42. It is unlikely the lender will lend money without knowing sufficient facts which would later lead a judge to find that it knew of the contravention of the section. Therefore section 42(3) will not provide much protection to the lender.[155]

The section causes delays and increases the cost of borrowing. Most lenders will not make the loan unless a lawyer or accountant gives an opinion that the transaction does not contravene section 42. If the cost of such an opinion is prohibitive to the lender's customer, the loan will not be made. This may be an insurmountable obstacle for some corporations. Even if the customer can afford such an opinion, he may have a difficulty in getting one. Most Alberta lawyers will not give such opinions. Even certain accountants refuse to give the opinions.

(2) Repeal of Section 42

The repeal of section 42 would solve some, but not all, of the problems created by the section. Upon repeal, lenders would not have to struggle with the question of which transactions are regulated by section 42. The underlying asset test would be irrelevant. If it was in its interest to do so, a corporation could issue a floating charge debenture to secure a loan made to a shareholder and director. There would be no delay and increased cost of borrowing caused by the need to get an opinion in respect of section 42.

Repeal of section 42 does not mean that every corporation can give financial assistance to anyone it chooses. Directors can only authorize a corporation to give financial assistance when they perceive that it is in the interest of the corporation to do so. The financial position of the corporation will be one factor the directors must consider in determining if it is in the corporation's interest to give the financial assistance. The reason for giving the financial assistance will also be an important factor.

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155 See discussion at pp. 11-12 of this report.

Will repeal of section 42 improve the lender's position? A lender's position is improved in all situations where the corporation giving the financial assistance benefits from the granting of the financial assistance. Where the granting of the financial assistance is of no benefit to the corporation, the lender's position is risky. The lender will know the purpose of the loan. Where the loan is made for the exclusive benefit of the third party, the lender has knowledge that no benefit accrues to the corporation giving the security. The lender also knows that the corporation is not using its assets for its purposes when it gives such security. A good argument can be made that the bank is a constructive trustee of the corporate assets.[156] The constructive trust arises because the bank knowingly received assets conveyed to it in breach of trust or it knowingly assisted a trustee in a fraudulent and dishonest design.

Repeal of section 42 will not mean that a lender can always take security from each member of a corporate group. However, it will lessen this problem to a large degree. Upon repeal of section 42, an insolvent or solvent corporation could give financial assistance in any situation in which the corporation would derive some benefit. Obviously if the continued existence of the corporation depends on the granting of the financial assistance, this would be allowed. Yet directors and lenders must be very careful that they do not confuse what is in the interests of the corporate group and what is in the interest of the corporation giving the financial assistance. As was said in *Charterbridge Corporation Ltd.* v. *Lloyds Bank Ltd. and Others*:[157] "Each company in a group is a separate legal entity and the directors of one company are not entitled to sacrifice the interest of that company." In deciding if the directors have breached their fiduciary duty by authorizing the financial assistance, the courts will look at what is in the interest of the corporation giving the financial assistance and not at what is in the interest of the corporate group as a whole.[158]

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[156] See discussion at pp. 57-66 and 92-94 of this report.

[157] [1969] 2 All E.R. 1185 at 1194

[158] See *Rolled Steel Products Ltd.* v. *British Steel Corporation*, supra n. 70 at 71-73 and *Charterbridge Corporation, Ltd.* v. *Lloyds Bank Ltd. and Others*, supra n. 157 at 1185.

(3) Concerns With Repeal of Section 42

At pages 150 to 153 of the Discussion Report, we discussed six concerns we then had about repeal of section 42 which can be summarized as follows:

(a) If a compliance order is not available under section 240 to a creditor to enforce the liability of directors authorizing financial assistance in contravention of section 42 created by section 113(3), then a derivative action would be necessary to remedy the breach of fiduciary duty. Every creditor cannot bring himself within the category of complainant.

(b) If section 42(3) is repealed, it should be replaced by legislation strengthening the position of the lender. If section 42(3) were merely repealed it is likely a lender will be seen as a constructive trustee on the basis of *Rolled Steel Products Ltd.* v. *British Steel Corporation.*[159]

(c) The remedy for breach of fiduciary duty under section 117 may not impose joint and several liability on directors who consent to the transaction.

(d) Without section 113(3), the exposure of directors could be greater than the amount not otherwise recovered by the corporation. An enthusiastic judge may expand liability to full or partial satisfaction of all creditors' claims if the corporation founders.

(e) Without section 113(9), the statutory limitation period may be unlimited if the principles in *Central and Eastern Trust Company* v. *Rafuse*[160] are applied.

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[159] *Supra* n. 70.

[160] *Supra* n. 153.

(f) The most serious reservation about repeal of section 42 arose from the hazy parameters of the fiduciary duty. Not only are the boundaries indefinite, they are constantly shifting.

The concern that a creditor cannot bring himself within the category of complainant for the purposes of section 232 has been put to rest by the approach taken in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski.*[161] The Institute believes that this case is rightly decided. If this decision is overruled by a higher court, we recommend that section 231 of the ABCA be amended so that for the purposes of section 232, complainant be defined to include a creditor.

The Institute is no longer of the opinion that lenders need special protection. By repeal of section 42, it is the Institute's intention that any corporation be able to give financial assistance when it is in its interest to do so. Solvency or insolvency will be only one factor in determining when it is in the interest of the corporation to grant the financial assistance. Repeal of section 42 should not be seen as an opportunity for the corporation's assets to be made available for the personal use of directors, shareholders or others when no benefit accrues to the corporation. If a lender takes security from a corporation which is solely for the personal benefit of the directors, shareholders or others, the bank should be accountable under the general law of trusts.

Further research has convinced the Institute that all directors who participate in the breach of fiduciary duty will be jointly and severally liable for the resulting loss caused to the corporation. This will mean that directors authorizing financial assistance when it is not in the best interests of the corporation to do so will be jointly and severally liable for the loss caused to the corporation. The loss can only be the value of the financial assistance given by the corporation and cannot be seen in terms of which creditors have not been paid.

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161 *Supra* n. 7.

The limitation period and the hazy parameters of fiduciary duty are still of concern. The proper place to deal with the limitation problem is in new limitations legislation. There is no doubt that the boundaries of fiduciary duty are constantly changing and shifting. Still, the Institute believes that the courts will not allow directors of a corporation to strip the corporate assets for their personal benefit or for any other purpose which does not in some way benefit the corporation granting the financial assistance.

## B. Recommendations

Repeal of section 42 would ensure that a corporation could give financial assistance to anyone when it was in its interest to do so. The result would be that a corporation could give financial assistance in circumstances where is it is currently prohibited from doing so. However, the repeal of section 42 would not allow the corporate assets to be used solely for the personal benefit of the directors, shareholders or their associates. A corporation could not give financial assistance to anyone in connection with the purchase of the corporation's shares unless it was in the interests of the corporation to do so. Shareholders and creditors can use the remedies discussed in Chapters 2 and 3 to deal with situations in which the corporation gives financial assistance when it is not in its interest to do so.

The most effective remedy will be a derivative action brought on behalf of the corporation against directors who have breached their fiduciary duty. This will result in an increased use of section 232. We believe this will be an effective tool available to shareholders and creditors to control unethical conduct of directors.

In view of the problems created by section 42 and the adequate remedies available to deal with most of the abuses section 42 was meant to deal with, the Institute makes the following recommendations:

1. In respect of non-distributing corporations, sections 42(1) to (3) be repealed immediately.

2. In respect of distributing corporations, sections 42(1)(a) and (b) be repealed immediately.

3. The ABCA should not contain any provision regulating financial assistance by a distributing corporation in connection with a purchase of its shares, either issued or to be issued.

4. The Department of Consumer & Corporate Affairs and the Alberta Securities Commission should consider whether there is a case for regulation of improper assistance by a distributing corporation in connection with a purchase of its shares, and if so, whether such undesirable practices as may be identified should be proscribed within the relevant Alberta securities legislation. Section 42(1)(c) should remain in force until this review has taken place.

5. In respect of a distributing corporations, section 42(1)(c) be repealed upon proclamation.

6. A non-distributing corporation be required to disclose to all of its shareholders financial assistance given by way of loan, guarantee or otherwise to a certain class of persons within 90 days of the transaction. The class includes a shareholder or director of the corporation or an affiliated corporation, an associate of a shareholder or director of the corporation or of an affiliated corporation or to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or an affiliated corporation.

7. The disclosure requirements imposed upon distributing corporations by section 42(4) be incorporated into section 149.

8. If the trial decision in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*[162] is overturned, section 231 be amended so that a creditor is a complainant for the purposes of section 232.

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CHAIRMAN

DIRECTOR

August 1989

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162 *Supra* n. 7.

## PART III - SUMMARY OF RECOMMENDATIONS

RECOMMENDATION No. 1

In respect of non-distributing corporations, sections 42(1) to (3) be repealed immediately.

RECOMMENDATION No. 2

In respect of distributing corporations, sections 42(1)(a) and (b) be repealed immediately.

RECOMMENDATION No. 3

The ABCA should not contain any provision regulating financial assistance by a distributing corporation in connection with a purchase of its shares, either issued or to be issued.

RECOMMENDATION No. 4

The Department of Consumer & Corporate Affairs and the Alberta Securities Commission should consider whether there is a case for regulation of improper assistance by a distributing corporation in connection with a purchase of its shares, and if so, whether such undesirable practices as may be identified should be proscribed within the relevant Alberta securities legislation. Section 42(1)(c) should remain in force until this review has taken place.

RECOMMENDATION No. 5

In respect of a distributing corporations, section 42(1)(c) be repealed upon proclamation.

RECOMMENDATION No. 6

A non-distributing corporation be required to disclose to all of its shareholders financial assistance given by way of loan, guarantee or otherwise to a certain class of persons within 90 days of the transaction. The class includes a shareholder or director of the corporation or an affiliated corporation, an associate of a shareholder or director of the corporation or of an affiliated corporation or to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or an affiliated corporation.

RECOMMENDATION No. 7

The disclosure requirements imposed upon distributing corporations by section 42(4) be incorporated into section 149.

RECOMMENDATION No. 8

If the trial decision in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* is overturned, section 231 be amended so that a creditor is a complainant for the purposes of section 232.

## PART IV - APPENDICES

### Appendix 1 - s. 42 of the ABCA

**42**(1) Except as permitted under subsection (2), a corporation shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise

(a) to a shareholder or director of the corporation or of an affiliated corporation,

(b) to an associate of a shareholder or director of the corporation or of an affiliated corporation, or

(c) to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or an affiliated corporation,

if there are reasonable grounds for believing that

(d) the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due, or

(e) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan or in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.

(2) A corporation may give financial assistance by means of a loan, guarantee or otherwise

(a) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation,

(b) to any person on account of expenditures incurred or to be incurred on behalf of the corporation,

(c) to a holding body corporate if the corporation is a wholly owned subsidiary of the holding body corporate,

(d) to a subsidiary body corporate of the corporation, or

(e) to employees of the corporation or any of its affiliates

(i) to enable or assist them to purchase or erect living accommodation for their own occupation, or

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

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

(4) Unless disclosure is otherwise made by a corporation, a financial statement referred to in section 149(1)(a) shall contain the following information with respect to each case in which financial assistance is given by the corporation by way of loan, guarantee or otherwise, whether in contravention of this section or not, to any of the persons referred to in subsection (1)(a), (b) or (c), if the financial assistance was given during the financial year or period to which the statement relates or remains outstanding at the end of that financial year or period:

(a) the identity of the person to whom the financial assistance was given;

(b) the nature of the financial assistance given;

(c) the terms on which the financial assistance was given;

(d) the amount of the financial assistance initially given and the amount, if any, outstanding.

## Appendix 2 - s.s. 117, 231-235 of the ABCA

**117**(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation, and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.

(3) Subject to section 140(7), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach of that duty.

(4) In determining whether a particular transaction or course of action is in the best interests of the corporation, a director, if he is elected or appointed by the holders of a class or series of shares or by employees or creditors or a class of employees or creditors, may give special, but not exclusive, consideration to the interests of those who elected or appointed him.

**231** In this Part,

(a) "action" means an action under this Act or any other law

(b) "complainant" means

(i) a registered holder or beneficial owner, or a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

(ii) a director or an officer or a former director or officer of a corporation or any of its affiliates, or

(iii) any other person who, in the discretion of the Court, is a proper person to make an application under this Part.

**232**(1) Subject to subsection (2), a complainant may apply to the Court for leave to

(a) bring an action in the name and on behalf of a corporation or any of its subsidiaries, or

(b) intervene in an action to which a corporation or any of its subsidiaries is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the corporation or subsidiary.

(2) No leave may be granted under subsection (1) unless the Court is satisfied that

(a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the Court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute, defend or discontinue the action,

(b) the complainant is acting in good faith, and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

**233** In connection with an action brought or intervened in under section 232 or 234(3)(q), the Court may at any time make any order it thinks fit including, without limiting the generality of the foregoing, any or all of the following:

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary;

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

**234**(1) A complainant may apply to the Court for an order under this section.

(2) If, on an application under subsection (1), the Court is satisfied that in respect of a corporation or any of its affiliates

(a) any act or omission of the corporation or any of its affiliates effects a result,

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the Court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the Court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing, any or all of the following:

(a) an order restraining the conduct complained of;

(b) an order appointing a receiver or receiver-manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws;

(d) an order declaring that any amendment made to the articles or by-laws pursuant to clause (c) operates notwithstanding any unanimous shareholder agreement made before or after the date of the order, until the Court otherwise orders;

(e) an order directing an issue or exchange or securities;

(f) an order appointing directors in place of or in addition to all or any of the directors then in office;

(g) an order directing a corporation, subject to section 32(2), or any other person, to purchase securities of a security holder;

(h) an order directing a corporation or any other person to pay to a security holder any part of the money paid by him for securities;

(i) an order directing a corporation, subject to section 40, to pay a dividend to its shareholders or a class of its shareholders;

(j) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(k) an order requiring a corporation, within a time specified by the Court, to produce to the Court or an interested person financial statements in the form required by section 149 or an accounting in any other form the Court may determine;

(l) an order compensating an aggrieved person;

(m) an order directing rectification of the registers or other records of a corporation under section 236;

(n) an order for the liquidation and dissolution of the corporation;

(o) an order directing an investigation under Part 18 to be made;

(p) an order requiring the trial of any issue;

(q) an order granting leave to the applicant to

(i) bring an action in the name and on behalf of the corporation or any of its subsidiaries, or

(ii) intervene in an action to which the corporation or any of its subsidiaries is a party, for the purpose of prosecuting, defending or discontinuing an action on behalf of the corporation or any of its subsidiaries.

(4) This section does not confer on the Court power to revoke a certificate of amalgamation.

(5) If an order made under this section directs an amendment of the articles or by-laws of a corporation, no other amendment to the articles or by-laws shall be made without the consent of the Court, until the Court otherwise orders.

(6) If an order made under this section directs an amendment of the articles of a corporation, the directors shall send articles of reorganization in prescribed form to the Registrar together with the documents required by sections 19 and 108, if applicable.

(7) A shareholder is not entitled to dissent under section 184 if an amendment to the articles is effected under this section.

(8) An applicant under this section may apply in the alternative under section 207(1)(a) for an order for the liquidation and dissolution of the corporation.

**235**(1) An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of the corporation or the subsidiary, but evidence of approval by the shareholders may be taken into account by the Court in making an order under section 207, 233 or 234.

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the Court given on any terms the Court thinks fit and, if the Court determines that the interests of any complainant may be substantially affected by the stay, discontinuance, settlement or dismissal, the Court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

(4) In an application made or an action brought or intervened in under this Part, the Court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for the interim costs on final disposition of the application or action.

## Appendix 3 - s.s. 122, 238-242 of the CBCA

**122.**(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.

(3) Subject to subsection 146(5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach thereof. 1974-75-76, c. 33, s. 117; 1978-79, c. 9, s. 31.

**238.** In this Part

"action" means an action under this Act;

"complainant" means

(a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

(b) a director or an officer or a former director or officer of a corporation or any of its affiliates,

(c) the Director, or

(d) any other person who, in the discretion of a court, is a proper person to make an application under this Part. 1974-75-76, c. 33, s. 231.

**239.**(1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

(a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued. 1974-75-76, c. 33, s. 232.

**240.** In connection with an action brought or intervened in under section 239, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action. 1974-75-76, c. 33, s. 233.

**241.**(1) A complainant may apply to a court for an order under this section.

(2) If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates

(a) any act or omission of the corporation or any of its affiliates effects a result,

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

(a) an order restraining the conduct complained of;

(b) an order appointing a receiver or receiver-manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending a unanimous shareholder agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors then in office;

(f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;

(g) an order directing a corporation, subject to subsection (6), or any other person, to pay to a security holder any part of the moneys paid by him for securities;

(h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 155 or an accounting in such other form as the court may determine;

(j) an order compensating an aggrieved person;

(k) an order directing rectification of the registers or other records of a corporation under section 243;

(l) an order liquidating and dissolving the corporation;

(m) an order directing an investigation under Part XIX to be made; and

(n) an order requiring the trial of any issue.

(4) If an order made under this section directs amendment of the articles or by-laws of a corporation,

(a) the directors shall forthwith comply with subsection 191(4); and

(b) no other amendment to the articles or by-laws shall be made without the consent of the court, until a court otherwise orders.

(5) A shareholder is not entitled to dissent under section 190 if an amendment to the articles is effected under this section.

(6) A corporation shall not make a payment to a shareholder under paragraph (3)(f) or (g) if there are reasonable grounds for believing that

(a) the corporation is or would after that payment be unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.

(7) An applicant under this section may apply in the alternative for an order under section 214, 1974-75-76, c. 33, s. 234; 1978-79, c. 9, s. 74.

**242.**(1) An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section 214, 240 or 241.

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given on such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for such interim costs on final disposition of the application or action. 1974-75-76, c. 33, s. 235; 1978-79, c. 9, s. 75.

Appendix 4 - s.s. 142, 224-225 of the BCCA

**142.**(1) Every director of a company, in exercising his powers and performing his functions, shall

(a) act honestly and in good faith and in the best interests of the company; and

(b) exercise the care, diligence and skill of a reasonably prudent person.

(2) The provisions of this section are in addition to, and not in derogation of, any enactment or rule of law or equity relating to the duties or liabilities of directors of a company.

**224.**(1) A member of a company may apply to the court for an order on the ground

(a) that the affairs of the company are being conducted, or the powers of the directors are being exercised, in a manner oppressive to one or more of the members, including himself; or

(b) that some act of the company has been done, or is threatened, or that some resolution of the members or any class of members has been passed or is proposed, that is unfairly prejudicial to one or more of the members, including himself.

(2) On an application under subsection (1) the court may, with a view to bringing to an end or to remedying the matters complained of, make an interim or final order it considers appropriate, and, without limiting the generality of the foregoing, the court may

(a) direct or prohibit any act or cancel or vary any transaction or resolution;

(b) regulate the conduct of the company's affairs in future;

(c) provide for the purchase of the share of any member of the company by another member of the company, or by the company;

(d) in the case of a purchase by the company, reduce the company's capital or otherwise;

(e) appoint a receiver or receiver manager;

(f) order that the company be wound up under Part 9;

(g) authorize or direct that proceedings be commenced in the name of the company against any party on the terms the court directs;

(h) require the company to produce financial statements;

(i) order the company to compensate an aggrieved person; and

(j) direct rectification of any record of the company.

(3) Every company referred to in subsection (1) shall file a certified copy of an order made by the court under this section, or on appeal from it, with the registrar within 14 days from its entry in the court registry.

(4) The rights granted by this section are in addition to those granted under section 251.

(5) Every company that contravenes subsection (3) commits an offence.

(6) For purposes of this section, a member includes

(a) a beneficial owner of a share in the company; and

(b) any other person who, in the discretion of the court, is a proper person to make an application under this section.

**225.**(1) A member or director of a company may, with leave of the court, bring an action in the name and on behalf of the company

(a) to enforce a right, duty or obligation owed to the company that could be enforced by the company itself; or

(b) to obtain damages for any breach of a right, duty or obligation referred to in paragraph (a),

whether the right, duty or obligation arises under this Act or otherwise.

(2) A member or director of a company may, with leave of the court, in the name and on behalf of the company, defend an action brought against the company.

(3) A member or director may, on notice to the company, apply to the court for the leave referred to in subsection (1) or (2) and, if

(a) he has made reasonable efforts to cause the directors of the company to commence or diligently prosecute or defend the action;

(b) he is acting in good faith;

(c) it is prima facie in the interests of the company that the action be brought or defended; and

(d) in the case of an application by a member, he was a member of the company at the time of the transaction or other event giving rise to the cause of action,

the court may require that notice of the application be served on those persons, and may grant the leave on terms it considers appropriate.

(4) While an action brought or defended under this section is pending, the court may

(a) on the application of a member or director, authorize any person to control the conduct of the action or give any other directions for the conduct of the action; and

(b) on the application of the person controlling the conduct of the action, order on terms and conditions it sees fit, that the company pay him interim costs, including legal fees and disbursements, for which he may be made accountable to the company by the court on the final disposition of the action.

(5) On the final disposition of the action the court may order that the costs taxed as between a solicitor and his own client incurred by the

(a) member or director bringing or defending the action of other person controlling the conduct of the action be paid to him by the company or other parties to the action; or

(b) company and any director or officer of the company be paid to them by the member or director bringing the action or other person controlling the conduct of the action.

(6) No action brought or defended under this section shall be discontinued, settled or dismissed without the approval of the court.

(7) No application made or an action brought or defended under this section shall be stayed or dismissed by reason only that it is shown that an

alleged breach of a right, duty or obligation, owed to the company, has been or might be approved by the members of that company; but evidence of that approval or possible approval may be taken into account by the court in making an order under this section.

(8) For purposes of this section a member includes

(a) a beneficial owner of a share in the company; and

(b) any other person who, in the discretion of the court, is a proper person to make an application under this section.

Appendix 5 - s.s. 117, 231-235 of the MCA

**117**(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act and the regulations, the articles and by-laws, and any unanimous shareholder agreement.

(3) Subject to subsection 140(4), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach thereof.

(4) This section is in addition to and not in derogation of, any enactment or rule of law relating to the duty or liability of directors or officers of a corporation.

**231** In this Part,

(a) "action" means an action under this Act;

(b) "complainant" means

(i) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates, or

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates, or

(iii) the Director, or

(iv) any other person who, in the discretion of a court, is a proper person to make an application under this Part.

**232**(1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

(a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

**233** In connection with an action brought or intervened in under section 232, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

**234**(1) A complainant may apply to a court for an order under this section.

(2) If, upon an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates

(a) any act or omission of the corporation or any of its affiliates effects a result; or

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner; or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner;

that is oppressive or unfairly prejudicial or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

(a) an order restraining the conduct complained of;

(b) an order appointing a receiver or receiver-manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending a unanimous shareholder agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors then in office;

(f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;

(g) an order directing a corporation, subject to subsection (6), or any other person, to pay to a security holder any part of the moneys paid by him for securities;

(h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 149 or an accounting in such other form as the court may determine;

(j) an order compensating an aggrieved person;

(k) an order directing rectification of the registers or other records of a corporation under section 236;

(l) an order liquidating and dissolving the corporation;

(m) an order directing an investigation under Part XVIII to be made; and

(n) an order requiring the trial of any issue.

(4) If an order made under this section directs amendment of the articles or by-laws of a corporation,

(a) the directors shall forthwith comply with subsection 185(4); and

(b) no other amendment to the articles or by-laws shall be made without the consent of the court, until a court otherwise orders.

(5) A shareholder is not entitled to dissent under section 184 if an amendment to the articles is effected under this section.

(6) A corporation shall not make a payment to a shareholder under clause (3)(f) or (3)(g) if there are reasonable grounds for believing that

(a) the corporation is or would after that payment be unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.

(7) An applicant under this section may apply in the alternative for an order under section 207.

**235**(1) An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section 207, 233 or 234.

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by the stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for the interim costs upon final disposition of the application or action.

Appendix 6 - s.s. 134, 244-248 of the OBCA

**134.** (1) Every director and officer of a corporation in exercising his powers and discharging his duties shall,

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.

(3) Subject to subsection 108(5), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act and the regulations or relieves him from liability for a breach thereof.

**244.** In this Part,

(a) "action" means an action under this Act;

(b) "complainant" means,

(i) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates,

(iii) any other person who, in the discretion of the court, is a proper person to make an application under this Part.

**245.** (1) Subject to subsection (2), a complainant may apply to the court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the complainant has given fourteen days' notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) and the court is satisfied that,

(a) the directors of the corporation or its subsidiary will not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

(3) Where a complainant on an *ex parte* application can establish to the satisfaction of the court that it is not expedient to give notice as required under subsection (2), the court may make such interim order as it thinks fit pending the complainant giving notice as required.

(4) Where a complainant on an application can establish to the satisfaction of the court that an interim order for relief should be made, the court may make such order as it thinks fit.

**246.** In connection with an action brought or intervened in under section 245, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees and any other costs reasonably incurred by the complainant in connection with the action.

**247.** (1) A complainant, the Director and, in the case of an offering corporation, the Commission may apply to the court for an order under this section.

(2) Where, upon an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates,

(a) any act or omission of the corporation or any of its affiliates effects or threatens to effect a result;

(b) the business or affairs of the corporation or any of its affiliates are, have been or are threatened to be carried on or conducted in a manner; or

(c) the powers of the directors of the corporation or any of its affiliates are, have been or are threatened to be exercised in a manner,

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer of the corporation, the court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing,

(a) an order restraining the conduct complained of;

(b) an order appointing a receiver or receiver-manager;

(c) an order to regulate a corporation's affairs by amending the articles or by-laws or creating or amending a unanimous shareholder agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors then in office;

(f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;

(g) an order directing a corporation, subject to subsection (6), or any other person, to pay to a security holder any part of the moneys paid by him for securities;

(h) an order varying or setting aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 153 or an accounting in such other form as the court may determine;

(j) an order compensating an aggrieved person;

(k) an order directing rectification of the registers or other records of a corporation under section 249;

(l) an order winding up the corporation under section 206;

(m) an order directing an investigation under Part XIII be made; and

(n) an order requiring the trial of any issue.

(4) Where an order made under this section directs amendment of the articles or by-laws of a corporation,

(a) the directors shall forthwith comply with subsection 185(4); and

(b) no other amendment to the articles or by-laws shall be made without the consent of the court, until the court otherwise orders.

(5) A shareholder is not entitled to dissent under section 184 if an amendment to the articles is effected under this section.

(6) A corporation shall not make a payment to a shareholder under clause (3)(f) or (g) if there are reasonable grounds for believing that,

(a) the corporation is or, after the payment, would be unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.

**248.** (1) An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its affiliate has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section 206, 246 or 247.

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of

prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its affiliate to pay to the complainant interim costs, including reasonable legal fees and disbursements, for which interim costs the complainant may be held accountable to the corporation or its affiliate upon final disposition of the application or action.

Appendix 7 - ss. 117, 231-235 of the SBCA

**117**(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall:

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

(2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, bylaws and any unanimous shareholder agreement.

(3) Subject to subsection 140(4) no provision in a contract, the articles, the bylaws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach thereof. 1976-77, c. 10, s. 117.

**231.** In this Division:

(a) "action" means an action under this Act;

(b) "complainant" means:

(i) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates;

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates;

(iii) the Director; or

(iv) any other person who, in the discretion of a court, is a proper person to make an application under this Division. 1976-77, c. 10, s. 231.

**232.**(1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that:

(a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued. 1976-77, c. 10, s. 232.

**233.** In connection with an action brought or intervened in under section 232, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing:

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary;

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action. 1976-77, c. 10, s. 233.

**234.**(1) A complainant may apply to a court for an order under this section.

(2) If, upon an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates:

(a) any act or omission of the corporation or any of its affiliates effects a result;

(b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner; or

(c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner;

that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

(3) In connection with an application under this section, the court may make any interim or final order it thinks fit including, without limiting the generality of the foregoing:

(a) an order restraining the conduct complained of;

(b) an order appointing a receiver or receiver-manager;

(c) an order to regulate a corporation's affairs by amending the articles or bylaws or creating or amending a unanimous shareholder agreement;

(d) an order directing an issue or exchange of securities;

(e) an order appointing directors in place of or in addition to all or any of the directors in office;

(f) an order directing a corporation, subject to subsection (6), or any other person, to purchase securities of a security holder;

(g) an order directing a corporation, subject to subsection (6), or any other person, to pay to a security holder any part of the moneys paid by him for securities;

(h) an order varying or settling aside a transaction or contract to which a corporation is a party and compensating the corporation or any other party to the transaction or contract;

(i) an order requiring a corporation, within a time specified by the court, to produce to the court or an interested person financial statements in the form required by section 149 or an accounting in such other form as the court may determine;

(j) an order compensating an aggrieved person;

(k) an order directing rectification of the registers or other records of a corporation under section 236;

(l) an order liquidating and dissolving the corporation;

(m) an order directing an investigation under Division XVII to be made;

(n) an order requiring the trial of any issue.

(4) If an order made under this section directs amendment of the articles or bylaws of a corporation:

(a) the directors shall forthwith comply with subsection 185(4); and

(b) no other amendment to the articles or bylaws shall be made without the consent of the court, until a court otherwise orders.

(5) A shareholder is not entitled to dissent under section 184 if an amendment to the articles is effected under this section.

(6) A corporation shall not make a payment to a shareholder under clause (3)(f) or (g) if there are reasonable grounds for believing that:

(a) the corporation is or would after that payment be unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities.

(7) An applicant under this section may apply in the alternative for an order under section 207. 1976-77, c. 10, s. 234.

**235**(1) An application made or an action brought or intervened in under this Division shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence or approval by the shareholders may be taken into account by the court in making an order under section 207, 233 or 234.

(2) An application made or an action brought or intervened in under this Division shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Division.

(4) In an application made or an action brought or intervened in under this Division, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for such interim costs upon final disposition of the application or action. 1976-77, c. 10, s. 235; 1979, c. 6, s. 53.

**REMEDIES UNDER THE BUSINESS CORPORATIONS ACT**

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**REMEDIES UNDER THE BUSINESS CORPORATIONS ACT**

# I. PERSONAL REMEDIES AND DERIVATIVE ACTIONS

## A. Introduction

The enactment of the ABCA has created a powerful arsenal of remedies for the shareholders and creditors of a corporation faced with a board of directors that is conducting the corporation's business in a manner that is harmful to the corporation, the shareholders or creditors. Some of these remedies are set out in Part 19 of the ABCA and are contained in sections 231 to 235. Section 232 allows complainants to seek leave to bring a derivative action on behalf of the corporation. Section 234 creates a personal remedy for complainants who have been oppressed, unfairly prejudiced or had their interests unfairly disregarded.

The purpose of this memorandum is to outline the scope of the new remedies found in Part 19 of the ABCA.

## B. Complainant

### 1. Is a shareholder a complainant?

Only a complainant as defined in s. 231 of the ABCA can avail himself of the personal remedies created by s. 234 and obtain leave pursuant to s. 232 to bring a derivative action on behalf of the corporation.

Section 231(b) reads as follows:

> (b) "complainant" means
>
> (i) a registered holder or beneficial owner, or a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates.

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates, or

(iii) any other person who, in the discretion of the Court, is a proper person to make an application under this Part.

"Security" as defined in s. 1 of the ABCA is a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation. Therefore a shareholder would be a registered holder of a security and is a complainant within the meaning of s. 231(b)(i). There are many cases in which a shareholder has sought leave to bring a derivative action on behalf of the corporation and in which a shareholder has brought a personal action under s. 234 or an equivalent section in another act.

2. Can a creditor be a complainant?

(a) Secured creditors

A registered holder of a security as used in s. 231(b)(i) has been interpreted to include secured creditors who hold security of the type which is capable of being registered under s. 88.2(2) and s. 88.2(5) with the Registrar of Corporations. Therefore a creditor who is a mortgagee or a holder of a debenture creating a charge is a complainant within the meaning of s. 231(b)(i) . An unsecured creditor such as a landlord is not a registered holder of a security: *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* (1988) 60 Alta. L. R. (2d) 122 (Alta. Q.B.)

The case of *Bank of Montreal* v. *Dome Petroleum Ltd and Amoco Canada Petroleum Company Ltd.* (1987) 54 Alta L. R. (2d) 289 (Alta. Q.B.) is an example of a secured creditor bringing an action under s. 234. Although the Bank of Montreal was unsuccessful in proving its case, it clearly had the right to bring such an action.

### (b) Unsecured creditors

When preparing the draft Business Corporations Act, it was not the intention of the Alberta Law Reform Institute ("Institute") to give unsecured creditors the right to be complainants so as to bring derivative actions and personal actions. In fact the Institute was wary of extending the definition of complainant to include secured creditors. Section 231(b)(iii) was included primarily to ensure uniformity with the CBCA and with the belief that the courts would rarely, if ever, have occasion to make use of its discretion under s. 231(b)(iii). The reference in s. 234 to creditors was intended only to ensure that a shareholder oppressed in his capacity as creditor would still have a remedy. It was not intended that all creditors be allowed to avail themselves of s. 234.

Notwithstanding the intention of the drafters, there are two decisions in which the courts have held that an unsecured creditor who is not a shareholder is a complainant within the meaning of s. 231(b)(iii). In *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*, Justice McDonald held that an unsecured creditor can be a complainant if the creditor is a person who, in the discretion of the Court, is a proper person to make an application under Part 19. Whether an unsecured creditor is such a person depends on the nature of the remedy he seeks.

To be considered a complainant for the purpose of bringing a derivative action, an unsecured creditor must be a person who could reasonably be entrusted with the responsibility of advancing the interest of the corporation by seeking a remedy to right the wrong allegedly done to the corporation. To be considered a complainant for the purposes of bringing an action under s. 234, the unsecured creditor must show there was some oppression or unfair prejudice to or unfair disregard of his interest as a creditor. An unsecured creditor would be a proper person to bring a s. 234 action in two situations. First, where the act of management of the corporation constituted using the corporation as a vehicle for committing fraud. Secondly, where the act or conduct of management of the corporation constituted a breach of the underlying expectation of the applicant arising from the circumstances in which the applicant's relationship with the corporation arose.

Justice McDonald stated that the goal of the court is to seek to balance protection of the creditor's interest against the policy of preserving the freedom of action for management and the right of the corporation to deal with a creditor in a way which might be to the prejudice of the interest of the creditor or that may disregard those interests so long as the prejudice or disregard is NOT UNFAIR.

The other case of mention is *R.* v. *Sands Motor Hotel Limited* [1985] 1 W.W.R. 59 where the Saskatchewan Queen's Bench held that the Crown is a proper person to bring an action under s. 234 where it wishes to remedy improper payment of dividends and improper redemption of shares which is oppressive or unfairly prejudicial to or that unfairly disregards the interests of the Crown as creditor. The court reasoned that if the creditors cannot complain no one will complain on their behalf. If the creditor cannot be a complainant so as to bring a s. 234 action how can a creditor have a remedy for breach of sections relating to payment of dividends and redeeming shares which were enacted to protect creditors, among others.

Even though s. 231 and s. 234 of the ABCA are identical to s. 231 and s. 234 of the SBCA, the reasoning of this case is not applicable in Alberta. The ABCA allows creditors to remedy improper payment of dividends and redemption of shares by bringing an application under s. 113(5). There is no equivalent remedy for creditors in the SBCA.

## C. Personal Remedies

### 1. Legislative history

Section 234 of the ABCA and s. 241 of the CBCA have their roots in s. 210 of the United Kingdom Companies Act, 1948. Section 210 created an alternative remedy to winding up in cases of oppression. To obtain a remedy under this section a shareholder had to establish several points. First, the companies affairs were being conducted in a manner oppressive to some part of the members, and to wind up the company would unfairly prejudice that part of the shareholders, including himself. Next, the facts justify the making of a winding up order on the ground it was just and equitable that the company be wound up. Finally, to wind up the company would unfairly prejudice the oppressed shareholders. If all this was shown the court could make such order as it thought fit to bring to an end the matters complained of.

The 1962 Company Law Report (Jenkins Report) recommended expansion of the remedy created by s. 210. The Jenkins Report's main concern was to avoid a restrictive interpretation of oppression. The Report recommended that the remedy cover conduct that was oppressive and those affairs that were being conducted in a manner unfairly prejudicial to the interests of certain members. The Report also thought the requirement that the facts must justify a winding up order was unduly onerous and unnecessary. It further recommended that s. 210 apply not merely to oppressive conduct, but to isolated oppressive acts.

The 1971 Proposals for a New Business Corporations Law for Canada (Dickerson Report) noted that the proposed s. 234 of the CBCA (which is now s. 241 of the CBCA) was derived from s. 210 of the United Kingdom Companies Act, 1948, which would be modified in accordance with the recommendations of the Jenkins Report.

The Dickerson Report quoted Lord Cooper in *Elder* v. *Elder* [1952] A.C. 49 at p. 55 to sum up the standard set out in s. 234 of the draft CBCA.

> [T]he essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealings, and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely.

Legislation based on s. 241 of the CBCA is found in Alberta, Manitoba, New Brunswick, Newfoundland, Ontario and Saskatchewan. Section 241 of the CBCA and legislation based on it are broader than the English legislation enacted to implement the recommendations of the Jenkins Report. The CBCA contains an extended definition of complainant which includes parties other than shareholders. Also, there is the addition of the term "unfairly disregards the interest" as a basis of remedy. The drafters of the CBCA wanted to make it clear that s. 241 applies where the impugned conduct is wrongful, but *not* illegal.

The oppression remedy in the BCCA parallels the English legislation.

2. Interpretation of S. 234

(a) General principles

The introduction of s. 234 was a deliberate departure from the policy of judicial non-intervention. It is not a codification of the common law. Section 234 ought to be broadly and liberally interpreted to implement the legislature's intention to ensure settlement of intra-corporate disputes on equitable principles as opposed to adherence to legal rights: *Keho Holdings Ltd and Oliver* v. *Noble* (1987) 52 Alta. L.R. (2d) 195 and *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski.*

Each case will turn on its own facts. As stated by the Ontario Court of Appeal in *Re Ferguson and Imax Systems Corporation* (1983) 150 D.L.R. (3d) 718 at 727, leave to appeal to the S.C.C. refused, "what is oppressive or unfairly prejudicial in one case may not necessarily be so in the slightly different setting of another". This statement was approved by the Alberta Court of Appeal in the *Keho Holdings Ltd.* case.

The oppression, unfair prejudice or unfair disregard of the shareholder's or creditor's interest must exist at the time the application is brought and it cannot be anticipatory: *Bank of Montreal* v. *Dome Petroleum Limited and Amoco Canada Petroleum Canada Ltd.* (1987) 54 Alta. L.R. (2d) 289 (Alta. Q.B.).

Section 234 has been drafted to allow the court to look at isolated acts, the conduct as a whole or both to determine if the conduct complained of was oppressive, unfairly prejudicial or unfairly disregarded the interest of the complainant.

The principles to be employed in evaluating fairness were discussed by the Alberta Court of Appeal in the *Keho Holdings Ltd.* case. At p. 201 the court stated:

> In my view the following extract taken from the reasons for judgment of Brooke J.A. in *Re Ferguson and Imax Systems Corp.* (1983), 43 O.R. (2d) 128, 150 D.L.R. (3d) 718, leave to appeal to the S.C.C. refused 2 O.A.C. 158, 52 N.R. 317, presents a model of the principles to be employed in evaluating fairness [p. 137]:
>
> "The policy of the law to ensure just and equitable treatment of minorities can be traced back to early cases. In *Allen* v. *Gold Reefs of West Africa, Ltd.* [1900] 1 Ch. 656 at p. 671, Lindley M.R., speaking of the powers of a corporation to amend its articles, said:
>
> '... it must, like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.'"
>
> In *Goldex Mines Ltd.* v. *Revill et al.* (1974), 7 O.R. (2d) 216 at p. 224, 54 D.L.R. (3d) 672 at p. 680, Arnup J.A. for this court, after considering the earlier cases, said:
>
> "The principle that the majority governs in corporate affairs is fundamental to corporation law, but its corollary is also important - that the majority must act fairly and honestly. Fairness is the touchstone of equitable justice and when the test of fairness is not met, the equitable jurisdiction of the court can be invoked to prevent or remedy the injustice which misrepresentation or other dishonesty has caused."
>
> But s. 234 [CBCA] must not be regarded as being simply a

> codification of the common law. Today one looks to the section when considering the interests of minority shareholders and the section should be interpreted broadly to carry out its purpose: see the Interpretation Act, R.S.C. 1970, c. I-23, s. 11.
>
> Accordingly, when dealing with a close corporation, the court may consider the relationship between the shareholders and not simply legal rights as such. In addition, the court must consider the *bona fides* of the corporate transaction in question to determine whether the act of the corporation or directors effects a result which is oppressive or unfairly prejudicial to the minority shareholder. Counsel has referred us to a number of decisions.
>
> They establish primarily that each case turns on its own facts. What is oppressive or unfairly prejudicial in one case may not necessarily be so in the slightly different setting of another.

(b) Key terms

(i) Oppression

"Oppression" has been defined as conduct that is burdensome, harsh and wrongful or conduct that suggests a lack of probity and fair dealing in the affairs of a company to the prejudice of some portion of its members: *Scottish Co-op Wholesale Soc. Ltd.* v. *Meyer* [1959] A.C. 324, [1958] 3 W.L.R. 404, [1958] 3 All E.R. 66. These definitions have been adopted in numerous cases.

(ii) Unfair prejudice

The leading case on unfair prejudice with respect to the rights, position or interest of a shareholder is *Diligenti* v. *R.W.M.D. Operations Kelowna Ltd. et al.* (1976) 1 B.C.L.R. 36 (B.C.S.C.). This was a case decided under the Companies Act, 1973 (B.C.), c. 18, s. 221, which is now s. 224 of the Companies Act, R.S.B.C. 1979, c. 59. The section in question provides relief only where there is oppression or unfair prejudice to the rights, position or interests of an applicant as shareholder and not with respect to his rights, position or interests as creditor, director, officer or employee.

In this case one of the actions complained of was the removal of the applicant shareholder from his position as director. The court followed a long line of English cases and British Columbia cases which held that removal of a shareholder from his position as director of a company is not oppressive conduct because it does not oppress the applicant in his status as shareholder but affects only his status as director. However, this did not end the matter. Justice Fulton went on to decide that oppression must have a different meaning than unfairly prejudicial and held that removal of a shareholder as director in this case could be unfairly prejudicial to the shareholder and therefore the action should proceed to trial.

In deciding what unfairly prejudicial meant, Justice Fulton looked at the dictionary definitions of the words "prejudice", "prejudicial" and "unfair" and held that these definitions supported his instinctive reaction that what is unjust and inequitable is obviously also unfairly prejudicial.

Justice Fulton adopted with approval the House of Lords decision in *Ebrahimi* v. *Westbourne Galleries* [1973] A.C. 360, [1972] 2 All E.R. 492. In that case a minority shareholder brought an application under s. 222 of the United Kingdom Companies Act, 1948 for an order winding-up the company on the grounds that it was just and equitable to do so. The House of Lords held that a company is more than a judicial entity with a personality of its own. Behind the company is an individual with rights, expectations and obligations that are not submerged in the company structure. Therefore, in certain cases the court will impose equitable considerations, that is considerations of a personal character, upon the exercise of legal rights.

In discussing when the court will impose these equitable considerations, Lord Wilberforce said at p. 500:

> It would be impossible, and wholly undesirable, to define the circumstances in which these considerations may arise.

> Certainly the fact that a company is a small one, or a private company, is not enough. There are very many of these where the association is a purely commercial one, of which it can safely be said that the basis of association is adequately and exhaustively laid down in the articles. The super-imposition of equitable consideration requires something more, which typically may include one, or probably more, of the following elements: (i) An association formed or continued on the basis of a personal relationship, involving mutual confidence -- this element will often be found where a pre-existing partnership has been converted into a limited company; (ii) An agreement or understanding, that all, or some (for there may be "sleeping" members), of the shareholders shall participate in the conduct of the business; (iii) Restriction on the transfer of the member's interest in the company -- so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.

The House of Lords held that the removal of a shareholder as a director is unjust and inequitable if there is some special underlying obligation of his fellow members in good faith or confidence, that so long as business continues he shall be entitled to management participation, an obligation so basic that if broken the conclusion is the association must be dissolved.

The facts before Justice Fulton were that four men had entered into a joint venture operated through a company whereby they would buy a franchise and operate a Keg'n Cleaver restaurant in Kelowna. Each individual was a director and held 225 shares in the company. Each shareholder expected to share equally in the management and direction of the company.

Justice Fulton held that in these circumstances there were rights, expectations and obligations that were not submerged in the company structure and these rights were enjoyed by members as part of their status as members. These rights included the right to participate in the direction of the company. Therefore, although the removal of the shareholder as a director was not oppressive conduct, it was unjust and inequitable and in breach of the equitable rights which the applicant possessed as a shareholder.

(iii) Unfairly disregard interest

In *Stech* v. *Davies and D.J.S. Music Services Ltd.* (1987) 53 Alta. L.R. (2d) 373 Justice Egbert of the Alberta Queen's Bench defined unfair disregard as to unjustly or without cause pay no attention to, ignore or treat as of no importance the interest of security holders, creditors, directors and officers of the corporation.

3. Is proof of intention to damage the interest of the complainant (i.e. bad faith) a condition precedent to relief being granted under s. 234?

A review of cases granting relief under s. 210 of the United Kingdom Companies Act, 1948 shows that their are two hallmarks to these cases. The first hallmark is conduct which was lacking in bona fides or lacking in probity and fair dealings. The second hallmark is substantial financial damage to the corporation reducing the shareholder's equity and thus oppressing the interest of the shareholder: M.A. Waldon, "Corporate Theory and the Oppression Remedy", (1981-82) 6 *Can. Bus. L.J.* 129 at 138.

These cases have been used as a springboard to make the argument that proof of bad faith, that is, proof of intention to damage the interest of the complainant, is a condition precedent to relief under s. 234 in respect of all three grounds of relief. For cases that support this argument: see *Bank of Montreal* v. *Dome Petroleum Limited and Amoco Canada Petroleum Company Ltd.*, *Brant Investments Ltd. et al.* v. *Keeprite Inc. et al.* (1987) 37 B.L.R. 65 and *Re Ferguson and Imax Systems Ltd.* (1983) 43 O.R. (2d) 128.

Cases which specifically reject this argument are *First Edmonton Place Limited* v. *315888 Alberta Ltd and Majeski*, *Low and Anderson* v. *Ascot Jockey Club Limited et al.* (1986) 1 B.C.L.R. (2d) 123 (B.C.S.C.) and *Palmer* v. *Carling O'Keefe Breweries of Canada Ltd. et al.* (1989) 41 B.L.R. 128 (Ont. S.C. Div. Crt.). There are also cases where the issue was not addressed specifically, but where relief was given under s. 234 or an equivalent section in the absence of bad faith. These are cases where the personal remedy was used to remedy oppressive conduct which was a breach of a fiduciary duty owed by a director to the corporation: see *Re Peterson and Kanata Investments* (1975) 60 D.L.R. (3d) 527 (B.C.S.C.), *Redekop* v. *Robco Construction Ltd.* (1978) 89 D.L.R. (3d) 507, and M.A. Waldron, "*Corporate Theory and the Oppression Remedy*", (1981-82) 6 Can. Bus. L.J. 129 at pp. 138 to 142.

It is submitted that the better view is that "the type of conduct against which s. 234 affords protection should be understood in terms of the impact of the conduct complained of upon the interests of the security holder, creditor, director or officer, not in terms of intention to damage such interests or to damage the corporation": *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*, p. 146. The Dickerson Report made it clear that s. 234 of the proposed CBCA was to have a broader scope than s. 210 of the Companies Act, 1948, U.K. The remedy was no longer to be confined to situations lacking in *bona fides* or lacking in probity and fair dealings. To affect this intention the terms "unfairly prejudicial to" and "unfairly disregard the interests of" were added. It would defeat this intention if the courts were to require proof of lack of *bona fides* as a requirement of s. 234 when the literal interpretation of the section does not require this. Furthermore, why should lack of appreciation of the rights of a complainant by a board of directors be a bar to granting a remedy under s. 234? The complainant suffers harm from the oppression, unfair prejudice or unfair disregard, no matter what the motives of the directors are.

4. Must economic loss to complainant be proven?

Proof of economic loss was necessary if relief was to be obtained under s. 210 the United Kingdom Companies Act, 1948. However, there is some authority to suggest that s. 234 does not require such loss before relief is to be granted. Yet in the majority of cases economic loss or fear of economic loss is what has prompted the complainant to seek relief under s. 234. This memorandum will not pursue this issue as the abuses that s. 42 of the ABCA was designed to prevent would all involve economic loss to the creditor or shareholder.

5. When is the personal remedy available to a shareholder?

(a) Review of cases

The courts are willing to use s. 234 to remedy situations where majority shareholders deplete the corporate assets for their benefit and to the detriment of the minority shareholders. These cases fall into three distinct fact situations: loans, financial assistance and misappropriation of corporate assets.

(i) Loans

*Jackman* v. *Jacket Enterprises Ltd.* (1977) 4 B.C.L.R. 358 was a case involving as application under s. 221 of The Companies Act, 1973 (B.C.) c. 18, as amended in 1976, c. 12 s. 44. The wording of s. 221 is very similar to s. 224 of the Company Act, R.S.B.C. 1979, c. 59 which creates a remedy for oppression and unfair prejudice.

The petitioner was the minority shareholder in Jackets Enterprise Ltd. ("Jackets") and Etsekson was the majority shareholder. Also Etsekson was the sole shareholder of Ben's Truck Parts of Canada Ltd. ("Ben's"). Jackets had been incorporated to buy land and build a building which was to be rented to Ben's. This was made possible by the assistance of Ben's in obtaining financing.

After the petitioner's husband was dismissed from the employ of Jackets, Etsekson ran Jackets as if it was his own company and without consultation with the petitioner. Etsekson caused Jackets to borrow $450,000 at 12% interest. The loan was secured by a mortgage on the lands and building owned by Jackets. Jackets used the money to pay off $210,000 owing on an existing mortgage which carried interest at 10%, to pay off a debt owed to Ben's, and to lend $214,000 to Ben's. The net effect was that Jackets was paying a 2% higher interest charge on the $210,000 and there was an impairment of equity represented by the loan to Ben's which was not secured. The financial statements of Ben's did not indicate that it would be able to pay the debt to

Jackets when the mortgage matured. The court held that the channelling of money to the benefit of Etsekson's company, Ben's, was conduct oppressive or unfairly prejudicial to the petitioner. Her equity is diminished or prejudiced proportionately by the extra borrowing from which she derives no benefit.

With the consent of Etsekson, the court ordered that Etsekson personally guarantee the payment of the loan made by Jackets to Ben's. Also the court ordered Etsekson to pay, or cause to be paid to Jackets the extra interest charges incurred on the $210,000. The court said it was empowered to order Etsekson to guarantee the payment of the loan by the general wording of s. 221 which gives the court jurisdiction, with the view to bringing an end to the matters complained of, to grant any interim or final order it considers appropriate.

In *Low and Anderson* v. *Ascot Jockey Club Limited et al.* (1986) 1 B.C.L.R. (2d) 123, the British Columbia Supreme Court dealt with a dispute between shareholders of a company which operated the Vancouver race track. Needless to say this company was very profitable. In settlement of a long-standing dispute among family members, the petitioners became minority shareholders in the company. After they became involved in the company they complained that the controlling shareholder paid himself a yearly management fee and bonuses of $480,000 as he had done in the past. He did this without approval of the board of directors. The petitioners also impugned the company's failure to require interest to be paid on loans previously made to relatives of the majority shareholder and companies controlled by the majority shareholder or his son.

The court held that payment of the $480,000 was oppression of the petitioners because the board of directors had not fixed the remuneration. The court said it was not called on to decide whether such a payment would have been oppressive if the board of directors had approved it. Failure of the company to insist on receiving interest on all loans was oppressive because it had the effect of conferring a benefit upon one branch of the family to the exclusion of the others.

The court ordered the majority shareholder to repay the $480,000. It also ordered the board of directors to meet and decide two issues. First, to determine the appropriate salary and bonuses to be paid to the controlling shareholder. Secondly, to decide what steps are to be taken to insure the loans are repaid or interest at a fair rate is collected on the loans.

In *Keho Holdings Ltd. and Oliver* v. *Noble et al.* (1987) 52 Alta. L.R. (2d) 195 the minority shareholders of Keho Holdings Ltd. ("Keho") had obtained an order under s. 207(1)(a) of the ABCA for liquidation and dissolution of Keho on the grounds that the conduct of Oliver was oppressive, unfairly prejudicial or unfairly disregarded the interests of the minority shareholder. Oliver appealed this decision. Oliver was a director of Keho and had managed the affairs of Keho successfully for over 20 years. He also exercised control over the majority of shares.

The court held that Oliver's exercise of his control of the voting power to prevent election of the minorities nominee as director was not oppressive in these circumstances because there was no underlying obligation that the minority shareholders participate in the management of the corporation. Yet, Oliver's exercise of this control of voting power to cause the corporation to grant him a stock option for shares at one-half their fair value was oppressive and unfairly prejudicial.

Oliver had also, without reference to the board of directors, arranged for Keho to borrow $258,000 from its bank and lend this money at a higher interest rate to Gyron Petroleum Ltd., a corporation wholly owned by Oliver. The loan was not secured. The court held that Oliver was treating Keho as his personal domain and this conduct was prejudicial to Keho and its shareholders.

The court held that a corporation should not be wound up under s. 207 if equity could be achieved by use of the remedies available under s. 234 without invoking dissolution. The court set aside the order for dissolution of Keho. Instead, it restrained

Oliver from exercising the stock option and ordered Keho and Oliver to repay the loan within 30 days or provide security for payment therefore.

(ii) Financial assistance

One case that is of particular interest is the case of *Westmore and Enchant Resources Ltd.* v. *Old MacDonald's Farms Ltd. and McAfee* (1986) 70 B.C.L.R. 332 (B.C.S.C.). This was an application brought under s. 224 of the BCCA. In 1978 Enchant Resources Ltd. ("Enchant") purchased 20 shares of the capital stock of Old MacDonald's Farms Ltd. ("the Company") and made a shareholder's loan to the Company in the amount of $144,000. Later, Enchant transferred the 20 shares to Westmore, the controlling shareholder of Enchant. On April 30, 1980 Westmore transferred the 20 shares to the Company pursuant to a purchase agreement and escrow agreement.

It was a key issue in this case whether "payment of the Company's debt due to Enchant was part of the consideration for the sale to the company of Westmore's 20 shares under written agreements between the parties executed as of 30th April 1980 (the purchase agreement and the escrow agreement) or whether those agreements constitute a completed sale of the shares and then a pledge or equitable mortgage thereof as security for repayment of the shareholder's loan due to Enchant ..." (p. 335). The court interpreted the purchase agreement and escrow agreement against McAfee Enterprises Ltd. because these documents were prepared by the law firm of John McAfee. The court held that Westmore had not intended to transfer the 20 shares to the Company until the Company paid the debt it owed to Enchant. This was part of the consideration for purchase of the shares. Therefore, Westmore was a shareholder at the time of the conduct complained of and could bring an action for relief against oppression and unfair disregard of a shareholder.

On April 1, 1982 the Company sold all of its assets for $1,500,000. The purchaser assumed payments under a debenture granted by the Company, transferred assets and cash to the Company worth $370,000 and granted a debenture to the Company to secure payment of $550,000.

The conduct complained of related to the declaration of dividends and the granting of financial assistance. On December 20, 1982 and July 2, 1983 the directors authorized the Company to pay dividends on issued and outstanding shares. A total of $270,000 was paid on shares owned by controlling shareholder, McAfee Enterprises Ltd. Dividends were not paid on the shares of Westmore. The dividends were set off against the debt McAfee Enterprises Ltd. owed to the Company. Also impugned was the transaction whereby the second debenture was discharged and the purchaser of the Company assets replaced it with two debentures. One was for the principal amount of $325,000 and the other for the principal amount of $225,000. The $325,000 debenture was granted priority over the other debenture. The debenture with priority was assigned by the Company to a bank to secure the personal indebtedness of John and Brenda McAfee, directors of the Company. John McAfee was the only shareholder in McAfee Enterprises Ltd., the controlling shareholder of the Company.

The Company was solvent when it declared the dividends and when the debenture was split and assigned. At that time there was no indication that the purchaser of the Company's assets would default on payment under the two debentures. John McAfee honestly thought that the $225,000 debenture would be paid and that the Company would use this money to repay the debt owed to Enchant. It happened that the purchaser did default on payments under both debentures. The assignee enforced the $325,000 debenture to satisfy payment of the personal debts of John and Brenda McAfee. There were no assets left to satisfy the debt of $225,000 owed to the Company and secured by the second debenture.

The court viewed the declaration of the $270,000 dividend to McAfee Enterprises Ltd. as reducing the Company's ability to pay the debt it owed to Enchant. Against the background of the declaration of the dividends, the transaction involving the splitting of the debenture and assignment of the debenture with priority was conduct which was unfairly prejudicial and oppressive to Westmore as a shareholder. The court was willing to say that even if the Company owed Westmore money for repayment of a shareholders loan made by Westmore, non-payment of the shareholders loan in these circumstances would be oppression of the shareholder in his capacity as shareholder and not just in his capacity as creditor. He viewed the shareholders loan as an investment on behalf of a creditor that cannot be distinguished from share capital.

Since the Company had no assets, the court ordered the Company and John and Brenda McAfee to complete the Company's purchase of Westmore's shares by payment to him, in trust for Enchant, of the balance now due on Enchant's shareholder loan to the Company with interest. The court justified the making of such an order on the basis that John and Brenda McAfee received the benefit of the assignment of the debenture for their personal use without consideration of any kind flowing to the Company.

The argument was made that this was really an issue of whether a preference had been made and this should be dealt with in an appropriate action. The court rejected this argument on the grounds that where the Company was not affluent and the stakes are not high the Court should make an order which reduces litigation, not encourages it.

Section 234 of the ABCA is broader than s. 224 of the BCCA. The result is that a shareholder who is oppressed in his capacity as creditor and not in his capacity as shareholder would still be able to seek a remedy under s. 234 of the ABCA. The problems the court had in finding oppression of Westmore in his capacity as creditor would not arise in Alberta.

Another case dealing with financial assistance obtained by way of an amalgamation is *Palmer* v. *Carling O'Keefe Breweries of Canada et al.* (1989) 41 B.L.R. 128 (Ont. S.C.). This case involved Elders IXL Limited ("Elders") which is a huge Australian corporation with assets worth 9 billion dollars. Elders incorporated IXL

Holdings Canada Inc. ("IXL"). IXL was the vehicle Elders used to purchase all the common shares in Carling O'Keefe Limited ("COL"). COL owned Carling O'Keefe Breweries of Canada Limited ("COB"). IXL borrowed 400 million dollars to buy all the common shares of COL. The preferred shares of COL were owned by others. Elders wanted to marry the debt of IXL with the assets of COL and COB. When this was done IXL would be able to deduct interest paid on the loan from the operating profit of the brewery. This could be done if IXL was the only shareholder. Yet IXL did not want to redeem the preferred shares at the prices stipulated in the conditions attached to the shares. To get around this problem, IXL, COL and COB amalgamated to form Carling O'Keefe Breweries of Canada Limited ("Carling O'Keefe").

Elders arranged for a support agreement to protect the position of preferred shareholders after the amalgamation. Elders agreed to pay preferred shareholders the voluntary redemption price for their shares if COL failed to pay dividends. Elders also assumed the 400 million dollar debt and convinced the bank to waive their right of recourse against Carling O'Keefe in the event of default.

The court said that if there had been no support agreement, the directors of the COL, in approving amalgamation had acted in a manner that was oppressive and unfairly prejudicial to and in unfair disregard of the interests of the holders of the preferred shares. The result of the amalgamation was COL had taken an additional debt of 400 million dollars without receiving any assets in return. The amalgamation was of great benefit to Elders but of no benefit to the preferred shareholders.

The court said that even with the existence of the support agreement, the conduct of the directors approving the amalgamation was unfairly prejudicial to and in unfair disregard of the interests of the preferred shareholders within the meaning of section 247 of the OBCA. It involved a breach by the directors of COL of their duty to act for the benefit of the company as a whole.

At page 142, the court stated:

> In the final analysis, the support agreement is only as good as Elders, an Australian company. The preference shareholders did not invest in Elders; they invested in COL, or one of its predecessors, which were Canadian brewing companies. There was no legitimate corporate purpose of COL for causing it to assume the acquisition debt of IXL. The marrying of the debt and the operating revenues was done for the exclusive benefit of Elders, and to the prejudice of the interest of the preference shareholders in COL. The preference shareholders, in my opinion, ought not to be obliged to accept a claim against an entirely different corporation in place of their investment in COL. The security interest of the preference shareholders in Carling O'Keefe has been drastically changed, and those shareholders have had foisted on them a claim against Elders without their consent or approval. This treatment of the preference shareholders, in my opinion, constituted conduct that was unfairly prejudicial to and unfairly disregarded the interests of the preference shareholders within the meaning of s. 247 of the Ontario *Business Corporations Act*, and involved a breach by the directors of COL of their duty to act for the benefit of the company as a whole.

(iii) Misappropriation of corporate assets

In *Re National Building Maintenance Ltd.* [1971] 1 W.W.R. 8, affirmed [1972] 5 W.W.R. 410 the British Columbia Court of Appeal held that payment of management fees for past services to directors was oppressive as being a device to divert profits of the company exclusively to the director.

In *Inversiones Montforete S.A.* v. *Javelin International Ltd. et al.* (1982) 17 B.L.R. (Que. S.C.) the court dealt with an application brought by a minority shareholder of Javelin International Ltd. ("Javelin") pursuant to s. 234 of the CBCA. Javelin had been the subject of a battle to gain control which lasted for many years. The directors had spent enormous sums to gain and maintain control of the company, it subsidiaries and their respective assets. Javelin had spent 2 to 3 million dollars annually for legal fees in 1981 and 1982. The board had permitted Javelin to pay huge consulting fees and interest to the controlling shareholder. As well Javelin was paying huge sums to Revenue Canada on account of the personal income tax owing by the controlling shareholder. Although some of the sums paid on behalf of the controlling shareholder were justified the court concluded that there was no control on the funds flowing for his benefit. The court held that there was oppression and unfair prejudice to the minority shareholder.

In *Re Little Billy's Restaurant* (1977) Ltd; *Faltakas* v. *Paskalidas* (1983) 45 B.C.L.R. 333 the court granted relief under s. 224 of the BCCA. The majority shareholders passed a resolution requiring the restaurant company to pay a franchise fee of 3% of gross sales to the franchise company owned by the majority shareholders. Such a franchise fee had in fact been paid before the formal resolution authorizing it. The court held that the franchise fee diverts funds from the restaurant company to the franchise company to the benefit of the majority shareholders and to the detriment of the minority shareholder. The court concluded that this was unfairly prejudicial to the minority shareholder. Also, payment of the unauthorized franchise fee did unfairly prejudice the minority shareholders.

The court held that majority shareholders do not owe a fiduciary duty to minority shareholders. The majority had a legal right to vote for the resolution. Yet, these legal rights are subject to equitable considerations where the persons acting in their capacity as shareholders are in a conflict with their duties as directors. Therefore, a shareholder who is also a director cannot vote for a resolution that is not in the best interests of the corporation, but is in his personal best interest.

The court ordered the resolution to be cancelled and prohibited the restaurant company from entering the franchise agreement as long as the petitioner was a shareholder. It also ordered the franchise company to repay the franchise fees paid to it.

In *Miller* v. *F. Mendel Holdings Limited and Mitchell* [1984] 2 W.W.R. 683 (Sask. Q.B.) the minority shareholders of F. Mendel Holdings Limited ("Mendel Holdings") complained that they were unjustly treated as minority shareholders. They sought an order directing the defendants to purchase their shares. The minority complained of:

1. The removal of Max Miller as director of Mendel Holdings

2. An application under the SBCA for a certificate of continuance which severely restricted the transferability of shares and removed the plaintiff's rights to notice of meetings.

3. Mendel Holdings exercised an option to purchase a ranch it had been paying a facility charge to use. The consideration for the purchase was the fair market price less the cost of certain improvements that Mendel Holdings had previously paid for. It then transferred the property to a corporation owned solely by the majority shareholder of Mendel Holdings for the same price paid for it by Mendel Holdings.

The court held that the defendants conduct was not oppressive and that the removal of the director and the change in the shareholders rights, which by the time of the application had been restored, were not by themselves unfairly prejudicial or in unfair disregard of the interest of the minority shareholders. Yet when viewed in total, it was clear that the affairs of Mendel Holdings were carried out in a manner that unfairly disregarded the interests of the minority shareholders and the result effected was unfairly prejudicial to those interests.

The corporate revisions which took place left the minority out in the cold. They were excluded as directors, had their privileges as shareholders removed and were placed in a position of being unlikely able to transfer their shares. This was prejudicial to the minority shareholders. The transfer of the ranch for the personal benefit of the majority shareholder and to the detriment of Mendel Holdings unfairly disregarded the minority's interest. The court ordered the defendants to purchase the minority shareholders' shares.

In *Re Abraham and Inter Wide Investments Ltd. et al.* (1985) 20 D.L.R. (4th) 267 (Ont. H.C.J.) a minority shareholder of Inter Wide Investments Ltd. brought an application under s. 247 of the OBCA seeking an order that the company purchase his shares. The minority shareholder complained of large director fees that were paid without a resolution of the board of directors and which were not associated with the duties and responsibilities of the directors. The court did not view this as oppressive conduct, but was satisfied that the company and the directors acted in a manner unfairly prejudicial to the minority shareholder or at least unfairly disregarded the interest of the minority shareholder.

In *Triple "L" Construction Ltd. and Lavergne et al.* v. *Aikens Lake Lodge Limited and Lavergne et al.* (1986) 41 Man. R. (2d) 283 (Man. Q.B.) the controlling shareholder of Aikens Lake Lodge Limited ("Aikens") complained of a benefit his brother's sons had received from Triple "L" Construction Ltd., another family owned company. To remedy this perceived injustice, the controlling shareholder of Aikens increased the salary Aikens paid to his son, had Aikens pay management fees to a company run by his son, and caused Aikens to build a cabin at a cost of $17,000 for his son's use. The court held that the transactions were not oppressive but did disregard the interest of Triple "L" Construction Ltd. as shareholder of Aikens. Pursuant to s. 234 of the Corporations Act, S.M. 1976, c. 40, now s. 234 of The Corporations Act, R.S.M. 1987, c. C-225, the court ordered the personal defendants or Aikens to buy the corporate plaintiff's shares. Failing this the corporate plaintiff was to have the right to buy the defendant's shares. If no purchase of shares was possible, Aikens was to be dissolved.

In *Credit Foncier Franco-Canadien* v. *CSW Enterprises Ltd, Carson and Sivak* (1986) 54 Sask. R. 97 the Saskatchewan Queen's Bench dealt with a dispute between Carson and Sivak. They were the two shareholders of CSW Enterprises Ltd. ("CSW") and each had equal shareholdings. CSW owned an office building and rented out the second floor to the law practice of Carson and Spivak for the monthly rental of $1000. Carson left the practice and Spivak remained in the space. As he was now a sole practitioner it was agreed by the two shareholders that Spivak would only pay $500 per month for rent. Spivak was to seek others to share the space. A few months later, Sutherland began to share space with Spivak and paid $400 per month as rent. Spivak sub-leased to Sutherland but did not pay any increased rent to CSW. When another lawyer moved in to the space Spivak increased the rent paid to CSW from $500 to $600 per month. Tenants in other parts of the building moved out and CSW fell into arrears on payments under the mortgage. Carson and Spivak were guarantors of the mortgage. To get capital for needed leasehold improvements and to pay for two months mortgage arrears, Spivak borrowed money from Sutherland and the other lawyer. It was agreed that the money borrowed could be offset against future rental payments.

The court held that Spivak acted to his own advantage and to CSW's detriment when it failed to give CSW the benefit of rent paid by Sutherland . This personal aggrandizement, his failure to increase rental payments made to CSW to $1000 per month instead of $600 per month when the other lawyer moved in, and his attempt to borrow money on the condition it was a prepayment of rent were all actions that unfairly disregarded Carson's interest as shareholder in CSW. The court exercised its authority under s. 234 of the SBCA and ordered Spivak to purchase Carson's shares.

### (b) Is the remedy only available to minority shareholders?

In *Re Vedova et al. and Garden House Inn Ltd.* (1985) 29 B.L.R. 236 the Ontario High Court of Justice held that relief provided by s. 247 of the OBCA was confined to the protection of minorities. Specifically, s. 247 is not intended as a method of mediating between opposing groups of shareholders acting from a position of equality. Oppression connotes an inequality of power or authority. There is no obligation to act equitably and impartially in the exercise of power or authority where power and authority in the legal sense are equally divided.

Subsequent Ontario decisions have either interpreted this case restrictively or ignored it. In *Re Gandalman Investments Inc. and Fogle et al.* (1985) 52 O.R. (2d) 614, the Ontario High Court of Justice distinguished the Vedova case. The court said that the case is not authority for the principle that a 50% shareholder can never apply for a remedy under s. 234. Where a 50% shareholder holds all the power and authority, the other shareholder can apply for a remedy under s. 234.

In *Gillespie et al.* v. *Overs et al.*; *Tesari Holdings et al.* v *Pizza Pizza Ltd.* (1987) 5 A.C.W.S. (3d) 430, the Ontario High Court of Justice was faced with a minority shareholder who was oppressing the majority shareholder. The court granted relief to the majority shareholder under s. 247.

In principle, there is no reason why the personal remedy should be restricted to just the use of minority shareholders. The section does not say it is to be so restricted. Surely it is the conduct complained of which should govern when the remedy is to be given and not the number of shares held by the shareholder complaining of the conduct.

(c) Does s. 234 restrict the power of majority shareholders and if so, to what extent?

Most cases support the principle that s. 234 does curtail the rights and powers of the majority shareholders. Yet these rights and powers are only affected to the extent that such rights and powers may still be exercised to the prejudice of the minority (if not unfairly) and may still disregard the interests of the minority ( if not unfairly): *Brant Investments Ltd. et al.* v. *Keeprite Inc. et al.* (1987) 37 B.L.R. 65 ( Ont. H.C.J.). Therefore, resolutions of shareholders authorizing the corporation to perform acts that are oppressive, unfairly prejudicial to or in unfair disregard of certain interests have been set aside. For example see *Keho Holdings* case where the Alberta Court of Appeal found that Oliver's exercise of his control of the voting power was oppressive in certain situations.

The only case that deviates from the norm is that of *Re Little Billy's Restaurant.* In that case the court affirmed that a shareholder is not in a fiduciary position with respect to the company or his fellow shareholders. Yet if the shareholder is also a director, he cannot place himself in a position where his fiduciary duty to the company conflicts with his personal interest. In that case the court set aside a resolution adopted by the majority shareholders because the resolution was not in the best interest of the company and therefore conflicted with their duties as directors.

The problem with this rationale is that it allows a shareholder who is not a director to cause the corporation to act in a manner that is oppressive, unfairly prejudicial to or in unfair disregard of the minority and to do so without penalty. The rationale ignores the fact that a corporation can only act through decisions made by the directors or the shareholders. Section 224(1)(a) provides relief when the affairs of the corporation are being conducted in a manner that is oppressive or where the powers of the directors are being exercised in a manner that is oppressive. Surely a resolution of the shareholders authorizing an oppressive act is a situation where the affairs of the corporation are being conducted in a manner oppressive to the shareholder. What is more confusing, is the fact that the court ignores s. 224(1)(b) of the BCCA which creates a remedy for resolutions of members that are unfairly prejudicial to one or more of the members.

In order to restrict the powers of the majority shareholders further, minority shareholders have asked the courts to find that a majority shareholder owes a fiduciary duty to the minority shareholders. Such a general fiduciary duty is recognized by American authorities. This has been rejected by some recent decisions: see *Brant Investments Ltd et al.* v. *Keeprite Inc. et al.*, *Re Little Billy's Restaurant*, and *Western Finance Company Ltd. and Hannard* v. *Tasker Enterprises Ltd. and Tasker* [1980] 1 W.W.R. 323 (Man. C.A.). Yet, the fact that the majority shareholder does not owe a fiduciary duty to the minority shareholder does not mean that the majority shareholder can act in a manner that is oppressive , unfairly prejudicial or in unfair disregard of the minority shareholder.

6. When is the personal remedy available to a creditor?

*First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* is the only case where a court has carefully considered when, if ever, a creditor can avail itself of s. 234 of the ABCA. Therefore, it is useful to review this decision in detail.

The applicant was the owner of a downtown office building. The three individual respondents were lawyers who were associated together. In 1984 the applicant and the lawyers negotiated a 10 year lease. The lease was taken in the name of the corporate respondent, of which the lawyers were the only shareholders and directors. The lawyers were not called upon to give personal guarantees. As an incentive to the lawyers agreeing to lease the premises, the applicant agreed that the first 18 months of the term would be rent-free. The applicant also paid to the corporate respondent a cash payment of $140,000. After the lease was executed, the lawyers occupied the premises without entering into a formal sublease with the corporate respondent. The $140,000 was paid to the three lawyers for their personal use. The lawyers occupied the premises for 21 months and then departed.

The applicant sought leave to bring a derivative action on behalf of the company and in the alternative sought relief under s. 234.

As earlier discussed, Justice McDonald held that a s. 234 remedy is available to creditors where there has been oppression, unfair prejudice or unfair disregard of the interests of the creditor. At p. 145 and 146, Justice McDonald stated:

> The s. 234 remedy would be available if the act or conduct of the directors or management of the corporation which is complained of amounted to using the corporation as a vehicle for committing fraud upon a creditor.
>
> Assuming the absence of fraud, in what other circumstances would a remedy under s. 234 be available? In deciding what is unfair, the history and nature of the

> corporation, the essential nature of the relationship between the corporation and the creditor, the type of rights affected and general commercial practice should all be material. More concretely, the test of unfair prejudice or unfair disregard should encompass the following considerations: the protection of the under-lying expectation of a creditor in its arrangement with the corporation, the extent to which the acts complained of were unforeseeable or the creditor could reasonably have protected itself from such acts, and the detriment to the interests of the creditor. The elements of the formula and the list of considerations as I have stated them should not be regarded as exhaustive. Other elements and considerations may be relevant, based upon the facts of a particular case.

Later on in his decision, Justice McDonald applied these principles to the facts in question. He decided that this was not a case in which the conduct of the directors or management of the corporation constituted using the corporation as a vehicle for committing a fraud *upon the applicant*. However, he suggested the conduct complained of may constitute fraud against the corporation. In deciding whether there was unfair prejudice or unfair disregard of the landlord, he held at p. 152:

> Second, the court might hold that the applicant is a "proper person to make an application" for an order under s. 234 if the act or conduct of the directors or management of the corporation, which is complained of, constituted a breach of the underlying expectation of the applicant arising from the circumstances in which the applicant's relationship with the corporation arose. For example, where the applicant is a creditor of the corporation, did the circumstances, which gave rise to the granting of credit, include some element which prevented the creditor from taking adequate steps when he or it entered into the agreement, to protect his or its interests against the occurrence of which he or it now complains? Did the creditor entertain an expectation that, assuming fair dealing, its chances of repayment would not be frustrated by the kind of conduct which subsequently was engaged in by the management of the corporation? Assuming that the evidence established the existence of such an expectation, the next question would be whether that expectation was, objectively, a reasonable one.

> Thus, in the present case, an inquiry would properly be directed at trial toward whether the lessor, First Edmonton Place, at the time of entering into the lease, consciously and intentionally decided to contract only with the numbered company, and not to obtain personal guarantees from the three lawyers. A further proper inquiry would be into whether the lessor entered into the lease fully aware that it was not protecting itself against the possibility that the corporation might pay out the cash advance to the lawyers, leaving no other assets in the corporation, and that the corporation might permit the lawyers to occupy the space without entering into a sub-lease either for ten years or for any lesser period.

Justice McDonald dismissed the landlord's application to bring a s. 234 action on the ground that it was not a complainant within s. 231(b)(iii) because there was no evidence before him to suggest unfair prejudice or unfair disregard.

He went on to hold that even if he was wrong on the issue of whether the landlord was a complainant, the landlord could not avail itself of s. 234 because it was not a creditor at the time of the action complained of since there was then no rent owing under the terms of the lease.

Another case of mention is the Supreme Court of Canada decision in *Constitution Insurance Co. of Canada et al.* v. *Kosmopoulos et al.* (1987) 22 C.C.L.I. 296. In this case the SCC was dealing with the issue of whether the sole shareholder and director of a corporation had an insurable interest in the assets of the corporation. The court had to review its previous decision of *Macaura* v. *Northern Assurance Co.* which held that a shareholder had no insurable interest in the corporate assets because he had no legal or equitable interest in the assets. The Macaura case involved a company with three shareholders.

In reviewing its previous decision the court considered the three policies cited in support of the Macaura rule. One of these policies was that a restrictive interpretation of insurable interest was necessary in order to prevent the temptation to destroy the insured property. The insurance company argued that if the proceeds of insurance could be paid to the shareholders free of the corporation's creditors, the sole shareholder would have a greater incentive to destroy corporate assets. This would not be the case if the proceeds were paid to the insolvent corporation subject to the claim of the creditors. The court rejected this argument and stated that there were several remedies that a court could use to ensure proceeds held by a shareholder were available to the corporation in the appropriate case. The third remedy referred to by the court is discussed at p. 315 as follows:

> In addition, where a controlling shareholder insures corporate assets in his or her own name and by using that control does not arrange for insurance to be taken out by the corporation on its assets, that conduct on the shareholder's part may constitute an act "oppressive or unfairly prejudicial" to the interests of creditors and result in liability under s. 247(2) of the Ontario Business Corporations Act, 1982. A creditor may, by order of the court, be able to bring such an action: see ss. 244(b)(iii) and 247(1). The directors of the corporation themselves may be liable to the corporation through a derivative action under s. 245 for breach of duty of care under s. 134(1)(b) or even under the oppression remedy (s. 247) itself. In light of these considerations, I simply cannot imagine that a corporation would not insure the assets of the corporation in its own name.

The comments of Justice Wilson are *obiter* only and cannot be taken as authority that a creditor can avail itself of the personal remedies created by the OBCA or the ABCA. However, it is support for the proposition that the court will not dismiss such an argument as out of hand.

In the only case to date in which a secured creditor attempted to avail itself of the personal remedy found in s. 234, the action was dismissed. This was the case of *The Bank of Montreal* v. *Dome Petroleum Limited and Amoco Canada Petroleum Company Ltd.* (1987) 54 Alta. L.R. (2d) 289 (Alta. Q.B.). Dome was attempting to sell its assets. Amoco, Imperial and Trans-Canada were interested in buying the assets. Dome entered into confidentiality agreements with Imperial and Trans-Canada. Dome also entered into an arrangement agreement with Amoco which prevented Dome from seeking other buyers for 6 months. The effect of all three agreements was that no meaningful appraisal of the value of Dome could be done by any interested purchaser for at least six months. The Bank of Montreal argued that this was oppressive, unfairly prejudicial or in unfair disregard of its interest as a secured creditor.

The court rejected this contention for several reasons. The Bank of Montreal had to consent to the arrangement agreement if it was to be implemented. The bank still had a right to appear in any other application made to force an arrangement upon dissenting creditors. There was no evidence of *mala fides* or lack of probity on part of the management of Dome when entering into the arrangement agreement. With respect to the enforcement of the bank's security, there was no evidence that it was deprived in some manner of the remedies it had prior to Dome entering into the arrangement agreement. Finally, in a deal of this magnitude the no-shop clause preventing Dome from seeking purchasers for six months is not conduct coming within the scope of s. 234 of the Act.

The case does not set out in detail why the Bank of Montreal was concerned with the no-shop clause. One can only assume that the bank was fearful that the elapse of time would diminish the value of the assets of Dome and thereby increase the loss of the creditors. It is also unclear whether the bank was adequately secured. Query whether it was worried about the unsecured portion of its loans to Dome.

### 7. What effect does unanimous shareholder approval have?

Section 235(1) provides that the court may take shareholder approval into account when making an order under s. 234, but such approval is not grounds for the action to be stayed or dismissed. The weight given to the shareholder approval will depend on the circumstances. If the wrongdoers are also the shareholders who approve the conduct, little or no weight will be given to the shareholder approval. If the shareholders approving the conduct are in the same position as the complainant and gave consent with full knowledge of the facts, then such approval would be an indication that those shareholders condoned the conduct on the basis that is was a mere error in judgment.

In *Redekop* v. *Robco Construction Ltd.* a director of Robco Construction Ltd. ("Robco") bought shares in C.F.R. Properties Ltd. ("C.F.R.") then Robco and C.F.R. enter into a contract which was profitable to the director. A minority shareholder of Robco said this conduct was oppressive within the meaning of s. 221 of the Companies Act, 1973 (B.C.) c. 18. The court held that it was even though Ramsey, another minority shareholder of Robco had no objection to the contract between Robco and C.F.R. The court did not see this as significant because Ramsey was an employee of Credit Foncier, the controlling shareholder of C.F.R.

8. Powers of the court under s. 234

Section 234 creates an impressive arsenal of remedies available to the court to redress conduct that is oppressive, unfairly prejudicial or in unfair disregard of the complainant's interest.

In most of the cases involving misappropriation of corporate assets, the court has ordered the corporation or the majority shareholders to purchase the shares of the minority shareholders. This is one of the specified remedies listed in s. 234(3). Yet the court is not confined to giving the specific remedies outlined in s. 234. The court has a broad power to give any interim or final order it thinks fit in order to remedy the matters complained of.

In exercise of its broad power to give any interim or final order it thinks fit to remedy the matters complained of, the courts have given the following orders:

(a) *Keho Holdings Ltd. and Oliver* v. *Noble et al.* The Alberta Court of Appeal enjoined Oliver from exercising the share option and Keho from accepting the option. It also held that if Keho and Oliver were to avoid liquidation of Keho, the loan must be repaid within 30 days or Keho and Oliver must secure the loan.

(b) *Jackman* v. *Jackets Enterprises Ltd.* The court ordered the majority shareholder of Jackets to guarantee a loan made by Jacket's to Ben's. Ben's was another company owned by the majority shareholder. Also the majority shareholder was required to pay, or cause to be paid, to Jackets the extra interest charges incurred or to be incurred by Jackets on the original borrowing of $210,000.

(c) *Low and Anderson* v. *Ascot Jockey Club et al.* The court ordered the majority shareholder to repay to the company the $480,000 improperly paid to him as salary and bonuses. The court also ordered the board of directors to meet and determine two issues. What amounts are proper as salary and bonuses? What steps should the company take to ensure the loans are repaid or that the loans bear interest at a fair rate?

(d) *Westmore and Enchant Resources Ltd.* v. *Old MacDonald's Farms Ltd et al.* The corporate assets were depleted for the benefit of two individuals and this prevented the Company from performing the contract. The court ordered the two individuals to perform the contract entered into by the Company.

(e) *Re Little Billy's Restaurant Ltd.* In this case the court ordered that the resolution of the shareholders approving the franchise agreement be cancelled. It further ordered that the respondents, who were owners of the franchise company, repay to the restaurant company the franchise fees received by the franchise company.

These cases show that the courts, in certain circumstances, will order the persons benefiting from the impugned conduct to remedy the loss suffered by the minority shareholders. This is important, as in situations where s. 42 of the ABCA is contravened the corporation is insolvent.

Under s. 234(3)(l) the court has the power to grant an order compensating an aggrieved person. In the Institute's Report No. 36, *Proposals for a New Alberta Business Corporations Act*, V. 2, p. 329, the Institute said that it was unclear if this section created a new cause of action for damages against another person for oppression. It appears to do so, but the courts may interpret it as a procedural means of enforcing one which would arise under the present law. If s. 234(3)(l) is not seen as creating a new cause of action for damages for oppression or if the courts will not make such an order under their general power created by s. 234, then the personal remedy will be of limited use when the directors strip the corporation of its assets.

Consider the case of *Liu et al.* v. *Sung et al.* (1988) 39 B.L.R. 234 which involved an application brought under s. 224 of the BCCA. Section 224 creates a personal action for shareholders faced with oppression or unfair prejudice. Under the section the court has the general power to make any final order it considers appropriate, with a view to bringing to an end or remedying the matters complained of and the specific power to order the *company* to compensate an aggrieved person.

The defendants brought a motion to have the Statement of Claim struck on the grounds that it did not disclose a cause of action. The action is described at p. 238 of the decision:

> The plaintiffs allege that they held 50 per cent of the equity shares in World View but that the defendants, other than the defendants World View, Wolrige and Selman, were the directors of World View. For ease of reference I will refer to these defendants as the directors. The plaintiffs further allege that the directors granted themselves a debenture for $350,000, advanced $50,000 to World View under that debenture, then as debentureholders called that loan, then as directors refused to meet the demand, thus putting World View in breach of the debenture. As debentureholders, the directors appointed Wolrige as receiver-manager of World View and a few months later, as directors, assigned World View into bankruptcy and appointed Wolrige as the trustee in bankruptcy. Selman is the present of Wolrige.

> The plaintiffs further claim that Wolrige, as trustee in bankruptcy, acting through Selman, sold the assets of World View to the directors for $1 million. The plaintiffs say that this procedure effectively took away their 50 per cent interest in World View and its assets and constituted a scheme to wrest control of World View from the plaintiffs and destroy World View.

The plaintiffs claimed against all defendants for an order pursuant to s. 224(2) of the BCCA, on the grounds that the affairs of World View had been conducted or the powers of the directors had been exercised in a manner oppressive to the plaintiffs, or alternatively on the grounds that some act of World View Television Limited had been done that was unfairly prejudicial to the plaintiffs.

From the facts plead, the court concluded that the predominate motive of the directors was to acquire control of World View's assets from the company. The court held that this created a cause of action for the company, but not for the shareholders, unless some rights were available under s. 224(2). The court concluded that s. 224 was of no assistance to the plaintiffs. The court's rationale is set out at p. 241:

> Although some of the cases under s. 224(2) refer to an award of "damages", they really deal with fixing a notional price for the sale of the oppressed member's shares. The statutory remedies set out in that section are remedies directed against the company, or involving its shares, record or actions. I see no authority in the section for awarding damages simpliciter against individuals in the circumstances and manner requested here.

One may be able to distinguish this case on the basis that remedies created by s. 234 are broader than those created by s. 224. Yet, if the reasoning in this decision is followed, it severely limits the use of the oppression remedy where the result of the director's oppressive conduct is to leave the corporation penniless. Even if the court is unwilling to make an order against defendants who are not directors, there is no reason why directors stripping the company of its assets cannot be held responsible. The court could order those directors to purchase the shares of the applicant, the value of such shares being determined on the basis that the assets of the corporation and its opportunities were not removed by the directors' elaborate scheme. It could also order the directors to return to the corporation its assets.

## D. Derivative Actions: S. 232

### 1. Relationship between derivative and personal actions

A derivative action is one where the shareholder is the self appointed representative of the corporation, suing to enforce a right the corporation has and doing so for the corporation's benefit. If the action is successful the result is a judgment in favour of the corporation against the named defendants. The shareholder would receive nothing more than his expenses. Before the enactment of s. 232 the action was brought in the name of the shareholder suing on behalf of himself and all other shareholders except the wrongdoers. The other shareholders were named as plaintiffs to ensure that they were bound by the judgment. The corporation was named as a defendant so judgment could be given in its favour. Section 232 now provides that such actions be brought in the name of the corporation. The remedy typically sought in such an action is damages for breach of the directors' fiduciary duty to the corporation . (See Institute of Law Research and Reform, Report No. 36, *Proposals for a New Alberta Business Corporations Act*, (1980) p. 138.)

A personal action is an action brought by a shareholder to enforce a personal right of the shareholder against the corporation. Traditionally, the most common personal rights of a shareholder were the right to receive timely and informative notice of company meetings, the right to vote at such meetings, the right to have a properly executed proxy accepted and the right to inspect certain of the company records: Stanley M. Beck, "The Shareholders' Derivative Action" (1974) 52 *Can. Bar Rev.* 159 at p. 169 to 170. The remedy typically sought in this type of action was a declaration or injunction.

A personal action could also be brought by a shareholder on behalf of himself and other shareholders with the same interest. This is known as a class action. Yet even if it is a class action, it is still a personal action and not a derivative action.

There is confusion between derivative actions and personal actions because some acts or omissions may inflict a wrong upon both the corporation and the shareholder. In some situations the same conduct will create a derivative cause of action and a personal cause of action. In other situations only a derivative cause of action will arise. It is important to differentiate between the two because a derivative action cannot be brought without leave of the court under s. 232, whereas a personal action is brought as of right. (Authority for this statement will be given subsequently at pp. 197-98.)

In *Goldex Mines Ltd.* v. *Revill et al.* (1974) 54 D.L.R. (3d) 672 the Ontario Court of Appeal dealt with the distinction between a derivative action and a personal action. The court held that an individual cause of action exists if the injury does not arise simply because the corporation itself has been damaged and as a consequence of the damage to it, its shareholders have been injured. If the shareholder has been injured by a wrong done to the corporation which causes a decrease in the value of shares held by the shareholder, the shareholder does not have a personal action. The court held that the holding of annual meetings and election of directors after the sending of a misleading information circular by the directors was a breach of the directors' fiduciary duty to the corporation and a breach of the duty owed to the shareholders. The shareholders are entitled to adequate information from which they can make intelligent business decisions. Therefore the court held that part of the writ would support a personal action. Yet the court struck out the entire writ because claims for relief that were personal and derivative were inextricably woven together and leave to bring the derivative action had not been obtained. In this case the limitation period to bring the actions had not expired.

The principles of this case were applied by Justice Berger of the Alberta Queen's Bench in *Strachan* v. *MacCosham* (1986) 46 Alta. L.R. (2d) 146. Certain shareholders brought an action on behalf of the corporation against the receiver-manager and the debenture holder for the wrongful appointment of the receiver-manager. They alleged that the wrongful appointment of a receiver-manager under the terms of a debenture had resulted in the loss of corporate assets and the deterioration in value of corporate assets. The shareholders also alleged that they suffered a personal loss because of the resulting decrease in the value of their shares. The court dismissed the shareholders' personal action on the grounds that there was no cause of action because the shareholders had been injured by a wrong done to the corporation which affected the value of the shares. See also *Rogers et al.* v. *Bank of Montreal et al.* (1985) 30 B.L.R. 41 (B.C.S.C.) and *Liu et al.* v. *Sung et al.* (1988) 39 B.L.R. 236 (B.C.S.C.).

It must be remembered that the *Goldex Mines Ltd.* case was decided under The Business Corporations Act, R.S.O. 1970 c. 53, which did not contain a remedy for oppression, unfair prejudice or disregard of the interests of complainants. It is submitted that the creation of such a remedy has expanded the "personal actions" now available to shareholders. A review of the cases decided under s. 234 of the CBCA and other similar sections, such as s. 247 of the OBCA, reveals that the courts are now giving personal remedies to shareholders in situations where such relief had historically been denied. For example, misappropriation of corporate assets by directors or majority shareholders was seen as fraud on the minority and came within the exclusion to the rule in *Foss* v. *Harbottle*, which will be discussed hereafter. In such circumstances the court would allow a shareholder to bring an action to remedy the wrong done to the corporation by the misappropriation of corporate property. With the enactment of the oppression remedy section, shareholders are being given personal remedies in the face of such conduct.

2. Is leave of the court a prerequisite to all derivative actions or does the rule in *Foss* v. *Harbottle* still have some application?

(a) The rule in *Foss* v. *Harbottle*

In *Foss* v. *Harbottle* (1843) 2 Hare 461, it was held that only the company itself could sue to remedy a wrong done to the company. If the shareholders in a general meeting could affirm a director's breach of fiduciary duty, individual shareholders would be precluded from bringing an action to enforce the company's rights. This was so even if such a general meeting had not been held.

The rule in *Foss* v. *Harbottle* gave effect to the principles of corporate personality and majority rule. The principle of corporate personality dictates that a company is a legal entity, separate from the individuals involved in its operation. Under the principle of majority rule, the majority must determine when the corporation will bring an action to remedy a wrong. Later cases extended the rule to prevent the court from interfering with decisions arrived at irregularly, but where the subject matter of the decision still fell within the scope of the corporate powers.

To give some relief in situations where the wrongdoers were the persons controlling the corporation, the courts developed four exceptions to the rule in *Foss* v. *Harbottle*. These were as follows:

(1) where a company acts or proposes to act beyond its powers.

(2) where a company acts in a way that requires the as yet unobtained authority of more than a simple majority

(3) fraud on the minority

(4) where the personal rights of the shareholder are infringed

In these situations the shareholders could bring an action in their own name. Category (4) is really a situation where the rule is inapplicable because the shareholder is bringing a personal action. The other three categories are situations where the shareholders would be able to bring representative actions on behalf of the corporation.

(b) Has s. 232 abolished the rule in *Foss* v. *Harbottle*?

The ABCA does not specifically repeal the rule in *Foss* v. *Harbottle* because the Institute thought that this should be a matter left up to the courts. Yet the Dickerson Report stated that s. 232 of the draft CBCA (now s. 239 of the CBCA) abrogates the notorious rule in *Foss* v. *Harbottle* and substitutes for that rule a new regime to govern the conduct of representative actions. Section 232 of the ABCA is based on s. 239 of the CBCA.

In *First Edmonton Place Limited* v. *315888 Alberta Ltd.* and Majeski, Justice McDonald concluded that s. 232 was designed to overcome the problems created for the minority by the rule in *Foss* v. *Harbottle*. However, he did not decide if the rule still had application in Alberta.

This issue had been addressed in other provinces and the courts have been willing to hold that sections similar to s. 232 abrogate the rule in *Foss* v. *Harbottle*. In *Farnham et al.* v. *Fingold et al.* (1973) 33 D.L.R. (3d) 156, the Ontario Court of Appeal held that the broad language of s. 99 of The Business Corporations Act, R.S.O. 1970 c. 53, embraces all actions by which a shareholder sues on behalf of a corporation. The court dismissed an action that was derivative in nature which was not brought with leave of the court granted pursuant to s. 99. See also *Goldex Mines Ltd.* v. *Revill et al.* which was discussed earlier. In *Shield Development Company* v. *Snyder et al. and Western Mines Limited* [1976] 3 W.W.R. 44 the British Columbia Queen's Bench held that s. 222 of The Companies Act, 1973 abrogated the common law derivative actions under the exceptions to the rule in *Foss* v. *Harbottle*. The court concluded that confusion would be created if the common law remedy was still available. See also *Phil Lloyd's Restaurant Ltd.* v.

*North Forty Restaurant Ltd.* (1983) 25 Sask. R. 40 (Sask. Q.B.) and the minority decision in *Churchill Pulpmill Ltd.* v. *Government of Manitoba et al.* [1977] 6 W.W.R. 109 (Man. C.A.).

For the purposes of Part 19 of the ABCA, "action" is defined in s. 231 as "an action under this Act or any other law". Therefore, the reasoning in *Farnham et al.* v. *Fingold et al.* is applicable. Even if this is not the case, the reasoning in *Shield Development Company* should be applicable. Therefore, it is submitted that the result in Alberta should be that leave of the court must be obtained by a complainant wishing to bring a derivative action.

In Ontario and British Columbia failure to obtain such leave will mean that the action will be struck. The result should be the same in Alberta unless the derivative action was wrongly plead as an action brought pursuant to s. 234. Section 234 gives the court the power to grant leave to the applicant to bring a derivative action. This provision was enacted to prevent the hardship faced when one wrongly evaluates an action as a personal action when it is, in fact, a derivative action.

3. When will the Court grant leave for the complainant to commence a derivative action?

(a) Section 232 of the ABCA

Section 232 of the ABCA provides as follows:

> 232(1) Subject to subsection (2), a complainant may apply to the Court for leave to
>
> (a) bring an action in the name and on behalf of a corporation or any of its subsidiaries, or
>
> (b) intervene in an action to which a corporation or any of its subsidiaries is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the corporation or subsidiary.

> (2) No leave may be granted under subsection (1) unless the Court is satisfied that
>
> (a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the Court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute, defend or discontinue the action,
>
> (b) the complainant is acting in good faith
>
> (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

Pursuant to s. 232 a complainant may apply to the Court for leave to bring an action in the name and on behalf of the corporation for the purpose of prosecuting the action on behalf of the corporation. The general attitude of the courts is to grant leave where all the statutory prerequisites have been met: *Re Marc-Jay Investments Inc. and Levy et al.* (1974) 50 D.L.R. (3d) 45 (Ont. H.C.J.) and *Armstrong* v. *Gardener* (1978) 20 O.R. (2d) 248 (Ont. H.C.J.). Yet in *Johnson* v. *Meyer* (1987) 57 Sask. R. 161 the Saskatchewan Queen's Bench made the *obiter* comment that even where the prerequisites of the statute are met, the court may still refuse to grant the order sought.

B. Welling, *Corporate Law in Canada* (1984) at p. 511 supports the view that even where all the statutory prerequisites are met leave should not be granted where the statute provides a more appropriate remedy elsewhere or where personal and derivative claims are insufficiently distinguished and leave was not obtained to bring the derivative action.

There are several cases where a statement of claim has been struck because personal and derivative claims were inextricably interwoven together and leave was not obtained to bring the derivative action. In each case the limitation period to bring the derivative action had not expired. See *Goldex Mines Ltd.* v. *Revill et al., Hoskins* v. *Price Waterhouse Ltd. et al.* (1982) 136 D.L.R. (3d) 553. In contrast is the decision in

*Shinkaruk et al.* v. *Ecclesiastical Insurance Office Public Ltd. Co et al.* ( 1985) 15 C.C.L.I. 129 (Sask. Q.B.). There the limitation period for bringing the action on behalf of the corporation had expired. The court held that the shareholder had not intended to bring a derivative action, but if that was the case, failure to obtain leave to bring such an action did not render the action a nullity.

(b) Notice to the directors

(i) Purpose of this prerequisite

The rationale behind this statutory prerequisite was discussed by Stanley M. Beck in his article entitled "The Shareholders' Derivative Action" (1974) 52 *Can. Bar Rev.* 159 at p. 202-203 as follows:

> Both sections 99 and 229 [239 of the CBCA] follow the common law in requiring that a shareholder first attempt to have the company commence the action itself. This seems a reasonable requirement as the company should be given the opportunity of vindicating its own rights. And the directors, faced with an application to the court and possible trial, may well decide that corporate action is the responsible course. Moreover, such a request might result in an amicable resolution of the dispute.

Section 99 of The Business Corporations Act, R.S.O. 1970 c. 53, referred to above required the applicant to make reasonable steps to cause the corporation to commence the action. Section 239 of the CBCA requires the complainant to give reasonable notice to the directors of the corporation of his intention to apply to the court under subsection (1) if the directors of the corporation do not bring the action.

(ii) Adequacy of notice

In *Re Northwest Forest Products Ltd.* [1975] 4 W.W.R. 724, the British Columbia Supreme Court was interpreting a statutory requirement that the applicant make reasonable efforts to cause the directors to commence the action. The court held that the directors must have full knowledge of the basis of the claim before they can bring the action, so in the notice to the directors the applicant must specify the precise nature of the action he wishes the company to pursue. The test applied by the court was " Did the applicant give the directors specifics of the cause of action and sufficient information to found an endorsement on a writ?".

Similar principles were applied in *Re Daon Development Corporation* (1984) 26 B.L.R. 38 (B.C.S.C.). In this case a shareholder sent a letter to the directors requiring them to join an application for leave to bring a derivative action or to undertake to the court to bring such an action. Failure to pursue either option was deemed to be a refusal to prosecute the action. The court held that this was insufficient notice. Adequate notice must be given even where it is naive to think the directors will commence the action.

Yet it is clear that failure to specify each and every cause of action does not invalidate the notice as a whole. In *Re Bellman et al. and Western Approaches Ltd.* (1981) 17 B.C.L.R. 117 the British Columbia Court of Appeal was faced with a situation where one ground in the petition for leave was not contained in the notice letters sent to the directors. The court held that reasonable notice was given under s. 232 of the Canada Business Corporations Act, S.C. 1974-75, c. 33 [now s. 239 of the CBCA] because directors were reasonably notified of the Bellman group's intention to apply to commence a derivative action.

In *Armstrong* v. *Gardener* (1978) 20 O.R. (2d) 648 the Ontario High Court of Justice seems to go one step further. The court held that letters sent between the solicitors of the minority and majority shareholders satisfied the requirement to make reasonable efforts to cause the corporation to commence the action. Although the letters did not set out the specific causes of action contemplated, the letters requested that action be taken to prevent the investment of the mortgage proceeds. The court was of the view that this prerequisite should not be construed in an unduly technical or restricted matter. This case seems to be contrary to the other decisions on this issue, but may be explained on the basis that the letters were passing between lawyers.

Where notice is given by the parties themselves and not through their lawyers, the following must be observed:

(a) Notice of intention to bring action under s. 232 must be sent by the complainant, not by some other entity.

(b) The notice should be addressed to the directors of the corporation and not to the corporation itself.

(c) The notice should name all the proposed defendants in the action to be brought on behalf of the corporation.

(d) The directors must be given an opportunity to consider whether or not the corporation should commence the proposed action: *Johnson* v. *Meyer* (1987) 57 Sask. R. 161 interpreting s. 232 of the SBCA.

(c) Good faith

(i) Purpose of this prerequisite

The Dickerson Report, at p. 161 indicated that the purpose of the good faith prerequisite was to preclude private vendettas. In *First Edmonton Place Limited* v. *315888 Alberta Ltd.*, Justice McDonald adopted this statement and interpreted it as merely requiring the courts to ensure that the action is not frivolous and vexatious.

In *Re Vedova et al. and Garden House Inn Ltd et al.* the court said the applicant was not acting in good faith when she was motivated less by potential returns to the corporation than by the tactical advantage against the respondent.

(ii) Must evidence of good faith be given by affidavit?

There is conflicting authority on this issue. In *Re Besenski* (1981) 15 Sask. R. 182 (Q.B.) the court held that it was not satisfied that the applicant was acting in good faith since no affidavit by him established good faith. The court also held that there was nothing before the court to show the action would be in the interest of the corporation. However, in *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski*, Justice McDonald held that the applicant was acting in good faith even though there was no affidavit evidence to that effect. The court was of the opinion that First Edmonton Place Limited was acting in good faith in seeking the potential return of money paid out by the corporation, so that the corporation could pay the rent owing to First Edmonton Place Limited. See also *Appotive* v. *Computrex Centres Ltd.* (1981) 16 B.L.R. 133 (B.C.S.C.) where the court held that the applicant was acting in good faith even though there was no affidavit from him in person. There was an affidavit of the applicant's lawyer in support of the petition.

(iii) Where relief claimed in a personal action and a derivative action is substantially the same, is this evidence of lack of good faith?

In several cases the argument has been made that where the relief requested in a personal action and a derivative action is substantially the same, this is evidence of lack of good faith. It is frivolous and vexatious to seek the same relief in the two actions. To date the argument has not been successful.

In *Re Bellman and Western Approaches Ltd.* the British Court of Appeal side stepped the argument by saying it is possible for both a personal and derivative action to proceed on the same set of facts. In the case before it, the relief claimed in the personal action (an oppression action) was not the same as that proposed in the derivative action. Damages for breach of fiduciary duty were claimed in the derivative action and not in the personal action. This was sufficient to justify leave being granted for the commencement of the derivative action.

In *Appotive* v. *Computrex Centres Ltd.* the court noted that there was an oppression action proceeding simultaneously in which the relief claimed included the relief sought in the proposed derivative action. The court refused to accept the argument that the application to obtain leave to bring the derivative action was therefore frivolous and vexatious. Yet the court sought further submissions from counsel on whether leave to bring the derivative action should be given on conditions relating to the other proceeding. The court wanted to minimize legal costs and duplicity of proceedings.

In *First Edmonton Place Limited* v. *315888 Alberta Ltd.* the court also rejected the argument that a litigant was acting in bad faith if he sought leave to bring two actions for substantially the same relief.

(d) Appears to be in the interests of the corporation that the action be brought

(i) Purpose of this prerequisite

At p. 161 of the Dickerson Report the purpose of a similar condition is discussed as follows:

> And by requiring the complainant to establish that the action is "*prima facie* in the interests of the corporation" it blocks actions to recover small amounts, particularly actions really instituted to harass or to embarrass directors or officers who have committed an act which, although unwise, is not material.

The standard recommended by the Dickerson Report is found in the BCCA. The standard adopted by the ABCA and CBCA is "appears to be in the interests of the corporation". Although the latter is a higher standard, the comments contained in the Dickerson Report still assist in determining the purpose of this prerequisite.

(ii) What is required to satisfy this prerequisite?

In deciding whether this prerequisite has been met the courts will not conduct a mini-trial in an application for leave to bring a derivative action. The court will review the evidence before it to ensure that an arguable case exists. If the material before the court does not disclose the nature of the proposed action, the parties on whose behalf the action is proposed, and the circumstances upon which the court could decide that it would be in the interests of the corporation that the action be brought, the action will be dismissed: *Re Besenski.*

To ensure that it appears to be in the interests of the corporation that the action be commenced, the courts have required that an "arguable case" be shown to exist: *Re Bellman and Western Approaches Ltd.* and *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski.*

To determine if it *prima facie* is in the interests of the corporation that the action be commenced the courts have reviewed the evidence before it to ensure that:

(a) there is sufficient evidence adduced, which on the face of that evidence discloses that it is, so far as can be judged from the first disclosure, in the interests of the company to pursue the claim: *Re Northwest Forest Products Ltd.* (There the court granted leave because *prima facie* evidence of carelessness on part of the directors in selling land at something substantially less that its real value was adduced.)

(b) a probable case is shown to exist: *Re Daon Development Corporation* (1984) 26 B.L.R. 38 (B.C.S.C.).

(c) an action could reasonably succeed: *Re Marc-Jay Investments Inc and Levy et al.* and *Armstrong* v. *Gardener.*

In deciding if it appears to be in the interests of the corporation that the action be brought, the court will also take into account the decision of the directors *not* to commence the action on behalf of the company. The court will be influenced by the honest and impartial opinions of directors that the best interests of the corporation do not require it to sue: *Re Bellman and Western Approaches Ltd.* In this case the respondents argued that it was not in the interest of the corporation to bring the action because independent directors had come to this conclusion based on legal opinions and accounting reports. The court held that the directors voting for the resolution not to commence the action were not independent, because they were nominees of the wrongdoers. Furthermore, the legal opinions and accounting reports were limited to certain time periods and are not conclusive of the substantive issues raised by the petitioner.

(iii) Conflicting evidence

When an application is heard for leave to bring a derivative action the court is usually presented with two conflicting versions of the facts. To what extent the court should weigh such evidence was discussed in the following cases. In *Re Marc-Jay Investments Ltd. and Levy et al.* the Ontario High Court of Justice discussed this point at page 47 as follows:

> The main position of the respondent was that the material filed by it should convince me that the purchase of Premium was not improvident for the shareholders of Levy. To reach that conclusion I would have to weigh the affidavit material filed on this application. I agree that I have to weigh it to determine whether it shows that the intended action is without merit or is frivolous or vexatious. Having weighed the evidence I am not of the opinion that the contemplated action is without merit or is frivolous or vexatious. I believe, however, that is the extent to which I am entitled to weigh the evidence. I am not to deny leave to bring an action

> simply because on a weighing of the evidence I should decide it is unlikely that the action will be successful. I might say I have not reached any such conclusion in this case.

In *W.E.H. Financial Corp.* v. *Powell River Town Centre Ltd.* (1983) 49 B.C.L.R. 145, the court commented upon conflicting evidence in such an application at pp. 150-151, 153:

> The ultimate rights of the parties will be resolved on the basis of which version of those facts is found to be correct. The authorities are clear that it is not appropriate to resolve such issues at this stage of the proceedings on the basis of conflicting affidavits which have not even been tested by cross-examination. Such conflict should be resolved at trial. . . . [T]he fact is that the opposing parties do put their differing views before the court and they become a factor in the exercise of the court's discretion. However, where the opposing views are at opposite poles and an issue of credibility arises, as here, the sole purpose in considering the respondents' version of the facts is to test the reasonableness on its face of the petitioners' version.

In *First Edmonton Place Limited* v. *315888 Alberta Ltd. and Majeski* the signing bonus had been paid by the corporation to the directors but there was a conflict of evidence on whether the directors used the money for their personal use or for the corporation's use. The court concluded that it was in the interests of the corporation that it be determined at trial if the taking of the money by the directors was a wrong against the corporation.

In *Appotive* v. *Computrex Centres Ltd.* the respondent argued that it had raised sufficient explanation of its conduct that leave should not be granted. The court held that it should not enter into a determination of whether the explanations given are sufficient. The court should not go into the merits further than is required for the purposes of the application. The court granted leave because the applicant had raised sufficient questions of the commission of alleged wrongs as would justify the matter going to trial.

(e) Summary

The decision in *Re Marc-Jay Investments Ltd. and Levy et al.* summarizes this area succinctly at p. 47 as follows:

> It is obvious that a Judge hearing an application for leave to commence an action, cannot try the action. I believe it is my function to deny the application if it appears that the intended action is frivolous or vexatious or is bound to be unsuccessful. Where the applicant is acting in good faith and otherwise has the status to commence the action, and where the intended action does not appear frivolous or vexatious and could reasonably succeed; and where such action is in the interest of the shareholders, then leave to bring the action should be given.

4. What is the effect of shareholders' approval of the directors actions?

Under the rule in *Foss* v. *Harbottle* the possibility that the shareholders might approve the conduct of the directors was, with exceptions, a bar to an action by a shareholder alleging breach of duty owed to the corporation. Section 235(1) was enacted to abolish this part of the rule. Section 235(1) provides that an application under Part 19 shall not be dismissed by reason only that it is shown the alleged breach of a right or duty owed to the corporation has been or may be approved by the shareholders. However, evidence of the approval of the shareholders may be taken into account by the court.

When preparing s. 235(1) of the proposed ABCA, the Institute contemplated that the ratification of the breach of a right or duty owed to the corporation would be relevant to the issue of whether it appears to be in the interest of the corporation that the derivative action be brought. If the misconduct was ratified by the wrongdoers casting their votes as shareholders, evidence of shareholder ratification would carry little weight. Yet if disinterested shareholders ratify the conduct of the directors it is some indication that they thought the conduct could be dismissed as a mere error of business judgment and therefore it is not in the interest of the corporation that the action be brought.

In *Re Northwest Forest Products Ltd.* the court gave leave to a shareholder to bring an action on behalf of the company against directors who allegedly breached their duty of care owed to the company by selling assets at substantially less than their real value. Leave was granted notwithstanding that the conduct of the directors in selling the assets was approved by the majority of the shareholders. Two of the directors were also shareholders. There was no evidence before the court establishing that the shareholders who voted to condone the conduct of the directors were disinterested parties.

In *LeDrew* v. *LeDrew Lumber Company Limited* (Nfld. S.C.T.D.) Sept. 23, 1988, the court dealt with the LeDrew Lumber Company Limited ("the Corporation"), a family-run corporation which had six shareholders, four of whom were directors. Peter LeDrew was a shareholder, director and employee of the Corporation. Since 1975 he had also operated an insurance agency out of the Corporation's premises, but no office was given to the insurance agency until 1985. The insurance agency had begun paying rent for the space in 1987. Gerald LeDrew, the applicant, was a shareholder of the Corporation who had an ongoing dispute with the directors because they would not let him be a director.

Gerald LeDrew put forth a resolution at a general meeting of the Corporation that the Corporation commence an action against Peter LeDrew to require the agency to compensate the Corporation for past and present use of the Corporation's property, personnel and resources in the conduct of the agency's business. The resolution was defeated by the four directors of the Corporation who voted their shares against the resolution. Gerald LeDrew then brought an application under s. 364 of the Corporations Act, S.N. 1986, c. 12 for leave to bring action on behalf of the Corporation against Peter LeDrew for compensation for use of the Corporation's premises by the insurance agency.

The court denied the application for leave on the grounds that the applicant was not acting in good faith and the action was not in the interests of the Corporation. The court doubted the good faith of the applicant because the application for leave was brought after the directors rejected the applicant's request to be a director. In addition, LeDrew Realty Limited, a corporation managed by the applicant, had occupied part of the Corporation's premises for 8 or 9 years without paying any compensation therefore.

With respect to the second grounds of refusal, the court was influenced by *Bellman et al.* v. *Western Approaches Limited et al.* which held that approval of a breach of a right owed by a corporation by the shareholders was not a grounds for refusing leave. However, when deciding if the "action appears to be in the interests of the corporation" the court can look to the decision of independent directors who decide not to assert a corporate right of action.

The court held that the action was not in the interests of the Corporation because:

(1) The directors had nothing to gain by voting their shares against the applicant's resolution.

(2) There was no evidence of misconduct or fraud or prejudice or breach of trust on the part of the directors.

(3) Even if the action is successful, no substantive amount of damages would be recovered.

5. Duties owed by directors to the corporation

(a) Duty of care, diligence and skill

(i) At common law

The leading authority on the duty of care, diligence and skill owed by a director to the corporation is the case of *Re City Equitable Fire Ins. Co.*, [1925] 1 Ch. 407 (C.A.). At pp 428-29 Romer J. set out the duties of directors as follows:

> (1.) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience . . ..
>
> (2.) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings, and at meetings of any committee of the board upon which he happens to be placed. He is not, however, bound to attend all such meetings, though he ought to attend whenever, in the circumstances, he is reasonably able to do so.
>
> (3.) In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director, is, in an absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.

(ii) Statutory duty

Recognizing the inadequacy of the common law duty of care, diligence and skill, the modern corporation acts have included sections which change the test from a subjective one to an objective one. A representative example of such a statutory duty is found in s. 117(1)(b) of the ABCA which provides that every director and officer of a corporation in exercising his powers and discharging his duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In *Grindrod & District Credit Union et al.* v. *Cumis Insurance Society, Inc.* (1983) 4 C.C.L.I. 47 (B.C.S.C.) the court had cause to interpret The Credit Union Act (B.C.). This Act provides "that every director, in exercising his powers and performing his functions, shall exercise the care, diligence and skill of a reasonably prudent person." The court compared the statutory standard to the three propositions set out in *Re City Equitable Fire Ins. Co.* which are quoted above. It concluded that the statutory standard is more stringent than proposition one cited above. The test created by the statute is an objective one. The court said that "in determining what degree of skill is required of a director, the Court must use the standard of the reasonable man with no reference to the knowledge and experience of the board of directors in this particular case". The court still considered the third proposition to apply under the statute. Therefore, if the directors do not have skill in operating a credit union they would be expected to rely on expert officials. The directors can rely on the official to carry out his responsibilities honestly, provided there is no prior misconduct on the part of the official.

(b) Fiduciary duties

(i) The common law

For the purposes of this memorandum we will broadly outline the common law fiduciary duties owed by a director or senior officer to the corporation. These duties were developed by the Courts of Equity over several hundred years. This outline is based on a review of Ellis, *Fiduciary Duties in Canada*, Waters, *Law of Trusts in Canada*, and B. Welling, *Corporate Law in Canada* (1984).

A director or senior officer owes a duty to the corporation of utmost good faith and heightened loyalty which compels the fiduciary to act at all times in the best interest of the corporation. In evaluating whether there has been a breach of fiduciary duty, any act of the director or senior officer will be evaluated on the basis of whether the act was in the best interests of the corporation. It is this departure from the adherence to the best interests of the corporation, and not the motives of the director, that constitute breach of the fiduciary duty. Therefore, even though a director has acted honestly, he will still be liable for breach of his fiduciary duty. Absence of malice will not validate a breach of fiduciary duty: *Regal (Hastings) Ltd.* v. *Gulliver* [1942] 1 All E.R. 378 at p. 381.

A breach of fiduciary duty can arise in an infinite variety of situations, the most common of which are management manipulation for the advantage of the directors or senior officers and the making of secret profit, that is, profit not approved by the shareholders. When the directors manipulate the management of the corporation in order to achieve personal benefit, they have breached their fiduciary duty because they are not acting in the best interests of the corporation. This argument is often made when the directors issue shares in face of an unwanted takeover bid. Any profit enuring to the benefit of the director from an opportunity presented to him as a result - and only as a result - of his being a director must be disgorged to his corporation, unless there is a contrary agreement ratified by the shareholders with respect to the specific transaction. Absent such an agreement, any personal profit is repugnant to the best interests of the corporation. Such conduct can only be ratified by the shareholders after complete disclosure. This liability to account arises because a director is strictly prohibited from putting himself in a position of conflict between his personal interest and his duty to the corporation. In such a situation the presence or absence of good faith is irrelevant. Also the fact that the corporation cannot avail itself of the business opportunity will not relieve the director of his liability to account.

(ii) Statutory duties

The fiduciary duties imposed upon directors by equitable principles have been set out in the new business corporation legislation enacted in several provinces in Canada. Section 117 of the ABCA enacts:

> 117(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation.

This and similar legislation is seen as a codification of the fiduciary duties created by the courts. It is submitted that the principles dealing with fiduciary duties of directors and officers which were developed by the courts will still be applicable under the application of s. 117.

The problem of directors having a personal interest in material contracts made with the corporation has been addressed specifically in s. 115 of the ABCA. This section requires a director who is a party to a proposed material contract or has a material interest in any person who is a party to a proposed material contract to disclose in writing to the corporation the nature and extent of his interest. Subject to certain exceptions, the interested director cannot vote on any resolution to approve the contract. If the director discloses the nature and extent of his interest in accordance with the Act, the contract is not void or voidable by reason only of the relationship as long as the contract was approved by the directors or the shareholders and it was fair and reasonable to the corporation. If the director fails to disclose his interest in a material contract, the court may on application of the corporation or a shareholder set aside the contract on any terms it thinks fit.

This section substantially reflects the common law position. However, it contemplates approval by the "directors or shareholders" as opposed to common law requirement of shareholder approval.

### (iii) Remedies

The breach of the duty of care, diligence and skill creates a cause of action in the corporation for negligence. However, as the common law duty of care was very subjective directors were rarely found liable for negligence. The new objective standard created by s. 117 may make this a more useful remedy to corporations complaining of the negligence of directors.

In a situation where a director acquires a profit by reason of and in the course of his office as director, he must account to the corporation for the profit. B.Welling, *Corporate Law in Canada* (1984) argues at p. 381 that this is not a situation where the director holds the profit in trust for the corporation. It is a situation where the director becomes the debtor of the corporation because of his duty to account. His argument is based on *Lister & Co* v. *Stubbs* (1890) 45 Ch. D. 1 in which the English Court of Appeal held that the company could not trace the secret profits invested by the director because the company owned no property in the profits held by the fiduciary.

Yet, the law in this area is very confusing because there are many cases which find that a director is a constructive trustee who holds the profits in trust for the corporation. Waters, *Law of Trusts in Canada*, at p. 337 attempts to rationalize the law in this area as follows:

> As to the problems presented by *Lister & Co.* v. *Stubbs*, it may be that the beneficiary of a fiduciary relationship should be seen in this light: he has a right to trace property which he owned and, for the purposes of the agency, transferred to the fiduciary, or empowered him to sell or exchange. He can also assert a priority for the recovery of that property in it original or converted form, over the general creditors of the insolvent fiduciary. But unless the particular fiduciary relationship is intense, the beneficiary must first establish that he is entitled to any profit coming to the fiduciary from third parties, such as moneys representing collected rents or debts, or secret commissions. As the Court of Appeal pointed out, this he can easily do. He can bring an action for an account, and, assuming his success, claim the right to trace there and then.

If a director uses corporate assets to generate profit for himself he holds the profits in trust for the corporation. Corporate property under the control of directors must be applied for the specified purposes of the corporation. The directors are trustees of the corporate assets and like any other trustee are liable for breach of trust in respect of the assets: *Selangor United Rubber Estates, Ltd.* v. *Craddock and others (No. 3)* [1968]

2 All E.R. 1073 (Ch.D.) and *Angus* v. *R. Angus Alberta Limited et al.* (1988) 50 D.L.R. (4th) 439 (Alta. C.A.), but see the conflicting case of *J.L.O. Ranch Ltd.* v. *Logan* (1987) 54 Alta.L.R. (2d) 130 (Alta. Q.B.) which held that the directors were only trustees of corporate property which was transferred to them. Therefore, when the director uses corporate assets to make himself a profit, he is in breach of trust. The profit is attributable to the use of corporate assets and is the property of the corporation itself and the directors holds the profit in trust for the corporation: B.Welling, *Corporate Law in Canada* (1984) at p. 408.

If a director misapplies corporate assets in breach of his fiduciary duty and causes loss to the corporation but does not gain personally, he is liable for his breach of trust as he is trustee of the property. The director must reimburse the corporation for its loss: *Selangor United Rubber Estates, Ltd.* v. *Craddock and others* (No. 3). (This case will be discussed in detail later on in this memorandum.)

This situation commonly arose where directors, acting honestly, misapplied property in furtherance of a *ultra vires* scheme. A recent illustration of such a case is *Angus* v. *R. Angus Alberta Limited et al.* This was a case where two minority shareholders brought a derivative action on behalf of the company against the directors . It was held that the directors authorized the company to repurchase shares of certain shareholders and the repurchase was in contravention of the ACA because made without the written consent of the minority shareholders. As the purchase of shares was made in contravention of the ACA it was *ultra vires* the company and incapable of being approved by a majority of shareholders.

When dealing with the liabilities of the directors the court held at p. 450:

> Directors owe a duty to the shareholders to act according to law and according to the provisions of the memorandum and articles of association. Misapplication of company funds in breach of that duty in furtherance of an *ultra vires* scheme is treated as a breach of fiduciary duty. The directors are trustees of the money misapplied and their liability for

> breach of that trust is the same as that of any other trustee. They must recoup the loss or compensate the company for it, with interest.

There are also situations were the director breaches his fiduciary duty without misapplying corporate assets. His breach of duty harms the corporation but he does not gain personally. Historically, the equitable remedy of compensation would be granted against a trustee or other fiduciary to compel restitution for the loss suffered because of his breach of fiduciary duty. Yet in practice this remedy and the common law remedy of damages are often not distinguished and there may be no useful purpose in keeping them distinct: Gower, *Gower's Principles of Modern Company Law*, 4th ed. , p. 607.

In *Guerin* v. *The Queen* [1984] 2 S.C.R. 335 Chief Justice Dickson and three other judges awarded damages for breach of a fiduciary duty. The case involved 160 acres of land surrendered by an Indian band to the Crown so that the Crown could lease it to a golf club on certain terms set out by the band. Dickson held that the Crown did not hold the land in trust for the band, but that in the circumstances the Crown was a fiduciary of the band. Although the Crown's obligation to the band was not in trust, it was trust-like in nature. The Crown had breached its fiduciary duty by obtaining, without consultation with the band, a much less valuable lease that the Crown promised. Dickson held that the Crown must make good the loss suffered by the band as a consequence. The quantum of damages was determined by analogy to trust laws. Dickson adopted the trial judge's award of damages of $10 million which was assessed on the basis of breach of trust of a trustee. See also *Standard Investments Ltd.* v. *C.I.B.C.* (1985) 52 O.R. 473 (Ont. C.A.), *William R. Barnes Co.* v. *MacKenzie* (1974) 2 O.R. (2d) 659 (C.A.).

Will the nature of the remedies change now that the fiduciary duty has become a statutory duty? It is submitted that this will not likely be the case. However, it may now be described as damages for breach of statute. In *Beamish* v. *Solnick et al.* (1980) 10 B.L.R. 224 (Ont. H.C.J.) the court held that a director had breached s. 144 of the Business Corporations Act, R.S.O. 1970 by failing to act in the best interests of the corporation. The director had refused to execute documents which would have sold the corporation's land and business when it clearly was in the interest of the corporation to do so. He refused to sign because the sale price was sufficient only to pay the creditors of the corporation and nothing would be left to pay him the $15,000 he expected from the sale. The court held that because of the violation of s. 144 the corporation suffered damage. Therefore the director was liable to the corporation for damages he had caused, such damages to be assessed by the Master. The court merely awarded damages for breach of statutory duty.

### 6. Restrictions on powers of directors to authorize the Corporation to grant financial assistance

#### (a) General analysis

Subject to a unanimous shareholder agreement, the power to authorize the corporation to grant financial assistance lies with the directors: Sections 97 and 98.1. Restrictions on the exercise of this power are found in the ABCA. Restrictions may also be found in a unanimous shareholder agreement or the articles and by-laws. For the purpose of this discussion we shall assume that there are no restrictions on the directors powers contained in any unanimous shareholder agreement, or the articles and by-laws.

What restrictions are now imposed by the ABCA on the directors power to authorize the corporation to grant financial assistance? The first such restriction is created by section 42 itself. Subject to the exceptions created by section 42(2), if a corporation cannot meet the solvency tests established by section 42, it cannot give the financial assistance contemplated by section 42. The recipients of funds or property transferred in contravention of section 42 must restore the funds or property to the corporation. Directors who authorize prohibited financial assistance are liable under section 113 to restore to the corporation the money paid by the corporation in contravention of section 42.

If the corporation satisfies the solvency tests of section 42, are there any restrictions upon the directors power to authorize the corporation to grant financial assistance? At first blush one might say no, but this is not the case. Section 117(1)(a) provides that *every director when exercising his powers must always act with a view to the best interests of the corporation.* This duty governs the directors in the exercise of their powers under section 97(1) and section 98.1(1). Furthermore section 234 indicates that the powers of the directors should not be exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of the shareholders or creditors.

As long as they get paid, creditors of a solvent corporation will not complain if financial assistance is given by a corporation. Yet shareholders may challenge the directors who authorize financial assistance. The challenge may take the form of a derivative action for breach of fiduciary duty or it could be a personal action under section 234 or an application for dissolution of the company under section 207. See for example *Keho Holdings and Oliver* v. *Noble* where minority shareholders complained, among other things, of a managing director who had the corporation make a loan to another corporation controlled by the managing director. Relief was granted under section 207 of the ABCA.

If section 42 is repealed the only restrictions on the powers of directors to authorize the corporation to grant financial assistance will be imposed by the fiduciary duty the directors owe to the corporation and by section 234. The directors should not authorize the corporation to grant financial assistance unless it is in the corporation's interests to do so. They should not exercise their powers in a manner that is oppressive or is unfairly prejudicial to or that unfairly disregards the interest of shareholders and creditors. The fact of solvency or insolvency will be only one factor the court will consider in determining if the directors have breached their fiduciary duty owed to the corporation or if the directors' conduct gives the shareholders some personal remedy under section 234 or justifies the dissolution of the corporation or some other remedy under section 207. Repeal of section 42 will *not* mean that the directors can, in every situation, authorize financial assistance formerly prohibited by section 42.

The repeal of section 42 will make the solvency tests set out in section 42(1)(d) and (e) no longer applicable. Yet in determining whether the granting of financial assistance was in the best interests of the corporation or is oppressive or unfairly prejudicial to shareholders or creditors, the fact of the solvency or insolvency will still be an important factor. It is submitted that the courts will fall back on the definitions of "insolvency" used in the general area of fraudulent conveyances and fraudulent preferences. See for example, *Robinson* v. *Country Wide Factors Ltd.* (1978) 1 S.C.R. 753 where the Supreme Court of Canada held that a person in insolvent circumstances within the meaning of the Fraudulent Preference Act of Saskatchewan, R.S.S. 1965, c. 39, is one unable to pay his debts in the ordinary course of business as they become due or one who does not have the means of paying his creditors in full out of assets which could be realized upon sale for cash or its equivalent. These tests are very similar to those now contained in section 42(1)(d) and (e) with the exception that in determining the realizable value of the assets, the corporation does not have to subtract the amount of the loan or the value of the assets pledged as security for a guarantee. The result is that the repeal of section 42 would allow a corporation to give a guarantee secured by a floating charge debenture but only when it is in the interests of the corporation to do so. Also, subject to section 36, a corporation can make a loan out of stated capital if it is in the interests of the corporation to do so.

When considering if a corporation should grant financial assistance the directors must determine if the granting of the financial assistance is in the interests of the corporation. In making this decision the directors must consider the following issues. Is the financial assistance reasonably incidental to the carrying on of the corporation's business? Does it serve a corporate purpose? Will the corporation gain from the giving of the financial assistance? Is the corporation insolvent or on the verge of insolvency? Does the granting of the financial assistance threaten the continued existence of the corporation? Will the position of present and future creditors be threatened?

In our opinion, it is not in the interests of a solvent or insolvent corporation to give financial assistance to anyone when the directors do not perceive that some benefit would accrue to the corporation as a result of the giving of the financial assistance. In this context we use the term "benefit" broadly and it is not limited to monetary gain. Any director who authorizes such financial assistance will be in breach of his fiduciary duty because he has not acted in the interests of the corporation.

For example, it is generally accepted that employees of a distributing corporation perform better if they participate directly in the corporation through share ownership. A guarantee of a loan made to an employee to enable him to purchase the corporation's shares would be of benefit to a distributing corporation. The directors have not breached their fiduciary duty by authorizing the financial assistance. Also, a director could authorize a corporation to give financial assistance for the purchase of its shares if the financial assistance was a necessary part of a scheme designed to overcome a management deadlock: *Brady* v. *Brady* [1988] 2 All E.R. 617 (H.L.). Yet if a director of a non-distributing corporation wishes to borrow money to start another business, it would not be in the interests of the corporation to guarantee such a loan. The corporation will not receive any benefit and only runs the risk of losing its assets. The directors authorizing the corporation to grant such a guarantee would be in breach of the fiduciary duty they owe to the corporation.

Many non-distributing corporations routinely give financial assistance to directors, shareholders and others when it is clear no benefit will accrue to the corporation. Does this fact support an argument that the directors are not breaching their fiduciary duty owed to the corporation? In our opinion it does not. These are just situations where no one has complained of the breach of fiduciary duty. As long as the creditors are paid and all the shareholders agree to the transaction, there is no one to complain about the breach of fiduciary duty. Yet, if at the time the financial assistance is given the corporation is insolvent or near insolvency or if the corporation becomes insolvent by reason of giving such financial assistance, the directors must be accountable for their breach of fiduciary duty. In Chapters 4 and 5 of this report, we shall discuss how a shareholder and creditor can make such a director accountable in these circumstances.

(b) Case law

As seen by a review of the case law, the courts have in several circumstances held that the granting of financial assistance to directors or their corporations is not in the best interests of the corporation granting the assistance. Consider:

1. *Saskatchewan Land and Homestead Co.* v. *Moore et al.* (1913) 26 O.W.R. 160, aff'd 8 O.W.N. 525 (Ont. S.C.,A.D.). The managing director of the plaintiff had made the plaintiff liable for two of his personal debts and had received payment of remuneration above what he was entitled to. The court ordered the director to repay these sums to the plaintiff of the grounds the managing director had appropriated the corporate funds to his own purpose in breach of his duty as managing director.

2. *Hughes* v. *Northern Electric & Manufacturing Co.* (1915) 21 D.L.R. 358 (S.C.C.). The operation of a mining company was made possible by loans of $43,000 made by its three shareholders. In time the three shareholders became deadlocked. The deadlock was broken and the continuance of the mining operations secured by an agreement entered into by the shareholders and the company. The agreement provided that two of the shareholders sell their shares to a trustee who would hold the shares in trust for the third shareholder. The sale of the shares was secured by a mortgage granted by the company. The third shareholder covenanted to pay $3000 per month to the company for its development. The Ontario Companies Act did not prohibit the company from granting financial assistance in connection with the purchase of shares of the company. A creditor of the company sought a declaration that the mortgage was void because *ultra vires* the company.

It was not argued that the mortgaging of the company's property for the purpose of securing the payment of the purchase price of shares bought by one of its shareholders for his own benefit would in itself, absent special circumstances, be within the powers of the company. Yet the court held that in these special circumstances it was within the power of the company to grant the mortgage. The transaction was necessary for the survival of the company's operations and there was nothing in the Companies Act prohibiting such a transaction and the court was not willing to imply such a prohibition.

3. *Plain Ltd.* v. *Kenly & Royal Trust Co.* [1931] 2 D.L.R. 801 (Ont. S.C., A.D.). Kenly and Brown were directors of Plain Ltd. Kenly was the sole shareholder of Plain Ltd. She wished to sell her shares to Brown for $60,000 but Brown could only commit to $35,000. To facilitate the sale of shares, the company transferred its land to Kenly for $1.00. Kenly resold the land for $25,000 to the corporation. The sale was secured by the morgage on the land granted by the company to Kenly. The trustee in bankruptcy of Plain Ltd. challenged the mortgage. The company was prohibited from buying its own shares. At pp. 804-805 the court held:

> In my judgment, the transaction cannot be supported for the following reasons:--
>
> (1) The directors cannot part with or encumber the assets of the company for the benefit of one of their number even though the assistance to him in his scheme may result in attaching his influence and services to the company and its business.
>
> (2) This prohibition applies in a case where it is sought by one director to secure control of the company, its assets and business, even with the assent of the director or shareholder holding control by a majority of the issued stock.
>
> (3) That the facts already outlined clearly show that, while the company received no consideration for the mortgage, which was given solely to assist Brown to provide the $60,000 required to buy Mrs. Kenley's 567 shares, the consideration was one which, in any case, the company could not legally receive, as it could not indirectly do that which it could not do directly.
>
> (4) That the creditors have, in the circumstances of this case, a right to dispute the validity of a security on the capital assets passing from the bankrupt placed there by the directors and to question it on the ground of breach of trust.

> (5) The creditors have also the right to attack the mortgage as based upon a purely voluntary transfer which as here vests in the donee, without any consideration passing from her, the whole estate in the company's hands.
>
> I would dismiss the appeal with costs.

4. *Export Brewing & Malting Co.* v. *Dominion Bank* [1937] 2 W.W.R. 586 (P.C.). This case involved Export Brewing & Malting Co. ("the Old Company") which owned a brewery operation used for the purpose of supplying bootleg liquor to the United States during prohibition. The Old Company was owned by the 3 directors and their wives. The directors had extensive real estate investments. In 1927 the Old Company sold all its undertaking and assets to Carling Breweries Limited. After the sale, the Old Company's assets consisted of shares in the new company and $400,000 in savings bonds. The savings bonds were deposited with the Dominion Bank as security for payment of any judgment for taxes the Crown might obtain against the Old Company in an ongoing action. When personal loans made to the directors were in default, the Dominion Bank insisted the directors authorize the Old Company to assign its interest in the savings bonds, subject to the claim of the Crown, to the bank as security for payment of the personal loans of the directors.

For the purpose of the judgment, the court assumed that the assignment of the company's interest in the savings bonds was *intra vires* the company. It then determined if the directors had the power to authorize the assignment. The court said at p. 584:

> But, further, their Lordships are of opinion that it is impossible by the application of any proper test to affirm that this transaction was for the old company's advantage or benefit. Its interest in the bonds was its principal, if not its only free, asset, available for the purpose of raising funds which would enable it to conduct to its end the litigation with the Crown. The suggestion that it was beneficial to the old company to deprive itself of its means of securing to itself the surplus value of that asset, in order that surplus value should be applied for the purpose of discharging the private debts of its directors, is a suggestion to which their

> Lordships cannot accede. They view the transaction as one wholly detrimental to the interests of the old company.
>
> Moreover, even if (contrary to their Lordships' opinion) some benefit did accrue to the old company from the transaction, the overriding fact remains that the old company (acting through its directors and not by its shareholders in general meeting ) purported to apply its property for the benefit of those directors. In such a case it is well settled that the Court will treat the transaction as unenforceable, and refuse even to inquire whether the company has derived any benefit from it: and that on the ground that the company has not received the protection to which it is entitled.

The court deprived the bank of its security because the bank had not satisfied itself that the security was a binding charge on the company. This was not a case where the bank had no notice of anything extraordinary being done. At p. 586 the court said: "It was a plain case of directors using their powers as directors to cause a limited company to apply its property for the benefit of those directors as debtors to the bank". The court ordered the bank to account to the Old Company for the balance of cash which remained to the credit of the Old Company in respect of the savings bonds.

5. *Charterbridge Corporation, Ltd.* v. *Lloyd's Bank Ltd.* [1969] 2 All E.R. 1185 (Ch.D.) Pomeroy Developments Ltd. ("Pomeroy") was the main company in a corporate group which carried on the business of land development. Pomeroy Developments (Castleford) Ltd. ("Castleford") was a member of the corporate group. Castleford was not a subsidiary of Pomeroy but had a common shareholding, directorate and offices. Castleford guaranteed a debt of Pomeroy and later gave a charge on its assets as further security. Charterbridge bought the asset and when it was not given clear title, sought a declaration that the charge was void. The main issue in the case was whether the granting of the guarantee and charge on the asset was *ultra vires* Castleford. In determining this issue the court looked at whether in granting the guarantee and charge the directors of Castleford had acted with a view to the benefit of Castleford. At p. 1194 the Court held:

> On the date of the guarantee, no sale agreement with the plaintiff company had been made and much work was required to complete the development. Castleford looked to Pomeroy for its own day to day management, for payment of the ground rent which Pomeroy had guaranteed, and, most important, looked to Pomeroy to supply the experience, skill and contacts requisite for the development of the site and to pay the outgoings involved in such development. It will be remembered that Castleford was under a covenant to erect buildings on the site to the value of 25,000 pounds. This being the position, the collapse of Pomeroy would have been a disaster for Castleford. It is true that Castleford would probably have remained solvent and it could no doubt have realised the site. But Castleford would almost certainly have been much worse off than if the site had been properly developed and realised at the most favourable opportunity.
>
> I am satisfied that a director of Castleford, taking an objective view in the exclusive interest of Castleford at the date of the guarantee, could reasonably have concluded that the transaction was for the benefit of that company.

6. *R.* v. *Olan, Hudson and Hartnett* (1978) 86 D.L.R. (3d) 212 (SCC).

This was a criminal fraud case but the statements contained therein reflect the court attitude. Justice Dickson said:

> Using the assets of the corporation for personal purposes rather than bona fide for the benefit of the corporation can constitute dishonesty in a case of alleged fraud by directors of a corporation.

7. *Re Horsley & Weight Ltd.* [1982] 3 All E.R. 1045 (C.A.)

Horsley & Weight Ltd had 5 directors. The respondent was a director in name only and took no part in the company's financial affairs. He was actually an employee. Two other directors were C and F, who were also the sole shareholders of the company. The other 2 directors were the wives of C and F. The wives took no part in the financial affairs of the company. Before the respondent's retirement, C and F decided the corporation would pay 10,000 pounds to purchase a pension plan to be held in trust for the respondent. This was done in recognition of his 23 years of service to the corporation. An object clause of the company allowed the company to grant pensions to directors. C and F acted without authority of the board of directors. The court held that the granting of the pension was not *ultra vires* the company. The court also said that misfeasance on the part of C and F was not proven.

At p. 1056, Templeman L. J. said:

> There remains the question whether the grant of the pension was in the circumstances a misfeasance committed by the two directors who procured the grant and by Mr. Horsley senior, the director who accepted the grant. If the company had been doubtfully solvent at the date of the grant to the knowledge of the directors, the grant would have been both a misfeasance and a fraud on the creditors for which the directors would remain liable. But the good faith of the directors is not impugned.
>
> In the absence of fraud there could still have been negligence on the part of the directors. If the company could not afford to spend £10,000 on the grant of a pension, having regard to problems of cash flow and profitability, it was negligent of the directors to pay out £10,000 for the benefit of Mr. Horsley senior at that juncture. There could have been gross negligence, amounting to misfeasance. If the company could not afford to pay out £10,000 and was doubtfully solvent so that the expenditure threatened the continued existence of the company, the directors ought to have known the facts and ought at any rate to have postponed the grant of the pension until the financial position of the company was assured.

Templeman L.J. went on to hold that their was no evidence to prove the directors were negligent. C and F were not called as witnesses and there was nothing in the financial information before the court to disprove that the directors reasonably believed at the time the pension premium was paid that the corporation could afford it.

8. *Re David Feldman Charitable Foundation* (1987) 26 E.T.R. 86 (Ont. Surr. Crt.). This was a case involving the passing of accounts of a charitable trust at the request of the Public Trustee. Feldman lent the Foundation $180,000 and shortly thereafter the Foundation loaned $175,000 to Feldman's company at market interest but

without security. The court held that the loan should not have been made even though the trustee had the power to make such an investment and it did not contravene the Income Tax Act. The court held that no independent advice had been obtained by the Foundation in respect to the granting of the loan. Also notwithstanding that the loan was one which the company could have obtained from a commercial lender, it was not in the best interests of the Foundation to lend money to Feldman's company secured only by a promissory note and repayable at the later of the death of Feldman or ten years. The court found that the directors were in a conflict of interest when allowing the Foundation to lend the money to Feldman's company.

9. *Keho Holdings and Oliver* v. *Noble et al.* In this case the Alberta Court of Appeal characterized the loan made by Keho Holdings to a corporation controlled by the managing director of Keho as prejudicial to Keho. The court objected to the fact that the loan was made without security for repayment.

## II. REMEDIES AVAILABLE AGAINST THIRD PARTIES DEALING WITH UNFAITHFUL FIDUCIARIES

### A. When Will a Stranger to a Trust Become Liable as Constructive Trustee?

The law in this area has developed from the decision in *Barnes* v. *Addy* (1874) 9 L.R. Ch.App. 244. Barnes was the husband of the beneficiary of an express trust created by will. He was appointed as sole trustee. Barnes misappropriated the assets of the trust for use in his business which subsequently failed. His children sued the former trustee who appointed Barnes as trustee and the solicitors engaged in respect of the appointment of Barnes as trustee.

At p. 251 Lord Selbourne discussed the liability of agents of trustees as follows:

> Those who create a trust clothe the trustee with a legal power and control over the trust property, imposing on him a corresponding responsibility. That responsibility may no doubt be extended in equity to others who are not properly trustees, if they are found either making themselves trustees de son tort, or actually participating in any fraudulent conduct of the trustee to the injury of the *cestui que trust*. But, on the other hand, strangers are not to be made constructive trustees merely because they act as agents of trustees in transactions within their legal powers, transactions which perhaps a Court of Equity may disapprove, unless those agents receive and become chargeable with some part of the trust property, or unless they assist with knowledge in a dishonest and fraudulent design on part of the trustees.

The test propounded by Lord Selbourne was adopted in the leading case of *Selangor United Rubber Estates Ltd.* v. *Craddock (No. 3)* [1968] 2 All E.R. 1073 (Ch.D.). This was a case where the cash of Selangor United Rubber Estates Ltd. ("Selangor") was ultimately applied in paying for the acquisition of some 79% of Selangor's shares which were acquired on behalf of Craddock. Selangor sued its directors, Craddock and several other parties through whose hands the funds flowed, including Selangor's bank. The

English companies act prohibited a company from granting financial assistance for the purchase of the company's shares.

The court held that money of the company under the control of the directors is held by them on trust for the company and is to be applied for the company in accordance with its purpose. The directors of the company had misapplied the corporate funds by using the funds to buy shares on behalf of Craddock and therefore had breached the trust. They were liable to reimburse the company for the lost funds.

The court then considered when a stranger to a trust could become liable as a constructive trustee in respect of a breach of trust. The court at p. 1095 discussed two types of constructive trusts:

> It is essential at the outset to distinguish two very different kinds of so-called constructive trustees. (i) Those who, though not appointed trustees, take on themselves to act as such and to possess and administer trust property for the beneficiaries, such as trustees de son tort. Distinguishing features for present purposes are (a) they do not claim to act in their own right but for the beneficiaries, and (b) their assumption to act is not of itself a ground of liability (save in the sense of course of liability to account and for any failure in the duty so assumed), and so their status as trustees precedes the occurrence which may be the subject of claim against them. (ii) Those whom a court of equity will treat as trustees by reason of their actions, of which complaint is made. Distinguishing features are (a) that such trustees claim to act in their own right and not for the beneficiaries, and (b) no trusteeship arises before, but only by reason of, the action complained of.

Except for the directors, the case brought against all the defendants was based exclusively on the argument that the second type of constructive trust should be imposed on them.

In determining when the courts will impose the second type of constructive trust upon strangers to a trust, the court adopted *Barnes* v. *Addy*. On this authority, a constructive trust will be imposed upon strangers where there is " assistance with knowledge in a dishonest and fraudulent design on the part of the trustees".

At p. 1104 the court discussed the type of knowledge required:

> The knowledge required to hold a stranger liable as constructive trustee in a dishonest and fraudulent design, is knowledge of circumstances which would indicate to an honest, reasonable man that such a design was being committed or would put him on enquiry, which the stranger failed to make, whether it was being committed. Acts in the circumstances normal in the honest conduct of affairs do not indicate such a misapplication, though compatible with it; and answers to enquiries are prima facie to be presumed to be honest,. . . .

At pp. 1094 and 1104, the court also gave some guidance on what is a "dishonest and fraudulent design". The court said that trusteeship and constructive trusteeships are equitable conceptions. Therefore, whether a misapplication of company funds for the purchase of shares occasions the imposition of liability as constructive trustees depends on equity and its principles, not upon statutory provision making it a criminal offence, or on statute or criminal law, or common law. The court rejected the argument that this was not a case of dishonest and fraudulent design because it did not amount to a crime. The court did not wish to define the term "dishonest and fraudulent design", but concluded that it at least included conduct which is morally reprehensible (see p. 1098 and 1104).

The court held the plaintiff's bank liable as constructive trustee because the bank honoured a cheque drawn on the company's account in circumstances where a reasonable banker would have known that the funds were being used to finance the purchase of shares in the plaintiff company by Craddock. Here the bank manager and assistant manager did not have such actual knowledge.

It is submitted that the statutory prohibition of financial assistance in these circumstances did not trigger the imposition of the constructive trust. Equity was offended by the use of company funds for personal interests of Craddock and not for company purposes. This is more forcefully stated by the court in *Karak Rubber Co Ltd.* v. *Burden (No. 3)* [1972] 1 All E.R. 1210 (Ch.D.) at p. 1214 which dealt with a similar factual situation:

> Karak was once a wealthy concern and became insolvent. It was, so it is said, the victim of a species of take-over fraud, whereby those seeking to buy a controlling interest in a company put their fingers in company's till and steal the money in order to pay for the purchase. The bank was the unconscious tool which aided this process. The fact that the theft involves a breach of s. 54 of the Companies Act, 1948 is purely incidental and of no fundamental importance in my view.

B. Extension of the Principles

This area of law developed from the case of *Barnes* v. *Addy*. In that case there had been a breach of trust by a trustee appointed under terms of a will. The court was dealing with the issue of liability of agents of the trustee. In *Selangor* the court made it clear that the question of how far directors are trustees was relevant to the question of whether the other defendants can be made liable as trustees under the principle in *Barnes* v. *Addy*.

One must then ask if the principles set out in *Barnes* v. *Addy* and the *Selangor* cases are applicable in situations where there is a breach of fiduciary duty and not a breach of trust. It is submitted that the principles have been applied in situations of breach of fiduciary duty. In *MacMillan Bloedel Ltd.* v. *Binstead* (1983) 22 B.L.R. 255 (B.C.S.C.) the manager of log trading for MacMillan Bloedel Ltd. ("MB") had acquired a secret interest in a log sales company ("Log Sales") with which MB did extensive business. While representing MB, Binstead had many business dealings with Log Sales. The court held that Binstead owed a fiduciary duty towards MB which he breached by allowing his personal interest in Log Sales to conflict with the duty he owed to MB. Binstead made secret profit and he had to account for this profit even though MB did not loose any profit or suffer any damages as a result of the conduct of Binstead.

The court found that the two shareholders of record of Log Sales and their companies had participated in Binstead's breach of fiduciary duty and derived profits as a result. Therefore, they were constructive trustees and liable to account for the profit they made. The court adopted the principles set out in *Barnes* v. *Addy* and the *Selangor* case. It also referred to the decision of Sheppard J.A. in *Morrison* v. *Coast Finance Ltd.* (1965) 54 W.W.R. 257 (B.C.C.A.) at p. 270 which held:

> When a third person knowingly participates with a trustee in the breach of trust, such third person becomes subject to the same liability as the trustee, including the liability to account.

The B.C.S.C. said that this statement must also apply to a breach of fiduciary duty.

The plaintiffs also sued the accountant who had advised Binstead and his two cohorts when incorporating Log Sales. The court held that a stranger to a trust who had not received any trust property can be fixed with liability as a constructive trustee on the basis of the principles already discussed. To succeed in an action for accounting against the accountant it was not necessary to show the accountant had been the recipient of the trust property (i.e. the secret profits of the shareholders) or that he had profited from the trust or that he was an active participant of the dishonest scheme. The issue was whether the accountant had "assisted with knowledge in a dishonest and fraudulent design on the part of the trustees". The court did not find the accountant liable as a constructive trustee because he did not have actual or constructive knowledge of the dishonest scheme.

The court held that Binstead and the two shareholders of record of Log Sales were jointly liable for the net profit Log Sales had made on all transactions with MB which took place during the eight year period of Binstead's conflict of interest. The result was that the defendants were $9 million poorer.

C. Cases

It is useful to review some of the cases where strangers to a trust or a fiduciary relationship have been found liable to account for assisting in a breach of trust or breach of fiduciary duty.

1. *Canada Safeway Limited* v. *Thompson* [1951] 3 D.L.R. 295 (B.C.S.C.). This case involved a scheme of Raley, a director of Canada Safeway Limited ("Safeways"). In the course of his employment with the company, he obtained information about Empress Foods Ltd. ("Empress"). Instead of recommending that Safeways purchase Empress, Raley , the three defendants and others purchased all the shares of Empress. They subsequently sold the shares at a profit to Safeways, without disclosing the interest of Raley in Empress. The court said that Raley as a director was a quasi-trustee and a fiduciary of Safeways. Raley had breached the fiduciary duty owed to Safeways by concealing his interest in Empress and profiting from the sale of shares to Safeways. Had he been a defendant in this action, there would have been no doubt as to his liability to account for the profit he made.

The defendants had aided Raley by concealing the fact that he was selling his shares in Empress. The court held that by doing this the three defendants had actively participated with Raley in the concealment of his breach of duty to Safeways and in fraud upon Safeways. In the circumstances the defendants became trustees *de son tort* or constructive trustees. As such they were liable to account for profits they made on sale of the shares and for the profits made by Raley. The liability of the constructive trustees was joint and several.

2. *Morrison* v. *Coast Finance Ltd et al.* (1966) 55 D.L.R. (2d) 710 per Sheppard. The plaintiff was an elderly widow who ran a boarding house. Lowe

convinced the plaintiff to mortgage her house so that she could obtain $350 to lend to Kitely, one of her boarders. The money was to be used to allow Kitely to buy into an auto sales business. Lowe and Kitely arranged for Coast Finance Ltd to loan $4200 to the plaintiff on the security of a mortgage on the boarding house. With some reluctance and doubt the plaintiff executed the mortgage. She endorsed the cheque she received from Coast Finance Ltd. and gave the cheque to Lowe. Lowe did not invest in the business. Instead Lowe paid a debt he owed to Coast Finance Ltd. and he bought two cars from Vancouver Associated Car Markets, a company associated with Coast Finance. The balance of the funds was taken by Coast Finance Ltd. as prepayment of the interest owing on the mortgage. Lowe ended up in jail and Kitely absconded. The plaintiff brought an action for a declaration that the mortgage be rescinded on the ground of undue influence.

Two of the judges granted the declaration on the basis that the transaction was unconscionable. Sheppard gave an alternative remedy in account on the basis of a personal liability of the defendants. The court held that Lowe and Kitely were agents and fiduciaries of the plaintiff because they had advised her and assisted her in getting the loan. The breached their fiduciary duty to her by not investing the money in the business. They became trustees of the loan proceeds. The court held that Coast Finance Ltd. and Vancouver Associated Car Markets were also liable to account. The court held that Crawford, manager of Coast Finance Ltd., had knowledge of the trust. He knew the purpose of the loan and that Kitely and Lowe had applied for the loan on the plaintiff's behalf. The court was of the view that Crawford had assisted Kitely and Lowe in obtaining the money for their own advantages. The court relied on the fact that the transaction was carried out in haste, the mortgage proceeds were released *before* the mortgage was registered, the mortgage proceeds were paid immediately to Coast Finance Ltd and its associated company, and Crawford sent the plaintiff an assignment of a conditional sales contract in respect of the two cars which was worthless because the cars had been paid for.

Sheppard held that the two companies held the loan proceeds in trust for the plaintiff and those funds should be treated as applied in payment of the mortgage.

3. *Karak Rubber Co. Ltd.* v. *Burden (No. 3)* [1972] 1 All E.R. 1210 (Ch. D.) This was another case involving a takeover where the corporate funds were used to pay for the shares acquired in the takeover. At the meeting of the shareholders to approve the takeover, the directors were to deliver to the new owners the cash of the company in form of a cheque payable to the company. The directors elected by the new shareholders, endorsed the cheque in favour of Barclay's bank. In return for the endorsed cheque, Barclay's gave the new directors a bank draft for the same amount payable to the National Bank. This was deposited in the company's account at the National Bank. This money was used to pay the shareholders for the shares bought in the takeover.

The court held that the new directors were trustees of the company funds and had breached that trust by misapplying them in financing the purchase of Karak shares. The court considered Barclay's bank as an agent of these trustees. As a reasonable banker in the circumstances would have been put on enquiry as to the propriety of the Karak cheque and such enquiry would have revealed the impropriety, the court said that Barclay's bank was a constructive trustee of the company. The result was that the directors and the bank were liable to repay to the company the money it lost.

4. *Groves-Raffin Construction Ltd. and Fidelity Insurance Company of Canada* v. *CIBC and Bank of Nova Scotia* [1975] 2 W.W.R. 673 (B.C.C.A.) This case involved Groves-Raffin Construction Ltd. ("G-R"), a building contractor who had a bank account and line of credit with the Bank of Nova Scotia ("Scotia"). Groves was president and Raffin was secretary. Each had signing authority on behalf of G-R. Scotia was worried about the financial position of G-R and asked G-R to pay the debt owing on the line of credit and find another banker.

In March 1982, Groves deposited 3 cheques payable to G-R under 3 separate construction contracts. By virtue of s. 3(1) of The Mechanics Liens Act, G-R was to hold these moneys on trust for the material men, sub-contractors and workers. Scotia knew that all of G-R's receivables were of the kind caught by s. 3(1).

Groves lied to Scotia when he told it that he had obtained a new line of credit for G-R with the CIBC and he would be moving the account of G-R to the CIBC. Scotia was instructed by Groves to withdraw $54,000 from the G-R account to pay the moneys owing on the line of credit and a further $3,000 to wipe out Grove's personal overdraft. Groves then drew a $176,000 cheque on the account of G-R payable to himself. He deposited this cheque in his personal account held at the CIBC. A few days later he withdrew most of this sum, in cash, from the CIBC.

Fidelity had paid the material men, workers and sub-contractors under the terms of a material and labour bond. It took an assignment from the persons it paid so that it could pursue a claim against Scotia on the basis of a constructive trust.

The court held that G-R committed a breach of the mechanics lien trust when it instructed Scotia to transfer $57,000 in payment of the amount G-R and Groves owed to the bank. Scotia became a party to the breach when it accepted the transfer. Scotia holds the property under a transmitted fiduciary obligation to account for it to the *cestuis que trust*, the workmen, material men and sub-contractors. Scotia was not a party to the breach of trust that Groves committed with respect to the cheque of $176,000 because Scotia's manager had an honest belief the money was to be used to transfer funds in the G-R account to another company account in another bank. This was not inconsistent with the observance of the trust. The court held Scotia liable for this amount on the basis of breach of contract with G-R.

Against the CIBC, G-R argued that the directors of G-R were trustees of the corporate funds and when a director misappropriates funds he commits a breach of trust. By stealing the $176,000 Groves, a director of G-R, committed a breach of trust.

CIBC was an agent who assisted the trustee with knowledge in a dishonest and fraudulent scheme of the trustee. The CIBC had sufficient knowledge of the circumstances to put it on inquiry.

The court adopted the principles of the *Selangor* case but held that the CIBC did not have sufficient knowledge of the circumstances to put it, as a reasonable man, on inquiry. All the CIBC knew was that Groves was an employee and principal of G-R. It had no knowledge of the financial strength of G-R or how its business operated. Groves lied when he told the CIBC that he needed the cash for tender on a land deal. Yet this lie was not preposterous and need not have raised suspicions.

5. *Carl P. Potter Limited* v. *The Mercantile Bank Of Canada* [1980] 2 S.C.R. 343 Anil Canada Limited ("Anil") received cheques from Carl P. Potter ("Potter Co.") and Douglas & Co. which, by the terms of a Bid and Performance Guarantee, Anil was to hold in trust for the two payees. Anil failed to do this and in the course of events, the cheques were cashed and the moneys of Potter Co were applied by the defendant bank as payment of Anil's debt to the bank. Anil told the bank that these moneys were to be kept separate from Anil's funds, but Anil did not make it plain that the cheques were not Anil's.

The S.C.C. held that the bank was in possession of sufficient information which required it to take steps to ascertain the character of the funds which were being deposited to Anil's credit. The relationship of Potter Co. to the bank was that of *cestue que trust* and trustee. The bank was ordered to repay to Potter Co the amount of the cheque and interest. The Contributory Negligence Act has no application in this situation.

6. *Ontario Wheat Producers' Marketing Board* v. *Royal Bank of Canada et al.* (1983) 41 O.R. (2d) 294 (Ont. H.C.J.). The Ontario Wheat Producers' Marketing Board ("the Board") is the only body that can buy wheat from Ontario farmers. Farmers sell wheat to the Board's agents. Wheat purchased by the agents is the property of the

Board. If the agent wishes to purchase wheat from the Board it must make a verbal offer subsequently confirmed in writing. If the offer is accepted, the agent may sell wheat to the third party.

Wellandport Feed Mill ("W Ltd.") was an agent of the Board which was experiencing financial difficulties. The Royal Bank of Canada ("Royal") appointed Bawden to enforce securities W Ltd. had granted to Royal. Before making a verbal offer to purchase wheat from the Board, W Ltd sold wheat in its possession to Maple Leaf Mills Ltd for approximately $250,000. W Ltd., with the knowledge of Bawden, delayed making the oral offer to purchase so that it could take advantage of the favourable credit terms which provided that no interest was payable until the 15th of the month following the month in which the wheat was bought.

The Board sought a declaration that W Ltd. held this money on trust for the Board and sought an accounting from W Ltd and Royal for the disposition of the funds. Royal had applied the funds towards payment of the debt of W Ltd.

The court held that W Ltd. was the agent of the Board. The requirement that an agent make a verbal offer to purchase wheat from the Board before it sold wheat to a third party was an integral part of the agency relationship. Breach of this requirement was a fundamental breach of fiduciary duty imposed upon the agent. This constituted a breach of trust on the part of W Ltd. Also it was a breach of trust for W Ltd. not to tell the Board of its shaky financial position. Royal, through Bawden, knew of the two breaches of trust. The court said that the conduct of W Ltd. was not in the circumstances normal in the honest conduct of affairs. Royal's concurrence in this conduct, through Bawden, brings it within the *Selangor* principle. Even though the court was not certain Royal had knowledge of the fraudulent intent to take improper advantage of the favourable credit terms, it certainly had knowledge of circumstances which constituted breach of the fiduciary duty.

W Ltd. as trustee and Royal as constructive trustee are liable for breach of trust. The measure of the trustee's liability for breach of trust is the loss caused thereby to the trust estate. Both defendants were held liable for damages in the amount of approximately $250,000 and interest thereon.

7. *Belmont Finance Corporation* v. *William Furniture Ltd. and Others (No. 2)* [1980] 1 All E.R. 393. Mr. Grosscurth sold the shares of Maximum Finance Ltd. ("Maximum") to Belmont Finance Corporation ("Belmont") for £500,000. Mr. Grosscurth used this money to buy shares in Belmont from the sole shareholder, City Industrial Finance Ltd. ("City"). At the time of the sale, no one obtained a valuation of the worth of Maximum. A subsequent evaluation suggested that at the time of the sale the shares of Maximum were worth £60,069, not £500,000. Mr. James, who was the Chairman of the Board of directors of City and Belmont, negotiated the agreement on behalf of Belmont and City. The trial judge found as a fact that Mr. James honestly believed that the purchase of the Maximum shares by Belmont, was in the interests of Belmont because Belmont was buying Mr. Grosscurth's ability to make money, such as it was!

The Court of Appeal held that the transaction contravened s. 54 of the Companies Act, 1948, U.K. which prohibited a company from granting financial assistance in respect of the purchase of its shares. Belmont did not attack the transaction as *ultra vires* the company and therefore void. Instead, it successfully argued that the defendants had conspired together to effect an unlawful purpose resulting in damage to Belmont.

Belmont also argued that City should be liable as constructive trustee in these circumstances. Buckley L.J. held at p. 405:

> I now come to the constructive trust point. If a stranger to a trust (a) receives and becomes chargeable with some part of the trust fund or (b) assists the trustees of a trust with knowledge of the facts in a dishonest design on the part of the trustees to misapply some part of a trust fund, he

> is liable as a constructive trustee (*Barnes* v. *Addy* per Lord Selbourne LC).
>
> A limited company is of course not a trustee of its own funds: it is their beneficial owner; but in consequence of the fiduciary character of their duties the directors of a limited company are treated as if they were trustees of those funds of the company which are in their hands or under their control, and if they misapply them they commit a breach of trust (*Re Lands Allotment Co.*, per Lindley and Kay LJ). So, if the directors of a company in breach of their fiduciary duty misapply the funds of their company so that they come into the hands of some stranger to the trust who receives them with knowledge (actual or constructive) of the breach, he cannot conscientiously retain those funds against the company unless he has some better equity. He becomes a constructive trustee for the company of the misapplied funds. This is stated very clearly by Jessel MR in *Russell* v. *Wakefield Waterworks Co.*, where he said:
>
> > "In this Court the money of the company is a trust fund, because it is applicable only to the special purposes of the company in the hands of the agents of the company, and it is in that sense a trust fund applicable by them to those special purposes: and a person taking it from them with notice that it is being applied to other purposes cannot in this court say that his is not a constructive trustee."
>
> In the present case, the payment of the £500,000 by Belmont to Mr. Grosscurth, being an unlawful contravention of s. 54, was a misapplication of Belmont's money and was in breach of the duties of the directors of Belmont. £489,000 of the £500,000 so misapplied found their way into the hands of City with City's knowledge of the whole circumstances of the transaction. It must follow, in my opinion that City is accountable to Belmont as constructive trustee of the £489,000 under the first of Lord Selbourne LC's two heads.

Buckley J. did not hold that City was liable as constructive trustee under Lord Selbourne's second head because Belmont directors were not guilty of dishonesty in buying the shares of Maximum, only guilty of misfeasance. The trial judges finding that Mr. James honestly believed that the transaction was in Belmont's interest made it impossible to hold that there was any dishonesty about the proceedings of the Belmont board.

Goff L.J. agreed with Buckley J. and gave further reasons. In respect of the issue of constructive trust, he held that payment of the £500,000 was a breach of trust for two reasons. First, the agreement was unlawful and secondly it was a misfeasance for the following reasons. Belmont paid far more than the shares were worth. There was not an independent board capable of considering the transaction from Belmont's point of view since Mr. James in fact controlled the board of Belmont. There was a conflict of duty and interest between the position of Mr. James as Chairman of the Board of Belmont and his position as Chairman of the Board of City. City wanted to sell Belmont and get a high price for the goodwill. Belmont wanted to keep the price of purchasing Maximum's shares as low as possible. Yet City knew Grosscurth would use the money from the sale of Maximum shares to pay for the Belmont shares. Goff held that City was a constructive trustee under the first head of constructive trusteeship, and for the same reasons given by Buckley J.C., held City was not a constructive trustee under the second head.

8. *Rolled Steel Products (Holdings) Ltd.* v. *British Steel Corporation and Others* [1985] 3 All E.R. 52. This case involved dealings of two companies, Rolled Steel Products (Holdings) Ltd. ("RSP") and Scottish Steel Sheet Ltd. ("SSS"). SSS was owned solely by Shenkman ("S") who also had a 51% interest in RSP. The other 49% of the shares of RSP were held in trust for S's children. S and his father were directors of RSP.

SSS became indebted to Colvilles Ltd. ("Colvilles") in the amount of £820,000. Colvilles obtained a guarantee from S in respect of this debt. In time Colvilles became aware that SSS was insolvent and was worried that S had insufficient assets to satisfy the indebtedness. The following arrangement was made by Colvilles, SSS, S and RSP. Colvilles agreed to lend RSP sufficient money for RSP to pay the £400,000 debt it owed to SSS. On the same day SSS paid this money to Colvilles in reduction of its £820,000 debt. RSP gave a guarantee for the balance of the SSS debt owed to Colvilles in consideration of Colvilles not demanding repayment of all sums due to it by SSS. If land of RSP was not sold by a certain date, RSP was to give Colvilles a debenture payable with interest at 1% above prime. The trustees of the RSP shares were aware that the transaction was an unwarranted depletion of trust assets. Therefore, the trustees agreed to the transaction on the basis that S would compensate them for an otherwise unwarranted depreciation in value of the trust asset. This compensation did not materialize.

In time Colvilles made demand for payment of the full amount secured by the debenture and a receiver-manager was appointed under the debenture. British Steel Corp. ("BSC") succeeded to all assets and obligations of Colvilles. After the debt to Colvilles was paid there were insufficient funds to pay the unsecured creditors of RSP.

The court held that there was clear evidence to support the trial judge's finding of fact that everyone on the RSP side understood the transaction proposed was not for the purposes of or in the interests of RSP and would be positively injurious to it.

The court rejected the defendants' argument that they thought the transaction beneficial to RSP and thought RSP's lawyer would not permit it to do anything improper or unlawful. The defendants had notice that advice had been given to S's lawyer that the granting of the guarantee for the amount above the £400,000 would be a gross misfeasance on the part of the directors of RSP.

Based on an interpretation of the memorandum of association, the court concluded that the relevant transactions were not beyond the corporate capacity of RSP and therefore were not *ultra vires*. Entering the guarantee and to the extent of the sum guaranteed, the debenture was beyond the authority of the directors because they were entered into for purposes not authorized by RSP's memorandum. Despite this lack of authority, directors would have been capable of conferring rights of Colvilles if Colvilles did not know of the lack of authority. Yet here Colvilles knew of the lack of authority and so acquired no rights under the transaction.

The court held the debenture and guarantee were not duly authorized by RSP because of a lack of quorum at the directors' meeting which passed the resolution providing for the financial assistance.

The court held that BSC and the receiver-manager were constructive trustees of RSP. The court adopted the principles set out by Buckley J. in the *Belmont Finance Corp.* v. *Williams Furniture Ltd. (No. 2)* case. The court stated at p. 88:

> The *Belmont* principle thus provides a legal route by which a company may recover its assets in a case where its directors have abused their fiduciary duties and a person receiving assets as a result of such abuse is on notice that they have been misapplied. The principle is not linked in any way to the capacity of the company: it is capable of applying whether or not the company had the capacity to do the acts in question.
>
> Furthermore, the *Belmont* principle must, in my opinion, be equally capable of applying in a case where the relevant misapplication of the company's assets by the directors has consisted either (a) of an application for purposes not authorized by its memorandum or (b) an application in breach of the company's articles of association (eg. pursuant to a board resolution passed at an inquorate meeting of the directors).
>
> From the findings of fact of the judge, with which I see no reason to disagree for reasons already stated, I think it is clear that (a) the directors of RSP were acting in breach of RSP's articles of association and of their fiduciary duties to RSP in purporting to authorise and in executing the guarantee and debenture, and (b) BCS and Mr. Cooper had notice of these facts when they respectively received the relevant assets.

The defendants were denied leave to amend the statement of defence to plead that all the shareholders of RSP had approved of the transaction. In *obiter* comments Slade J. said that notwithstanding authority suggesting otherwise, a transaction which:

(i) falls within the letter of the express or implied powers of a company conferred by its memorandum and

(ii) does not involve a fraud on its creditors and

(iii) is assented to by all shareholders

would likely bind a fully solvent company even where the intention of directors, or shareholders, is to effect a purpose not authorized by the memorandum. Yet he specifically said this case did not call for a decision on this point.

## Appendix 9 - Statute of Elizabeth

*An act against fraudulent deeds, alienations, &c.*

*For the avoiding and abolishing of feigned, covinous and fraudulent feoffments, gifts, grants, alienations, conveyances, bonds, suits, judgments and executions, as well of lands and tenements as of goods and chattels, more commonly used and practised in these days than hath been seen or heard of heretofore: (2) which feoffments, gifts, grants, alienations, conveyances, bonds, suits, judgments and executions, have been and are devised and contrived of malice, fraud, covin, collusion or guile, to the end, purpose and intent, to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts, accounts, damages, penalties, forfeitures, heriots, mortuaries and reliefs, not only to the let or hindrance of the due course and execution of law and justice, but also to the overthrow of all true and plain dealing, bargaining and chevisance between man and man, without the which no commonwealth or civil society can be maintained or continued.*

**II.** Be it therefore declared, ordained and enacted by the authority of this resent parliament, that all and every feoffment, gift, grant, alienation, bargain and conveyance of lands, tenements, hereditaments, goods and chattels, or of any of them, or of any lease, rent, common or other profit or charge out of the same lands, tenements, hereditaments, goods, and chattels, or any of them, by writing or otherwise, (2) and all and every bond, suit, judgment and execution, at any time had or made since the beginning of the Queen's majesty's reign that now is, or at any time hereafter to be had or made, (3) to or for any intent or purpose before declared and expressed, shall be from henceforth deemed and taken (only as against that person or persons, his or their heirs, successors, executors, administrators and assigns, and every of them, whose actions, suits, debts, accounts, damages, penalties, forfeitures, heriots, mortuaries and reliefs, by such guileful, covinous or fraudulent devices and practices, as is aforesaid, are, shall or might be in any wise disturbed, hindered, delayed or defrauded) to be clearly and utterly void, frustrate and of no effect; any pretence, colour, feigned consideration, expressing of use, or any other matter or thing to the contrary notwithstanding.

**III.** And be it further enacted by the authority aforesaid, that all and every the parties to such feigned, covinous or fraudulent feoffment, gift, grant, alienation, bargain, conveyance, bonds, suits, judgments, executions and other things before expressed, and being privy and knowing of the same, or any of them; (2) which at any time after the tenth day of June next coming shall wittingly and willingly put in ure, avow, maintain, justify or defend the same, or any of them, as true, simple, and done, had or made bona fide and upon good consideration; (3) or shall alien or assign any the lands, tenements, goods, leases or other things before-mentioned, to him or them conveyed as is aforesaid, or any part thereof; (4) shall incur the penalty and forfeiture of one year's value of the said lands, tenements and hereditaments, leases, rents, commons or other profits, of or out of the same; (5) and the whole value of the said goods and chattels; (6) and also so much money as are or shall be contained in any such covinous and feigned bond; (7) the one moiety whereof to be to the Queen's majesty, her heirs and successors, and the other moiety to the party or parties grieved by such feigned and fraudulent feoffment, gift, grant, alienation, bargain, conveyance, bonds, suits, judgments, executions, leases, rents, commons, profits, charges and other things aforesaid, to be recovered in any of the Queen's courts of record by action of debt, bill plaint or information, wherein no essoin, protection or wager of law shall be admitted for the defendant or defendants; (8) and also being thereof lawfully convicted, shall suffer imprisonment for one half year without bail or mainprise....

**VI.** Provided also, and be it enacted by the authority aforesaid, that this act, or any thing therein contained, shall not extend to any estate or interest in lands, tenements, hereditaments, leases, rents, commons, profits, goods or chattels, had, made, conveyed or assured, or hereafter to be had, made, conveyed or assured, which estate or interest is or shall be upon good consideration and bona fide lawfully conveyed or assured to any person or persons, or bodies politic or corporate, not having at the time of such conveyance or assurance to them made, any manner of notice or knowledge of such covin, fraud or collusion as is aforesaid; any thing before mentioned to the contrary hereof notwithstanding.

## Appendix 10 - Fraudulent Preferences Act

HER MAJESTY, by and with the advice and consent of the Legislative Assembly of Alberta, enacts as follows:

1 Subject to sections 6 to 9, every gift, conveyance, assignment, transfer, delivery over or payment of goods, chattels or effects or of bills, bonds, notes or securities or of shares, dividends, premiums or bonus in any bank, company or corporation, or of any other property, real or personal, made

(a) by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full or knows that he is on the eve of insolvency, and

(b) with intent to defeat, hinder, delay or prejudice his creditors or any one or more of them,

is void as against any creditor or creditors injured, delayed or prejudiced.

2 Subject to sections 6 to 9, every gift, conveyance, assignment, transfer, delivery over or payment of goods, chattels or effects or of bills, bonds, notes or securities or of shares, dividends, premiums or bonus in any bank, company or corporation, or of any other property, real or personal, made

(a) by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full or knows that he is on the eve of insolvency, and

(b) to or for a creditor with intent to give that creditor preference over the other creditors of the debtor or over any one or more of them,

is void as against the creditor or creditors injured, delayed, prejudiced or postponed.

3 Subject to sections 6 to 9, every gift, conveyance, assignment, transfer, delivery over or payment of goods, chattels or effects or of bills, bonds, notes or securities or of shares, dividends, premiums or bonus in any bank, company or corporation, or of any other property, real or personal, made

(a) by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full or knows that he is on the eve of insolvency, and

(b) to or for a creditor and having the effect of giving that creditor a preference over the other creditors of the debtor or over any one or more of them,

is, in and with respect to any action that within one year thereafter is brought to impeach or set aside the transaction, void as against the creditor or creditors injured, delayed, prejudiced or postponed.

**4**(1) A transaction shall be deemed to be one that has the effect of giving a creditor a preference over other creditors, within the meaning of section 3, if by the transaction a creditor is given or realizes or is placed in a position to realize payment, satisfaction or security for the debtor's indebtedness to him or a portion of it greater proportionately than could be realized by or for the unsecured creditors generally of the debtor or for the unsecured portion of his liabilities out of the assets of the debtor left available and subject to judgment, execution, attachment or other process.

(2) Independently of the intent with which the transaction was entered into or of whether it was entered into voluntarily or under pressure, the preferential effect or result of the impeached transaction governs, and no pressure by a creditor or want of notice to the creditor alleged to have been so preferred of the debtor's circumstances, inability or knowledge as aforesaid, or of the effect of the transaction, avails to protect the transaction except as provided by sections 6 and 9.

**5** In sections 2 to 4 "creditor" includes

(a) a surety, and the endorser of a promissory note or bill of exchange, who would, on payment by him of the debt, promissory note or bill of exchange in respect of which the suretyship was entered into or endorsement was given, become a creditor of the person giving the preference within the meaning of sections 2 to 4, and

(b) a cestui que trust or other person to whom liability is equitable only.

**6** Nothing in sections 1 to 5 applies to

(a) a bona fide sale or payment made in the ordinary course of trade or calling to innocent purchasers or parties, or

(b) a payment of money to a creditor, or a bona fide conveyance, assignment, transfer or delivery over of any goods, securities or property, of any kind as above mentioned, that is made in consideration of a present actual bona fide sale or delivery of goods or other property or of a present actual bona fide payment in money, or by way of security for a present actual bona fide advance of money,

if the money paid or the goods or other property sold or delivered bear a fair and reasonable relative value to the consideration therefor.

**7** When there is a valid sale of goods, securities or property and the consideration or part thereof is paid or transferred by the purchaser to the creditor of the vendor under circumstances that would render the payment or transfer void if it were made by the debtor personally and directly, the payment or transfer, even though valid as respects the purchaser, is void as respects the creditor to whom it is made.

**8** When a payment that is void under this Act has been made and a valuable security has been given up in consideration of the payment, the creditor is entitled to have the security restored or its value made good to him before or as a condition of the return of the payment.

**9** Nothing in this Act

(a) affects a payment of money to a creditor when the creditor by reason or on account of the payment has lost or been deprived of or has in good faith given up a valid security that he held for the payment of the debt so paid, unless the value of the security is restored to the creditor,

(b) affects the substitution in good faith of one security for another security for the same debt so far as the debtor's estate is not thereby lessened in value to the other creditors, or

(c) invalidates a security given to a creditor for the pre-existing debt when, by reason or on account of the giving of the security, an advance is made in money to the debtor by the creditor in the bona fide belief that the advance will enable the debtor to continue his trade or business and pay his debts in full.

**10**(1) One or more creditors may, for the benefit of creditors generally or for the benefit of those creditors who have been injured, delayed, prejudiced or postponed by the impeached transaction, sue for the rescission of, or to have declared void, agreements, deeds, instruments or other transactions made or entered into in fraud of creditors or in violation of this Act or by this Act declared void.

(2) If, in any such action, an amendment is made to the statement of claim, the amendment relates back to the commencement of the action for the purpose of the time limited by section 3.

**11**(1) If a gift, conveyance, assignment or transfer of any property, real or personal, that in law is invalid against creditors, was made to a person, and that person has sold or disposed of, realized or collected the property or a part of it, the money or other proceeds or the amount thereof, whether further disposed of or not, may be seized or recovered in an action by a person who would be entitled to seize and recover the property if it had remained in the possession or control of the debtor or of the person to whom the gift, conveyance, assignment, transfer, delivery or payment was made.

(2) The right of seizure and recovery exists in favour of all creditors of the debtor.

(3) When the proceeds are of such a character as to be seizable under execution, they may be seized under the execution of any creditor and shall be distributed among creditors under the *Execution Creditors Act.*

(4) Whether the proceeds are or are not of such character as to be seizable under execution, an action may be brought for them or to recover the amount of them by a creditor, whether a judgment creditor or not, on behalf of himself and all other creditors, or any other proceedings may be taken that are necessary to render the proceeds or the amount of them available for the general benefit of the creditors.

(5) This section does not apply as against innocent purchasers of any of the property.

**12** This Act shall be read and construed subject to the provisions of the *Bankruptcy Act* (Canada).

## FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES

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## FRAUDULENT CONVEYANCES AND FRAUDULENT PREFERENCES

### I. Introduction

It is important to make a distinction between a fraudulent conveyance and a fraudulent preference. A fraudulent conveyance is a transfer of property made generally to someone other than a creditor with the intent to delay, hinder or defraud creditors. A fraudulent preference[1] is a transfer of property by a debtor to one or more, but not all, of his creditors with the intent to prefer those creditors receiving the transfer.

### II. Fraudulent Conveyances

#### A. Applicable Legislation

In Alberta, creditors can attack fraudulent conveyances under the Statute of Fraudulent Conveyances, 13 Eliz. c. 5, 1571[2] (hereafter "Statute of Elizabeth") and under section 1 of the Fraudulent Preferences Act, R.S.A. 1980 c. F-18 (hereafter "Fraudulent Preferences Act").

Section II of the Statute of Elizabeth and section 1 of the Fraudulent Preferences Act are very similar. However, proof of insolvency of the transferor is not required under the Statute of Elizabeth as it is under the Fraudulent Preferences Act. The other difference between the two statutes is that the Statute of Elizabeth applies to "creditors and others". Only persons who are creditors at the time of the fraudulent conveyance can avail themselves of the Fraudulent Preferences Act.

#### B. Transactions that are Fraudulent Conveyances

The Statute of Elizabeth is broadly worded and has been liberally interpreted. The Statute refers to every "feoffment, gift, grant, alienation, bargain and conveyance" and the interpretation of the Statute indicates that the form of the transaction is largely immaterial. May in *The Law of Fraudulent and Voluntary Conveyances*, 3rd ed. (1908) p. 4 states as follows:

> ... the chief feature of the statutes of Elizabeth, which are couched in very general terms, so as to include, and allow their application by the Courts to, any fraudulent contrivances to which the fertility of man's imagination might have resorted, as a means of eluding a more precise and inflexible law. The

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1 Ontario Law Reform Commission, *The Enforcement of Judgment Debts and Related Matters - Part IV*, p. 125.

2 The courts of Alberta have held the Statute of Elizabeth is in force in Alberta: see *Goyan* v. *Kinash* (1945) 1 W.W.R. 291, *Arnold* v. *Fleming et al.* (1923) 1 W.W.R. 706 and *Connors* v. *Egli et al.* (1924) 1 W.W.R. 1050.

> statute 13 Eliz. c. 5, is expressed to be directed against fraudulent feoffments, &c., "more commonly used and practiced in these days, than hath been seen or heard of heretofore". So it has been since, and will ever be to the end of time; for fraud is infinite, and will always attempt to evade whatever is done for its suppression; to prune it back on one side is but to give it a stimulus to branch out with fresh vigour in another direction. But the simplicity of the enactment and -- if the expression may be allowed -- its expansiveness, have enabled the judges to bring within its scope, and extend its operations to, almost every kind of transaction resorted to by debtors to the prejudice of their creditors.
>
> "These statutes", said Lord Mansfield, C.J., "cannot receive too liberal a construction, or be too much extended, in suppression of fraud". [In *Cadogan v. Kennett* (1776), 2 Cowp. 432, 98 E.R. 1171]. So in *Twyne's Case* (1602), 3 Co. Rep. 82a, 76 E.R. 809, it was resolved that "because fraud and deceit abound in these days more than in former times, all statutes made against fraud should be liberally and beneficially expounded to suppress the fraud."

The recent case of *Lee* v. *Glenval Holdings Ltd.* (1988) 85 A.R. 394 (Alta. Q.B.) adopted a liberal interpretation of the Statute of Elizabeth. In that case the directors and shareholders of Glenval Holdings Ltd. personally owed the Bank of Nova Scotia $229,000. Glenval Holdings Ltd. owed no money to the Bank of Nova Scotia. To secure repayment of the director's debt, the bank insisted the directors authorize Glenval Holdings Ltd. to give a guarantee of the director's debt and execute two collateral mortgages on the company's sole asset, a piece of land. Several months later, the company transferred the property to one of the directors for the consideration of the dollar. The bank eventually got an order for foreclosure in respect of the land. Creditors of Glenval Holdings Ltd. applied under Rule 383 to set aside the transfer of land and to set aside the mortgages registered against the land on the basis that all were impeachable under the Statute of Elizabeth.

Justice Sinclair rejected the bank's argument that the mortgage did not fall within the term "conveyance" as used in the Statute of Elizabeth. The Court held that the transaction that took place between the bank and the directors, by which the bank had acquired the land to the detriment of the creditors of the company, was a conveyance within the meaning of the Statute of Elizabeth. He ordered that an issue be tried as to whether the guarantee contravenes the Statute of Elizabeth, whether the mortgages contravene the Statute of Elizabeth, and whether the transfer of land contravenes the Statute of Elizabeth. Sinclair also said this was not a preference situation as Glenval Holdings Ltd. owed no money to the bank when it executed the guarantee.

It is a startling proposition that the granting of a guarantee is a conveyance within the meaning of the Statute of Elizabeth. It is unclear from the decision if the judge made this decision or merely left the issue to be decided at trial. However, it is clearly correct to hold that a mortgage is a conveyance within the Statute of Elizabeth.

In *Carew* v. *Power and Melvin* (1984) 50 C.B.R. 275 a loan was held to be a conveyance of property made with the intent to defeat, hinder, delay or defraud creditors.

## C. Financial Status of Debtor

When attacking conveyances under the Statute of Elizabeth, the creditors do not have to prove that the grantor is insolvent at the time the conveyance is made.[3] Yet, when applying under the Fraudulent Preferences Act onus is on the plaintiff to prove that the conveyance is made by a "person at a time when he is in insolvent circumstances, or is unable to pay his debts in full or knows that he is on the eve of insolvency".

As early as 1887 the courts have had an opportunity to consider legislation similar to our sections 1 and 2 of the Fraudulent Preferences Act. In *Rae* v. *McDonald* (1887) 13 O.R. 352 the court considered how one could determine when the debtor was in insolvent circumstances. Rose J. said that a debtor is legally insolvent when he has not sufficient property subject to execution to pay all his debts if sold under legal process. He defined commercial insolvency as an inability to pay off and discharge one's commercial obligations as they become due in the ordinary course of business. Cameron J. agreed with the definition of insolvency, but said that in determining solvency assets are to be estimated at their fair value for cash on the market at an ordinary sale, not at a forced sale under execution. The third judge concurred but he doesn't say who with. The court also said only one of the three conditions in the Act need to be filled, not all three.

In *Robinson* v. *Countrywide Factors Ltd.* [1978] 1 S.C.R. 753, the Supreme Court of Canada considered the Fraudulent Preferences Act of Saskatchewan, R.S.S. 1965, c. 397 which is almost identical to our Act. The court said that a person in insolvent circumstances is one unable to pay his debts in the ordinary course as they become due or one who does not have the means of paying his creditors in full out of the assets which could be realized upon sale for cash or its equivalent. Failure to meet either test meant the debtor was in insolvent circumstances. The court clearly said that the creditor must prove one of three conditions: either the debtor is in insolvent circumstances, or unable to

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3 *Gillespie* v. *Grover* (1852) 3 Gr. 558 (Ont. C.A.).

pay his debts in full or knows that he is on the eve of insolvency. There is no requirement that all three be proven.

In light of this case the decision in *C.I.B.C.* v. *Grande Cache Motor Inn Ltd.*; *Hobema Farms Ltd.* v. *Fowles* (1978) 4 Alta. L.R. (2d) 319 which states that all three conditions must be proven, is wrong on this point. The later Alberta decision in *Coopers & Lybrand Limited* v. *Alcan Canada Products Ltd.* (1982) 46 A.R. 32 cites the Supreme Court of Canada decision in *Robinson* as the authority on this point.

It is unclear whether the valuation of assets is by their fair market value or the value they will bring on a sale under execution.[4] The majority of the commentators and judges appear to favour an execution sale valuation.[5]

### D. Fraudulent Intent

Under the Statute of Elizabeth every person challenging a transaction as a fraudulent conveyance must show that the debtor had the intent to delay, hinder or defraud creditors. Under the Fraudulent Preferences Act it must be shown the debtor had the intent to defeat, hinder, delay or prejudice his creditors. No practical difference arises because of the different terminology used.

It is rare indeed when a creditor can prove the fraudulent intent of the debtor by direct evidence. Debtors do not often admit to their fraudulent intent. Yet courts will infer fraudulent intent from the circumstances surrounding the transaction and the effect it had on the parties to it and on their creditors.

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4 New Brunswick Department of Justice, Law Reform Division, *Legal Remedies of the Unsecured Creditor After Judgment, 3rd Report of the Consumer Protection Project*, Vol. 2 (1976) p. 109.

5 Ontario Law Reform Commission, *Report on the Enforcement of Judgment Debts and Related Matters - Part IV* (1983) p. 131.

There is substantial case authority to support the proposition that payment of an existing debt or granting of security for an existing debt are made for valuable consideration within the meaning of the Statute of Elizabeth. Therefore, a preference of one creditor over another is not a fraudulent conveyance, per se. Yet, where the real intent of a preference is to delay, hinder or defraud creditors, then it will fall within the Statute of Elizabeth.[6]

### 1. Presumption that one intends the natural consequences of the transaction

The courts start out with the presumption that one intends the natural consequences of one's acts, as determined by all the circumstances of the case. Following from this presumption is the line of cases, of which *Freeman* v. *Pope* (1870) L.R. 5 Ch. App. 538 is most often cited, which suggests that when a debtor who is solvent makes a voluntary conveyance or conveyance for a nominal consideration the effect of which is to render him insolvent, the court must infer the debtor had fraudulent intent. This presumption is irrebuttable and evidence of actual intent of the debtor is irrelevant: *Sun Life* v. *Elliott* (1900) 31 S.C.R. 91.

Another line of cases following *Ex Parte Mercer* (1886) 17 Q.B. 190 rejects this irrebuttable presumption and says that the fraudulent intent of a debtor is always a question of fact. Even where a debtor conveys all his assets and thereby renders himself insolvent, evidence can be lead to establish that the debtor did not intend to defeat his creditors.

The issue remains unsettled in Canada and there are Alberta decisions to support both lines of cases. Yet, the scholars seem to prefer the approach taken in *Ex Parte Mercer* (1886) 17 Q.B. 190. See the Manitoba Court of Appeal decision in *Mandryk* v. *Merco* (1981) 19 D.L.R. (3d) 238 for a good discussion on this debate.

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6 Dunlop, p. 522 and authorities cited in footnotes 91-94.

2. Badges of fraud

One of the earliest cases to give useful guidelines on when a court could infer fraudulent intent from the circumstances is *Twyne's Case* (1601) 3 Co. Rep. 806; 76 E.R. 809. This was a case where the debtor, Pierce, owed £400 to Twyne and £200 to C. After C commenced action against Pierce to recover the £200, Pierce sold all his property, valued at approximately $300, to Twyne in satisfaction of his debt owed to Twyne. Pierce continued in possession of the goods and sold some of them. C obtained judgment against Pierce and directed the sheriff to seize Pierce's goods pursuant to the judgment. Twyne intervened and said that the goods belonged to him. The Star Chamber made a finding that Pierce had intended to defraud his creditors based on the following circumstances:

1. The conveyance comprised all of Pierce's goods, including his clothing and other necessities;
2. Pierce continued in possession of the goods and used them as his own;
3. The conveyance was made in secret;
4. The conveyance was made pending C's action;
5. It was apparent some trust arrangement had been made which provided a benefit to Pierce;
6. The deed by which the conveyance was made stated specifically that it was made honestly, truly and *bona fide*.

These circumstances have come to be known as badges of fraud. The list of badges of fraud has grown over the years and includes, as stated by Dunlop in his text, *Creditor Debtor Law in Canada* at p. 526 the following:

7. The deed gives the grantor a general power to revoke the conveyance;
8. The deed contains false statements as to consideration;
9. The consideration is grossly inadequate;
10. There is unusual haste to make the transfer;

11. Some benefit is retained under the settlement by the settler;

12. Cash is taken in payment instead of a cheque;

13. A close relationship exists between the parties to the conveyance.

The effect of establishing a badge of fraud was discussed in the *Report on Fraudulent Conveyances and Preferences* prepared by the Law Reform Commission of B.C. at p. 27 as follows:

> There are two views on the effect of establishing a badge of fraud. The first is that proof of a badge of fraud is sufficient evidence of fraud to entitle the court to find that the plaintiff has made a case suitable for hearing by a trier fact. The second view is that once a badge of fraud is established, the onus shifts to the defendant to establish that the transaction was not made with any fraudulent intent. On the first view, the court would not be obliged to void a transaction if the evidence is equivocal. Not all badges of fraud are clear and unambiguous, and the weight of the inference to be drawn will vary from case to case. On the second approach, however, defendant's failure to rebut the inference or adduce positive evidence of a lawful intent will cause judgment to be issued against him. Doubts would be resolved in favour of the plaintiff. Both approaches find support in case law.

### 3. Doctrine of close connection

The doctrine of close connection was propounded by the Supreme Court of Canada in *Koop* v. *Smith* (1915) 51 S.C.R. 554, 8 W.W.R. 1203. The doctrine provides that the court should exercise more than usual care in examining whether a transaction offends the Statute of Elizabeth or the Fraudulent Preferences Act where the grantor of a security was a person closely related to the grantee. In cases of conveyances between close relatives which have the effect of defeating the claims of creditors, the onus of establishing the validity of the transaction is upon the parties upholding it. Although as a matter of prudence, courts will often require that those seeking to uphold a transfer furnish corroborated evidence, this is *not* a rule of law.

The doctrine of close connections applies to related corporations: *C.I.B.C.* v. *Grande Cache Motor Inn Ltd.*; *Hobbema Farms Ltd.* v. *Fowles* (1978) 4 Alta. L.R. (2d) 319 and to individuals and corporations controlled by those individuals: *Burton* v. *R. & M. Insurance Ltd. & Poole* (1977) 5 Alta. L.R. (2d) 14.

E. Transactions Protected by S. VI of the Statute of Elizabeth

Section VI of the Statute of Elizabeth protects conveyances made upon "good consideration and *bona fide* lawfully conveyed" to persons not having at the time of such conveyance "any manner or notice of knowledge of such covin, fraud or collusion as is aforesaid".

1. Voluntary Conveyances

Voluntary conveyances or conveyances for nominal consideration do not fall within the protection of s. VI of the Statute of Elizabeth because they are not made for "good consideration". The result is that when such a conveyance is attacked as fraudulent it is only necessary to determine if the debtor intended to delay, hinder or defraud his creditors by such a conveyance. The transferor's intent is irrelevant.[7]

Kerr in *The Law of Fraud and Mistake* (7th ed., 1952) at p. 308 explains the rationale behind these line of cases as follows:

> Assuming his intent to be fraudulent within the meaning of the statute, it does not matter whether or not the donee had knowledge or notice of that intent; for the donee is not within the exception made by the statute in favour of *bona fide*

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7 *Oliver* v. *McLaughlin* (1893) 24 O.R. 41 (Q.B. Div.); *Gauthier* v. *Woolatt* (1940) 1 D.L.R. 275 (Ont. H.C. of Justice); *Union Bank of Canada* v. *Murdoch* (1917) 3 W.W.R. 820 (Man. C.A.); *Banque d'Hochelaga* v. *Potvin* [1924] 1 D.L.R. 678; *Cromwell* v. *Comeau* (1957) 8 D.L.R. (2d) 676; and *Traders Group Ltd.* v. *Mason* (1973) 43 D.L.R. (3d) 76 (N.S. S.C. Trial Div.) varied 1974 53 D.L.R. (3d) 103 (N.S. S.C. App. Div.).

> purchasers. A volunteer cannot be said to be injured by the gift to him being defeated; no loss is inflicted on him; he is only deprived of the gain to which others had a better right.

2. Conveyances upon Good Consideration and *bona fide* lawfully conveyed

a. "*Bona fide* conveyances"

In its report, at page 138, the Ontario Law Reform Commission states that there is authority to support the following three interpretations of "*bona fide*" as used in s. VI of the Statute of Elizabeth:

1. *Bona fide* characterizes the state of mind of the debtor;
2. *Bona fide* refers to the transferee;
3. It means the transaction must be genuine and not a sham.

If the debtor is *bona fide* the transaction does not fall within the scope of the Act at all. Therefore the first interpretation is illogical. The second interpretation would make *bona fide* redundant because s. VI specifically requires the transferee have no knowledge of the fraudulent intent of the debtor. The third interpretation is more sensible. The cases supporting this position interpret a *bona fide* transaction as one which is not a mere cloak for retaining a benefit to the grantor: see *Union Bank* v. *Murdoch* [1917] 2 W.W.R. 112 (Man. Q.B.) rev'd. on other grounds [1917] 3 W.W.R. 820 (Man. C.A.) and *Banque d'Hochelaga* v. *Potvin* [1924] 1 D.L.R. 678 (Alta. S.C. A.D.).

b. "Good" and "valuable" consideration

"Good consideration" as used in s. VI of the Statute of Elizabeth has been interpreted to mean valuable consideration. It is not enough that the transferee supplied consideration which would be sufficient in a simple contract case.

One of the clearest statements of law on this point is found in *Union Bank* v. *Murdoch* [1917] 2 W.W.R. 113 in the Trial Division decision which was reversed by the Manitoba Court of Appeal on other grounds. The trial judge said that:

> To avoid the statute, a conveyance must be for good (i.e., valuable) consideration and *bona fide*. There must be a real consideration paid, or a fair interchange of interests, for though mere inadequacy of price is not in general a circumstance which will of itself make an assignment void, yet, if the inadequacy is very great, at least if it is so palpable that it must be taken to have been a fraudulent contrivance between the parties, the transaction will be void, especially if what little consideration consisted of an existing debt.

It is unnecessary to show that there exists a one to one correspondence between the fair market value of the property transferred and the consideration applied. The court's attitude on this point was set out in the decision of the Alberta Supreme Court Appellate Division in *Banque d'Hochelaga* v. *Potvin* [1924] 1 D.L.R. 678. They said that:

> Where it is found that the transaction at issue is, on the whole, fair and honourable, and not induced by fraudulent intention of defeating the creditors, the court is not very particular as to the amount of the consideration, if it is valuable, and not so entirely inadequate as, from its insufficiency, to induce the presumption of fraud, it is enough. The smallness of the consideration is not a matter that the court will go into except so far as it evidences that the transaction is a sham.: May on Fraudulent Conveyances (3d ed.) pp. 194-5."

Two cases of note are *Lee* v. *Glenval Holdings Ltd.* 85 A.R. 394 (Alta. Q.B.) and *Jack Cewe Ltd.* v. *Irving* (1978) 26 C.B.R. 142 (B.C. S.C.). In *Lee* v. *Glenval Holdings Ltd.*, Justice Sinclair said that the fraudulent intent of both parties need only be proven where the conveyance was made for valuable consideration. The Court said the issue was whether any consideration passed to the company for the granting of the guarantee. Unfortunately this issue will not be decided as this matter has been settled.

In *Jack Cewe Ltd.* v. *Irving and CIBC* (1978) 26 C.B.R. 142 (B.C.S.C.) Irving gave a mortgage to the C.I.B.C. to secure a guarantee he had executed two years earlier. Creditors of Irving attacked the mortgage as a fraudulent conveyance under legislation similar to the Statute of Elizabeth and the Fraudulent Preferences Act. The mortgage was given in consideration of the bank agreeing not to sue on the guarantee. The court held that the mortgage was *bona fide* because the bank had no knowledge of the mortgagor's insolvency. It further held that the mortgage was given for the bank's forbearance to sue on the guarantee and this was "valuable consideration". The court said the transaction was protected by sections equivalent to our s. VI of the Statute of Elizabeth and s. 6 of our Fraudulent Preferences Act. Yet, there was no discussion of gross inadequacy of consideration and no discussion on whether the $7,300 equity in the property mortgaged bore a fair and reasonable relative value to the consideration thereof, the forbearance to sue.

The court also held that "transfer of property by way of security for any present actual *bona fide* advance of money" did not mean the advance must be contemporaneous with the granting of the mortgage. The court held that advance included a past advance now being secured. On this point the decision conflicts with the law in Alberta which is set out in *Smith* v. *Sugarman* (1909) 2 A.R. 442 and *Trusts and Guarantee Co. Ltd.* v. *R.J. Whitlaw Co. Ltd.* (1914) 6 W.W.R. 42.

c. Transferee's notice or knowledge

The literal interpretation of s. VI of the Statute of Elizabeth suggests that mere notice of the debtor's fraudulent intent should be sufficient to make a transaction for value voidable. Nonetheless, the courts have generally not interpreted the section literally, although there are some cases which take this position. As long ago as 1880 the court in *Re Johnson* ((1880) 20 Ch. D. 389) stated that if mere notice or knowledge of the fraudulent intent of the debtor was sufficient to avoid the transaction then it would overthrow all the plain dealing between businessmen.

In *Meeker Cedar Products Ltd.* v. *Edge* (68 D.L.R. (2d) 294), the British Columbia Court of Appeal had occasion to interpret a section in the Fraudulent Conveyances Act of that province which is very similar to s. VI of the Statute of Elizabeth. This decision was later affirmed by the Supreme Court of Canada without reasons. In the Court of Appeal, MacFarlane J.A. held:

> I think it is clear as a matter of interpretation of the statute as a whole and upon authority that where a sale is made for good and valuable consideration the transaction will not be void by reason of the purchasers having notice or knowledge of the vendor's intent to delay, hinder or defraud creditors and others unless it be proved that the purchaser was actually privy to the fraud, i.e., a party to carrying out the fraudulent intention and purpose.

The test set out by MacFarlane in this case is known as the concurrent intent test.

F. <u>Protected Transactions Under the Fraudulent Preferences Act</u>

Section 6 of the Fraudulent Preferences Act reads as follows:

> Nothing in section 1 to 5 applies to
>
> (a) a *bona fide* sale or payment made in the ordinary course of trade or calling to innocent purchasers or parties, or
>
> (b) a payment of money to a creditor, or a *bona fide* conveyance, assignment, transfer or delivery over of any goods, securities or property, of any kind as above mentioned, that is made in consideration of a present actual *bona fide* sale or delivery of goods or other property or of a present actual *bona fide* payment in money, or by way of security for a present actual *bona fide* advance of money,
>
> if the money paid or the goods or other property sold or delivered bear a fair and reasonable relative value to the consideration therefore.

1. *Bona fide* transactions

Section 6(1)(a) of the Fraudulent Preferences Act is very similar to s. VI of the Statute of Elizabeth, except the term "innocent purchasers or parties" is used instead of persons without notice or knowledge of fraud. In an Ontario case, a section identical to our s. 6(1)(a) was interpreted and the court held that "innocent purchasers or parties" means persons without notice or knowledge: *Johnson* v. *Hope* (1890) 17 O.A.R. 10.

It is unclear whether under s. 6(1)(a) of the Fraudulent Preferences Act mere knowledge of the debtor's fraudulent intent will render the transaction invalid. Some cases say it is necessary to prove concurrent intent of the transferee and other cases say this is not necessary. This issue remains unsolved.[8]

2. Fair and reasonable consideration

Under the Statute of Elizabeth courts must wrestle with the concept of good (i.e., valuable) consideration. Unless consideration is grossly inadequate, the courts are unlikely to set aside the transaction on the basis of consideration alone. Yet s. 6 of the Fraudulent Preferences Act requires that transactions listed in s. 6 are only protected if the money paid or the goods or other property sold or delivered bear fair and reasonable relative value to the consideration thereof.

The Nova Scotia case of *Leighton* v. *Muir* (1962) 34 D.L.R. (2d) 332 (N.S. S.C.) illustrates the difference between these two sections. This was a case where a brother transferred property worth $8,500 to his sister in consideration of her assuming a $3,500 mortgage on the property. The court said that this was a valuable consideration within the Statute of Elizabeth but that the transaction was invalid under the Assignments and Preferences Act R.S.N.S. 1954, c. 17 (similar to our Fraudulent Preferences Act) because the transaction infringed the express provision regarding adequacy of consideration. That

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8 OLRC, *Enforcement of Judgment Debts and Related Matters, Part IV*, pp. 146-47.

is, the property sold did not bear a fair and reasonable relative value to the consideration therefore.

Yet some cases ignore the difference between "good consideration" and "fair and reasonable consideration". For example, see the case of *Jack Cewe Ltd.* v. *Irving and CIBC* discussed at page 263 of this memorandum.

G. Remedies

The Statute of Elizabeth provides that the conveyance is void against creditors of the grantor and that the penalty for participation in such a fraud is forfeiture of the value of the goods. One-half of the value of the goods goes to the Crown and the other one-half goes to those prejudiced by the fraudulent conduct of the recipient. The penalty clause in the Statute of Elizabeth is not in force in Alberta. Therefore in Alberta a creditor cannot sue for one-half the value of the goods.[9]

There is a line of old cases that holds that under the Statute of Elizabeth and equivalent statutes, a creditor cannot attach the sale proceeds of property fraudulently conveyed and later resold. An illustration of one of these earlier cases is found in *Davis* v. *Wickson* [10] where the court held:

> The right of the plaintiff in this class of cases is to have any impediment removed or declared invalid which intercepts the action of his writ of execution. So long as the property of his execution debtor remains distinguishable and so long as no purchaser for value without notice intervenes, so long may the court award relief against that property in the hands of the fraudulent or voluntary holders. But where, as here, the first holder sells the property obtained from the debtor and receives the proceeds in a shape that cannot be earmarked, there is no

9 See *Goyan* v. *Kinash* [1945] 1 W.W.R. 291 (Alta. S.C.T.D.) and *Connors* v. *Egli et al.* [1924] 1 W.W.R. 1051 (Alta. S.C.A.D.).

10 (1882) 1 O.R. 369 at 374

> jurisdiction to go beyond the further remedy which the Statute of Elizabeth prescribes, namely that all parties to fraudulent conveyances alienating or assigning thereunder shall forfeit a year's value of lands and the whole value of goods, whereof one-half goes to the Crown and one-half to the party aggrieved.

The injustice created by this line of cases has been overcome in Manitoba and Ontario. In *John Deere Limited* v. *Paddock et ux*,[11] the Manitoba Court of Appeal held that section 49(1) of the Assignments Act[12] applies to all transactions that in law are invalid against the creditors. As the transfer in question was invalid against the creditors by reason of the Fraudulent Conveyances Act, the transaction is invalid in law and within the meaning of section 49(1) of the Assignments Act. The result was that the court ordered that the judgment creditor of the husband recover from the wife the sum of $2,000 being the sale proceeds of land which was conveyed to the wife with the intent to delay, hinder or defraud creditors.

In *Westinghouse Canada Ltd.* v. *Buchar et al.*[13] the Ontario Court of Appeal held that the tracing provisions of section 12 of the Assignments and Preferences Act should be available where a conveyance is void under the Fraudulent Conveyances Act. That section is similar to the Manitoba section 49(1) except in Ontario the wording is "which is invalid against creditors" and in Manitoba the wording is "that in law is invalid against creditors". Notwithstanding the different wording, the court was willing to follow the decision in *John Deere Limited* v. *Paddock et ux*. It specifically overruled the case of *Grey* v. *Quinn*[14] that said that the words "which is invalid against creditors" applies only to transactions invalidated by the Assignment and Preferences Act.

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11 (1983) 2 W.W.R. 116.

12 S. 49(1) of the Assignments Act of Manitoba is very similar to our section 11 of the Fraudulent Preferences Act.

13 (1975) 9 O.R. (2d) 137.

14 (1922) 22 O.W.N. 325.

There are no Alberta decisions dealing with this issue. In view of the similarity between section 11 of the Fraudulent Preferences Act of Alberta and section 49(1) of the Assignments Act of Manitoba the reasoning in *John Deere Limited* v. *Paddock et ux* is applicable. Section 11 of the Fraudulent Preferences Act should apply to transfers which are void under the Statute of Elizabeth. This would allow the creditor to follow sale proceeds into the hands of a fraudulent transferee and to require that transferee to account for the sale proceeds even where the transferee has spent them for his personal use.

## III. Fraudulent Preferences

### A. Applicable Legislation

#### 1. Common Law Position

Under the common law there was no requirement that a debtor treat his creditor equally and therefore preferences per se were not invalid.[15]

#### 2. Preferences Under the Statute of Elizabeth

As discussed earlier in this memorandum, the Statute of Elizabeth has no application to preferences per se. The Statute of Elizabeth was not designed to provide equal distribution of the debtor's property among his creditors.[16]

#### 3. Fraudulent Preferences Act

In Alberta, a fraudulent preference can be attacked under sections 2, 3 and 4 of the Fraudulent Preferences Act.

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15 Ontario Law Reform Commission, *Enforcement of Judgment Debts and Related Matters - Part IV*, p. 160.

16 *Ibid.* at p. 160.

## B. Financial Status of Debtor

When attacking a transaction as a fraudulent preference, it must be proven that "the gift, conveyance, assignment, transfer, delivery over or payment of goods, chattels or effects ..." was made by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full or knows that he is on the eve of insolvency. The earlier discussion at pages 256-257 of this memorandum on proving insolvency also applies to fraudulent preferences cases.

## C. Fraudulent Intent

### 1. Intent

Pursuant to s. 2 of the Fraudulent Preferences Act, if a debtor in insolvent circumstances conveys property to or for a creditor with intent to give that creditor preference over other creditors, the transaction is void. By s. 3 of the Fraudulent Preferences Act, if an insolvent debtor transfer property to or for a creditor and the transfer has the effect of giving a creditor a preference, it can be impeached as void if action is brought within one year after the transfer. Under s. 3, the actual intent of the debtor is irrelevant, because s. 4 deems the preferential effect to govern "independently of the intent with which the transaction was entered into and of whether it was entered into voluntarily or under pressure".

### 2. Unilateral or Concurrent Intent

Section 2 does not require concurrent intent of a preferred creditor. However, judicial interpretation of the Fraudulent Preferences Act has created such a requirement. In an action brought under s. 2 of the Fraudulent Preferences Act, the plaintiff must prove that the debtor intended to give one creditor preference over other creditors and that the preferred creditor intended to receive a preference over other creditors: Parker, *Fraud on Creditors and Assignments for the Benefit of Creditors*, p. 163 and *Re Barnett* (1983) 43 A.R.

215 (Alta. Q.B.). By contrast, under s. 73 of the Bankruptcy Act dealing with fraudulent preferences, the Supreme Court of Canada has held that only the intent of the debtor is relevant: *Hudson* v. *Benallack* [1976] 2 S.C.R. 168.

Under sections 3 and 4 of the Fraudulent Preferences Act, intent of the debtor and creditor is irrelevant. Only the preferential effect of the transfer and the insolvency of the debtor are in issue. Yet if the creditor receiving the preference can show he entered the transaction in good faith, that is he didn't know of the insolvency of the debtor and did not know of or share in the fraudulent intent of the debtor, then the creditor will be protected if he can come within any of the transactions listed in s. 6 of the Fraudulent Preferences Act.[17]

3. <u>Proving Intent</u>

The badges of fraud and doctrine of close connection are also used to prove intent to prefer. See earlier discussions on these topics.

When proving concurrent intent of the creditor to accept a preference, knowledge of the debtor's insolvency is very important. As stated in *Johnson* v. *Hope* (1890) 17 A.R. 10, a *bona fide* creditor who at the time of dealings has no knowledge or notice of the insolvency of the debtor is safe from the consequences of legislation such as s. 2 of the Fraudulent Preferences Act. The existence of knowledge of the debtor's insolvency is necessary to give rise to an inference that the creditor, in taking the security, intended to except the preference over other creditors of the debtor: *Gulf and Fraser*; *Fishermen's Credit Union* v. *W.R. Menchions & Company* (1966) 55 W.W.R. 191 (B.C.C.A.). Yet, where the debtor had no intent to give a preference, knowledge by the creditor of the debtor's insolvency is not sufficient in itself to cause a transfer to be set aside as a fraudulent preference: *Fisher* v. *Kowslowski* (1913) 5 W.W.R. 91 (Man. K.B.).

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17 Law Reform Commission of British Columbia, *Report on Fraudulent Conveyances and Fraudulent Preferences*, 1988, pp. 45-48 and pp. 49-50.

Parker in *Frauds on Creditors and Assignments for the Benefit of Creditors* discusses the relevancy of notice of insolvency at p. 167:

> **Notice of "Insolvency."**--If the creditor then had notice or knowledge of *insolvency*, but acted in good faith, receiving his preference without any participation in the intent of the debtor, the transaction will in Ontario be considered valid. If the creditor has assisted in bringing about the transfer by pressing the debtor, it is clear that he might well be acting and taking the security in good faith. But if the creditor received a preference from a debtor whom he had not pressed for payment or security, and of whose insovlency he had notice or knowledge, one would think that he must be taken to know or perceive the debtor's intent to prefer him, and that under such circumstances knowledge of insolvency would be almost tantamount to knowledge of intent. Or to put it another way, if the creditor had notice or knowledge of the insolvency he must have known the security voluntarily offered him would have the effect of giving him a preference and so he could not reasonably be acting in good faith in accepting it.

D. Doctrine of Pressure

A transfer of property to a creditor is only a preference if made with the intent that "one creditor steal a march on the other creditors".[18] A transfer of property is not a preference where the transfer was made as a result of legitimate commercial pressure applied by the creditor. In this situation, the transfer of property is in response to pressure and not given with intent to prefer creditors: *Stephens* v. *McArthur* (1981) 19 S.C.R. 446, 453.

The doctrine of pressure will not validate a transaction that results in a preference when the transaction is attacked within 1 year.

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[18] *Ibid.* at 43.

## E. Protected Transactions

### 1. *Bona Fide* Transactions

Section 6 protects from the operation of the Act the following transactions:

1) *bona fide* sale or payment made in the ordinary course of trade or calling to innocent purchasers or parties;

2) the payment of money to a creditor;

3) a transfer of property made in consideration of a present actual *bona fide* sale;

4) a transfer of property made in consideration of delivery of goods or other property;

5) a transfer of property made in consideration of a *bona fide* payment in money;

6) a transfer of property by way of security for a present actual *bona fide* advance of money.

All the transactions in s. 6 are protected only if the money paid or the goods or other property sold or delivered bears a fair and reasonable relative value to the consideration therefore.

In order to show that the transaction was not *bona fide*, onus is on the plaintiff to prove that the creditor knew of the debtor's insolvency or should have known at the time he accepted the challenged conveyance and that the creditor participated in the fraud in the sense that he knowingly and willingly accepted the preference over his fellow creditors. Proof of insolvency was made easier by the decision in *National Bank of Australia* v. *Morris* [1892] A.C. 289 at 290 where the court said:

> Their Lordships conceive that if the creditor who receives payment has knowledge of circumstances from which ordinary men of business would conclude that the debtor is unable to

> meet his liabilities, he knows, within the meaning of the Act
> that the debtor is insolvent.

This test was adopted in *Gulf & Fraser Fishermen's Credit Union* v. *W.R. Menchions & Co.* (1965) 55 W.W.R. 191 at 192 (B.C. C.A.). Yet knowledge of insolvent circumstances will not be imputed even where the creditor fails to make reasonable inquiries: *Jack Cewe Ltd.* v. *Irving and C.I.B.C.* (1978) 6 C.B.R. 142 and *Toronto Dominion Bank* v. *Terrance Bavarian Inn Ltd.* (1977) 24 C.B.R. (N.S.) 214 (B.C.S.C.).

2. Payment of Money

Any payment of money to a creditor that bears a reasonable and fair value to consideration given therefore is excepted from the Fraudulent Preferences Act: s. 6(b). Therefore any payment by an insolvent debtor of an existing debt by way of cash or cheque cannot be impeached no matter what the intention of the parties thereto was: *Re Cohens and Lyons*; *Canadian Credit Men's Trust Association* v. *Spivak* [1927] 1 D.L.R. 577 (Alta. S.C. A.D.). S. 6(6) does not require that the payment be *bona fides*.

3. Security for Existing Debt

When an insolvent debtor grants security for an existing debt, the security will be void if attacked within 1 year of the transaction. The intent of the debtor and creditor is irrelevant and s. 6 of the Fraudulent Preferences Act does not protect such a security because the security was not given for a present actual *bona fide* advance of money or for a present *bona fide* delivery of goods.

If the transaction is not attacked within the 1 year period, the plaintiff must prove the insolvent debtor had the intent to give a preference and the creditor had an intent to receive a preference. If the creditor had no such intent the preference is not fraudulent: *Smith* v. *Sugarman* (1909) 2 Alta. L.R. 442 (Alta. S.C. T.D.) upheld by the Supreme Court of Canada and *Trusts and Guarantee Company Ltd.* v. *R.J. Whitlaw Company Limited* (1914) 6 W.W.R. 42 (Alta. S.C. T.D.). This is not a situation where s. 6 of the Fraudulent

Preferences Act protects a transaction, but where the judicial gloss of "concurrent intent" saves the transaction.

The policy of the court is best expressed in *Johnson* v. *Hope* (1889-90) 17 O.A.R. 10 at p. 13 as follows:

> But then the word *bona fide* is used throughout, and it would seem to follow that the legislature did not intend to involve persons having neither knowledge or notice, in the disabling and penal consequences of the Act thereby forbidden. It would paralyze trade and mercantile business altogether, if transactions entered into in all honesty and good faith, and for valuable consideration, with persons apparently solvent and prosperous, were liable to be undone upon its being afterwards discovered and proved that such persons were at the time in embarrassed circumstances or unable to pay their debts in full. Such a construction of the Act would make it a trap and a snare instead of an enactment salutary and beneficial to the mercantile community. It has always been the policy of law to protect, as far as possible, persons acting *bona fide*, and without notice of fraud or other wrongdoing, and so I think a person who deals *bona fide* with an embarrassed debtor, and who at the time of the dealing has no knowledge or notice of his embarrassed condition, is safe from all the consequences enacted by the statute. It is hard to imagine how a transaction can be otherwise than *bona fide*, with reference to what is forbidden in the statute, if it has been entered into without knowledge or notice of the embarrassments of the debtor.