INSTITUTE OF LAW RESEARCH AND REFORM

EDMONTON, ALBERTA

FINANCIAL ASSISTANCE BY A CORPORATION: SECTION 42, THE BUSINESS CORPORATIONS ACT (ALBERTA)

Report For Discussion No. 5

August 1987

PREFACE

and

INVITATION TO COMMENT

In 1980 the Institute issued Report No. 36, Proposals for a New Alberta Business Corporations Act (2 Vols.). The Institute's proposals were, with some (relatively minor) modifications subsequently enacted as the Business Corporations Act (S.A. 1981, c. B-15). (Hereafter ABCA).

It was quite unlikely that, even after the close attention the prospective new statute received from many quarters, a new statutory regime of that magnitude would be found to be flawless in practice. Accordingly, officials of Alberta Corporate and Consumer Affairs and Institute legal staff maintained a watching brief on improvements which might, with advantage, be made to the statute at some appropriate time.

Throughout 1986 a number of suggestions for amendments to the ABCA were canvassed by the Institute and that Department, after consultation with the bar and other interested persons. Those amendments were introduced into the Legislature as Bill No. 35 (Business Corporations Amendment Act, 1987), and received assent on June 17, 1987.

One matter however seemed to call for more intensive study. This was s. 42 of the ABCA, which, it was said, has given rise to a good deal of difficulty for practitioners and lenders in Alberta, and consequently to have attracted some adverse comment. In broad terms, that section purports to prohibit the granting of loans and other financial assistance to directors, and the provision of financial assistance by a corporation towards the purchase of shares in that corporation. It was suggested that the section as presently cast is difficult to interpret and apply (thereby rendering the giving of a legal opinion quite hazardous), has actually prevented some legitimate transactions from taking place and, on one view of the relevant authorities, may leave a lender in the unenviable position of being unable to recover a loan even as an unsecured creditor if the section is infringed. At the very least, the doubts surrounding the section are said to have unduly increased the complexity and costs associated with some lending and restructuring arrangements, and at worst, to have inhibited legitimate commercial transactions.

These concerns lead the Institute to a view that this subject area should be the subject of a more in depth study, and a consultative report, before final recommendations for any amendments to the section are recommended to Alberta legislators. Accordingly no recommendations on this subject were included in the package of more "routine" amendments forwarded by the Institute to Alberta Consumer and Corporate Affairs in 1986.

In retrospect, this cautious approach seems to the Institute to have been justified. Further investigation has suggested that the matters involved in this, at first blush, innocuous provision are quite complex and raise serious policy issues, as well as difficult technical issues. The Institute found that there is no published study of these issues by a law reform agency anywhere. The legislative answers given to the sort of problems posed by s. 42 range from no prohibition at all in some U.S. states to an extraordinarily complex regulatory scheme covering many pages of the statute book introduced recently in the U.K. In these circumstances, the present report may - apart from whatever assistance it ultimately provides in Alberta in arriving at a reassessment of the present section - assist those who are called upon to struggle with the problems in this subject area in other jurisdictions.

In the result this is not a final report. It includes an assessment of the present position in Alberta and elsewhere, and tentative recommendations for a restructuring of s. 42. The Institute's purpose in issuing a report at this time is to allow interested persons the opportunity to consider these tentative conclusions and proposals and to encourage them to make their views known to the Institute. Any comments forwarded to the Institute will be considered when the Institute determines what, if any, recommendations for reform it will make to the government.

It is just as important for interested persons to advise the Institute that they approve the recommendations as it is to advise the Institute that they object to them, or that they believe they need to be revised in whole or in part. The Institute may substantially revise tentative proposals as a result of comment it receives. The proposals do not have the final approval of the Institute's Board of Directors, and they have not been adopted, even provisionally, by the Alberta Government.

Comments should be in the Institute's hands by January 8, 1988. If more time is needed, please advise before that date. Comments in writing are more convenient, but oral comments will be noted, and should be made to the Director of the Institute, Professor R.G. Hammond.

INSTITUTE OF LAW RESEARCH AND REFORM

The Institute of Law Research and Reform was established on 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.

The Institute's office is at 402 Law Centre, University of Alberta, Edmonton, Alberta, T6G 2H5. Its telephone number is (403) 432-5291.

The Institute's legal staff consists of Professor R.G. Hammond (Director); R.W. Bauman; R. Bowes; B.R. Burrows; Professor P. Lown and M.A. Shone. W.H. Hurlburt Q.C. is a consultant to the Institute.

ACKNOWLEDGEMENTS

During the period when the proposals in this Report were developed, Mr. George C. Field, Q.C. (then of Counsel to the Institute) had the primary responsibility for the carriage of this project and the drafting of the Report. However, the Board assumes sole responsibility for the recommendations in the Report.

Table of Contents

TABLE OF ABBREVIATED REFERENCES iv
PART I. SUMMARY OF THE REPORT 1
PART II. REPORT FOR DISCUSSION: PROVISION OF FINANCIAL ASSISTANCE 7
CHAPTER 1. INTRODUCTION 7
CHAPTER 2. THE ENGLISH EXPERIENCE 11
1. Loans, Guarantees and Charges on Assets 11
(a) Statutory Provisions 11
(b) Common Law 17
2. Transactions Involving Shares 22
(a) Statutory Provisions 22
(b) Case Law 31
CHAPTER 3. THE LAW IN ALBERTA 43
1. Predecessor Acts 43
2. Background to Section 42, ABCA 46
(a) The Dickerson Report 46
(b) The CBCA Provisions 46
(c) The ABCA Provisions 48
(d) Common Law Principles 49
(e) The Effect of a Statutory Prohibition 60
CHAPTER 4. THE LAW IN OTHER JURISDICTIONS 65
1. Canadian 65
(a) New Brunswick 65
(b) Ontario 66
(c) British Columbia 68
2. United States of America 71
(a) Model Business Corporations Act 72
(b) Maine and Louisiana 73
(c) Delaware and Michigan 73
(d) California 74
(e) New York and Tennessee 74
CHAPTER 5. THE NATURE AND FINANCIAL EFFECT OF TRANSACTIONS OF THE KIND AT ISSUE 76
1. Introduction 76
2. Loans 76
(a) The Effect on the Corporation 76
(b) Classes Adversely Affected 77
3. Guarantees 78
(a) The Effect on the Corporation 78
(b) Classes Adversely Affected 78
4. Charges on Assets 79
(a) The Effect on the Corporation 79
(b) Classes Adversely Affected 80
5. Transactions Involving Shares 81
(a) The Effect on the Corporation 81
(b) Classes Adversely Affected 83
6. Conclusions 84
CHAPTER 6. THE PRESENT SECTION 42 OF THE ABCA 86
1. The Basic Structure 86
2. Corporations to Which the Provisions Apply 87
3. THE PROHIBITED CLASS 87
4. The Solvency Test 89
(a) Background 89
(b) the Bankruptcy Act 90
(c) Current Liquidity 91
(d) The Underlying Asset Test 93

5. Exceptions 98
(a) Lending Companies 98
(b) Expenses 100
(c) Employee Housing 100
(d) Employee Share Purchase Plans 101
(e) Holding and Subsidiary Corporations 103
6. Sanctions 106
(a) Duties and Liabilities of Directors 106
(i) Liability of the Recipient Director 106
(ii) Liability of the Remaining Directors 107
(b) Shareholder Remedies 108
(c) Creditors' Remedies 109
(d) Fines and Penalties 110
(e) The Income Tax Act (Canada) 110
7. The Position of the Third Party 111
8. Disclosure 112
CHAPTER 7. POLICY ISSUES 115
1. Introduction 115
2. The Concept of the Corporation 115
3. Economic Factors 120
4. The Secured vs the Unsecured Creditor 122
5. Corporate Governance 123
6. Uniformity 126
7. CONCLUSIONS 128
CHAPTER 8. PROPOSALS FOR REFORM 130
1. Introduction 130
2. The Distinction Between Distributing Corporations and Non-Distributing Corporations 130
3. Financial Assistance to Directors and Other Persons with Respect to Distributing Corporations 132
(a) The Prohibited Transactions 132
(b) The Prohibited Class 133
(i) Director of an Affiliated Corporation 134
(ii) Associates of Directors 134
(iii) Officers 137
(iv) Shareholders 138
(v) Employees 138
(c) Exceptions 139
(i) Lending Corporations 139
(ii) Advances on Expenses 139
(iii) Advances on Salaries 141
(iv) Housing 142
(v) Purchase of Shares 142
(d) Disclosure 145
(e) Conclusion 146
4. Financial Assistance to Directors and Other Persons with Respect to Non-Distributing Corporations 148
(a) Introduction 148
(b) The Alternatives for Reform 150
(i) Repeal 150
(ii) Solvency as a Control Mechanism 153
(iii) The Use of General Terms 154
(iv) A Pragmatic Approach 155
(c) The Regulated Transactions 158
(d) Disclosure 162
(e) Exceptions 164

5. Financial Assistance by a Distributing Corporation in Connection with a Purchase of its Shares 165
6. Financial Assistance by a Non-Distributing Corporation in Connection with a Purchase of its Shares 168
(a) Introduction 168
(b) The Nature and Effect of the Financial Assistance 170
(c) The Parties Concerned in the Transaction 171
(i) The Unsecured Creditor 172
(ii) The Vendors of the Shares 174
(iii) The Third Party Lender 175
(iv) The Buyer of the Shares 176
(d) Possible Solutions 177
(e) The Solvency Approach 178
(f) The Restorative Approach 179
(g) An Insurance Analogy 180
(h) Indirect Assistance 183
(i) Disclosure 184
7. The Position of the Third Party or Lender 186

PART III. SUMMARY OF RECOMMENDATIONS 189
PART IV. APPENDICES 193
APPENDIX 1. Section 190 U.K. Companies Act, 1948 193
APPENDIX 2. Sections 330-343, Companies Act, 1985 (U.K.) 195
APPENDIX 3. Section 45, Companies Act, 1929 (U.K.) 209
APPENDIX 4. Sections 151-158, Companies Act, 1985 (U.K.) 210
APPENDIX 5. Northwest Territories Ordinance Chapter 61 (1886) 219
APPENDIX 6. Companies Act O.N.W.T. 1901 220
APPENDIX 7. Section 14, Companies Act, 1929 (Alberta) 221
APPENDIX 8. Companies Amendment Act, 1934 (Alberta) 222
APPENDIX 9. Companies Amendment Act, 1954 (Alberta) 223
APPENDIX 10. Section 43, New Brunswick, BCA 225
APPENDIX 11. Section 42, ABCA 227
APPENDIX 12. Section 16, Ontario Business Corporations, 1970 229
APPENDIX 13. Section 20, Ontario Business Corporations, 1982 231
APPENDIX 14. Sections 126-128, British Columbia Company Act 233
APPENDIX 15. Section 42, CBCA 235

TABLE OF ABBREVIATED REFERENCES

Reference:		Abbreviation:
England		
1.	Company Law Amendment Committee, 1925-26 Report.	Greene Committee
2.	Report of the Committee on Company Law Amendment, Cmd. 6659, 1960.	Cohen Committee
3.	Report of the Company Law Committee, Cmnd. 1749, 1962.	Jenkins Committee
Canadian		
1.	Proposals for a new Business Corporations Law for Canada by Robert W. V. Dickerson, John L. Howard and Leon Getz, 1971.	Dickerson Report
2.	Alberta Business Corporations Act.	ABCA
3.	Alberta Securities Act.	ASA
4.	British Columbia Company Act.	BCCA
5.	Canada Business Corporations Act.	CBCA
6.	Canadian Institute of Chartered Accountants.	CICA
7.	Generally accepted accounting principles as contained in the CICA Handbook.	GAAP
American		
1.	American Law Institute.	ALI

PART I. SUMMARY OF THE REPORT

Introduction

Section 42 of the ABCA was enacted in 1981. In broad terms, the section regulates the conditions under which a corporation may give financial assistance, directly or otherwise, to a shareholder or director of that corporation, or to any person in connection with the purchase of shares in that corporation where there are reasonable grounds for believing that the corporation is or would (after the transaction complained of) be insolvent. Certain exemptions are provided for. For instance a loan may be given to enable employees of a corporation to assist them to purchase or erect living accommodation for their own occupation.

The perceived evils sought to be addressed by the section are the prevention of the personal aggrandizement of directors of companies by "siphoning off" of corporate funds through loans to themselves, the inhibition of certain practices on corporate rearrangements or the sale of shares, and the protection of trade creditors.

The section has legislative predecessors in prior Alberta companies legislation, and many corporations statutes in the common law world contain provisions aimed at these same evils, although the precise terminology, terms, and strength of sanction, vary. The Alberta section closely follows the model first established in Canada by the CBCA.

Problems Arising with Section 42

This section has given rise to problems in practice and has attracted adverse comment from the practising bar and the financial community. The report suggests that these problems fall under several heads:

a) The ABCA makes a distinction between distributing corporations and non-distributing corporations. These two categories are functionally different. The former corresponds most nearly to the older concept of a public company and is characterised by diffuse shareholding (derived from public subscription) and a genuine "split" between management and ownership. The latter is more in the nature of an incorporated partnership with closed subscription, and a close - often indistinguishable - relationship between management and ownership. Section 42 does not observe this distinction. The rules laid down by the section apply to all corporations, without differentiation. In the result, some restrictions in fact apply which make no sense in particular cases.

b) The section attempts to protect creditors by ensuring that a corporation is "solvent" before the particular transaction is entered into. The concept of solvency - difficult at the best of times - is made even more difficult in the case of section 42 by a double-barrelled test. First, the corporation must be able "to pay its liabilities as they become due" (a "liquidity" test) and second, the "realizable value" of the corporation's assets must (after certain adjustments) exceed the aggregate of the corporation's liabilities and the stated capital of all classes of shares (an "underlying asset" test).

The interpretation and application of these provisions (particularly the latter) has proven difficult, and has led to doubts as to whether a corporation (even if it could otherwise meet the section) is within whatever the appropriate accounting formula is. Hence, it has been suggested, some commercial transactions have been unduly inhibited.

c) The precise effect of the section upon a transaction which infringes its provisions has been the subject of some debate. It appears to be the position that the security transaction is void and cannot be relied on in any way. The result is that a lender cannot recover a loan or at all. That is, the secured lender is placed in a worse position than even unsecured creditors. This, it is said, is contrary to the original intent of the framers of the present provision.

Hence, it has been suggested, the section is confusing in terms, uncertain of application, renders hazardous the giving of legal and accounting advice, and is Draconian in result.

The Protective Policy

On the other side, it can be said, and the report so argues, that there is a case for providing limited protective provisions. The report suggests that if the various transactions to which the section purports to apply are analyzed more closely, it becomes apparent that the section has brought together under one umbrella, and hence one set of criteria, situations which more properly require differential treatment. The report suggests that the relevant considerations vary amongst several different functional problems, and that each of those problems requires its own solution.

Comparative and Policy Perspectives

The Institute has been assisted in arriving at the foregoing strategic conclusion by a review of the historical evolution of this kind of protection in Alberta, and the position in other Canadian jurisdictions and other countries. We have looked at the strategy and structure of comparable provisions elsewhere. Several chapters record the research undertaken under those heads. Also, to the extent that it is necessary to appreciate the accounting and other commercial aspects of transactions affected by this section, a background chapter addressing those matters has been included. And, to the extent that some of the policy questions involve questions which may be thought to relate to the proper "philosophy" or "direction" of company law reform, a chapter on that topic is included.

Restructuring the Section

1) The report suggests that the present s. 42 of the ABCA should be repealed.

2) The report suggests that some degree of regulation is required, but that several discrete situations require differential treatment. A new section or sections should therefore be enacted, in accordance with the under-mentioned scheme.

3) For the purpose of this scheme, the distinction, already enacted in the ABCA between distributing and non-distributing corporations should be utilised, and applied to four discrete

situations.

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.

b) Financial assistance to directors and other persons with respect to non-distributing corporations should not be absolutely prohibited. Corporations 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 take-overs 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 <u>any</u> 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.

4) With respect to the effect of a transgression of the statutory prohibition, we do not think that it is appropriate that the transaction should be rendered absolutely void, as is the case under the present law. Recommendations are made which are designed to overcome the Draconian effect of the present law.

PART II. REPORT FOR DISCUSSION: PROVISION OF FINANCIAL ASSISTANCE

CHAPTER 1

INTRODUCTION

1.1 Since its introduction on February 1, 1982, no section of the Alberta Business Corporations Act (ABCA) has created more problems for the practicing Bar than section 42. This section attempts to regulate various forms of financial assistance granted by a corporation to its directors, shareholders and others.

1.2 This report suggests that a good number of the problems created by the present section 42 arise from its attempt to cover a variety of transactions under the same general rules.

1.3 There are four basic transactions that the section purports to cover. They are:

(1) Loans by the corporation to its shareholders or directors.

(2) Guarantees of repayment of an obligation owing by a shareholder or director.

(3) Charging the assets of the corporation to secure repayment of an obligation of a shareholder or director or a security for the performance of a guarantee given under 2. above.

(4) Financial assistance provided by the corporation in connection with transactions involving a purchase of

its shares.

1.4 All of these transactions are within the control of the corporation. They are consensual in nature in that the corporation is not compelled to enter into any of them. There is, however, a distinction between the first three and the last. Loans or financial assistance to a director or shareholder that are not connected with a transaction involving a purchase of the corporation's shares may have an adverse effect on the remaining shareholders or the creditors. Financial assistance in connection with a purchase of the corporation's shares will not adversely affect the shareholders of the corporation prior to the transaction if all of the shareholders sell. In any such case the resulting conflict is usually a priority battle among different classes of creditors. The first three transactions are directly related to the fiduciary duty of the directors: the last involves a far more difficult problem in the determination of the precise boundary of the fiduciary duty. A transaction involving the purchase of a corporation's shares may be the best course of conduct for the corporation. It may be desired by all, shareholders and creditors alike, but under the present section it may not be possible. These two problems have had a different history in both Canadian and English jurisprudence, which will be discussed later in this report.

1.5 We understand that the Alberta Bar has had considerable difficulty with this section. It has been suggested to us that lawyers in other Canadian jurisdictions that contain a similar section have also encountered problems. Indeed the problem is not confined to Canadian jurisdictions alone. Different jurisdictions have taken a surprisingly varied view of the nature and extent of any prohibitons of this kind that should be contained in their corporation statutes. We will outline briefly in subsequent chapters of this report the origins of, and the variety of statutory techniques which have been, or are now used in various jurisdictions. They range along a spectrum from absolute prohibition, through regulated prohibition, to no statutory prohibition at all. If the choice is to be at either end of this spectrum, that is, absolute prohibition or no prohibition, neither will present any great problem in drafting a statutory provision which will implement that choice. Any choice lying between these two extremes will inevitably require a number of policy decisions, and will likely give rise to difficult definitional problems.

1.6 This one section of the ABCA also raises fundamental questions concerning the position of the corporation in our society and the degree to which it should be regulated. Differences in philosophic outlook will undoubtedly produce differences in the suggested answers to these basic questions. For that reason, Chapter 7 discusses some of the fundamental policy issues involved in reform of modern corporations statutes.

1.7 We have presently no empirical data upon which to base our discussion. We do not know how many corporations have been adversely affected because they granted financial assistance to their directors or shareholders. We do not know how many minority shareholders have been prejudiced, how many creditors have gone unpaid, or how many lenders have found to their shock that their security is invalid and void. We do know from the number of inquiries that we have received, and our consultations, that the section has caused great difficulty for the practicing bar and that legitimate agreements for financing have had to be rearranged or in some cases cancelled completely. There are surprisingly few reported cases to "prove" that these things do happen. The few cases that are reported do not reveal any consistent approach. One reason for issuing a consultative report, rather than a final report is that it may be that there have been incidents of which we are not presently aware that have been caused by the terms of the present section. We encourage the profession to contact the Institute with respect to any operational difficulties which have been encountered in practice.

1.8 This report is intended to outline the evolution of provisions of this kind in Alberta and elsewhere, the nature and results of reported (litigated) cases, and some possibilities for reform. Further consultation will follow before final recommendations are made.

CHAPTER 2

THE ENGLISH EXPERIENCE

1. LOANS, GUARANTEES AND CHARGES ON ASSETS

(a) Statutory Provisions

2.1 It is somewhat surprising to find that the first statutory prohibition in the English Companies Acts preventing a corporation from granting a loan to, or guaranteeing the indebtedness of, any of its directors was enacted as late as 1948. The Greene Committee in its 1926 Report discussed loans to directors. In the Committee's view it was not "practicable or desirable to prohibit loans to directors, officers or managers of a company".[1] The Committee did not give any reason for this view and did not discuss any submissions it had received in this regard.

2.2 The Committee did however recommend that the aggregate amount of such loans should be disclosed in the company's annual accounts. Banks, lending companies and small loans to employees were to be exempt from the disclosure rules that it recommended. Neither the English Act of the time, nor the 1929 Companies Act which was based to a large degree upon the report of the Committee, contained an oppression section. The derivative action was still confined within the narrow limits set by the rule in Foss v. Harbottle.[2] Without these shareholder remedies it is difficult to understand just what benefit would be conferred by disclosure other than some loose form of moral

---

[1] Paragraph 48.

[2] (1843) 67 E.R. 461.

suasion. It is possible - although we do not know if it happened or to what extent - that loans to directors were regarded as an acceptable perquisite of office.

2.3 Section 128 of the 1929 Act[3] required that the annual accounts show all outstanding loans to directors and officers and any amounts repaid on such loans. Loans made by a company whose ordinary business was the lending of money and loans of £2,000 or less to an employee were exempted from the disclosure provisions.

2.4 In June of 1945 the Cohen Committee submitted its report. In paragraph 94 of that report the Committee set out its opposition to the granting of financial assistance by a company to one of its Directors or Officers in the clearest terms. It said:

> If the Director can offer good security, it is no hardship to him to borrow from other sources. If he cannot offer good security, it is undesireable that he should obtain from the company credit which he would not be able to obtain elsewhere.

The Committee recorded that it had heard of several recent cases in which directors had borrowed money from their companies on inadequate security and had been unable to repay the loans. It therefore recommended that, subject to certain exceptions, it should be made "illegal" for a company to grant financial assistance to its directors or officers. There was no discussion of the possible effect of this, namely, that if in spite of the statutory prohibition financial assistance was given to a director, even in such a simple case as a loan, that illegality might result in a void transaction and the company might never be

---

[3] Companies Act, 1929 (U.K.), c. 23.

able to collect the loan. One thing is apparent. There would have been no necessity for this recommendation if the Committee had felt that the established fiduciary relationship of a director to his or her company, and the very stern prohibitions that the English courts had evolved regarding a director in a conflict of interest situation was sufficient to prevent the abuses which they had cited.

2.5 Not all of the recommendations contained in the Cohen Report found their way into the 1948 Companies Act.[4] And section 190 of that Act[5] covered a broader range of subject matter than that discussed in the report. The section made it unlawful for a company to make a loan to a director, or a director of its holding company or to enter into any guarantee or provide security in connection with a loan to any such director. Four exceptions were provided. First, an exception was made for an exempt private company. This exception produced enormous definitional problems, and the concept of an exempt private company was later abandoned. Second, the prohibition did not apply to financial assistance given by a subsidiary to its holding company. Third, an exception was provided for expenses incurred or to be incurred by a director for the purpose of enabling him to properly perform his duties as an officer of the company. Fourth, lending companies were excepted.

2.6 The third exception was made subject to two conditions, contained in subsection (2). The financial assistance could only be given with the prior approval of the company given at a

---

[4] Companies Act, 1948 (U.K.), c. 34.

[5] See Appendix 1.

general meeting at which the purpose of the expenditure and the amount were to be disclosed, and if this condition had not been met at or before the next annual general meeting, the loan or the liability under the guarantee or the security had to be discharged within six months of the date of that annual meeting. Subsection (3) went on to say that where the approval of the company was not given as required under subsection (2) the directors were jointly and severally liable to indemnify the company against any loss.

2.7 In June of 1962 the Jenkins Committee submitted its report. It acknowledged that it had received submissions that section 190 should be subject to a further exception to provide assistance to a "working" director to purchase a house for his or her own occupation. It had also received submissions that there were gaps in the provisions; that the section could be circumvented and that it should be extended to prohibit loans by a company to another company in which a director of the lending company held a majority interest.

2.8 Part 1 of the Companies Act, 1967,[6] abolished the concept of the exempt private company which had caused so much trouble. and did implement a substantial number of the recommendations of the Jenkins Committee, but none that affected section 190 of the 1948 Act.

2.9 In November of 1977 the Department of Trade produced an in-house White Paper[7] The main thrust of the report deals with

---

[6] Companies Act, 1967 (U.K.), c. 81.

[7] Cmnd. 7037, November, 1977, The Conduct of Company Directors.

insider trading, but loans to directors are discussed in paragraphs 8 to 15. These recommendations appear to have been the basis for the provisions which were later implemented in the 1985 Companies Act. The report refers to a number of serious cases in which directors had sought to circumvent section 190 in order to obtain large sums of money from their companies. It states that the recommendations were made by inspectors following recent company investigations. In general there was to be greater disclosure of loans to directors for all companies. For public companies and private companies which belonged to a group including a public company it was proposed to widen the scope of section 190 to include in the prohibited class directors' families and companies in which a director had an interest. Criminal sanctions were also recommended. The report then went on to deal with the exceptions in section 190, of which only three remained following the repeal of the exempt private company. No great concern was shown with the exception granted to a subsidiary to lend money to its holding company, but further disclosure provisions were required in the annual accounts.

2.10 The White Paper recommended that an upper limit of 10,000 pounds be placed on the exception for expenses. It adopted the same technique with regard to lending companies and placed an upper limit of 50,000 pounds on a loan to a director of a lending company by that company. It also applied the same limit to loans to assist in providing housing for working directors. The Paper then went on to cover one additional point, namely a debt incurred by a director, including his or her family, in the normal course of trade. It recommended disclosure in any such case where the total indebtedness exceeded 5,000 pounds.

2.11 The Paper does contain some interesting statistics and comparisons with North American corporations. It mentions that outside directors are extremely rare in Great Britain. Only 35% of companies in the Times top 1,000 had more than two non-executive directors and 30% had none. In general, the Paper exhibited a concern that directors and management are, in the vast majority of cases, one and the same and that therefore this group must be controlled and regulated.

2.12 The 1985 Companies Act[8] contains even stronger sanctions. Sections 330 to 344[9] inclusive deal at considerable length and in astonishing detail with restrictions on loans and other financial assistance to directors. The general thrust is a flat prohibition subject to some exceptions. The range of the prohibited class has been extended as broadly as possible, as has the range of transactions, including a singularly opaque definition of a "quasi-loan". The provisions deal with inter-company loans in the same group, transactions at the behest of a holding company, provide for disclosure and upper limits wherever there is an exception, and give rise to civil remedies and criminal penalties.[10]

---

8 Companies Act, 1985 (U.K.), c. 6.

9 See Appendix 2.

10 For those who might, as an intellectual exercise, choose to find their way through this maze of regulation, we suggest reference to Tolley's <u>Company Law</u> at pages 270 and 271, wherein the learned author gives a two-page spreadsheet, complete with squares and lines in all directions, which may be of assistance.

(b) Common Law

2.13 It is difficult to assess the effectiveness of these statutory measures. There were no reported cases before they were implemented, nor were there any after. In 1926 the Greene Committee felt they were unnecessary. In 1945 the Cohen Committee noted cases of which they were aware. We do not know how or where they heard of them but it certainly was not as a result of any reported cases. In 1962 the Jenkins Committee mentioned no reported case nor can we find one dealing with the law regarding loans, guarantees or a charge on the assets of the corporation given for the benefit of a director. The Department of Trade White Paper was published in 1977 and no cases are mentioned, or cited.

2.14 By the time the 1985 amendments were enacted however, one case was before the courts. The 19 day trial in Rolled Steel Products (Holdings) Ltd. v. British Steel Corporation and Others[11] had ended in April of 1981, and it was known that the trial decision would be appealed. The brief facts of that complicated case are that S owned 51% of the shares of company A and 100% of the shares of company B. The remaining 49% of the shares of A were held by a trust in favour of the children of S. In spite of the very broad objects contained in its Memorandum of Association, A's main purpose was to hold the necessary land for the operations of B. B advanced £400,000 to A in order that A could purchase and erect the necessary building to carry on B's operations. In the meantime, B had become indebted to its main supplier in an amount in excess of £800,000. The supplier grew

---

11 [1985] 3 All E. R. 52 (C.A.).

restless. In May of 1968 S hoped to buy some time and agreed at the insistence of the supplier to execute a personal guarantee of the indebtedness owed by B. He did not get much time. Fifteen days after execution of the guarantee, the supplier demanded payment from him of the entire amount due by B. Negotiations dragged on but finally in January of 1969 documents were completed under which the supplier agreed to lend £400,000 to A. A in turn was to immediately repay its debt of £400,000 to B. B would then pay the same amount to reduce its indebtedness to the supplier. This money went the full circle in one day. On the same day A executed three documents. First, a guarantee of payment of the balance owing to the supplier by B. Second, an agreement under which A acknowledged its indebtedness of £400,000 to the supplier and that it had guaranteed payment to the supplier by B. Further, unless by the 17th of February, 1969 it had sold sufficient assets to discharge both these liabilities, A would issue to the supplier a debenture to secure the outstanding amount on both accounts. Third, a debenture issued by A in favour of the supplier which was to be held in escrow until the 17th of February, 1969 to enable A to sell certain assets. If these assets had not been sold by that time the debenture was to be delivered to the supplier. The assets were not sold. The debenture was delivered. Under its terms the supplier was entitled to demand immediate payment, and if payment were not received by the 1st of April the company was entitled to appoint a receiver. Demand was made on the 12th of March. Payment was not forthcoming. Clearly the entire transaction benefited S since the assets of A were not available to pay the debt of B, repayment of which had been guaranteed by S personally. The formal resolution of the directors of A approving execution of all of these documents made no mention of the fact that S was in a conflict of interest position, or that he had disclosed his conflict to the meeting of the board. The receiver was able to realize a substantial sum out of the assets of A. £1,025,000 was paid to the supplier, being the total debt plus interest, £50,000 was paid to the receiver, but there were no excess funds with which to pay the unsecured creditors of A. A sued to set aside the guarantee, the agreement and the debenture and therefore the appointment of the receiver, and to obtain repayment from the supplier of all monies received by the receiver. In the meantime S was declared bankrupt, and the other director of A (the father of S) had died and there was not much money in his estate. There was no point therefore in arguing about the fiduciary relationship owed by the two directors of A since a judgment would be of little use. The transaction was not caught by section 190 of the 1948 Act since the guarantee was not given with regard to a director or a director of a holding company, but with regard to the indebtedness of another company. The decision therefore depends entirely on common law principles.

2.15 The first of these is *ultra vires*. The Court of Appeal were at great pains to point out that all of the transactions involved took place before the enactment of section 9 of the European Economic Communities Act.[12] *Ultra vires* has been described in one recent article as "one of company law's oldest fresh problems"[13] Slade, J., who gave the main judgment in the Court of Appeal, discusses two types of *ultra vires*. One

[12] European Economic Communities Act, 1972 (U.K.), c. 68.

[13] G. Shapira, "Ultra Vires Redux", (1984) 100 L.Q.R. 468.

involves an act beyond the capacity of the company, in which case that act is void and no defence or ratification is possible. The second type is that in which the act is beyond the power of the company or the authority of the directors. In such a case a defence based on the principle enunciated in Royal British Bank v. Turquand[14] is available to an outsider, providing always that the outsider did not have actual knowledge of the absence of power or lack of authority. His Lordship then concludes that the relevant transactions were not beyond the corporate capacity of A, but beyond the authority of the directors because they were entered into in furtherance of purposes not authorized by the Memorandum of Association of A. Because the supplier had knowledge of this lack of authority (its own solicitors had warned it of the problem) the transaction should be set aside.

2.16 His Lordship then went on to find that the directors of A were not only acting in breach of the Articles of Association, but also of their fiduciary duties. As trustees of the company's funds they had committed a breach of trust and the third party was well aware of it. The third party could therefore not conscientiously retain those funds unless it had a better equity. In effect, the third party became a constructive trustee for the misapplied funds. The original £400,000 which had been lent to A, and which went full circle, did confer a benefit on A by reducing its indebtedness to B. The supplier was therefore entitled to retain this sum but without interest. The remainder of the funds, including the receiver's charges of £50,000 were to be repaid to A.

---

[14] (1856) 119 E. R. 327.

2.17 English company law has always seemed uneasy with the concept of limited liability. There are historical reasons for this, but it is surprising that the influence of the past has lasted so long. The Memorandum and Articles of Association structure of a company as interpreted by the English courts would seem to involve two fundamental concepts. The first is the sanctity of capital. The paid up capital of a company was the only fund to which creditors could look. Any action by the company which reduced this capital, other than those specifically permitted in the Act, was an *ultra vires* transaction. The second was the restricted capacity of the corporate personality. A company incorporated under a Memorandum and Articles jurisdiction has only the capacity to do those acts which are included either specifically or by necessary implication in its Memorandum of Association. One would have thought that with the decision in Bell Houses Ltd. v. City Wall Properties Ltd.[15] the long war between the practitioners and the judges had finally been won by the practitioners. Rolled Steel appears to indicate that the judges are still fighting in the trenches, drawing distinctions between objects and powers, and still limiting powers to their application as necessarily incidental to achievement of the objects of the company. The indoor management rule as expressed in Royal British Bank v. Turquand[16] has been given remarkably inconsistent application. It remains to be seen whether the English attempt to abolish the principle of *ultra vires* in section 9 of the European Economic Communities Act will be effective to do so.

---

[15] [1966] 2 All E. R. 674.

[16] Footnote 14, supra.

2.18 In summary therefore, the English experience would seem to indicate that whatever common law prohibition may exist depends upon the doctrine of *ultra vires*. Whether or not a particular action is *ultra vires* depends firstly upon the Memorandum of Association of the company. The company, being an artificial person, has no capacity to do anything outside of the objects specified in its Memorandum. If the transaction is outside those objects it is void unless it can reasonably be implied that the action is necessarily ancillary to one of its objects. If however the company has the capacity to carry out a transaction but has not done so in compliance with the manner of exercising its powers contained in its Articles of Association then the transaction may be voidable. A third party whose contract is under attack can use the indoor management rule first expressed in Royal British Bank v. Turquand.[17] Applied to the facts in Rolled Steel, the lender does not have to inquire as to the purpose of the loans, but having done so and having obtained knowledge that the actual execution of the documents regarding the loan do not comply with the provisions contained in the Articles of Association, then the indoor management rule has no application. As many a mother has said of her children, "it is better not to know".

2. TRANSACTIONS INVOLVING SHARES

(a) Statutory Provisions

2.19 In contrast to the prohibition regarding loans, guarantees and a charge on the assets of a corporation for the benefit of its directors, the prohibition against a company

[17] Footnote 14, supra.

providing financial assistance in connection with a purchase of its shares first appeared as section 45 of the 1929 Act.[18] In paragraph 30 of its report, the Greene Committee discussed a practice which had apparently become fairly common following World War I in which syndicates or individuals would obtain short-term financing to buy control of a company. Having done so they would appoint themselves as directors and cause the company to lend them sufficient funds to repay the short-term loan. The Committee considered these transactions to be, "highly improper and to offend against the spirit if not the letter of the law which prohibits a company from trafficking in its own shares". Just why the Committee regarded these take-overs with such displeasure is neither analyzed nor explained. In any event, the Committee recommended a statutory prohibition subject to two exceptions, the first being the ubiquitous lending company and the second being an employee share purchase plan where the shares were to be held by a trustee for the benefit of the company's employees.

2.20 These recommendations were adopted with minor changes and became section 45 of the 1929 Act. Under that section, as enacted, it was unlawful for the company to give financial assistance, directly or indirectly, to any person in connection with a purchase of shares of the company. Three exceptions were provided. First, the lending company; second, the trusteed employee share purchase plan; and third, loans to employees other than directors to enable the employees to purchase shares directly. Disclosure of loans under the last two exceptions had to be shown as a separate item in the balance sheet of the

[18] See Appendix 3.

company. The sanction provided for a maximum fine of £100 against the company and every officer of the company in the case of contravention. The word "officer", as in other English enactments, was defined to include a director.

2.21 Nineteen years later the Cohen Committee recommended only two small changes to section 45. The first was to extend the prohibition not only to shares being purchased but shares to be issued, and the second was to prohibit a subsidiary from providing financial assistance in connection with a purchase of shares of its holding company. English law then, and today, contains no section similar to ABCA section 30. It did not recommend an outright prohibition preventing a subsidiary from holding shares in the parent company, but did suggest that the subsidiary should not be able to vote such shares. These recommendations were adopted and became section 54 of the 1948 Companies Act.[19] Except for these minor variations, and no mention is made in the section of the exclusion of the voting power, section 54 is nearly identical to the former section 45. It is not reproduced as part of the paper because of the similarity.

2.22 The Jenkins Report contains, in paragraphs 170 to 186 thereof, one of the few thoughtful and analytic discussions of the problems in this area of the law. Some of the submissions which they received will have a familiar ring to the ears of Alberta lawyers struggling with ABCA section 42. The first complaint about section 54 of the 1948 Act was that it was drawn in terms so wide and general that it either penalized or

---

[19] Footnote 4, supra.

prohibited a number of innocent and legitimate transactions. Some of the submissions questioned whether the section served any intelligible purpose. All submissions agreed that clarification of the wording was needed and that by and large the section was usually ignored. The Committee pointed out that there was a clear distinction between a company buying its own shares and providing financial assistance regarding the purchase of its shares. The first involves a reduction of the company's capital; the second does not. In the Committee's view the purpose of the section is to prevent abuses which might arise when buyers with insufficient funds acquire control of a company. In such cases the buyers will inevitably be forced to use the company's funds to pay for the shares. No one would suffer if the company continued to operate profitably, but they felt it all too likely that the purchasers, having gained control and having a debt to repay, would cause the target company to part with its assets for inadequate security or illusory consideration. The Committee concluded that section 54 had proved to be an embarrassment to the honest without being a serious inconvenience to the unscrupulous.

2.23 The Committee then turned its attention to possible solutions. Analyzing the "scandalous malpractices"[20] it concluded that these occur where the acquirer, having gained control with no prospect of paying for it, must do so out of the company's funds. All too frequently when this had occurred, the company had failed financially; the company's remedies against the acquirer were worthless because the acquirer had disappeared, disposed of his assets or was insolvent. The Committee suggested

[20] Paragraph 175.

that the ideal solution would be to prevent the transaction from taking place at all, rather than imposing sanctions after the event. The only way in which this "cut them off at the pass" approach would be effective would be a provision that blocked the interim loan to be granted to the acquirer in order to gain control.

2.24 Attractive as this solution appeared at first glance, the Committee felt that it would not be possible to implement such a prohibition without imposing a totally unreasonable burden on banks and financial institutions. Instead it sought to protect the classes of persons who might be adversely affected, namely, minority shareholders and creditors.

2.25 Minority shareholders were to be protected by the requirement of a special resolution of the shareholders (75% under the Companies Act of the time). Furthermore, the resolution was not to be effective for 28 days after its passage. During that period 10% or more of the shareholders could apply to the court to prohibit the transaction. In the event of a unanimous resolution by the shareholders there would be no 28 day waiting period.

2.26 Creditors were to be protected by a requirement that the resolution would not be effective unless, at the time it was filed with the Registrar, it was accompanied by a statutory declaration of solvency completed by all of the directors if there were only two and by a majority if more than two. Directors who made the declaration without reasonable grounds were to be subject to severe penalties. If within 12 months of filing the declaration the company went into liquidation and its debts were not paid in full, then there was to be a presumption that the declaration had been made without reasonable grounds.

2.27 The Committee recommended that the solvency declaration disclose the form of the assistance, the person to whom it was to be given and the purpose for which it was intended. In addition the declaration was to contain a statement that the declarants had made full inquiry into the affairs of the company and that having given effect to the transaction the company would be able to pay its debts as they fell due. It specifically rejected the idea that in making the declaration, the declarants must assume that the funds used to assist the transaction would be lost to the company. It further recommended substantial penalties be imposed on any officer who was in breach, but pointed out that it would not be reasonable to impose the penalty on the company as the existing section 54 did, since this would only penalize the minority shareholders that the section was designed to protect.

2.28 It then went on to recommend that the transaction in breach of the conditions should be voidable at the instance of the company as against any person who has notice of the facts. It was felt that this would be a safer course than an absolute sanction. In the Committee's view a lender who knew neither the purpose of the loan nor the fact that repayment to him had been made possible by a breach would be prejudiced. If the lender had notice of the purpose and accepted repayment without inquiring whether the suggested provisions had been complied with then, in its opinion, the lender should be liable to compensate the company to the extent that it had been prejudiced. In the event of liquidation, the liquidator of the company would have a remedy against the directors for misfeasance and against the person who provided the assistance with knowledge that it was in breach of the section.

2.29 In spite of representations that there should be an exception for housing in favour of working directors the Committee did not recommend any such exception. The remainder of its recommendations dealt with rather small and insignificant drafting problems that had arisen.

2.30 These recommendations did not find their way into legislation until the enactment of the 1985 Companies Act. Chapter 6 of that Act deals exclusively with financial assistance by a company regarding a purchase of its shares, through sections 151 to 158.[21] Section 151 imposes the general prohibition. It has been both carefully and broadly worded. It also includes a provision that every officer who is in default is liable to imprisonment or fine or both. Section 152 contains definitions for the chapter and defines financial assistance, distributable profits and distribution. The definition of distribution is interesting in that it refers to section 263(2) of the Act. Under that section English company law imposed a new obligation. Dividends could no longer be paid until all previous losses had been made up. Sanctity of capital was still alive and well.

2.31 Section 153 provided for the following exceptions:

(1) A company can give financial assistance for the purpose of acquisition of shares in itself or its holding

[21] See Appendix 4.

company if the giving of assistance is but an incidental part of some larger purpose, or if the assistance is given in good faith and in the interests of the company.

(2) This exception is similar to (1) except that it applies to any person, not just to the company itself or its holding company.

(3) The section did not prohibit a lawful dividend, an allotment of bonus shares (share dividend), a reduction of capital confirmed by order of the court or anything done under a compromise or arrangement sanctioned by the court.

(4) Subsection (4) contained three additional exceptions. First, once again, the lending company was excepted. Second, employee share purchase schemes which applied to the company or its holding company. Under the curious wording of this exception it would seem to imply a trusteed share purchase plan. The third was simply the provision of loans to persons (other than directors, to enable them to purchase shares of the company or its holding company).

2.32 Section 154 went on to provide special restrictions for public companies. The exceptions contained in subsection (4) of 153 were only to be available providing the company could meet a solvency test.

2.33 Section 155 relaxes the provisions of section 151 for private companies. A reading of this section will reveal the detailed nature of its provisions. The meat is contained in subsection (4) which requires a special resolution of the shareholders.

2.34 Section 156 provides for the statutory declaration under section 155, and embodies the recommendations of the Jenkins Committee, with one addition, namely, that the directors' statutory declaration have annexed to it a report of the company's auditors stating that the auditors have inquired into the state of affairs of the company and that they are not aware of anything to indicate that the opinion expressed by the directors in the declaration is unreasonable in all the circumstances.

2.35 Section 157 implements the recommendations of the Jenkins Committee that 10% of the shareholders could object after the special resolution had been passed, and section 158 deals with the time frame in which it is permissible to give financial assistance. (It must be remembered that sections 155 to 158 deal only with private companies.)

2.36 Generally the restrictions were tightened up with regard to public companies. Even the exceptions contained in section 153(4) are subject to the solvency test. On the other hand, the restrictions have been relaxed somewhat regarding private companies since assistance is permitted providing the assistance has been approved by a special resolution of the company, the declaration of solvency is completed and 10% or more of the shareholders have not exercised their right to apply to the court to block the transaction. The actual sections as enacted also contained a further provision that the assistance must be given within 8 weeks from the day in which the directors of the company made their statutory declaration regarding solvency.

(b) Case Law

2.37 Unlike the statutory provisions with regard to loans to directors, there are a good number of reported cases dealing with financial assistance given by a company in connection with a purchase of its shares. They fall into two groups; those concerned with section 45 of the 1929 Act (including, in one case, litigation concerning a counterpart of that section from Australia) and those in which section 54 of the 1948 Act was in question. No case has yet come before the courts concerning the provisions contained in the 1985 Act. A discussion of these cases is useful because it indicates the sorts of difficulties courts have had with these kinds of provisions, and because it illustrates the kinds of fact situations that may be considered sufficiently objectionable that some legal sanction is desirable. The cases, in short, are a reflection of real life behaviour.

2.38 Spink (Bournemouth) Ltd. v. Douglas Oliver Spink[22] is the first case in which the courts were called upon to consider the effect of section 45 of the 1929 Companies Act. Douglas Spink, his brother and one other were the only shareholders of the plaintiff. The brothers had a falling out and in the autumn of 1934 they agreed to part. Douglas, in consideration of £100 paid by the company and a release of any and all indebtedness owed by him to the company, resigned his life directorship and entered into a restrictive covenant not to compete for five years

---

22 [1936] 1 All E. R. 597.

within 10 miles of Bournemouth. As part of the transaction, he also agreed to sell his shares to his brother for £250. Both cheques were paid by the company. In February of 1936 Douglas became sales manager of a firm in direct competition with the plaintiff and the plaintiff sued to enforce the restrictive covenant. Douglas defended on the basis that the £250 had been paid by the company in connection with a purchase of the company's shares and since this was unlawful under section 45 the whole transaction was void and unforceable. He did not succeed. Luxmore J. held first, that the components of the transaction were severable, and second, that there was insufficient evidence that the payment of £250 had been made for the particular purpose of enabling John to purchase the shares. This second holding by the learned judge flies in the face of the agreed facts, but it is obvious that the court was approaching the whole question of the affect of illegality of the contract with great caution.

2.39 The next case to come before the courts was in Re V.G.M. Holdings, Limited.[23] This case was heard by Lord Greene M.R. (who had been the Chairman of the Greene Committee). Three gentlemen had incorporated V.G.M. Holdings, Limited, with a capital of £20,000 divided into 20,000 shares of £1 each. They had subscribed for all of the issued capital, paying 4 shillings per share down and the remaining 16 shillings per share being subject to call. These gentlemen then caused the company to buy all of the shares of another company (Century) and in a one-day transaction the company issued a cheque to Century, Century issued cheques to its shareholders, who were the same as the shareholders of the company, and the shareholders immediately

[23] [1942] 1 Ch. 235.

endorsed the cheques back to the company, thereby paying off the call on their shares. Shortly thereafter Century went into voluntary liquidation. Approximately one month later V.G.M. was ordered to be wound up. The liquidator took out a summons alleging that the payment to Century was made fraudulently, in breach of trust, and also in breach of the provisions of section 45 of the Companies Act. Lord Greene repeated almost word for word the commentary contained in the Greene Committee's report as to the origins and the necessity of section 45. However he held that section 45 did not apply in this case since it was not a question of "a purchase" of shares, but simply in connection with "the subscription for the company's shares". In spite of his strong views he was not prepared to extend the section to include payment for a subscription for shares.

2.40 The next case to come before the English courts was Victor Battery Co. Ltd. v. Curry's Ltd. and Others.[24] J agreed to buy all of the issued shares of Victor Battery, (B), for £15,000. J paid £6,000 down, and the remaining £9,000 was to be paid over a short period of time. J persuaded the plaintiff's main customer to advance £10,000 to himself and two other companies which he controlled, and as security for repayment of the loan from the supplier, J caused B to execute a floating charge debenture in the amount of £10,000 in favour of the supplier. J used approximately £1,200 for his personal use and the remainder he used to pay off the indebtedness regarding the shares so that he became the owner of all of the shares of the plaintiff. Payments due under the loan fell in arrears, and a receiver was appointed. The plaintiff commenced an action for a

[24] [1946] 1 All E. R. 519.

declaration that the debenture was invalid in that it contravened section 45 of the Act. Roxburgh J. held that the security was valid. His Lordship pointed out that the penalty in the section was a fine not exceeding £100. If the debenture was held to be invalid a company could obtain a loan of £100,000 in contravention of the section, shortly thereafter repudiate it and be subject only to a fine of £100. In the opinion of the learned judge such a result would be both fantastic and unreal and he therefore refused to place this interpretation upon the section. He went on, however, to point out that if he was wrong, and if the debenture was an illegal contract the general rule is that neither party can take action to affirm or disaffirm unless the party seeking the aid of the court is one of the class of persons for whose protection the illegality of the contract has been created. He pointed out that the only person named in the section is the company itself. Citing <u>V.G.M. Holdings Ltd.</u> he concluded that the section had been enacted to protect creditors of the company, not the company itself. The company therefore was not included in the class of persons designed to be protected by the statute and therefore was not entitled to seek the assistance of the court in either affirming or disaffirming an illegal contract.

2.41 Section 54 of the 1948 Act was designed to cover the gap pointed out by Lord Greene in <u>V.G.M. Holdings Ltd.</u>. The prohibition was extended to cover not only a purchase of shares but a subscription of shares. The requirement to show as a separate item any outstanding loans made pursuant to the exceptions for employee share purchases was dropped. In 1957 the section was extended by adding a provision prohibiting the lending of money by a company to assist a subscription for the shares of its holding company.

2.42 Following the enactment of the new section 54 of the 1948 Act, the first case to come before the courts, was the leading case of Selangor United Rubber Estates Ltd. v. Craddock and Others.[25] The facts are complicated (there were ten defendants in the case) but can be summarized as follows. Following the end of World War II and the independence of Malaya, the English rubber companies that had been operating in that country were bought out. Selangor was one of these. In 1958 it had liquid assets of £235,800, a listing on the London Stock Exchange and no business other than managing its investments. A common scheme of the time was for an entrepreneur to buy more that 75% but less than 80% of the shares of any of these shell companies. Having acquired control of the company he would transfer to it an asset at his cost, and then have the company sell the asset at a profit. The entrepreneur would then be able to sell his shares on the stock exchange for a considerable profit which, under the tax laws of the time, would not attract capital gains tax. Because of the stock exchange listing, the shares in these companies were sold at a slight premium. In the case of Selangor the premium was fixed at £9,250. Shareholders who did not accept the take-over offer would share in the appreciation of the value of the shares.

2.43 To put the necessary facts of this case as simply as possible, a small merchant bank (Contanglo, one of the defendants) acting on behalf of Craddock, offered to buy all of

---

[25] [1968] 2 All E. R. 1073.

the shares of Selangor for 5 s. 1 1/2 d. per share which price represented the net asset value of Selangor plus the premium. Contanglo acquired 79% of the shares of Selangor for a total of £195,000 which included the price to be paid for the shares, some expenses and Contanglo's fee of £7,500. Under the arrangement between Craddock and Contanglo, Contanglo was to attend at the closing to pay for the shares. The closing would include the resignation of the former directors and the appointment of Craddock and his nominees as the new directors. Craddock undertook to pay Contanglo the £195,000 within 7 days of closing. Immediately after the closing Craddock caused Selangor to lend to another company controlled by him £232,500 at 8%. That company immediately lent the same sum to Craddock at 9% and Craddock paid Contanglo the £195,000. No assets were ever transferred to Selangor. In fact while not important for our consideration of the decision, Craddock assigned his entire interest in the transaction to one Burden. Not long after these events, Selangor was forced into compulsory liquidation and an action was commenced by the Board of Trade in the name of the company.

2.44 The case deals with nine distinct points of law but the one that concerns us is the effect of section 54 of the 1948 Companies Act. Having found a breach of trust by Craddock and his nominees as directors of Selangor, the court then considered the defence of illegality. The general rule concerning the unenforceability of an illegal contract was acknowledged. However in this case Selangor had suffered the loss due to a breach of trust by its own directors. This breach of trust included causing Selangor to act in contravention of section 54. Therefore the defence of illegality was unavailable to the directors. The court then discussed at some length the Victor Battery case and disagreed with Roxburgh's conclusion in that case. It acknowledged the harshness of the illegality rule, but re-affirmed that it was rooted deep in public policy and that the harshness was a necessary concommitment to enforce that policy. In essence the court concluded that, had there been no breach of trust by the directors, the defence would have been available.

2.45 Put in its shortest terms, Selangor before the transaction had £232,500 in cash. After the transaction it had had an unsecured debt owed to it by one of Mr. Craddock's companies which bore interest at 8% but proved to be uncollectable. While the law is exhaustively discussed, the decision and a later decision in the same case (Selangor, No. 4)[26] settling the general terms of the order, it is difficult if not impossible to tell just how many shares were issued and outstanding in Selangor before the transaction and just precisely what the actual figures are that resulted from the formula used in settling the terms of the order. At first blush the blunt statement as to what happened to the company's money would indeed indicate that something was seriously wrong, but on further examination it is not clear where the money went, and who was adversely affected. The company was not carrying on any active business, therefore there were no creditors of the company who were adversely affected. The action was commenced by the Board of Trade following an investigation and with the authority of the liquidator of the plaintiff company, but there is no indication as to how the liquidator was appointed or at whose behest he was appointed. Sorting through the mass of figures that are given in

[26] [1969] 3 All E. R. 965.

the judgment and the complexities of the transaction, it is apparent that 79% of the shareholders received a completely fair price for their shares since the price was based on the net asset value plus the premium. The other 21% were either slow off the mark or were prepared to take their chances that the value of their shares would increase.

2.46 In the final result, Mr. Craddock and Selangor's bankers, together with some other defendants, were held jointly and severally liable for the £190,000, and Mr. Craddock was held liable for the remainder of the money that had disappeared from Selangor. Under the formula used for the final judgment the defendants were entitled to a credit of £190,000 less the costs times the 79%. It is not clear how much this amounted per share to the 21% of the shareholders who did not sell. Presumably they got something close to the 5 s. 1 1/2 d. per share on the liquidation of the company, less the liquidator's costs.

2.47 In the later case of Karak Rubber Co. Ltd. v. Burden and Others (No. 2),[27] a decision of Brightman J. involving a similar transaction, (indeed some of the playes are the same) it is possible to work out some of the figures. The net assets of the company were worth 41 s. per share. The offer was made at 44 s. per share and 77.5% of the shareholders accepted the offer. At the end of the day when all of the smoke had cleared the 22.5% of the shareholders who did not sell would have received 54 s. per share less the costs of the liquidator.

2.48 In Heald and Another v. O'Connor,[28] Fisher J. also

[27] [1972] 1 All E. R. 1210

[28] [1971] 2 All E. R. 1105.

disagreed with Mr. Justice Roxburgh. In that case he held a debenture that had been given to secure payment of the balance owing on a share purchase to be invalid. Fisher J. stressed the deterrence factor and felt that it was much more likely to be effective if the result was that the transaction was void rather than a small fine. The fact that the holder of a security or the indebtedness could not collect, in his opinion, would more effectively discourage such transactions.

2.49 The matter was finally laid to rest in Belmont Finance Corporation v. Williams Furniture Ltd.[29] In that case the Court of Appeal held that the agreement involved was illegal under section 54. This being so, an agreement between two or more persons to effect an unlawful purpose is a conspiracy. While the company involved had executed the agreement and was therefore a party to the transaction, it was not a co-conspirator; it was the object of the conspiracy. As a result of the transaction the company had been denuded of over £400,000 and in any event the conspiracy consisted of the negotiations prior to the agreement. The agreement simply implemented the conspiracy and the plaintiff company was not a party to the conspiracy. The plaintiff was therefore entitled to bring the action and the defence that it was a party to the illegal transaction failed.

2.50 One other case deserves mention before proceeding to the next chapter. It is the New Zealand case of Re Wellington Publishing Company Limited.[30] Wellington made a take-over bid for all of the shares of Blundell Brothers Ltd. Payment was to

---

[29] [1979] 1 All E. R. 118.

[30] [1973] 1 N.Z.L.R. 133.

be made by allotting three shares of Wellington for every five shares of Blundell together with a cash payment of 95¢ per share. The offer was accepted and Wellington had to find just under $3,000,000 to pay the 95¢ per share. Wellington proposed to cause Blundell to pay a dividend of $3,000,000 out of its liquid assets. There was no question that this money would ordinarily be available for payment of a dividend. However two directors of Wellington raised questions as to whether this payment would be in breach of section 62 of the New Zealand Companies Act 1955 which read as follows:

> 62(1) Subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security, or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company.

2.51 The court held that payment of a dividend was an ordinary function of any company, and indeed one of its primary functions. So long as the payment of the dividend did not contravene the provisions regarding dividends this was a perfectly legitimate transaction. Wellington as the sole shareholder of Blundell could cause Blundell to pay the dividend at any time and for any purpose from the funds that were legally available to do so. The court further pointed out that, given that Wellington owned all of the shares of Blundell, there were no minority shareholders of Blundell who could be adversely affected, and that following declaration of the dividend and payment to the former shareholders Wellington would have total assets of approximately $5,700,000 and current liabilities of

$2,500,000. There was therefore no creditor who would be placed at risk.

2.52 In an interesting argument, counsel opposing the transaction suggested that future creditors should also be taken into account. The court firmly rejected this argument, implying that it would be totally unrealistic to impose upon directors of a company an obligation to have regard to the demands of creditors who may at some indefinite time in the future appear and who may never appear at all. This decision appears to have been enacted as one of the exceptions in section 153(3) of the 1985 English Companies Act, insofar as section 151 does not prohibit a distribution of the company's assets by way of dividend lawfully made or a distribution made in the course of the company's winding up.

2.53 These cases reveal a distinct attitude on the part of the English courts with respect to the the effect of illegality. With the exception of the Victor Battery case (which was later overruled) the courts have unanimously held that a transaction in contravention of the section is an illegal agreement and therefore unenforceable by any party to it. They have, however, recoiled from the logical result of this finding, (which would leave the company without a remedy) and have resorted to misfeasance on the part of the directors, the law of conspiracy and the imposition of constructive trusts to give relief. They have clearly relied on the disastrous effect upon the third party as the main mechanism to enforce compliance with the section. By the use of the words "It is not lawful" in section 151 of the 1985 Act it is apparent that English company law proposes to continue to do so.

2.54 For nearly 60 years English company law has regarded financial assistance by a company in connection with a purchase of its shares as an act that is somehow or other wrongful in itself. The basis suggested in the report of the Greene Committee for this is questionable. Such a transaction is not analogous to the prohibition preventing a company from buying its own shares. The analysis contained in the report of the Jenkins Committee is both more careful and more accurate. Yet there are relatively few cases that have come before the courts. The cases that have come before the courts have done so at the instigation of a receiver, liquidator or arising from an investigation by the Board of Trade. It is an inescapable conclusion that providing no creditor or minority shareholder has been adversely affected the section has never been put to use. This suggests the question: Is the protection the prohibition purports to afford worth the cost imposed upon businessmen and their advisors to ensure that any proposed transaction is not caught by the section and the inhibiting effect on what might otherwise be legitimate transactions?

CHAPTER 3

THE LAW IN ALBERTA

1. PREDECESSOR ACTS

3.1 The statutory provisions found in Albėrta company law have followed a slightly different path from the English provisions. The prohibition against loans to directors has been with us since 1886. In contrast, the statutory prohibition regarding financial assistance by a corporation in connection with a purchase of its shares did not appear in the Alberta Companies Act until 1954. Unlike the English provisions which separate the two classes of transactions, since 1954 the Alberta statutory provisions have been combined both in one section, and this arrangment was continued in section 42 of the ABCA.

3.2 The Northwest Territories Ordinance of 1886[31] created the first non-federal corporation statute applying to (*inter alia*) what is now Alberta. Section 66 of that Ordinance[32] imposed a flat prohibition: no loan shall be made by the company to any shareholder. The sanction provided was to impose joint and several liability on all directors and officers of the company who made the loan. They were to be liable for the amount of the loan with interest both to the company and also to any creditors of the company for all debts of the company existing at the time the loan was made. The ommission of directors from the prohibited class is explained by section 35 of the Ordinance which, unlike the present ABCA provisions, contains only one

---

[31] Companies Act, O.N.W.T. 1886, c. 6.

[32] See Appendix 5.

qualification to be a director, namely, that person must be a shareholder of the company. The prohibition applying to shareholders therefore included directors.

3.3 In 1901 the Northwest Territories changed from a grant of letters patent jurisdiction to a Memorandum and Articles of Association jurisdiction.[33] The former section 66 became section 53 of the new Act,[34] but nowhere in the 1901 Act, or in the Table A Articles of Association appended to it, is there any counterpart to section 35. A loan by the company to a director who was not a shareholder would thus not be caught by the prohibition. Presumably no one at the time could believe that such a strange being as a director who was not a shareholder could possibly exist.

3.4 In 1929 Alberta adopted a substantially similar version to the recently enacted English Companies Act. Section 14(1) of the 1929 Act[35] contained a flat prohibition, applicable to public companies only, and prohibited loans to shareholders or directors. Subsection (2) provided an exception for loan companies.

3.5 In 1934 sanctions were added to the section by a new subsection (3).[36] The company and any person who contravened the Act were guilty of an offence. Directors were henceforth liable to compensate the company and any person injured for any loss, but a director was not liable if he could prove that the

[33] Companies Act, O.N.W.T. 1901, c. 20.

[34] See Appendix 6.

[35] See Appendix 7.

[36] See Appendix 8.

contravention was not due to his misconduct or negligence and proceedings to recover any loss had not been commenced within two years. The somewhat unusual wording provided an absolute defence after two years and a conditional defence before that time.

3.6 By a 1954 amendment,[37] the section was repealed and replaced by the present section 14 of the Alberta Companies Act.[38] The prohibition contained in subsection (1) of the present section applies only to public companies and their shareholders and directors; applies not only to loans but to any financial assistance whether direct or indirect, by means of a loan, guarantee, the provision of security or otherwise; or in connection with the purchase of any shares of the company. Subsection (2) provides four exceptions. First, if the lending of money by the company is in the ordinary course of its business. Second, to employees, whether or not they are shareholders or directors, to assist in acquiring housing for their own occupation. Third, to provide money for the purchase by trustees of fully paid up shares in the capital stock of a company to be held for the benefit of employees, including any director holding a salaried employment or office in the company. Fourth, a loan to employees of the company, including directors holding salaried employment, to enable them to purchase fully paid up shares in the capital stock of the company.

3.7 Subsection (3) provided the sanctions. Those involved in making the loan were no longer guilty of an offence. Directors and officers making the loan were, until repayment of

---

[37] S.A. 1954, c. 14, s. 4.

[38] See Appendix 9.

the loan, jointly and severally liable to the company and to any person injured for any loss that the company or that person sustained. Subsection (4) placed a limit on the liability of the directors to the amount of the loan plus interest stipulated in the loan, and provided that a director should not be liable if he proved that the contravention was not due to any misconduct or negligence on his part. Subsection (5) imposed a limitation period of two years from the date upon which the loan was made, after which no action could be commenced against the directors.

2. BACKGROUND TO SECTION 42, ABCA

(a) The Dickerson Report

3.8 The ABCA is derived in the main from the CBCA, enacted following the Dickerson report. Paragraphs 145, 146 and 147 of that report deal with what was to become section 42 in the CBCA as originally enacted. The report recommended extending the prohibition to officers and to associates of shareholders, directors and officers. It proposed the solvency test as a further safeguard, and the addition of a counterpart to the present ABCA section 42(3), "to make it clear that the corporation and a *bona fide* lender will not be barred from enforcing a loan or contract made in breach of the section."

(b) The CBCA Provisions

3.9 Section 42 of the CBCA when first enacted adopted the technique of a prohibition with exceptions. The prohibition regarding financial assistance generally applied to shareholders, directors, officers and employees. The prohibition was extended to cover an associate of any person in the prohibited class and further extended not only to the corporation but to include affiliated corporations. A special paragraph was added prohibiting financial assistance to any person in connection with a purchase of a share issued or to be issued by the corporation.

3.10 Subsection (2) provided for five exceptions from the general prohibition regarding financial assistance. They were:

1. If the lending of money was part of the ordinary business of the corporation.

2. On account of expenditures incurred or to be incurred on behalf of the corporation.

3. To a holding body corporate if the corporation was a wholly owned subsidiary.

4. To employees of the corporation or any of its affiliates to assist in providing housing or for employee share purchase plans using a trustee.

5. In any other case if the corporation could meet the solvency test.

3.11 Apparently this absolute prohibition and the exceptions to it proved to be unworkable. There were complaints that it blocked many legitimate business transactions. The section was repealed and replaced with the present section,[39] the full text of which is set out in Appendix 15.

3.12 The effect of the amendment was to shift the solvency test from the category of an exception, to a necessary

---

[39] S.C. 1978-79, c. 9, s. 17.

precondition that would apply in all cases other than the exceptions set out in subsection (2). These exceptions were expanded by adding as a permitted exception a loan to a subsidiary body corporate of the corporation. The underlying policy of the section would appear to be that the solvency test would provide sufficient protection for creditors and minority shareholders, but even with this conditional prohibition, some exceptions were necessary. Subsection (3) was retained in the belief that it would protect the *bona fide* lender, although the Latin tag was dropped and the exact expression used was "a lender for value in good faith without notice of the contravention."

(c) The ABCA Provisions

3.13 In Report No. 36, Volume 1 the Institute expressed some doubts about CBCA section 42. In one respect we thought it too broad and in another too narrow. We thought it too broad in the class of prohibited persons. In our opinion the whole thrust of the Act was to increase director's powers but that this should be balanced by an increase in their responsibilities. The prohibition, therefore, should apply only to directors since they are the persons in control of the corporation, and to shareholders who still retain a residue of control under certain circumstances. The CBCA section extends the prohibition to both officers and employees. The Institute felt that this extension was unnecessary. Both include associates of the prohibited class and extend the class to affiliated corporations. Both start with an absolute prohibition concerning financial assistance by the corporation for the purpose of dealing in the shares of the corporation but in both all prohibitions are negatived if the corporation can meet the solvency test. Put succinctly, so long as everything is going well financially, who cares?

3.14 The Institute recommended another change. While we agreed with the Dickerson Report that the greatly expanded remedies of minority shareholders, and in particular the oppression remedy, should act as a check on any abuse by directors, we felt that the abused shareholder must have some knowledge of the abuse before he or she could be in any position to enforce a remedy. We therefore recommended an additional disclosure provision which was enacted as subsection (4). The ABCA when enacted followed the Institute's recommendation. The full text of the present ABCA section 42 is set out in Appendix 11.

(d) Common Law Principles

3.15 We now proceed to a discussion of what, if any, common law principles may exist in Alberta today that would impose a prohibition with regard to financial assistance in the form of a loan, guarantee or a charge on the corporation's assets, and the more vexatious problem of the corporation granting financial assistance, usually in the form of a charge upon its assets, in connection with a purchase of its shares.

3.16 There are two common law concepts that may act as a prohibition. The first is the fiduciary duty of the directors and the second is the doctrine of *ultra vires*.

3.17 The most recent discussion of the doctrine of *ultra vires* occurs in the case of Rolled Steel Products (Holdings)

Ltd. v. British Steel Corporation[40] which we have discussed earlier. The whole basis of the doctrine of *ultra vires* rests upon the Memorandum and Articles of Association form of incorporation. It is an interesting and as yet unresolved question whether or not there can be any basis for the doctrine in a jurisdiction, such as Alberta, which uses Articles of incorporation without objects as the basic structure for incorporation. If an Alberta corporation is not incorporated for a specific object, and particularly in view of the provisions of section 15 of the ABCA which grants to a corporation the capacity, the rights, powers and privileges of a natural person, we have doubts that the doctrine can still prevail.

3.18 Whenever a company or corporation lends money to one of its directors, the director is in a conflict of interest situation. The strict rule regarding the duties of a fiduciary come into effect. The director can be held to account. The Courts have not held such a transaction to be *ultra vires*, but have relied on the fiduciary duty, for the practical reason that if the loan were an *ultra vires* act it could be uncollectable by the company. No case in English or Canadian law has declared that a loan to a director is an *ultra vires* act. It is difficult to see why anyone but a director who obtained the loan from his or her company would advance such an argument, and it is even more difficult to conceive that a court could be persuaded to adopt a line of reasoning that would result in the director going scot-free.

---

[40] Footnote 11, supra.

3.19 The situation however is different in the case of a guarantee or a charge on the assets of the corporation. In any such case there may be a double sanction. The directors may be personally liable if they were in a conflict of interest situation because they received some benefit from the transaction. In addition however, the courts had been prepared to hold that the transaction was an *ultra vires* act and that the person to whom the guarantee had been given, or in whose favour the charge was executed, finds himself without any rights because of the declaration that the contract is void. The courts have consciously imposed an obligation on the third party to act as policeman.

3.20 The courts have been less than consistent in defining the precise boundaries of the fiduciary relationship that a director owes to his or her corporation. In Canada Trust Company v. Lloyd et al[41] the Supreme Court stated that the relationship was similar to that of a trustee. Directors who had removed funds from their company without authorization in 1921 were held to account for the money plus simple interest at 5% per annum up to the date of the judgment in 1968. By holding their actions to be a breach of trust, the Supreme Court neatly avoided any limitations problem. On the other hand MacDonald J. in Abbey Glen Property Corporation v. Stumborg[42] stated that the directors are not trustees and that therefore section 292 of the Alberta Companies Act (now section 311) could not apply to relieve the directors from their liability arising from a conflict of interest since no breach of trust was involved.

41 [1963] S.C.R. 300.

42 [1976] 2 W.W.R. 1, at page 50 (Alta. S.C.).

3.21 There are not many cases in Canadian law that deal with loans to directors, guarantees given by a company or corporation to guarantee the indebtedness of a director, or, exclusive of transactions involving a purchase of the corporation's shares, granting a charge on the assets of the corporation. One case has however come before the courts in which a company did pledge some of its assets in order to secure repayment of a debt owed by its directors. The case is Export Brewing and Malting Co. Ltd. v. Dominion Bank.[43] In 1927 the company deposited $400,000.00 of Canada Bonds with the defendant bank as security for a guarantee given by the bank to the federal government in relation to a disputed assessment for sales tax. Three of the directors of the company who owned practically all of the issued shares had agreed to indemnify the company from any loss arising as a result of the assessment. In 1929 the three directors were personally indebted to the bank in an amount of approximately $1 million. The bank was pushing hard for payment. The company entered into an agreement whereby the bonds presently lodged with the bank would be retained by the bank, less any sum required to pay the sales tax assessment when finally determined, as security for the indebtedness of the directors. In 1931 the assessment was finalized by a decision in the Privy Council and the company demanded the return of the balance of the bonds, alleging that the pledge of the bonds, as security for the indebtedness of the three directors, was an *ultra vires* act and, in the alternative, that the appropriation of the company's assets for the personal use of the directors was a breach of trust to which the bank was a knowing party.

[43] [1937] 3 D.L.R. 513.

3.22 The lower courts had held that the three directors were the beneficial owners of all of the issued shares and that therefore there had been implicit ratification of the transaction by the shareholders. In addition they were of the view that the transaction, being indirectly for the benefit of the corporation, was neither *ultra vires* nor a breach of the director's fiduciary duty. The Privy Council disagreed. It held that the three directors were not the only shareholders and that therefore the actions of the directors had not been explicitly or implicitly ratified by the shareholders. It did not decide whether the transaction was *ultra vires* the company because it felt a decision on the point to be unnecessary. On the breach of trust point it was clear and adamant: the three directors had breached their fiduciary duty; no benefit had accrued to the corporation as a result of the transaction; the bank had full knowledge of the breach and as a participant in it the bank had no right to any claim arising from the transaction.

3.23 In contrast to the paucity of cases involving loans, guarantees or pledging assets to secure the debt of a director, there are a good number of cases in which the company or corporation has granted a charge on its assets in connection with a transaction involving a purchase of its shares. From time to time two lines of argument have been presented by those wishing to have the charge set aside as void and unenforceable on the grounds that the transaction was *ultra vires*. The first is an argument based on an analogy to the rule in Trevor v. Whitworth[44] which prohibits a company from buying its own shares. Under this analogy any "trafficking" in its shares by a

[44] (1887) 12 A.C. 409 (H.L.).

corporation is a wrong of itself and is therefore *ultra vires*. The second line of argument depends on the first portion of the doctrine of *ultra vires*, namely that such a transaction has nothing to do with the objects for which the company or corporation was formed and is therefore beyond the capacity of the corporation.

3.24 In Trevor v. Whitworth, the executor of a shareholder sued for the balance owing on a contract under which a company had agreed to purchase his shares. The objects of the company as set out in its Memorandum of Association were to carry on the business of flannel manufacturers and any connected business. Article 179 of the Articles of Association permitted the company to purchase its own shares from a shareholder at a price not exceeding their then market value. The House of Lords held the contract to be unenforceable and void on the basis that the Companies Act of the time permitted an increase in capital but did not permit any decrease in capital. The capital of the company must be maintained for the protection of the creditors. Lord MacNaughten stated that the power to purchase its own shares would be invalid even if set forth in the Memorandum of Association of the company as one of its objects.

3.25 Modern corporation statutes have abrogated this rule by statute. The Alberta Companies Act was amended in 1980 following the Institute's Report No. 21. The problems involved in applying this modern concept to the 1929 Companies Act were akin to an attempt to install a jet engine on a horse drawn wagon. In the result the provisions were both restrictive and cumbersome. The present ABCA differs from the CBCA section 32 by the addition of subsections (3) and (4). These subsections are basically disclosure requirements. The main thrust of both the CBCA and the ABCA however is a requirement that the corporation must be able to meet the solvency test set out in subsection 32(2).

3.26 We have outlined the basis of the early prohibition against a company buying its own shares, its abrogation by statute and the protections against abuse built into the statutory provisions. The difficult question under the decided cases has been how far this early prohibition has been extended by analogy to a company or corporation providing financial assistance regarding a transaction involving the sale of its shares.

3.27 In Hughes v. Northern Electric and Manufacturing Company,[45] Duff J. expressed the view that such a transaction would as a general rule be *ultra vires* the company, but in that case, because there was no express statutory prohibition, it was (in His Lordships's view) wrong to work by analogy from Trevor v. Whitworth and, most importantly, because under any common sense view of all of the circumstances the transaction was necessary to keep the company alive, he held the transaction to be valid. His Lordship thus gave a flexibility to the application of the doctrine of *ultra vires* that few courts have seen fit to do since. Anglin, J. who wrote the only other judgment in favour of validity (two of the other six judges concurred with Duff, J.) simply looked at the mathematics of what had happened. Three directors owned all of the shares of Cordova

---

[45] (1915) 50 S.C.R. 626.

Mines Limited (the company). They had advanced $43,000 to the company. Unhappy differences arose regarding the future operations of the company. Hughes and one other director agreed to sell their shares to K, the remaining director, for $60,000 on condition that the debt of $43,000 be discharged and forgiven; that the company grant a mortgage on its property to secure payment of the $60,000 and that K would continue to support the company by advancing at least $3,000 per month to cover its expenses. K and his new associates made payments on the share purchase agreement totalling $19,000 and advanced further funds for the use of the company of nearly $60,000. The company incurred a debt to Northern Electric and Manufacturing Company of slightly over $800. Northern Electric sued to recover the debt and to declare that the mortgage was insolvent.

3.28 In the view of Anglin, J., the company had replaced a debt of $43,000 for one of $60,000. He pointed out that $19,000 had been paid by the purchasers of the shares leaving a balance owing of less than the $43,000 debt that had been forgiven. A company is of course always entitled to pay its obligations and to give a charge on its assets to secure payment. The Ontario Court of Appeal had held the transaction valid to the extent of the $43,000 indebtedness but no more. By attributing the $19,000 paid to the purchased price of the shares, Anglin, J. was able to hold the entire transaction valid.

3.29 In Thibault v. Central Trust Company of Canada,[46] the vendor sold all of the shares of his company for $65,000, which was to be paid in equal annual installments plus interest over 15

[46] [1963] S.C.R. 312.

years. He took as security for the debt owing to him, a mortgage covering all of the assets of the corporation. No shareholder's loans were involved. The Supreme Court of Canada set the mortgage aside at the suit of the company's creditors. It did so on the grounds that the mortgage was given by the company in flagrant breach of the statutory prohibition contained in the New Brunswick Companies Act. Thibault was discussed in Olafson v. Twilight Cariboo Lodge Ltd.[47] In that case substantial shareholders' loans were involved. The Court followed the lead of Anglin, J. in the Hughes case and looked at the net effect to the company of the mathematics involved. Since the charge granted was less than the liabilities of the company either owed to other creditors or under the shareholders loans, the Supreme Court reversed the British Columbia Court of Appeal and held the charge to be valid.

3.30 From all this, the conclusion might be drawn that the prohibition depends upon a statutory provision and not upon an extension by analogy to the common law doctrine laid down in Trevor v. Whitworth. But in Alberta, there are two well known authorities: Murray v. C.W. Boone Ltd.[48] and Mt. View Charolais Ranch Ltd. v. Haverland.[49] Both cases are decisions involving a private company that granted security in connection with the transaction involving the sale of its shares. The first is a decision of Haddad, D.C.J., (as he then was), who held the transaction to be invalid. His Lordship simply states that the principle prohibiting the transaction has long been recognized in

[47] [1966] S.C.R. 726

[48] [1974] 2 W.W.R. 620 (Alta. D.C.).

[49] [1974] 2 W.W.R. 289 (Alta. C.A.).

Canadian company law and is based on an extension by analogy of the decision in Trevor v. Whitworth.

3.31 The Alberta Court of Appeal (in a two to one decision) upheld the validity of the transaction in the Mt. View case. Mr. Justice Clement, who wrote the dissenting opinion, did not specifically rely on an analogy derived from Trevor v. Whitworth. He acknowledged that section 14(1) of the Alberta Companies Act provided a statutory prohibition only with respect to public companies and that the power was available to a private company, but like any other power it could only be exercised for the purpose of carrying out the objects of the company. In his view the granting of assistance by the company to enable a purchaser to purchase shares of the company, without more, could not be considered an object of the company. The transaction was therefore *ultra vires* but only to the extent that the chattel mortgage exceeded a shareholder loan of $87,000, since this was always an obligation of the company.

3.32 Prowse, J.A., with whom Allen, J.A. concurred, discussed the decision in Trevor v. Whitworth at length and concluded that the rule in that case is based upon the sanctity of capital and that no reduction of capital was permitted by the English Companies Act of the time. He was firmly of the view that the principle in Trevor v. Whitworth had not been extended by analogy to prohibit the granting of financial assistance by a company to aid a person in the purchase of a company's shares, since no reduction of capital is involved. He then addressed the question considered by Clement, J. Does the granting of the chattel mortgage for such a purpose fall within the objects of the company, or a power reasonably incidental to its objects? He reached the conclusion that it did because of the very broad wording of the Memorandum of Association which set out powers as well as objects. He did not address the thorny question of the distinction between the two. He revived the statement of Lord Justice James in A-G v. Great Eastern Railway Company,[50] that the doctrine of *ultra vires* should be reasonably and not unreasonably applied. Since the company did receive some benefit from the transaction, the doctrine should not be unreasonably applied; therefore the chattel mortgage was valid for its entire amount.

3.33 What is the law in Alberta today? If the prohibition depends upon an extension by analogy of the reasons in Trevor v. Whitworth, the common law doctrine might be alive and well in Alberta. While sections 32 and 33 of the ABCA permit a corporation to purchase its own shares under certain controlled conditions, section 26(11) prohibits a corporation from reducing its stated capital in any manner not provided in the Act. Of four Alberta Judges to have considered the matter, one has held the analogy to apply, one has adopted the same reasoning used in Trevor v. Whitworth and two have said that the analogy is incorrect. It is difficult to fault the proposition of Mr. Justice Prowse that there is a distinction. When a company or corporation buys its own shares, the paid up or stated capital has been reduced. This is not so when a company or corporation grants a charge on its assets and therefore the present section 26(11) would not apply. We are of the view that the prohibition applies because of a statutory provision only, not because of the common law doctrine based on an analogy to the reasoning of

50 (1880) 5 A.C. 473 (H.L.).

Trevor and Whitworth, and this is consistent with the actual decision of the Alberta Court of Appeal.

(e) The Effect of a Statutory Prohibition

3.34 We have reached the conclusion that, apart from the common law principles governing a breach of fiduciary duty by a director, if a prohibition is desirable it must be a statutory prohibition. However, throughout the statutes of Alberta, Canada and other provinces, there has been no set terminology to guide either practitioners or the courts as to the precise effect of a prohibition created by the statute. If ever there was an area of law in which the decision in a particular case seems to depend on its own facts and the attitude of the judge who decided it on the day that he did so, this is it. By a liberal interpretation of the classic rule regarding the effect of a prohibition by statute first laid down in Heydon's case,[51] the late Chief Justice Harvey in Spooner v. Spooner[52] was able to find that the words "null and void" used in the Dower Act of the time did not mean what they apparently said but that the sale of the homestead which was in dispute in that case was a valid sale subject only to the interest granted to the wife under the Dower Act. The casebooks are replete with cases dealing with the subject,[53] but they are not marked by any great consistency of approach.

3.35 If the effect of the illegality is to render the contract void, then there is no contract and title to any

---

[51] (1584) 76 E. R. 637.

[52] [1939] 2 W.W.R. 237.

[53] See the cases cited in Pinvicska v. Pinvicska [1974] 6 W.W.R. 512.

property involved will not pass. Under these circumstances there are cases in which the original owner has been able to reclaim his property in spite of the illegality. If the effect is to render the contract unenforceable then the maxim *in pari delicto* will apply and the court will not assist either party. If the property is not what it was represented to be, the purchaser has no recourse. If the vendor is owed any balance of the price he cannot sue for that balance. If the contract has been completed the court will not set it aside since the only way to do so would be lend assistance to one or other of the parties, and this the court will not do. Like the Statute of Frauds, the maxim acts as a shield, not as a sword.

3.36 Two recent Canadian cases illustrate this point. Sections 126, 127 and 128 of the BCCA deal with financial assistance to directors.[54] Section 127 deals with financial assistance to any person in connection with a transaction involving the purchase of a company's shares. In the case of Royal Bank of Canada v. Stewart,[55] the bank advanced $62,000 to three shareholders of a hotel company to enable them to buy out a fourth shareholder. As security for the loan the bank demanded and got a guarantee of repayment from the company and a mortgage on the hotel property as security for the guarantee. The loan was not repaid. The bank sued the three shareholders and the company under the guarantee for repayment. It succeeded as against the shareholders but lost as against the company. The Court held that the guarantee fell within the ambit of prohibited financial assistance; that there was no evidence that it had been

[54] See Appendix 14.

[55] (1980) 8 B.L.R. 77 (B.C. S.C.).

given in the best interests of the company and that the guarantee was therefore unenforceable (the mortgage having been previously discharged upon payment of money into Court). The bank then argued that it was entitled to succeed under the provisions of the then counterpart of the present section 128 of the BCCA, but the Court refused relief under that section based on a finding of fact that the bank knew the purpose of the loan before it was made and could not therefore bring itself within the section as being "without notice". In the end the result was the same as a finding of *ultra vires*. The guarantee given by the company was held to be void and unenforceable.

3.37 The second case arose in Nova Scotia. The prohibition in the Nova Scotia Companies Act regarding financial assistance granted by a company in connection with the purchase of its shares is even more forceful than the prohibition contained in the BCCA. Prior to 1982 the relevant section 96(5) read as follows:

> (5) Subject to this Section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company.

Subsection (6) provided three exceptions which need not concern us here.

3.38 The facts in Central and Eastern Trust Company v. Irving Oil Ltd.[56] were as follows. In 1968 three gentlemen entered into an agreement with B to purchase all of the shares of

---

[56] [1980] 2 S.C.R. 29.

a motel company owned by B for $315,000. $225,000 of the purchase price was to be raised by a mortgage on the company's property. The vendor was obliged to discharge approximately $110,000 of the company's liabilities out of the funds he received from the sale. The transaction was completed. The motel fell on hard times. In 1976 Irving Oil Ltd. obtained judgment against the company for slightly over $10,000. The mortgage fell in arrears and the trust company commenced foreclosure proceedings in November, 1977. The trial judge granted an order for foreclosure. The Nova Scotia Court of Appeal set aside the foreclosure order, holding that the transaction was partially valid, to the extent of a proportion of the liabilities of the company paid off by the vendor of the shares on the basis of the Supreme Court's decision in Olafson v. Cariboo Twilight Lodge Ltd.[57] The remainder was held to be a void transaction and hence unenforceable and uncollectable by the trust company. The Supreme Court, in a unanimous judgment delivered by Ritchie, J., held the transaction to be entirely void as being in breach of a clear statutory prohibition. No previous case is cited in the judgment. The Supreme Court did not look beyond the fact that the vendor had received the entire proceeds, that the transaction was specifically prohibited by the Act, and it was therefore void.

3.39 It will be noted that in both of these cases it was the third party lender that was seeking to enforce its security. These are not cases in which the company had parted with its money and now sought (by way of the imposition of a constructive trust) to get the money back. Since in neither case, with the exception of the debts paid by the vendor in Central and Eastern

[57] Footnote 46, supra.

Trust, was the money received by the company, but by a vending shareholder, it would of course be difficult to hold the company accountable for money that it did not receive. The surprising element in Central and Eastern Trust is that the court refused to make any allowance for the legitimate debts of the company that were paid by the vendor following the transaction. Since to this extent the money advanced was used for the benefit of the company it may have been arguable that the constructive trust argument would be available.

3.40 On the whole, English courts have been more willing than Canadian courts to find some method to avoid the harsh effects of illegality. In Canada, at least in the area of corporate law in recent years, the attitude would appear to be far more rigid. Whether this harshness requires some mitigation, and, if so, possible solutions for it, will be left until Chapter 8.

CHAPTER 4

THE LAW IN OTHER JURISDICTIONS

1. CANADIAN

4.1 This chapter will examine similar provisions to ABCA section 42 in those jurisdictions that have adopted the Articles of Incorporation structure, and in British Columbia (which still uses the Memorandum and Articles of Association structure). We have already noted the differences between the ABCA section 42 and the CBCA section 42. They will not, therefore, be discussed further here. Saskatchewan and Manitoba are identical to the CBCA section 42, even to bearing the same section number. The Yukon Territories Act follows the Alberta model.

(a) New Brunswick

4.2 The New Brunswick Act (enacted in 1981)[58] adopts a less restrictive attitude. A copy of the New Brunswick section 43 is attached as Appendix 10. While the structure is very similar to the CBCA there are distinct differences between the New Brunswick provisions and the federal provisions. Section 43(1) of the New Brunswick Act uses a conditional prohibition. The corporation shall not grant financial assistance directly or indirectly to any shareholder, director, officer or employee of the corporation or affiliated corporation, or to an associate if the corporation cannot meet the solvency test. The solvency test is the same as that set out in the federal Act. Section 43(2) however lays down a flat prohibition prohibiting the corporation from making a loan to any person that is secured by a share of the corporation or

[58] Business Corporations Act, S.N.B. 1981, c. B-9.1.

giving financial assistance to any person by means of a loan guarantee or otherwise in connection with a purchase of shares issued or to be issued by the corporation. The exceptions contained in CBCA 42(2) are permitted exceptions under both the New Brunswick section 43(1) and (2). The New Brunswick subsection (4) parallels CBCA subsection (3) and is an attempt to protect the third party.

4.3 A striking (and unique) feature of the New Brunswick Act is however contained in the opening words to section 43(1), which reads as follows:

> "Except as permitted under subsection (3) or except where the Articles provide, a corporation...shall not..."

Presumably this exception became standard boiler-plate in the Articles of Incorporation under New Brunswick law, so that the provisions of all of the section other than subsection (2) could be ignored. The net effect therefore is that in the hands of any reasonably competent practitioner only subsection (2) and (4) would have any effect. Trafficking in its own shares by the corporation would then be the only reprehensible transaction in New Brunswick.

(b) Ontario

4.4 In 1970 Ontario enacted the Ontario Business Corporations Act.[59] This was the first Act in Canada to adopt the Articles of Incorporation format and to introduce the new concepts of fundamental change and the right to dissent, the oppression remedy and several of the more modern ideas in

[59] Business Corporations Act, S.O. 1970, c. 25.

corporation law. In 1982 Ontario repealed the 1970 Act and replaced it with a new Business Corporations Act,[60] the provisions of which are more closely aligned to the CBCA.

4.5 The 1970 Act used the technique of a flat prohibition and exceptions. Section 16(1)(a) of that Act[61] prohibited loans by the corporation to any of its shareholders, directors or employees. Notably, officers were not included in the prohibited class. Paragraph (b) prohibited the Corporation from giving financial assistance directly or indirectly by means of a guarantee or otherwise to any person for the purpose of or in connection with a purchase or subscription of the shares of the corporation.

4.6 Subsection (2) provided five exceptions, the first four of which deal with loans only. They are:

1. Loans to any of the prohibited class if the making of the loan is part of the ordinary business of the corporation.

2. Loans to full time employees whether or not they were shareholders or directors to assist in providing housing for their own occupation.

3. Loans to employees whether or not they were shareholders or directors to enable them to purchase shares of the Corporation if the shares were to be held by a trustee.

---

60 Business Corporations Act, S.O. 1982, c. 4, proclaimed July 5, 1983.

61 See Appendix 12.

4. Loans to *bona fide* employees other than directors whether or not they were sharesholders to enable them to purchase shares of the Corporation.

The remaining exception applied only to a corporation not offering securities to the public. Such a corporation was permitted to give financial assistance by means of a loan, guarantee, or the provision of security, or to a shareholder or director to enable them to purchase issued shares of the corporation.

4.7 The advantages of uniformity were obviously apparent to the drafters of the 1982 Act. Section 20 of that Act[62] is an almost exact parallel of section 42 of the CBCA. The only difference occurs in paragraph 1(b) regarding the prohibition against providing financial assistance in connection with a purchase of a share of the corporation. This has been extended to include a security convertible into or exchangeable for a share.

(c) British Columbia

4.8 We now turn to the British Columbia Act,[63] the only Act under discussion that uses the Memorandum and Articles of Association structure. It is however a substantially modernized version compared with the Alberta Companies Act. The Memorandum of Association is not required to set out the objects for which the company is formed but it may set out any restrictions on the business to be carried on by the company. Under section 21 a

---

62 See Appendix 13.

63 The Companies Act, R.S.B.C. 1979, c. 59.

company has all the power and capacity of a natural person. Section 26 abolishes constructive notice. Unquestionably these provisions were a valiant attempt to abrogate the doctrine of *ultra vires*. Three sections[64] are concerned with the problems of financial assistance to shareholders, directors and others.

4.9 Section 126 prohibits any company from giving financial assistance to a person directly or indirectly by way of loan, guarantee, the provision of security or otherwise if at the time of giving the financial assistance the company is insolvent, or in the case of a loan, the giving of the loan would render the company insolvent. This is a typical example of the conditional prohibition, but it should be noted it applies to any person.

4.10 Section 127 is considerably broader in a scope than the provisions of any of the other Acts which have been discussed other than New Brunswick. It adopts the technique of a flat prohibition with exceptions. Subsection (1) starts out with a complete prohibition preventing the company from giving financial assistance to any person directly or indirectly by way of loan guarantee or otherwise

(a) for any transactions concerning shares or debt obligations carrying a right of conversion into or to exchangeable for shares of the company

(b) on security in whole or in part of a pledge or charge of shares of the company given by that person to that company or

(c) in any other case, unless there are reasonable grounds

---

[64] See Appendix 14.

for believing that, or the directors are of the opinion that, the giving of the financial assistance is in the best interests of the company.

4.11 Section 126 imposes a primary hurdle; the company must be solvent if the transaction is not in connection with a sale of the company's shares. Section 127(1)(c) imposes a second hurdle; the financial assistance must be in the best interests of the company. The determination of what is in the best interests of the company may be either objective, based on reasonable grounds for believing that it is, or subjective, that is, that the directors are of the opinion that it is. We suspect that a Court, when faced with something like this would still impose the objective test on the opinion of the directors, that is, they must have some reasonable grounds upon which to base their opinion. It would seem therefore that financial assistance cannot be given regarding any transaction in connection with the shares of the company, but paragraph (c) contains an interesting exception if the loan is not made in connection with the company's shares.

4.12 Subsection (2) expands on the exception contained in 1(c). Notwithstanding subsection (1) the company may, if previously authorized by special resolution, and where there are reasonable grounds for believing that the giving of the financial assistance is in the best interests of the company, provide money for the purchase of shares to be held by trustees for the benefit of the *bona fide* employees of the company and provide financial assistance to *bona fide* full time employees of the company to enable them to purchase shares or debt obligations of the company.

4.13 Subsection (3) contains another interesting exception to subsection (1). If the financial assistance is given in connection with the acquisition of shares and after the acquisition not less than 90% of the issued shares of every class in the capital of the company will be owned by the person receiving financial assistance, and the financial assistance is authorized by special resolution before it is given, and if the company is not a reporting company (a non-distributing corporation in Alberta terms), the company may give financial assistance for the benefit of that person. However, under subsection (4), if financial assistance is given under subsection (3) this will trigger the right to dissent. This right to dissent matches the right to dissent in the case of the takeover bid provisions. Subsection (5) contains a further exception to subsection (1), namely, financial assistance may be given to or for the benefit of a wholly owned subsidiary by its holding company or by a wholly owned subsidiary.

4.14 The British Columbia Act unquestionably introduces a new sanction, namely the right to dissent for a minority shareholder. The other interesting thing about the section in its entirety is the introduction of the concept that some of these transactions may be perfectly valid if there are reasonable grounds for believing that the giving of the financial assistance would be in the best interests of the company.

2. <u>UNITED STATES OF AMERICA</u>

4.15 We have examined some U.S. State corporations statutes. We have selected the Model Business Corporations Act[65] as a starting point and a few other state codes to demonstrate the wide variety of treatment from state to state in that country in the area of financial assistance to directors.

(a) Model Business Corporations Act

4.16 Section 47 of the Model Business Corporations Act reads as follows:

> A corporation shall not lend money to or use its credit to assist its directors without authorization in the particular case by its shareholders, but may lend money to and use its credit to assist any employee of the corporation or of a subsidiary, including any such employee who is a director of the corporation, if the board of directors decides that such loan or assistance may benefit the corporation.

It will be noted that the prohibition applies only to directors and that while it starts with a prohibition, the section contains a built-in escape hatch. The loans or financial assistance are permissible if the board of directors decides that the loan or assistance would benefit the corporation.

4.17 Section 48 is roughly equivalent to section 113 of the ABCA, but it contains no specific reference to section 47. It deals only with dividends, purchase by a corporation of its own shares and distribution of assets on liquidation.

4.18 Section 41 of the Model Business Corporations Act deals with the director's conflict of interest. It states that no contract is void or voidable because there was a conflict of

---

[65] Model Business Corporations Act Ann. 2d, 1971.

interest, whether or not the director or directors who were in a conflict of interest position approved the contract or their votes were counted for that purpose, if the conflict had been disclosed to the board or the conflict disclosed to the shareholders upon any vote to ratify the contract.

(b) Maine and Louisiana

4.19 At one end of the spectrum are state codes such as those of Maine[66] and Louisiana[67] that contain no statutory prohibition regarding loans or other financial assistance to directors or to anyone else. The statutes of each of these two states contain a conflict of interest section, which, with minor variations on other conditions such as disclosure and voting, permit a transaction if it is of benefit to the corporation.

(c) Delaware and Michigan

4.20 The Delaware Corporations Code[68] section 143 and the Michigan State Code[69] section 450-1548 specifically permit loans, guarantees or other financial assistance to a director whenever in the judgment of the directors the loan, guarantee or other financial assistance may reasonably be expected to benefit the corporation. Both contain conflict of interest sections similar to the Model Business Corporations Act. There is no evidence to demonstrate that Delaware or Michigan corporations are regarded less favourably by investors in the market place than those

---

66 Maine B.C. 1971, c. 439 as amended.

67 L.S.A. 12:1, as amended.

68 Delaware Corporations Code, 8 Del. C. 1953, as amended.

69 MCLA: c. 450, as amended.

incorporated in other, more protective, states. Indeed the evidence may indicate the contrary, given the popularity of Delaware as an incorporation state.

(d) California

4.21 California seems to have entertained almost annual adjustments and amendments to section 315 of its Corporations Code,[70] which deals with loans and guarantees to directors. Prior to 1977 a corporation could not grant financial assistance upon the security of its own shares unless the proposed loan had been approved by a two-thirds vote of all classes of shares, voting or non-voting. Following a series of amendments in 1978, 1979, 1980, 1982 and 1984 the section now prohibits loans to or guarantees of the obligation of a director unless approved by a majority of the shareholders having a right to vote. If the corporation had 100 shareholders or less, and the by-laws so provided, the directors could authorize the loan or guarantee. The prohibition regarding a loan or a guarantee supported by a charge on the shares of the company, once repealed, was reinstated under somewhat different terms. Either there had to be additional adequate security or approval of the shareholders was required. Exceptions were made for advances on expenses to be incurred; for employee stock purchase plans; for certain deposit taking institutions and for loan and guarantee corporations.

(e) New York and Tennessee

---

[70] California Corporations Code, 1947, as amended.

4.22 The Tennessee State Code[71] 48-1-814 and the New York Corporations Code[72] section 714 both require approval by a majority vote of every class of shareholder of a loan by the corporation to a director. A loan made in violation of the section is a violation of the duty owed by the director to the corporation but the obligation of the borrower to repay the loan is not affected. The New York Corporation Code is the only American statute that we have examined that contains a counterpart of ABCA section 113(3)(d) imposing a specific liability upon the remaining directors who vote for or consent to a loan contrary to the prohibition. Section 713 of the New York Code deals at length with and expands in considerable detail what are basically the same provisions contained in the Model Business Corporations Act section 41.

4.23 This admittedly cursory review of the provisions contained in a few of the state Codes reveals a wide divergence in the basic policy decisions regarding regulation by statute of loans and financial assistance to directors, and the form that any prohibitions take.

---

[71] Tennessee General Corporations Act, Title 48, 1963, c. 523, as amended.

[72] New York Business Corporations Law, 1961, c. 855, as amended.

CHAPTER 5

THE NATURE AND FINANCIAL EFFECT OF TRANSACTIONS OF THE KIND AT ISSUE

1. INTRODUCTION

5.1 The effect that various transactions will have on the actual financial position of a company is variable, and not easily assimilated. In this chapter we will outline, in a relatively straightforward manner, and as an aid to understanding, the accounting and financial consequences of the various transactions which may be called into question by the kind of statutory provisions we have been discussing.

2. LOANS

(a) The Effect on the Corporation

5.2 A loan to a shareholder or director, providing the corporation has its own cash to make the loan, will only affect the asset side of the balance sheet. Cash is decreased and accounts receivable are increased. A short term loan about which there is no doubt as to its collectability has no effect on the ratio between current assets and current liabilities. If however, there is doubt about the collectability of the loan or if the time for repayment for the loan extends beyond one year, then in either case the ratio between current assets and current liabilities is adversely affected. The loan will have no immediate effect on the profit and loss statement of the corporation, but it will affect the statement of changes in financial position in that cash has gone out of the corporation to be replaced by an account receivable. The statement of retained earnings will only be affected if the loan has to be discounted because of problems foreseen in collecting it.

(b) Classes Adversely Affected

5.3 Unless all of the shareholders receive loans in proportion to their shareholding, there has been an unequal distribution of corporation funds. While it is true that the loan must be repaid, the shareholder or director who received the loan has cash in hand and the remaining shareholders do not. To the extent that the loan has any adverse effect upon the corporation it has an adverse effect upon all of the shareholders. If the corporation must borrow money in order to provide the funds for the loan there will be an additional interest expense to the corporation. Even if it can make the loan using its own funds, it has that much less to pay down its bank indebtedness, if any, and therefore there will usually be a greater interest expense to be borne by the corporation. By reducing its cash on hand the corporation may not be able to take advantage of cash discounts for prompt payment of the goods that it purchases. It is of course possible, but the number of cases must be rare, that the corporation will suffer none of these adverse effects, but even in such a case the funds used for the purposes of the loan could have been invested in or outside of the business or distributed to the shareholders.

5.4 A creditor will be adversely affected only if the loan is improvident and uncollectable or if the term of repayment is such that the corporation is cash shy and must delay paying its normal trade creditors. If neither of these will occur, then the creditor will suffer no adverse effect. Even if the loan is so improvident that it would tip the corporation into either bankruptcy or receivership, it still remains a debt owing to the corporation and no doubt the trustee in bankruptcy or the receiver will exert every effort to collect it. This may however prove to be a fruitless pastime. A loan by a corporation to one of its shareholders or directors does not involve a third party.

5.5 We have noted that some American jurisdictions prohibit secured loans to directors, if the security for the loan is the shares of the corporation itself. This transaction has not previously been prohibited under Canadian law and the discussion as to whether it should or should not be prohibited will be left until Chapter 8.

3. GUARANTEES

(a) The Effect on the Corporation

5.6 The only adverse affect upon the corporation of execution of a guarantee is a possible reduction in its line of credit. An outstanding guarantee is a contingent liability and should be disclosed in a note to the financial statements. It is not execution of the guarantee, it is having to perform it that causes the adverse effect.[73]

(b) Classes Adversely Affected

5.7 When the corporation is called upon to pay the amount guaranteed the classes who may be adversely affected are the same as those for loans, and for the same reasons. The corporation

---

[73] It has been said that the quickest way in which to make time pass is to guarantee the indebtedness of another that will fall due within six months.

will have that much less cash in order to satisfy its creditors. The director or shareholder whose debt has been guaranteed and which has been paid in full or in part by the corporation has been given the same advantage as though he or she had received a loan. Under the law of suretyship the corporation will have the right to recoup the amount that it has paid under the guarantee, but the situation is more ominous than in the case of a loan. Presumably the only reason that the corporation has been called upon to pay is because the principal debtor could not do so. While the corporation may have the right to repayment it may have great difficulty in realizing much in the enforcement of that right. Hence any prohibition applied to guarantees should be at least as onerous as that applying to loans.

4. CHARGES ON ASSETS

(a) The Effect on the Corporation

5.8 A charge on its assets given by a corporation as security for payment of an obligation owing by one of its directors will probably have a more immediate adverse effect upon the corporation than would a guarantee granted by the corporation. The charge will inevitably be registered in a public registry. Given modern credit reporting, subscribers to any one of the commercial credit organizations will become aware of the charge shortly after it is registered. Substantial trade creditors, those most likely to use the services of a credit reporting agency, may think twice before maintaining or extending credit to the corporation once they have this information. The corporation's bankers may grow restive if there is any chance that the security given might take priority over the security that they presently hold. Details of the charge must be disclosed in a note to the financial statements if they are prepared in accordance with GAAP, so it would seem likely that in most cases the fact that the corporation has granted such a charge would become known to the corporation's shareholders and to its bankers.

5.9 If, of course, the corporation is called upon to either pay the debt or risk losing the asset charged, it will be in a position to do so only at the cost of an immediate cash outlay or surrendering the asset charged. Both of these things will have an adverse effect on the corporation unless the asset charged is no longer of any value to the corporation. Even in this unlikely event the corporation would have been better off if it had sold the asset. As in the case of a guarantee, if the corporation is called upon to honour the charge it is because the director or shareholder for whose benefit the charge was given could not meet his or her obligation. The chance of any recovery by the corporation would be small indeed.

(b) Classes Adversely Affected

5.10 To the extent that the corporation is adversely affected by the granting of the charge or its enforcement, shareholders other than a shareholder who received the benefit will suffer an adverse effect proportionate to their shareholdings. If the corporation founders, whether or not as a result of granting the charge, a priority battle will ensue between the secured creditor who holds the charge and the remaining unsecured creditors. The holder of the charge has two advantages over the unsecured creditor; he can exercise his security, and in most cases having done so, will still be in a position to enforce his rights against the principal debtor to recover any deficiency. If the security is unenforceable then the security holder has only a right to collect from the principal debtor with the result that there will be no priority battle and there will be that much more to divide amongst the corporation's unsecured creditors.

5. TRANSACTIONS INVOLVING SHARES

(a) The Effect on the Corporation

5.11 If financial assistance is given by a corporation by way of a loan granted by the corporation to the buyer of the shares before or shortly after the buyer becomes the new owner of the shares, or the corporation makes a loan through another corporation or series of related corporations that ends up in the hands of the buyer and is used either to pay for the shares or to repay the bridge financing used to acquire the shares, the effect on the corporation will be the same as that of a loan to a director. If the corporation guarantees repayment of the indebtedness incurred by the buyer to acquire the shares, the affect on the corporation will be the same as if it had guaranteed repayment of the indebtedness of a director. A charge on its assets granted by a corporation as security for repayment of a loan or as collateral security for a guarantee, the underlying basis for which is a purchase of the corporation's shares, will have the same affect on the corporation as any other charge on its assets. The form of financial assistance that a corporation may provide in connection with a purchase of its shares, however, is limited only by the ingenuity of the buyer or the buyer's legal advisors. The restrictions applying to loans, guarantees or charges upon the assets of the corporation are not enough in themselves to provide an adequate prohibition if there is to be a prohibition at all.

5.12 A transaction involving the purchase of a corporation's shares does not directly affect the stated capital of the corporation. As we have seen, both the Alberta courts and the English courts have now rejected the idea that there is any common law prohibition based on an analogy to the reasoning in Trevor v. Whitworth.[74] If the financial assistance is accomplished by the acquirer causing the target corporation to pay a dividend shortly after the acquisition, and assuming that the payment of the dividend does not infringe any other statutory provision, then if the Wellington Publishing case[75] is followed such a course of conduct is perfectly legitimate. The reported cases have invariably arisen because, following the purchase, the corporation got into financial difficulties (although not always as a result of the transaction).

5.13 It is not necessary for the corporation to be solvent at the time of the transaction; indeed, a change of management may be desired by minority shareholders and creditors alike. If the corporation continues in good health after the transaction then it may be for the benefit of all interested parties. The difficult question is whether or not the financial assistance was the primary or at least a substantial cause of the corporation's downfall. Put in its simplest terms, there is no adverse effect

---

[74] Footnote 43, supra.

[75] Footnote 30, supra.

upon the corporation if the financial assistance that was granted was structured in such a manner that the corporation could continue to prosper after the transaction.

(b) Classes Adversely Affected

5.14 If all of the shareholders willingly sell their shares through the mechanism of some form of financial assistance given by the corporation, they may have done so at the expense of the corporation's creditors but there is no shareholder who will be adversely affected. As the expression goes, they are laughing all the way to the bank. A minority shareholder in a distributing corporation that is listed on a stock exchange simply takes a chance. That person can sell or hold on and hope that this is the better course, but in either event has a liquid asset. An exception may arise if the acquirer has been successful in a bid limited to less than all of the shares and acquires only sufficient for control, but even in such a case the minority shareholder has the full arsenal of shareholder remedies available to protect his or her investment. The minority shareholder in a non-distributing corporation is usually protected against the possibility of being marooned as a minority under new management by restrictions on the transfer of shares contained in the Articles of the corporation, or the provisions of a unanimous shareholder agreement. In any event such a minority shareholder has the protection given by the various shareholder remedies.

5.15 Given the protection for minority shareholders built into the ABCA, they are not, in all but the most exceptional cases, likely to be adversely affected. It is the creditors who may suffer because the financial assistance given by the corporation turns out to be more than the corporation can bear. In the event that the financial assistance has taken the form of a charge on the corporation's assets, then the result will usually be, if the corporation is not successful, a battle between the secured creditor holding the charge opposing the unsecured creditors. Solvency at the time that the financial assistance is given is really in the nature of a band-aid provision. It is the result of the financial assistance and its structure that may adversely affect the creditors of the corporation.

6. CONCLUSIONS

5.16 Unless every shareholder benefits in proportion to his or her shareholding, a loan given by a corporation to one of its directors, a guarantee granted by the corporation to secure repayment of the indebtedness owed by one of its directors or a charge on its assets given by a corporation as security for repayment of a debt owed by a director, or a guarantee given by the corporation, invariably confers a benefit on the recipient at the expense of the remaining shareholders. There are some exceptions to this in which the financial assistance provided to a director is in the best interests of the corporation for sound commercial reasons, but these will be discussed later. A transaction involving a purchase of the corporation's shares may or may not favour one shareholder or group of shareholders over the remaining shareholders, but in most cases it will not. Thus in the case of loans, guarantees and charges on its assets given to a director or shareholder, the main group to be adversely affected are the remaining shareholders, although creditors may be adversely affected as well. In the case of financial assistance given regarding a purchase of the corporation's shares, the probability is that the group to be adversely affected will be the creditors, or a particular class of creditors.

5.17 Insofar as the corporation itself is concerned, loans, guarantees and a charge upon its assets for the benefit of one shareholder or director will inevitably reduce either the corporation's current cash position, or its available credit. Whether or not financial assistance given by a corporation in connection with a purchase of its shares will affect the corporation's cash or credit will depend on the particular structure involved in the transaction. Subject to the exceptions which will be discussed later, loans, guarantees and a charge on its assets for the benefit of a director of a corporation can confer no benefit upon the corporation whatsoever. Financial assistance given by a corporation in connection with a transaction involving the purchase of its shares may be in the best interests of the corporation. We have concluded therefore, that any attempt to draft a statutory prohibition that treats both problems as being the same is bound to be unsatisfactory. In Chapter 6 we will discuss the basic structure of the present Section 42 and the problems that have arisen under those provisions, some of which are caused by the attempt to cover both prohibitions in the one section.

CHAPTER 6

THE PRESENT SECTION 42 OF THE ABCA

1. THE BASIC STRUCTURE

6.1 The present Section 42 applies to all corporations. It attempts to regulate, in the one section, both financial assistance by way of a loan, guarantee, a charge upon its assets or otherwise provided by a corporation for the benefit of one of its shareholders or directors, together with financial assistance provided by a corporation in connection with a purchase of its shares. The prohibition regarding loans, guarantees and charges upon assets applies to directors and shareholders, their affiliates and their associates. The prohibition regarding financial assistance in connection with a purchase of the corporation's shares applies to any person. The necessary prerequisite for any of the otherwise prohibited transactions is the ability of the corporation to meet the solvency test contained in 42(1)(d) and (e). Subsection (2) provides some exceptions to the prohibitions; subsection (3) attempts to protect the third party or lender; and subsection (4) requires disclosure of the transactions.

6.2 The keystone of the section is the solvency test. None of the transactions are prohibited if the corporation can meet this test. Leaving aside for the moment the problems connected with the specific solvency test contained in the section, reliance on the solvency test together with the exceptions contained in subsection (2) creates some startling results. It would seem to be permissible for a corporation, part of whose business is the lending of money, to make a loan to one of its directors even if that corporation was in fact, if not formally, bankrupt. The various transactions in subsection (2) are permissible even if the corporation is obviously and completely unable to meet either or both branches of the solvency test.

2. CORPORATIONS TO WHICH THE PROVISIONS APPLY

6.3 The prohibitions contained in Section 42 apply to all corporations whether distributing or non-distributing. The distinction between these two categories in the ABCA was an attempt to divide corporations on a functional basis. It was thought that, with very few exceptions, any corporation having more than 15 shareholders would inevitably result in a division between those who are active in management and those who are not; that there would be one group who are the managers and another composed of investors. We are of the opinion that the characteristics of the two categories, the problems faced by each and the likelihood of an adverse affect upon one or other class of persons concerned are substantially different for the two categories. We will discuss the effect and our recommendations with regard to these differences in several particular instances later in this paper.

3. The Prohibited Class

6.4 The prohibition in regard to financial assistance given by a corporation in connection with a purchase of its shares applies to any person. Since the form of such financial assistance is limited only by the imagination of businessmen and their advisors, presumably it was felt that whatever prohibition or regulatory scheme may be imposed, it must apply to "any person".

6.5 In Report No. 36 the Institute expressed some doubts about the extent of the prohibition contained in CBCA Section 42[76] with regard to financial assistance by a corporation other than in connection with a purchase of its shares. We thought it too broad in the class of prohibited persons in that it included directors, officers, shareholders and employees. We recommended that it apply only to directors and shareholders, which recommendation was followed when the ABCA was enacted.

6.6 One gap is that the present prohibition extends only to affiliated corporations, not to affiliated bodies corporate. A corporation could therefore provide financial assistance to a director of an affiliated extra-provincial corporation. Second, it does not cover all of the corporations in some complex corporate groups.

6.7 For instance, assume that: A corporation owns 52% of the voting securities of B corporation; B corporation owns 100% of the voting securities of C corporation and 55% of the voting securities of D corporation; D corporation owns 100% of the voting securities of E corporation. B corporation is a subsidiary of A corporation; C and D corporations are subsidiaries of B corporation; and E corporation is a subsidiary of D corporation. Under the provisions of section 2(1)(a) A corporation is affiliated with B corporation; B corporation is affiliated with C corporation; B corporation is affiliated with D corporation; C and D are affiliated corporations since they are

[76] Institute Report No. 36, Vol. 1, p. 79.

both subsidiaries of the same body corporate; and D corporation is affiliated with E corporation. Under the provisions of section 2(1)(b) A corporation and C corporation are affiliated because both are affiliated with B corporation. The same is true of A corporation and D corporation since both of those corporations are affiliated with B corporation. Similarly, both C corporation and B corporation are affiliated with E corporation since both are affiliated with D corporation. There is however a gap because A corporation is not affiliated with E corporation since neither are affiliated with the same body corporate at the same time.

4. THE SOLVENCY TEST

(a) Background

6.8 We have earlier described the dual nature of the solvency test contained in section 42. This has been one of the main sources of the problems associated with this section. One might reasonably ask therefore, how and why was it enacted in its present form? Since it is a carbon copy of the solvency test contained in CBCA section 42, it is necessary to examine the background to that legislation. The Dickerson report was published in 1971. The CBCA came into force on the 15th of December 1975. During the 10 year period prior to 1975 two dominant factors influenced the form of the test actually adopted. The first was the inflationary nature of the economy during those years. The second was the then current vogue in accounting circles for the adoption of current value accounting as a standard rather than the traditional historical cost basis. If the purpose of financial statements of a corporation is to present a fair picture of its financial condition as of a specific date, there is much to be said in support of current value accounting being the better method to accomplish that purpose. The solvency test in section 42(1)(e) in using the word "realizable" is basically a current value test rather than an historical cost test.

6.9 The current value test does however produce at least one anomaly. Under section 149 a corporation is required to prepare its financial statements in the prescribed form. The form prescribed is in accordance with GAAP. The CICA Handbook requires that the basis for preparation of financial statements shall be historical cost, not current value. It is not enough therefore for the directors to rely on the financial statements of the corporation prepared as they are required to be under the Act. Having done so they must make all of the necessary adjustments to convert those financial statements to current value. Inevitably this will result in additional time spent and in additional cost. Equally inevitably the result will be at best an educated guess.

(b) The Bankruptcy Act

6.10 Solvency, or its reverse, insolvency, has caused definitional problems since the concept was first invoked. "Insolvent person" is defined in section 1 of the present (federal) Bankruptcy Act. The definition could be described as a three-part test. First, that person's debts must exceed $1000. Second, that person must be unable to meet his obligations as they generally become due, or have ceased to pay his current obligations in the ordinary course of business. Third, there is an underlying asset test which requires that the aggregate of that person's property is not, at a fair valuation sufficient, or if disposed at a fairly conducted sale under legal process, would not be sufficient to enable payment of all of his obligations due and accruing due. It is not clear which of the two tests, fair valuation, or the prospective result of a legal sale, is to be the standard.

6.11 The latest in a series of proposed new Bankruptcy Acts, Bill C-17 of 1984, defines an insolvent person as one whose property, if realized at fair value, would be insufficient to pay his certain and liquidated debts whether or not the debts are due, or, if the person has ceased to pay his certain and liquidated debts, as they become due. Section 5 of the proposed Act goes on to provide various instances in which a person is deemed to have ceased to pay his certain and liquidated debts as they become due. The fate of Bill C-17 is still unknown. All this aside however, there may be a question whether the solvency test contained in any version of section 42 that is proposed should match, or be the counterpart, of the insolvency test in the Bankruptcy Act. We suggest that it should not. The two tests serve quite different purposes, one of which is, in section 42 that of maintaining the stated capital of the corporation.

(c) Current Liquidity

6.12 Both the current liquidity and the underlying asset test are the necessary pre-conditions to the validity of any transaction, other than those excepted in subsection 42(2). The current liquidity test contained in section 42(1)(d) applies the test both before and after the transaction. It is suggested that the word "after" has a multiple purpose. In the case of a loan it must mean after the loan has been made and before it is repaid. In the case of a contingent liability such as a guarantee or a charge upon the assets of the corporation, the likelihood of the contingent liability falling in must be assessed. Under the provisions of GAAP all contingent losses and gains must be disclosed in a note to the financial statements.[77] If the amount of the contingent loss can be reasonably estimated and it is likely that the future event that will trigger the contingency will occur, then the amount of the contingent loss should be accrued by a charge to income. Whether or not the likelihood that a contingent liability will fall in is imminent still remains, in most cases, simply a best guess at the course of future events.

6.13 The classic basic test of whether or not a corporation can meet its liabilities as they fall due is the ratio of current assets to current liabilities. Modern accounting methods have developed refinements to this test, and other tests which are more accurate depending upon the nature of the corporation's business. One example of the former is known as the acid test ratio which is the ratio of current assets less inventory to current liabilities. Examples of the latter are such tests as receivable turnover, inventory turnover, the ratio of net sales on credit to average accounts receivable and the number of days in receivables. Each might be the proper test for a particular corporation depending upon the nature of its business. The great advantage of the current liquidity test is that it can be ascertained by a wide variety of known tests in accordance with

[77] CICA Handbook sec. 3290.12.

accepted accounting techniques. It does not introduce a new basic accounting theory such as current value accounting. So far as we are aware the current liquidity portion of the solvency test has not been the cause of any problems or concern, other than perhaps the use of the word "after" with regard to contingent liabilities, but we suggest that at least some standard for assessing contingent liabilities is set forth in the CICA Handbook.

(d) The Underlying Asset Test

6.14 Stripped to its essentials, section 42(1)(e), the underlying asset test, requires that the realizable value of the corporation's assets must be greater than the total of the corporation's liabilities and the stated capital of all classes. On a balance sheet of the corporation the difference between these two represents the retained earnings which may be a positive or negative (deficit) figure. In its essentials this is the same test that is used in section 40 regarding dividends. When applied to dividends the effect is to abrogate the rule in _Ammonia Soda Co._ v. _Chamberlain_[78] that a company could pay a dividend out of a current year's profits without making up a previous deficit in the retained earnings. The figure derived for retained earnings will, of course, vary considerably if the basis used in determining the balance sheet figures is historical cost or if it is current value. When applied to dividends one of the other effects of this test is to permit an immediate payment of dividends out of an appraisal surplus.

---

78 [1918] 1 Ch. 266.

6.15 Realizable value is a two-edged sword. In inflationary times the derived figure for retained earnings will probably be greater than that shown on the basis of historical cost. In recessionary times the converse will be true. Realizable value has yet to be interpreted by a Canadian court and its meaning remains unclear. The definition of the word "realize" in the Shorter Oxford English Dictionary is as follows:

> Realize: to convert (securities, paper, money, etc.) into cash, or property of any kind into money.

The Unabridged Random House Dictionary uses the following definition:

> Realize: to convert into cash or money.

6.16 But just what does the phrase "realizable value" really mean? Is it the net amount that the corporation would receive if it sold all of its assets for cash; or if it sold all of its business as a going concern? Does it mean that a sale on time cannot be considered? What instructions do the directors give to an appraiser when seeking his or her advice as to the realizable value of any asset or assets? No answers can be given with any confidence on these questions. Certainly caution would dictate that the <u>lowest</u> value should be used. This perhaps is no bad thing with regard to loans, guarantees or financial assistance for the benefit of a director of the corporation, but it may well inhibit a perfectly legitimate transaction regarding the purchase of the corporation's shares.

6.17 The word "value", like the word "capital", has so many meanings that it is almost meaningless unless accompanied by an adjective. Other phrases such as market value, fair market value, or fair value, have often been interpreted by the courts and are the accepted standard of the appraisal profession. Section 184 (the "appraisal right" section) of the ABCA uses the phrase "fair value" and it has by now been the subject of a good deal of judicial interpretation.

6.18 We now turn to the question of whether some other phrase than realizable value might more usefully be adopted. If any change is to be made, there would seem to be two alternatives. The first is to use a phrase such as "the value of the corporation's assets shown on the financial statements of the corporation prepared in accordance with section 149". The use of this phrase would shift the basis from current value to historical cost. It has the advantage of permitting the directors to simply refer to the financial statements of the corporation prepared in accordance with GAAP. As we have pointed out however, historical cost can be misleading.

6.19 The second alternative is to use the phrase market value, or fair market value, both of which have been the subject of a good deal of interpretation by the courts in expropriation law. The generally accepted definition is the amount that a willing, informed buyer would be prepared to pay a willing, informed seller, neither being under any compulsion to complete within a limited time. The advantage of this phrase would be in its use of a standard phrase readily understood by appraisers and business valuators that has often been interpreted by the courts. It would allow valuation of individual assets or valuation of the business as a going concern, including a reasonable allowance for goodwill. If there <u>is</u> to be a change we would favour the use of either market value or fair market value.

6.20 We now turn to the problems involved if any change is to be made to the solvency test in section 42(1)(d) and (e). If the change is to be made in section 42 as part of the solvency test, should a similar change be made in the various other sections of the Act that use the phrase "realizable value"?[79] Changing the definition in section 42 alone imposes a different solvency test for different purposes in the Act. Not only does it lack symmetry but it produces one of those nagging small differences that businessmen and their advisors must always keep in mind. And of course any change necessarily involves a departure from uniformity. While we are of the view that such a departure from uniformity is warranted with regard to section 42 we are hesitant about the massive divergency from uniformity entailed in the alteration of every other section which uses the underlying asset test as part of the requirement of solvency.

6.21 For the purposes of the following discussion we shall use the one word "value" without elaboration. The underlying asset test contained in section 42(1)(e) requires that the value of the corporation's assets exceeds the aggregate of the corporation's liabilities and stated capital of all classes. The net affect is that the corporation must have some retained earnings in order to validly enter into any of the transactions regulated under section 42. With two exceptions, $1 of retained earnings is sufficient providing that this amount of retained earnings will be there both before and after the transaction.

---

[79] Ss. 32(2), 34(2), 36(3), 40, 179(2), 184(20).

The first exception arises in the case of a loan by the corporation to a director or shareholder, or to any person in connection with a purchase of the corporation's shares. The amount of the loan must be deducted from the value of the corporation's assets before a determination whether that value will exceed the aggregate of the corporation's liabilities and stated capital of all classes. At first glance this seems to be a rather gloomy assumption that the loan will never be repaid. When analyzed however, it limits the amount of the loan to an amount not exceeding the retained earnings of the corporation, or in other words a loan cannot be validly made out of the stated capital of the corporation.

6.22 The second exception applies to guarantees, but only if some of the assets are pledged or encumbered to secure the guarantee. In any such case the value of the assets pledged or encumbered must be deducted from the value of the assets in the necessary determination as to whether or not the corporation can meet the underlying asset test. The net affect is the same as for a loan; the amount of the guarantee cannot exceed the retained earnings of the corporation.

6.23 The wording of section 42(1)(e) results in some curious anomalies and creates some problems. If no asset is pledged or encumbered to secure the guarantee given by the corporation, the guarantee can be for any amount or even unlimited provided that the corporation has retained earnings of $1 or more. If however the guarantee is supported by a floating charge debenture, a routine occurrence in inter-corporate financing, covering all of the assets of the corporation, then the underlying asset test cannot possibly be met and the transaction is invalid. So long as the prohibited class includes shareholders this provision severely restricts financing arrangements by and within corporate groups. Section 42(2)(c) provides an exception to a holding body corporate if the corporation is a wholly owned subsidiary. "Wholly owned subsidiary" is not defined in the Act but must mean at least ownership of all of the voting securities.

5. EXCEPTIONS

6.24 The corporation does not have to meet the solvency test with regard to six particular transactions set out in section 42(2). The curious result that a corporation can enter into any of the six excepted transactions, even if insolvent, arises from the history of CBCA, section 42. As originally drafted the section imposed an absolute prohibition and solvency was simply one of the exceptions. Unfortunately, at the time of the amendment in 1977 making solvency a pre-condition to any of the transactions, the section was not restructured and the remaining exceptions remained in subsection (2). It seems to us doubtful that the result was the product of any careful examination of the section and the potential effect of the amendment at the time that it was made. We turn now to a discussion of each exception.

(a) Lending Companies

6.25 Paragraph 42(2)(a) permits an exception from subsection (1) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation. It will be noted that the exception applies to all of the transactions regulated under subsection (1). If part of the ordinary business of the corporation is the lending of money, then the corporation may provide financial assistance to a shareholder or director by means of a loan, guarantee or otherwise, and may assist in a transaction involving the purchase of its shares. This exception appears to be an historical anomaly. It occurred in the first English provisions that were enacted, and it has been a recurring theme in Alberta legislation before the ABCA. What constitutes lending money as part of the ordinary business of the corporation? Does this mean that a loan to a supplier once every year would bring the corporation within the exception? According to the Privy Council it does not. In Steen v. Law [80] the Privy Council held that in order for a company to fall into the category of one in which "the lending of money is part of the ordinary business of a company", the company must be in the commercial business of lending money normally available for unfettered disposition by the borrower and not being confined to particular or defined purposes except in special circumstances. It would appear that the exception applies to banks and lending institutions only.

6.26 We can understand an exception being made for lending corporations if the prohibited class includes shareholders. A large financial institution whose business is the lending of money and which has a large number of shareholders may inadvertently fall into the trap of lending money to one of its shareholders. If the prohibition is to be applied to directors only, the logic of the Cohen Committee recommendations with

[80] [1963] 3 All E. R. 770.

regard to distributing corporations would appear to be unassailable.[81] It is not apparent why, in practical terms there should be an exception in favour of lending institutions with respect to their directors.

(b) Expenses

6.27 Section 42(2)(b), which provides for an exception in favour of any person on account of expenditures incurred or to be incurred on behalf of the corporation, seems to have been inserted in all of the Acts (other than the British Columbia Act) from an abundance of caution. Expenses already incurred, if legitimate, are surely a debt owed by the corporation and need not be the subject of any exception. If they are not legitimate, there is no reason whatsoever to except them. Advances on expenses to be incurred could possibly be classified as a loan if the advance had been made and the expenses were never incurred, or could be classified as a loan up until the time that they were incurred. The American statutes noted earlier in this report, if they refer to an exception for expenses at all, refer only to an exception for expenses to be incurred.

(c) Employee Housing

6.28 Section 42(2)(e)(i) provides an exception to employees of a corporation to enable them to purchase or erect living accommodation for their own occupation. CBCA section 42 includes employees in the prohibited class; the ABCA section does not. Under the present ABCA section the only application of this exception would be to a director or shareholder who is also an

---

[81] Supra, para. 2.5.

employee. If there is to be an absolute prohibition against the provision of financial assistance to its directors by a corporation, or a corporation of a particular class, then such an exception will be necessary. Large distributing corporations are sometimes faced with the problems arising when employees are moved from one city in which the price of housing may be depressed, to another in which housing prices are high. It is a legitimate exercise for the corporation to assist in providing housing for its employees, particularly in a case where it has insisted upon the move. There seems no reason to penalize a particular employee simply because he or she is a member of the prohibited class.

6.29 If the precondition for validity is the ability to meet a solvency test, then the question arises whether or not there should be such an exception. Should an insolvent corporation be entitled to provide financial assistance to one of its directors or shareholders who is a full time employee to assist them with housing? The answer will depend in part on the nature of the solvency test. As we have seen, solvency and insolvency are not easily defined. If the solvency test is both conservative and difficult to interpret it may well block a legitimate and desirable loan or other financial assistance to an employee who is also a member of the prohibited class through an abundance of caution on the part of the directors of the corporation.

(d) Employee Share Purchase Plans

6.30 The necessity for the exception regarding employee share purchase plans stems from both prohibitions. In a limited number of cases the corporation cannot lend money or provide financial assistance to its directors or shareholders in order to purchase shares, and the corporation is prevented from providing financial assistance in connection with a purchase of its shares unless there is some exception. The second prohibition applies to any person. The exception removes employees from that category. A director who is a full time employee therefore falls within the exception and the corporation need not be solvent in order to validly enter into the transaction. An outside director does not fall within the exception but the transaction is permissible if the corporation is solvent.

6.31 It should also be noted that the exception only applies if the share purchase plan is structured through the use of a trustee. The reason for the requirement of a trustee is not clear. The cash position of the corporation is the same whether or not a trustee is used. If the loan is made to the employee and the employee immediately uses the cash to buy shares of the corporation, the cash position of the corporation has not changed. The increase in accounts receivable has been matched by an increase in stated capital. If the money is lent to the employee and the employee then pays it over to a trustee who buys the shares and holds them in trust for the employee until such time as the debt is paid, the effect on the financial position of the corporation is the same. There are advantages to the trustee plan in that it may provide a fixed present price for a larger block of shares, and may also provide for a staged takedown of the shares as the employee pays off the debt which he owes to the corporation. If the corporation is successful, the employee (through the means of a short term loan) may pay off the debt, acquire the shares from the trustee, sell them at a profit, and repay the short term loan. Trusteed agreements will usually contain special provisions applicable in the event of the termination of the employee's employment or his or her death. While there may well be many business advantages to the trustee arrangement over a straightforward loan and purchase of the corporation's shares, there is no reason to restrict the exception to the trusteed arrangement only.

6.32 Although we are not aware of any Alberta corporation in which the provisions of section 101(9) have been used to enable employees to elect a director or director of the corporation, we strongly recommended in our report number 36 that provision for employee directors be possible in the event a corporation wished to implement such a scheme. It follows that every accommodation should be made in the Act in order to enable employees to become shareholders of the corporation.

(e) Holding and Subsidiary Corporations

6.33 The reason for the exception for holding and subsidiary corporations is that the prohibited class includes shareholders. A holding corporation is a shareholder of the subsidiary. A subsidiary, following a successful takeover of another body corporate, may become a shareholder of the holding corporation if the target corporation owned shares of the holding corporation. Under the provisions of section 30 of the ABCA the subsidiary must dispose of any shares it acquires in the holding corporation within five years, but during the period before disposal it may be a shareholder of the holding corporation.

6.34 Assuming that the prohibited class is restricted to directors only with regard to financial assistance by means of a loan, guarantee or otherwise, the necessity for the exception disappears, but it leaves unanswered the question whether the Act should attempt to regulate financial transactions within related corporate groups. The effect of the present section 42 in providing an exception to the requirement of solvency is generally permissive. There are however limits to this permissiveness. The exception for financial assistance to a holding body corporate only applies if the subsidiary is a wholly owned subsidiary. In the example we used in section 3 of this chapter[82] the exception in section 42(2)(c) would only apply to financial assistance given by corporation C to corporation B and by corporation E to corporation D, since corporation C is a wholly owned subsidiary of corporation B and corporation E is a wholly owned subsidiary of corporation D. The exception in section 42(2)(d) would permit financial assistance by corporation A to corporation B because corporation B is a subsidiary of corporation A, but not by corporation B to corporation A unless corporation B could meet the solvency test because corporation B is not a wholly owned subsidiary of A. These curious distinctions have been the cause of much difficulty in connection with financing arrangements by corporate groups.

6.35 If the prohibited class is restricted to directors only with regard to loans, guarantees and other forms of financial assistance except a transaction involving a purchase of the shares of the corporation, and nothing more is done, then there would be no restriction on inter-corporate financing

---

[82] See para. 6.7.

arrangements except the prohibition that would apply to the recipient corporation in cases in which one individual was a director of both corporations and owned more than 10% of the voting securities of the recipient corporation. In these circumstances the recipient corporation would be an affiliate of the director. Should there be any restriction beyond that imposed by the prohibition in connection with affiliated corporations, prohibiting corporations within a related corporate group from providing financial assistance to other corporations within the same related corporate group? If there should be any such restriction the next question that arises is whether or not the precondition to validity should be the ability to meet a solvency test.

6.36 The necessity for any regulation will depend, basically, upon two factors. First, what are the reasonably forseeable abuses that may occur; and second, are other sanctions insufficient to prevent those abuses? It is possible that corporation A, a subsidiary of corporation B, could become insolvent through a guarantee of the indebtedness of corporation B or by providing some other means of financial assistance to it. Solvency, as we have seen, is difficult both conceptually and from a definitional perspective. These problems become more complex and more intractable in any attempt to apply them to related corporate groups.

6.37 While it is possible that by guaranteeing the obligations of corporation B, corporation A (being either a subsidiary or a holding corporation of corporation B) could become insolvent, it is clear law that the directors of corporation A are under a duty imposed by section 117 of the Act to act in the best interests of corporation A. A deliberate decision to bankrupt corporation A by means of financial assistance to corporation B would impose liability on the directors of corporation A without any further prohibition or sanction in the section.[83] We think it unlikely that the directors of a corporation would deliberately act so as to cause the corporation to become insolvent. In any event, if they did do so, the law presently provides a remedy.

6. SANCTIONS

(a) Duties and Liabilities of Directors

(i) Liability of the Recipient Director

6.38 A director who borrows money from his or her corporation without authority can be held to account as a trustee. If the loan is authorized by the remaining directors, the director who receives the money is in a conflict of interest situation and can only escape the harsh common law consequences if he or she complies strictly with the provisions of section 115. The director must disclose his or her interest, must not vote to approve the transaction and the contract must be fair and reasonable to the corporation at the time it was made. Section 117 of the ABCA imposes upon all directors a statutory fiduciary duty. Other than the exceptions that we have mentioned, there can be few instances in which a loan, a guarantee or some other form of financial assistance by the corporation for the benefit of one or more of its directors could fall within the rubric "in

[83] See Scottish Co-operative Wholesale Society Ltd. v. Meyer [1958] 3. All E. R. 66 (H.L.).

the best interests of the corporation". Whether authorized by his or her fellow directors or not, the director who seeks some form of financial assistance from his own corporation does so at his or her peril.

(ii) Liability of the Remaining Directors

6.39 Directors who do not receive a loan or other form of financial assistance, but who vote for or consent to the transaction are jointly and severally liable to make good any loss suffered by the corporation under the provisions of section 113(3)(d). While this provision may seem harsh, it must be remembered that there are saving provisions which a director can use to escape liability. The director can vote against the resolution approving the loan or other form of financial assistance. A director who has approved or consented to the transaction can plead the provisions of section 113(8) and escape liability if he or she can prove that they did not know and could not reasonably have known that the financial assistance was given contrary to section 42. In addition, the director can use the provisions of section 118(3) and escape liability if he or she can show reliance in good faith on financial statements of the corporation presented by an officer of the corporation or by the corporation's auditor, the opinion of a professional, be it a lawyer, an accountant, engineer or the member of another profession.

6.40 In addition, section 117(1)(a) requires that all of the directors must act honestly and in good faith with a view to the best interests of the corporation. The effect of all this is to make the directors a self-policing group. We think these sections provide the basic sanctions necessary to ensure compliance with whatever prohibition may appear in the Act regarding financial assistance to directors and others, and that they should not be changed.

(b) Shareholder Remedies

6.41 The basic structure of the ABCA is to increase the power of the directors to manage and control the corporation. This power is offset by an increase in their statutory duties and liabilities and an arsenal of shareholder remedies to provide the means whereby the shareholders can ensure that the directors observe their obligations. A shareholder, or former shareholder, is included within the definition of "complainant" in section 231. A complainant may apply to the court under section 232 for leave to commence a derivative action in the name of the corporation to enforce a right of the corporation, such as a right to claim against a director for a breach of his or her fiduciary duty. A complainant may also commence an oppression action under section 234. In addition the Act contains other remedies available to shareholders such as the right to apply to the court under section 223 for an order appointing an investigator. Basically, the Act relies on the private citizen whose interests are at stake to enforce a reasonable standard of conduct by the directors. A shareholder whose interests have been adversely affected has ample means to rectify the abuse. We do not think that any additional special remedies are needed to protect shareholders from the consequences of a breach of section 42.

(c) Creditors' Remedies

6.42 As we have noted, the two primary remedies available to shareholders are the derivative action under section 232 and the oppression action under section 234. "Complainant" as defined in paragraph 231(b) is not restricted to shareholders or directors. Under subparagraph (iii) a complainant includes any other person who, in the discretion of the court, is a proper person to make an application under Part 19. In R. v. Sands Motor Hotel Ltd.[84] the Saskatchewan Court of Queen's Bench held that the Crown (Revenue Canada) as a substantial creditor of the defendant fell within the definition of complainant and was therefore entitled to bring an action under section 234. Whether or not any creditor can bring itself within the class of complainant depends upon an exercise of the discretion of the court, but we suggest that in any case of gross abuse where an amount of any substance is involved it is almost certain that the court would exercise this discretion to include a creditor within the class of complainant.

6.43 Canadian corporate law, unlike the corporate law of most European countries, has never imposed a minimum capitalization requirement, nor does it impose any counterpart to the American thin capitalization rules. Approximately 97% of the corporations incorporated in Alberta are non-distributing corporations. We suspect that fewer than 15% of this 97% have a stated capital of more than $500. Some non-distributing corporations (with only one class of shares) have shares which were issued for as little as 1/10 of a cent per share. Hence,

---

[84] [1985] 1 W.W.R. 59 (Sask. Q.B.).

the underlying asset portion of the solvency test can have little relevance when applied to the vast majority of non-distributing corporations.

(d) Fines and Penalties

6.44 Section 244 of the ABCA is the only section of the Act which might impose a fine or other penalty for a breach of the provisions of section 42. It is cast in general language and could be described as a catch-all section. This is just as well. It seems clear that a specific penalty for breach of a specific provision in a statute implies that the intention of the legislation is to prohibit absolutely the designated act. If the intention of the statute is to prohibit the designated act then generally the court will hold that any contract made in contravention of the prohibition is void.[85] We do not, therefore, recommend any change.

(e) The Income Tax Act (Canada)

6.45 Ever since the Income War Tax Act, loans to shareholders by a corporation have been the subject of special legislative provisions. The present provisions are contained in section 15 of the Income Tax Act (Canada) and in particular subsection (2) which attributes the capital amount of the loan to income unless the loan is repaid before the end of the taxation year following the taxation year in which it was made, and subsection (9) which creates a deemed interest component on certain interest free loans. Exceptions are made for lending companies, employee housing, purchase of an automobile for use in

[85] See Brown v. Moore, (1902) 32 SCR 93; Milne v. Peterson, [1925] 1 DLR 271 (Alta. S.C.).

the shareholder's employment by the corporation and certain employee share purchase plans. There is therefore, some control and sanction concerning loans to shareholders by corporations quite outside the provisions of the ABCA. Considering the long history of these provisions in order to tax corporate distributions of any kind, we anticipate that the same (or similar provisions) will likely endure, whatever the future shape of Canadian income tax law.

7. THE POSITION OF THE THIRD PARTY

6.46 Subsection (3) of section 42 was originally intended and designed in the CBCA to implement the recommendations of the Dickerson Report that the third party or lender would not be put at risk.[86] If the reasoning behind the decision in Royal Bank v. Stewart[87] and Irving Oil Limited v. Central and Eastern Trust Company[88] is applicable, subsection (3) has failed in its designed purpose. By including all of the standard phrase, "for value in good faith without notice", the protection granted to the third party is severely limited. There can be few, if any, financial institutions or lenders today who will advance money without knowing the purpose for which it is to be used. If they do know the purpose, they will not come within the saving provision because they will have had notice. The effect is disastrous. The third party or lender does not simply become an unsecured creditor along with the remaining unsecured creditors, it loses all rights to enforce the contract or to collect the

[86] Dickerson Report, cap. 5, par. 147.

[87] Footnote 54, supra.

[88] Footnote 55, supra.

debt at all. It is because of this possibility that businessmen, their legal advisors and the legal advisors of lending institutions are put to such time and expense to satisfy themselves that any proposed transaction does not involve a breach of the provisions of section 42.

6.47 Had we been discussing English company law we would have included this section as a further subheading under the section dealing with sanctions. It has been a deliberate policy of English company law to put the third party or lender at risk as one of the most effective sanctions to ensure compliance with the section. There is no question that it is an effective sanction but it is achieved at the cost of enormous expense of time and effort and at the further cost of discouraging legitimate transactions through the understandable caution of lending institutions and their advisors. If there is any doubt at all that the provisions of section 42 may be infringed, any lender will think very carefully before entering into the transaction and usually will not do so.

6.48 The necessity for a very stern sanction should relate to the seriousness of the abuse to be prevented and, in a much broader sense, to the degree of regulation to be imposed upon the corporate structure. If the abuse that can occur is not too serious or if there are other effective sanctions available, the position of the third party should be protected, as subsection (3) was originally intended to do.

8. DISCLOSURE

6.49 Subsection (4) of the ABCA section 42 is unique to Alberta and the Yukon Territories. Shareholders have been given an arsenal of remedies to ensure that directors observe their duties, but these remedies are of little avail if shareholders have no knowledge of what events have occurred. With regard to loans, guarantees and other forms of financial assistance to directors, we will later suggest that these transactions be prohibited with respect to distributing corporations. But should they occur in spite of the prohibition they will not go unnoticed since the effect of section 149 and the regulations promulgated under that section is to require that the financial statements be prepared in accordance with the CICA Handbook. Section 3840 of the Handbook deals specifically with related party transactions and requires disclosure in the annual financial statements of the nature and extent of the transactions, a description of their relationship and the amounts due to or from a related party and, if not otherwise apparent, the terms of settlement.[89] Notwithstanding the provisions of the CICA Handbook, the statutory requirement of disclosure serves a salutary purpose in discouraging these transactions.

6.50 The problem is somewhat different in the non-distributing corporation. In most cases the shareholders will likely be aware of any financial assistance given by the corporation to one of its directors, but there are bound to be some instances in which this is not true. The present subsection (4) provides that unless disclosure is otherwise made, it shall be made in the financial statements. A shareholder may not receive the financial statements for any one fiscal year until

[89] CICA Handbook, sec. 3840.13.

nearly 18 months after the end of that particular year, by which time the damage may well have been done.

6.51 In Chapter 8 we will set out our specific recommendations for reform of this section.

CHAPTER 7

POLICY ISSUES

1. INTRODUCTION

7.1 Business corporations play a critical rôle in North American life. Yet even the modern corporations statutes have tended to evolve pragmatically, and without any distinct philosophy of the possible directions for reform of corporate structure and governance, and the policy initiatives that might be necessary to support perceived over-arching objectives.

7.2 The failure to adequately address these larger issues makes it even more difficult to resolve issues arising in the context of concerns such as those posed by s. 42. Whose corporation is it anyway? If it is a truly "closed" corporation, why should the outside world care what happens, so long as rights between members are not egregiously trampled, or creditors defrauded? Should a corporation's regime be limited to a statutory code, or are the courts or some regulatory body to have a larger "watch dog" role?

7.3 In this chapter we will outline certain larger policy issues which seem to us to be relevant to a reconstruction of section 42 type provisions.

2. THE CONCEPT OF THE CORPORATION

7.4 English and Canadian Company Law developed primarily from the economic necessity of an expanding industrial age to provide a vehicle that could raise substantial amounts of capital, provide centralized management for that capital and grant the characteristic of perpetual succession together with fully transferrable shares. Large pools of capital could not be raised without limited liability. The small investor is not likely to invest in a new enterprise if he or she can be subject to possible liability far in excess of the amount invested. The position of a creditor was protected by prohibiting any reduction of the pool of capital so raised except under the most limited circumstances. Centralized management was provided by a board of directors whose duty it was to oversee, if not actually manage the affairs of the company. Perpetual succession ensured continuation of the enterprise and led the courts to seldom allow dissolution except in cases arising from insolvency. Investors invest their money to make money either from a return on their investment (dividends) or an increase in the value of the shares which they have acquired. In order to realize the latter, the share must be freely transferable and there must be a market in which the shares may be bought and sold. The development of stockmarkets parallels the development of the various English and Canadian company law statutes over the last 130 years. Since shareholders are primarily investors who have deliberately parted with the function of management, not only do they desire a freely transferable share, the last thing they want is any duty to other investor shareholders. English and Canadian law has never imposed such a duty upon the shareholder of a public company or a distributing corporation.

7.5 None of these characteristics or attributes apply to or are desirable for the private company or the non-distributing corporation. In the overwhelming majority of modern non-distributing corporations the paid-up or stated capital is at the best nominal. Managers and investors are one and the same. Dissolution, so long restricted to the deadlock situation, is often a desirable course of action in order to relieve oppression. Since the *de facto* relationship amongst shareholders of a small closely held non-distributing corporation is closer to that of a partnership, shareholders desire restrictions on transferability of their shares so that they may control those individuals with whom they will be in a close business association. In very recent years the law has moved closer to imposing the duty owed by one partner to another upon shareholders of the non-distributing corporation. The two main shareholder remedies embodied in the modern Business Corporations Acts, the derivative action, now released from the strictures of the rule in Foss v. Harbottle,[90] and the oppression action are primarily designed to relieve and ameliorate corporate law provisions that are applicable mainly to distributing corporations.

7.6 Mr. Salomon of the famous case of Salomon v. Salomon and Company[91] was the acknowledged sole *de facto* proprietor of his company in spite of the fact that the English Companies Act of the time required a minimum of seven incorporators and seven shareholders. The House of Lords acknowledged even at that time the common practise of dummy shareholders and directors. It was not until 1929 however that the English or Alberta Companies Act made any special provision for private companies, and these were mostly permissive. One of the great surprises in any study of company law of England or Alberta is how recently the statutes

90 Footnote 2, supra.

91 [1897] A.C. 22.

and the courts have acknowledged any difference between the public and the private company. Until the modern Canadian Corporations Acts and particularly the concept of the unanimous shareholder agreement, private or non-distributing companies have generally been forced to comply with a totally inappropriate legal regime designed for public or distributing corporations.

7.7 English and Alberta company law have taken a different course in one fundamental respect since 1929. With the passage of the Alberta Companies Act of that year, the legislature also enacted the Securities Fraud Prevention Act[92] later superseded by the Securities Act of 1936.[93] Changing economic times and new problems have drawn a rapid response from the legislature in this area of the law. Complete new Securities Acts were enacted in 1955,[94] 1967[95] (which was amended almost yearly), and 1981[96] (which was amended in 1982 and saw further substantial amendments in 1984.[97]). We understand that an entirely new Act is presently under consideration. The basic theory of the 1981 Act is that it is an umbrella Act. All corporations come under its provisions unless they can bring themselves within one of the exemptions. The most common exemption is that provided for a private company, defined in section 1(t.1) of the 1981 Act. This definition is the same as the definition of a private company under the

---

92 S.A. 1929, c. 10 Repealed and re-enacted by S.A. 1930 c. 8.

93 S.A. 1936, c. 100.

94 S.A. 1955, c. 64.

95 S.A. 1967, c. 76.

96 S.A. 1981, c. S-6.1.

97 S.A. 1984, c. 64.

Companies Act,[98] namely, a company having no more than 50 shareholders exclusive of employees or former employees, and which restricts in some manner the transferability of its shares, and by its constitution prohibits any solicitation of the public to purchase any of its securities.

7.8 In a consideration of section 42, two basic concepts of the present Securities Act are of importance. These are Part 11, Continuous Disclosure, and Part 13, Take-Over Bids and Issuer Bids. Unless it falls within one of the exemptions, a corporation must file annual audited statements and must file quarterly unaudited statements. Creditors and commercial credit reporting agencies therefore have access to reasonably current financial information concerning any corporation subject to the Securities Act provisions. In addition, the corporation is required to disclose in a timely fashion any material change in its circumstances.

7.9 Part 13 provides an exhaustive regime regarding take-over bids and issuer bids, the area in which a corporation is most likely to be involved in financial assistance regarding a purchase of its shares. If there is one area of corporation law which is currently the subject of spirited discussion amongst academics, the practising Bar and the regulators, it is in the area of take-over bids. There are bound to be changes in this area of security law. Changes in security law provisions raises the spectre of differing provisions in the Business Corporations Act from those contained in the Securities Act and the possibility of incompatibility between the two.

[98] The Companies Act R.S.A. 1980, c. C-20, s. 1 (r).

7.10 We think the distinction between a distributing and non-distributing corporation (which, amongst other things, means one that is under the Securities Act umbrella and one that is not) has been substantially overlooked in the present Section 42. The cause of the oversight appears to have been the desire for uniformity with the CBCA. Since Canada has no federal securities law, the drafters of the CBCA were probably inclined to ignore these differences. We think that these distinctions are necessary in order to provide a sensible and workable Section 42.

3. ECONOMIC FACTORS

7.11 One of the classes, the possible abuse of whose legitimate interests are of concern in moulding a revised section 42, is the creditor of the corporation. Whether the creditor is owed money by a distributing or a non-distributing corporation, he, she or it is faced with limited liability. Generally the creditors of a distributing corporation do have a locked-in pool of stated capital to which they can look for payment. Alberta has provided some widely publicized exceptions to this general rule in the last few years, but they have been the result of astonishing debt to equity ratios created or allowed in boom times. This phenomenon has come home to roost during the recent savage downturn of the Alberta economy. These problems are not caused by breaches of section 42 nor could they have been prevented by corporation law. Corporation law can never ensure that corporations will always succeed.

7.12 Limited liability also serves another purpose beyond raising capital. Since many trade creditors are themselves corporations composed of several or many shareholders, failure of a corporation has the effect of spreading the loss amongst many. There is a reverse side to this coin. In an economy precariously balanced at the peak of a boom, one large failure can have reverberations through a large sector of the economy. However, we think it generally true that limited liability does not pose serious problems for the creditors of a large distributing corporation.

7.13 Almost invariably limited liability can only be partially achieved in the non-distributing corporation. The main source of capital for most of these corporations is institutional financing. Institutional lenders inevitably demand personal guarantees from the owners and the managers, or both, of repayment of their corporation's debt, together with any and all other forms of security that the corporation can possibly give. The larger trade creditors who have an aggressive credit department often demand the same. Not only does the personal guarantee provide additional security, it satisfies the institutional lender, or a trade creditor, that the shareholder managers are attending to their business. The usual problem for the normal trade creditor of a non-distributing corporation is that he, she or it has no security whatsoever whereas the lending institution always does and the large trade creditor may sometimes have the same. The secured creditor will have priority in the event of insolvency. There are only two defences available to the normal trade creditor of a non-distributing corporation: to build in an allowance for bad debts in the price of the goods that it sells or, less effectively, to use the facilities of one of the available commercial credit reporting agencies.

7.14 We think that the likelihood of directors of non-distributing corporations taking unauthorized loans from their corporations in severe economic times is not that much greater than in boom times, but we hasten to add that this statement is pure conjecture. In any event we do not think that corporation law should be designed with either severe or boom times in mind; it should serve a reasonable purpose in both.

7.15 The availability of capital in severe times is more difficult and more important than in boom times. Since the main source of capital for most non-distributing corporations is the institutional lender, it is more important during severe times that the institutional lender is not confronted with the possibility of losing both its security and the right to collect its debt. Reorganization of a non-distributing corporation which is perilously close to extinction is difficult enough without the added hurdle of convincing the institutional lender and its advisors that the financing requested will not be held to be invalid.

4. <u>THE SECURED VS THE UNSECURED CREDITOR</u>

7.16 We have seen that the main dispute which will arise if a non-distributing corporation has granted a charge on its assets as security for an obligation of one of its directors or in connection with a purchase of its shares, will be a priority battle between the holder of the security and the unsecured creditors in the event of insolvency. Which of the two classes should the law favour? Our discussions with the practicing bar to date suggests that their sympathies have been with the small unsecured trade creditor. Usually these concerns have arisen in connection with a receivership, not a transgression of section 42, but presumably the sympathies of those who communicated with us would be the same.

7.17 Our law has always favoured the secured creditor. There is no reason for the secured creditor to advance funds unless security for repayment is provided. We are more inclined to protect the third party who has advanced money on the strength of the security obtained. Creditors and lending institutions may be unwilling to advance credit or funds at all, unless they can obtain valid security. Having done so in the belief that they were secured it seems inequitable to later invalidate that security and to cancel any obligation for repayment. Any proposed reform of section 42 is hardly the place to start to change the law of priorities between secured and unsecured creditors. On the whole therefore we feel that the position of the third party, usually an institutional lender, should clearly protect both the obligation and the security for performance of the obligation.

5. CORPORATE GOVERNANCE

7.18 Canadian and English legal scholars have not been as concerned with the basic concept of the corporation, its necessary objectives, and the manner in which these objectives may be achieved as have their American cousins. The past 50 years of American jurisprudence have seen the emergence of three distinct philosophic models as being the proper objective of a corporation. The first of these may be described as the "market model". It is much favoured by economists of the Milton Friedman school. Under this model the corporation is a set of rules designed to provide for efficient exchanges. Efficiency and maximization of profits are the only legitimate objectives of a corporation. This has the attractions of symmetry and simplicity. Any contribution to charity would produce a *prima facie* presumption that the directors who had authorized the gift had been derelict in their duty to the corporation.

7.19 The market model is not quite as simple as it looks. Those who support it have been faced with two major problems. It is easy to suggest that the function of the corporation is to achieve efficiencies in the marketplace and to maximize profits. But, profit to whom - the corporation or its shareholders? Spirited defences by management to a takeover bid reveal the difference. Shareholders who have been denied the opportunity to sell their shares at a price considerably in excess of the recent market price because management has successfully defended the citadel from the marauding infidels, are inclined to view maximization of profits in a different light than do the successful defenders. Then too there is the distinction between short term profit and long term profit. Where does the balance lie if the sole objective is to maximize profits? Courts have traditionally been loath to interfere with the decision of the directors balancing short term against long term. The market, if ideal, will presumably discount to present value the prospect of long term profits arising from research, but the market does not usually know about the nature of the research carried on unless the corporation chooses to make the information available. The market will therefore reflect to a much greater degree the results of annual and even quarterly statements. Directors under the market model must be perpetually weighing one against the other, and this imposes a duty that has no firm boundaries.

7.20 The turbulent decade of the 1960's saw the emergence of a totally different model, generally referred to in American jurisprudence as the "political model". Under this model the corporation is regarded as a powerful individual whose actions should adhere to desirable moral and social conduct, and whose primary objectives should be to bring benefits to those whom it affects and the community at large. Unlike the market model, a corporation under the political model would be required to devote some of its resources to charitable and philanthropic objectives.

7.21 The American Law Institute has been struggling with this basic concept for some time now. It formally commenced its project on corporate governance in 1978, and expected that the project would be completed in 3 years. At present the hoped for completion date is some time in 1988. Under the original plan the project was split into seven topics, only one of which, the second, dealing with the objectives of conduct for the business corporation is of concern to us here. Tentative draft #2 of the Objectives of Conduct of the Business Corporation was presented to and discussed at the annual meeting in May of 1984. The draft provoked spirited discussion, but hesitantly adopted the following wording for section 2.01 on the clear understanding that it be subject to review when the entire report was completed. The wording is as follows:

> (a) A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
>
> (b) Even if corporate profit and shareholder gain may not thereby be enhanced, the

corporation, in the conduct of its business

> (1) is obliged, to the same extent as a natural person, to act within the boundaries set by law,
>
> (2) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and
>
> (3) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

7.22 As might have been expected this statement was unacceptable to the dedicated adherents of either the pure market or political model. The ALI model is a compromise between the two. Its basic premise is that the primary objective of a business corporation is to make money, not to cure all the evils in the world. There are however some limitations on this primary objective. The corporation must act within the law. An industrial concern has no duty under corporation law to ensure that its manufacturing process is environmentally safe, but it does have a duty to comply with any law imposing environmental standards. Subparagraph (b)(3) permits a corporation to benefit the community without having to justify such actions as an exercise of the business judgment rule, and provides a limitation in that the amount must be "reasonable".

7.23 One feature of the ALI model is notable, for our purposes: once again the basis of any examination of corporation law seems to have been approached solely from the point of view of the distributing corporation and the existence of so many small, "closed" corporations is not weighed.

6. <u>UNIFORMITY</u>

7.24 In Volume 1 of our Report No. 36 we discussed the merits of uniformity[99] between federal and provincial corporate legislation, and between Alberta legislation and the legislation of the other Provinces and Territories. Briefly, our support for uniformity between federal and Alberta corporate law was and is based on the fact that both regimes are in force in Alberta. Substantial, if not slavish, uniformity saves considerable cost in the long run. Businessmen and their advisors need not familiarize themselves with two entirely different concepts of corporation law. For the most part professors can teach and students learn only the one system. Since the CBCA model has now been substantially followed in four other Provincial and one Territorial jurisdiction, there is now a considerable body of judicial interpretation of the newer concepts contained in these modern corporate statutes.

7.25 All of these factors remain important, but the ABCA was never, and is not, a carbon copy of the CBCA. We remain of the view that the ABCA should only differ from the CBCA if there are sound reasons for doing so. ABCA section 42 does not now match its counterpart in the CBCA. The question must therefore be asked is further divergence justified?

7.26 We are convinced from the many submissions made to us, or that have been passed on to us by the Registrar of Corporations, that the problems posed by the present section are real; that the members of the practicing bar are not jumping at shadows and that reform is necessary even if uniformity must be further sacrificed in the process. In addition we understand

---

[99] Report No. 36, Vol. 1, p. 5.

that similar sections in other Canadian jurisdictions that have followed the CBCA model without significant amendments have created problems in those jurisdictions. We think it misguided to cling doggedly to an inappropriate provision simply for the sake of uniformity. There will be varying policy decisions across the country as to the degree of regulation required concerning a corporation granting financial assistance to its shareholders, directors or other closely related persons, and perhaps even more divergence regarding the question of financial assistance in connection with a purchase of the corporation's shares. We suspect that uniformity with regard to the area covered in section 42 of the ABCA is a lost cause and that in this area the next 10 years will see considerable divergence across the country. While we regret this result, we are convinced that a more workable section is essential.

7. Conclusions

7.27 The basic purpose of the ABCA is to provide a readily available and convenient vehicle to carry on commercial activity. Incorporation is a matter of right providing the incorporators complete and file the required forms. Incorporation provides limited liability, perpetual succession and the status of a person in law. It circumvents the necessity for a multiplicity of contractual relationships that would otherwise be necessary. The basic objective of the ABCA is not that different from the objectives of a corporation contained in tentative draft #2 of the American Law Institute, although perhaps not as explicitly stated and perhaps not as clear in its exceptions to the profit motive for charitable and philanthropic activity.

7.28 The amount of regulation in the ABCA is minimal. The main function of the Registrar is to administer the public record. There are very few areas in which the Registrar is called upon or permitted to exercise any discretion. Enforcing compliance with the statute is generally left to those whose interests are affected.

7.29 Distributing corporations that do not fall under the exemption for private companies contained in the Alberta Securities Act, are subject to a high degree of regulation under that Act. Thus, Alberta presents the unusual picture of a permissive Business Corporations Act that applies to all corporations and a highly regulated regime that applies to most distributing corporations. The reasons for this are clear. Securities regulation may be regarded as a special form of consumer protection legislation. Its main purpose is the protection of investors. It is a fundamental necessity of any industrialized nation to provide an efficient market for capital unless all industry and development is owned and controlled by the state. Securities regulation is designed to ensure that such a market for capital will continue to exist. Corporation law, as opposed to securities law, should provide only the basic framework for distributing corporations. On the other hand corporation law should be more explicit with regard to non-distributing corporations since they are subject to few other forms of regulation.

CHAPTER 8

PROPOSALS FOR REFORM

1. INTRODUCTION

8.1 We have previously indicated that the nature of the problems presently regulated by Section 42 are more easily analyzed, and our proposals for change more easily understood, if divided into four discrete subsets. They are, loans and financial assistance to directors and others by a distributing corporation; loans and other forms of financial assistance to directors and others by a non-distributing corporation; financial assistance in connection with a purchase of shares of a distributing corporation; and financial assistance in connection with a purchase of shares of a non-distributing corporation. Such an analysis will not necessarily result in the four separate sections. There will be areas of overlap that can be accommodated in whatever legislation is finally adopted.

8.2 We will commence with a discussion of the distinction between distributing and non-distributing corporations, and then discuss each of the four subsets. The problems concerning the positions of the lender and third parties and the various sanctions necessary to ensure compliance with all four transactions are common to all. These problems will be discussed in sub-section 7.

2. THE DISTINCTION BETWEEN DISTRIBUTING CORPORATIONS AND NON-DISTRIBUTING CORPORATIONS

8.3 The prohibitions contained in Section 42 apply to all corporations, but we believe that there are basic differences between a corporation that has raised substantial funds from the investing public and one in which the managers are operating with their own money. Unfortunately the two main Alberta statutes dealing with corporation law, the ABCA and the Alberta Securities Act[100] use different criteria to distinguish between these two basic categories.

8.4 A distributing corporation under the ABCA is defined in section 1(i). Briefly, a distributing corporation is one that has distributed any of its shares to the public and has over 15 shareholders. There is no definition of a non-distributing corporation. The distinction between these two categories was an attempt to divide corporations on a functional basis. It was thought that, with very few exceptions, any corporation having more than 15 shareholders would inevitably result in a division between those who are active in management and those who are not; that there would be one group of managers and another composed of investors.

8.5 The ASA has been described as an umbrella Act in that it applies to all corporations unless they fall into one of the exceptions. The largest single exception is for private companies, which are not under the umbrella. A private company is defined in section 1(t.1) of the Alberta Securities Act. Briefly a private company under that Act is one that has not more than 50 shareholders, exclusive of employees; one in which the right to transfer its shares is restricted; and one in which any invitation to the public to subscribe for securities is prohibited. "Security" is exhaustively defined in section 1(v),

100 R.S.A. 1980, c. 5-6.

and includes almost anything that one could imagine might possibly be classed as a security.

8.6 There is an intermediate category of corporation under the ABCA. These are corporations that have never solicited the public to purchase any of their securities, but have more than 15 shareholders. They were private companies under the Alberta Companies Act, and still fall within the definition of "private company" under the Alberta Securities Act. For the purposes of Section 42 we would regard them in the same manner as the non-distributing corporation, since their funds were not raised by any general solicitation of the public. They will fall in the same category as the non-distributing corporation for the purposes of any proposed legislation.

3. FINANCIAL ASSISTANCE TO DIRECTORS AND OTHER PERSONS WITH RESPECT TO DISTRIBUTING CORPORATIONS

(a) The Prohibited Transactions

8.7 The present Section 42 prohibits a corporation, directly or indirectly, from giving financial assistance by means of a loan, guarantee or otherwise to the prohibited class. When applied to loans, guarantees and other forms of financial assistance to directors, this wording is unnecessarily broad. It is however necessary in the present section since the present section also deals with financial assistance with regard to purchase of shares. If however discussion is confined to financial assistance to directors and others of a distributing corporation, excluding assistance with regard to a purchase of shares, what transactions should be prohibited? We suggest that the prohibition should be as clearly defined as possible so that businessmen and their advisors can know with reasonable certainty whether any proposed action is within or without the prohibition.

8.8 We think the prohibition should apply to a loan by a distributing corporation to one of the prohibited class, a guarantee of the indebtedness of one of the prohibited class and a charge upon the assets of the corporation to secure the indebtedness of a member of the prohibited class. We do not suggest that the prohibited transactions be extended to the same extent that they are in sections 330 and 344 of the 1985 English Companies Act.[101]

RECOMMENDATION No. 1

That, subject to the exceptions later discussed, a distributing corporation be prohibited from granting financial assistance by means of a loan, guarantee or otherwise to a member of the prohibited class.

(b) The Prohibited Class

8.9 The CBCA includes directors, officers, shareholders and employees in the prohibited class. The ABCA includes directors and shareholders in the prohibited class. Because shareholders are included in the prohibited class, exceptions have to be made for the lending company such as a large financial institution that could inadvertently be lending money to one of its shareholders. An exception must be made for the loan from a parent corporation to a wholly owned subsidiary, since the parent is a shareholder of the wholly owned subsidiary. We suggest that there are only two classes that should be considered in relation to a loan by a distributing corporation, namely, the directors and the officers. We have no hesitation about the directors.

[101] See Appendix 2.

But there are some changes that we feel should be made to make the class more inclusive. We will discuss whether or not officers should be included after we have dealt with our recommendations regarding directors. In order to be effective "directors" should include the two following classes.

(i) Director of an Affiliated Corporation

8.10 This prohibition is presently contained in section 42(1)(a). The definition of an affiliate is contained in section 2(1) of the Act. Section 2(1) refers to "body corporate". Section 42(1) refers to "corporation". Under the present wording therefore it would seem that an Alberta distributing corporation could lend money to a director of a wholly owned subsidiary providing that the director of the subsidiary was not a director of the parent, and that the subsidiary was incorporated in any other jurisdiction. Logically, if we are opposed to a distributing corporation, that has raised its money from the public, lending any of its money to one of its directors, we should equally be opposed to it lending money to a director of a wholly owned subsidiary. Since the prohibited class does not include shareholders, the wholly owned subsidiary itself is not within the prohibition. In order to ensure effective regulation the section should be cast in terms that are broad enough to cover the extra-provincial corporation as well as the Alberta corporation.

RECOMMENDATION No. 2

That the prohibited class of director include a director of an affiliated body corporate.

(ii) Associates of Directors

8.11 An associate is defined in the present section 1(c). The section sets out five distinct categories of relationship that would be included within the word associate. We have comments regarding only the first and the fourth of those categories. Under the first category any body corporate of which a director of corporation A (the corporation to which the prohibition applies) is an associate of the director if the director owns 10% or more of the voting shares. This percentage may be too restrictive. We understand that in some conglomerates the management of a subsidiary is deliberately given, or allowed to hold, a more substantial interest than 10% as an incentive for performance of the subsidiary. If the chief executive officer of the subsidiary owns more than 10% of the shares of the subsidiary, and is also a director of the parent corporation, then the prohibition would apply and the parent corporation cannot lend money to the subsidiary. We think that what was intended was to block a loan made by corporation A to another corporation in which one of corporation A's directors owns a substantial or significant interest. The use of such words as "substantial" or "significant" in the actual legislation would not, we feel, be welcomed by the profession, but we think that this was the intent of the section. We should point out that the word "associate" is used in one other section of the Act, namely section 188(2) for the purpose of defining the majority of the minority rule in takeover bids. Once again we think what is intended is a substantial or significant interest.

8.12 While we feel that 10% is too low, we are not sure what would be acceptable to the profession as representing a significant or substantial interest. There are four important percentages of voting shares that are of importance under the ABCA. Over 50% of the voting shares gives the holder control since he, she or it can elect the directors of the corporation. Fifty per cent is a highly specialized situation requiring highly specialized solutions. Less than 50% but more than 33 1/3% at least assures the holder that no special resolution may be passed without his, her or its consent. Any one holding less than 33 1/3% is a true minority shareholder. Rather than requiring all of those who use the Act to remember an additional percentage, we suggest that the figure of 10% be raised to 33 1/3%.

RECOMMENDATION No. 3

That section 1(c)(i) be amended by striking out the figure of 10% and substituting the figure of 33 1/3%.

8.13 Section 1(c)(iv) includes in the definition of "associate" a spouse of the director. The CBCA definition includes both spouse and child. Legal staff who were at the Institute at the time that Report No. 36 was prepared, cannot recall why the CBCA inclusion of child was not repeated in the ABCA. We now think the term should be included, and in this respect we strike a blow for uniformity.

RECOMMENDATION No. 4

That section 1(c)(iv) be amended by adding immediately after the word "spouse", the words "or child".

8.14 There are two additional cases which these recommendations would not cover. The first is a loan by distributing corporation A to an associate of a director of one of its affiliates. We have suggested that the prohibition apply to a director of an affiliated body corporate. If this is so then logically the prohibition should also apply to an associate of a director of an affiliated body corporate.

8.15 A prohibition that prevents distributing corporation A from lending money to corporation B would be ineffective if directed solely to the situation in which corporation B was an associate of corporation A. It would be perfectly possible for other associates, for instance the director's wife and three children, and perhaps other holding corporations to own well over 33 1/3% of the associate corporation. In order to prevent this situation therefore an additional expansion of the prohibited class is necessary to include a corporation in which the director, either alone or in conjunction with an associate or associates of the director control more than 33 1/3% of the corporation.

RECOMMENDATION No. 5

That the prohibition in Recommendation No. 1 should apply to an associate of a director, an associate of a director of an affiliated body corporate and to any body corporate in which the director of the corporation together with an associate or associates of that director, directly or indirectly, controls more than 33 1/3% of the voting securities of that other body corporate.

(iii) Officers

8.16 One of the basic thrusts of the ABCA is to increase the power of the directors to manage on the one hand, and to impose a regime of liability on them on the other hand. In theory at least, it is the directors who are responsible for the management of the corporation. In practice there may well be distributing corporations in which it is the officers who are the true controlling force through their ability to dominate the outside directors. The North American tendency is to increase the number of outside directors in distributing corporations. Every distributing corporation must have at least two outside directors.[102] We understand that reputable underwriters today insist that a reasonable proportion of the directors of a corporation that they are taking to the public for the first time be outside directors. In those distributing corporations in which a high proportion of the directors are inside directors, the inside directors consist of the top management of the corporation, and the provisions of the section would apply to them. We therefore see no reason to change from the recommendation we made in Report No. 36, that officers not be included in the prohibited class.

(iv) Shareholders

8.17 We can see no reason to include shareholders in the prohibited class with respect to distributing corporations. The shareholder of a distributing corporation has entrusted his money to others to manage and invest. Whether or not the corporation would choose to lend money to a shareholder is a matter of business judgment. We point out that inclusion of shareholders in the prohibited class necessitates an exception for subsidiary and holding body corporates. This necessity disappears if shareholders are excluded from the class.

(v) Employees

8.18 The CBCA section 42 applies to employees as well as directors, officers and shareholders. We could not see the

---

[102] See ABCA, S.A. 1981, c. B-15, ss. 97(2).

reason for this at the time Report No. 36 was prepared. Nothing has happened since to change our minds. Whether or not the corporation lends money to one of its employees is a matter of business judgment for the management, for the directors or a committee of the directors. We see no reason to include employees in the prohibited class.

(c) Exceptions

(i) Lending Corporations

8.19 Section 42(2)(a) of the ABCA excepts lending corporations from the provisions of section 42(1). The curious result is that a lending company may make a loan to, or guarantee the indebtedness of, one of its directors even if it is insolvent. This exception was and is necessary so long as the prohibited class includes shareholders. A large distributing corporation, that is in the business of lending money, may not know that it has lent money to one of its shareholders. If shareholders are not included in the prohibited class, the reason for the exception disappears. If loans to directors by distributing corporations are to be prohibited, we can see no reason to make any exception for distributing corporations that are in the business of lending money.

RECOMMENDATION No. 6

That no exception to recommendation 1 be made for lending corporations.

(ii) Advances on Expenses

8.20 There is no reason to make any exception for expenses that have been incurred. Once incurred such expenses are a legitimate debt owed by the corporation and there is no need to make any exception for them. We have grave doubts that any exception for an advance on expenses is needed at all, but we note the provisions in the CBCA and in the other provincial Business Corporations Acts patterned upon the CBCA. We can see no harm in retention of the exception. More from an abundance of caution than any other reason, we suggest that the exception be retained.

8.21 The next question is whether there should be any limit on the advances. There are three alternatives. The first is to adopt the concepts of the 1985 English Companies Act and impose monetary limits on the amount of the advances. We are not enthusiastic about this alternative. It imposes the problem of setting an upper limit either in the Act or by regulation. In order to be effective it must not be too high a figure, but it must be high enough to cover a wide variety of circumstances. We simply do not know what an appropriate figure might be. Then too, we are worried that any upper limit will become a standard amount without regard to the particular circumstances.

8.22 The second alternative is to add the modifier "reasonable" before the word expenses. On balance we are not persuaded that any benefit to be derived is not outweighed by the imposition upon the directors of having to determine what is "reasonable" in each and every set of circumstances. Nor are we persuaded that such a modification is necessary. Over and above the fiduciary duty imposed upon officers and directors under section 117 of the ABCA, hangs the diligently enforced provisions of the Income Tax Act (Canada) regarding expenses. The expenses are only deductible from income if necessary to produce that income. In light of all this, therefore, we do not recommend the addition of the word "reasonable". This leaves us with the third alternative; to leave the section as it is at present, and this is our recommendation.

RECOMMENDATION No. 7

That advances to a director on account of expenditures to be incurred on behalf of the corporation be excepted from the prohibition in recommendation 1.

(iii) Advances on Salaries

8.23 It has been suggested to us that an advance on salary is analogous to an advance on expenses. To the best of our understanding the normal practice in Canada is to pay outside directors so much per meeting and so much per year. The yearly salary is, in a sense, compensation for the risks of being a director. The meeting fee is paid to encourage directors to attend meetings. We are not aware of any instances in which the outside directors are paid in advance, but it is possible that this may occur on the rare occasion. A far more likely instance in which an advance on a salary would be paid, would be to a director who is an employee of the corporation in some capacity or another. While we are no more persuaded that such an exception is necessary than we were regarding expenses to be incurred on behalf of the corporation, having recommended that expenses be made an exception, we can see no harm in providing a similar exception for a director who is a full time employee of the corporation.

RECOMMENDATION No. 8

That an advance on salary to a director who is a full time employee be excepted from the prohibition in recommendation 1.

(iv) Housing

8.24 At paras. 6.28-6.29 of the Report we discussed the present exception for employee housing. If the prohibited class is limited to directors only, this exception should apply only to a director who is a full time employee of the corporation. We think that this is a necessity and particularly for the large distributing corporation whose senior management may be moved from province to province, or whose position with the corporation required that he or she live in an area of Canada or in another country in which conventional mortgage financing may be difficult or impossible to obtain. In certain circumstances it may well be that the corporation is not actually advancing money by way of a loan, but is simply guaranteeing repayment of a mortgage or charge upon the housing. We feel that this exception should be continued for a director who is a full time employee of the corporation.

RECOMMENDATION No. 9

That financial assistance by way of a loan, guarantee or otherwise by a distributing corporation to a director who is a full time employee of the corporation, or any of its affiliates, to enable the director to purchase or erect living accommodation for his or her own occupation be excepted from the prohibition in recommendation 1.

(v) Purchase of Shares

8.25 This is one of the areas of overlap. The topic could be dealt with either under this section or under section 5 in which we discuss financial assistance regarding the purchase of its shares by a distributing corporation. For reasons which will become apparent following our discussion in section 5, we have chosen to discuss this exception under this heading.

8.26 We recognize that the directors of many large distributing corporations are convinced that it is impossible to obtain the more than competent personnel for the top management positions of the corporation unless some form of equity participation in the corporation is offered over and above salary and other benefits. In the opinion of many business consultants, equity participation is considered to be a greater incentive for long term senior employees than salaries or bonuses. The simplest form of providing equity participation is by means of an option to purchase the shares of the corporation. The option is granted at a fixed price. If the corporation does well then the holder of the option can exercise it and sell the shares so acquired for a gain. For some years, although not at present, the gain so realized was a benefit arising from employment and therefore taxable as income. Partly to overcome the tax consequences, the trusteed scheme was devised which we have described in paras. 6.30-6.32.

8.27 While the distinction between the trusteed scheme and a straight loan to purchase shares seems negligible in relation to its affect upon the corporation, the straight loan to the employee, who then uses the money to purchase the shares from the corporation, may well offend section 25 of the Act, which states that shares may only be issued if fully paid for in money or property, and that property does not include a promissory note or promise to pay given by the allottee. We can see no great difference in the result between the use of a trustee or a direct loan to the employee who then uses that money to purchase the shares of the corporation. If, however, there is to be an exception for directors, of one class or another, then we feel that the exception should provide for both methods, and would of course have to be introduced by words such as "notwithstanding section 25".

8.28 Equity participation by senior management is a recognized fact of Canadian business life. We remind the reader that it is our recommendation that the prohibition regarding loans, guarantees and other forms of financial assistance by a distributing corporation apply only to directors. The sole remaining question therefore is whether an exception should be made only for directors who are full time employees of the corporation, or for all directors of the corporation. The senior executives who are given some opportunity for equity participation are often directors, and we feel no doubts about providing an exception for them. Whether the outside director should be included in the exception or not is to our minds a more difficult question. Under section 117 we have imposed by statute a high moral code of conduct upon the directors. The outside directors of a distributing corporation do not manage the corporation, they are responsible for the general strategy of the corporation, and to ensure compliance with the law. It is their duty to police senior management. To make an exception for outside directors permitting the corporation to lend them money with which to acquire shares of the corporation seems to us to be analogous to leaving a hungry child to guard the cookie jar. We suggest therefore that the exception apply only to directors who are full time employees, and this is our recommendation set out below. This recommendation is one on which comment would be particularly helpful.

RECOMMENDATION No. 10

> That notwithstanding section 25, a corporation be permitted to lend money to a director who is a full time employee of the corporation, or any affiliate of the corporation, to enable such a director to purchase shares of the corporation or of any of its affiliates either directly or to be held by a trustee.

(d) Disclosure

8.29 At para. 6.49 *et seq* we discussed the reasons why subsection (4) of section 42 was recommended in Report No. 36. If our recommendations in this chapter are followed concerning loans, guarantees and other forms of financial assistance to directors of distributing corporations, then some modifications must be made to subsection (4) of section 42. Under the preceding recommendations we have suggested a flat prohibition subject to some exceptions. It would therefore be the exceptions only that would have to be disclosed. Of these we think it an unwarranted burden to require disclosure by the corporation of advances on expenses or advances on salary. Amounts lent to, and therefore due from subsidiary corporations will be disclosed on the financial statements of a distributing corporation in any event. While housing loans will probably involve an amount substantially greater than advances on expenses or salaries, we feel that the normal housing loan would be small potatoes on the financial statements of a large distributing corporation. It has been suggested to us that disclosure should be made of housing loans in excess of $150,000, or perhaps some other prescribed figure. It is the duty of the directors to ensure that the amount of any such loan is not totally unreasonable. We doubt that directors would authorize a loan that would enable a senior officer who is also a director to live in the style of an oriental potentate. In any event, under the CICA requirements, a loan to any director or officer must be disclosed on the financial statements of the corporation.

8.30 Loans or financial assistance to a director to enable the director to acquire shares of the corporation come close to the pocket book of other shareholders. While it is true the sums may vary, the issuance of any additional shares will dilute the existing shareholders' equity in the corporation. Under GAAP the option to acquire shares must be disclosed on the financial statements. If the shares have actually been issued, then the observant reader will notice the change in the amount of stated capital from the previous year on the balance sheet, and the funds received for the shares on the statement of change in financial position. On the whole therefore, we are of the view that the disclosure provisions are not necessary with regard to the excepted financial assistance to directors of a corporation.

RECOMMENDATION No. 11

That no disclosure be necessary with regard to the excepted loans and financial assistance to directors of a distributing corporation.

(e) Conclusion

8.31 It will be noted that we have not recommended the use of a solvency test as a control mechanism to regulate loans, guarantees and other forms of financial assistance given by a distributing corporation to one of its directors. As a general rule it is not the creditors of a distributing corporation who are or will be adversely affected if a distributing corporation lends money to one of its directors and is unable to collect it. A distributing corporation has raised a substantial amount of stated capital from the investing public which does provide a cushion to which creditors can look for payment. Distributing corporations that come under the umbrella of the ASA are required to file quarterly statements that are available to creditors directly or through credit reporting agencies. Generally therefore, creditors do have available to them current financial statements upon which they can base their estimate of risk.

8.32 It is the shareholders whose legitimate interests are being adversely affected by these actions. Admittedly the adverse affect is negligible when a large and prosperous distributing corporation grants a small loan to one of its directors, but ability to meet a solvency test does not solve the problem, it has just lessened the adverse affect of such undesirable conduct on the part of the directors.

8.33 The overall effect of our recommendation would not be that much different from the present section. We are suggesting an absolute prohibition with some exceptions. But the present section demands solvency as a precondition and then goes on to provide exceptions in which the corporation need not be solvent. The complexities of the present solvency test have effectively imposed an absolute prohibition. Imagine being faced with the problem of determining the realizable value of the assets of Shell Canada Ltd., (a prospect which the Saskatchewan Court in a slightly different context found utterly daunting and enormously expensive[103]) merely for the purposes of a loan to a director! In an increasingly litigious age businessmen who act as directors of distributing corporations and their advisors are justifiably unwilling to assume the risk of possible liability, which may extend far beyond the amount of the loan. Our recommendations do, we think, have the merit of certainty, and a large and largely useless financial accounting exercise is done away with.

4. FINANCIAL ASSISTANCE TO DIRECTORS AND OTHER PERSONS WITH RESPECT TO NON-DISTRIBUTING CORPORATIONS

(a) Introduction

8.34 Corporate Registry informs us that 97% of Alberta corporations are non-distributing corporations. We are not able to obtain nearly as accurate a figure as to the proportion of this 97% that have 10 or fewer shareholders. Admitting that the figure is at best a guess, Corporate Registry estimates that at least 85% of the non-distributing corporations have fewer than 10 shareholders. From the experience of Institute counsel and those members of the practising 8ar with whom we have discussed the matter, we would be inclined to place the estimate somewhere between 90 to 95%. In any event, the vast majority of non-distributing corporations may be characterized as incorporated partnerships. After 60 years of conflicting decisions, English law finally recognized that the close personal relationship of shareholders in a small private company was so closely akin to the relationship that prevails in partnerships and that the remedy of dissolution available under partnership

---

[103] See <u>Montgomery</u> v. <u>Shell</u> <u>Canada</u> <u>Ltd.</u> (1980) 10 D.L.R. 261.

law should be available on just and equitable grounds in private companies.[104] Ebrahimi has been followed twice in Alberta.[105]

8.35 In a great number of cases the owners of non-distributing corporations run their affairs as though they were partners in a partnership. They often do not formally set their salaries at the beginning of each year, but simply take an agreed amount every month - a little more if it has been a good month, a little less if not so good. At the end of the year they sit down with their accountants to determine the most favourable tax mix of salaries, bonus and dividends. Under these circumstances, if the salaries have not been formally determined at the start of the year, the corporation could be considered as having given financial assistance to their owners. There is nothing wrong with this, after all it is their "own" money, but an absolute prohibition similar to that which we have recommended for distributing corporations is neither practical nor desirable.

8.36 Why regulate these transactions at all? The only reason to do so is to protect the trade creditors of the corporation. It is one thing for the owners to withdraw funds from their own corporation. It is another if by so doing they have taken funds that should have been used to pay the corporation's trade creditors. The shareholders of a non-distributing corporation will almost always be aware of what is going on if one director is taking more than his or her share. In any event, the Act provides the minority shareholder with

---

104 See Ebrahimi v. Westburn Galleries Ltd. [1972] 2 All E.R. 492 (H.L.)

105 See Johnson v. W.S. Johnson and Sons Ltd. (1979) 95 D.L.R. (3d) 495 and Re Pe Ben Pipelines Ltd. (1979) 7 Alta. L.R. (2d) 174.

remedies to rectify any abuse. The problem therefore, is to find a minimum workable method of providing some protection for the trade creditors.

(b) The Alternatives for Reform

(i) Repeal

8.37 We have received submissions from the practising Bar, some made tongue-in-cheek and some completely serious, that the best solution to the problems created by section 42 is to repeal the entire section. The underlying basis for this suggestion is that the expanded fiduciary relationship imposed upon the directors under section 117 provides all that is needed in the way of a control mechanism. As we understand these submissions, those who make them are not suggesting that certain of the actions prohibited under section 42 should be allowed without restriction. They are suggesting that the fiduciary duty under section 117 is a sufficient control device. We have considered the idea carefully, and its simplicity is attractive. There are however some serious disadvantages.

8.38 The first is the manner of enforcement, since, if section 42 were repealed, section 113(3) would of necessity and as a consequence also be repealed. Without section 113(3) there is no specific provision under which a Compliance Order under section 240 would be available. In almost all cases a derivative action under section 232 would be necessary to remedy the breach. Notwithstanding _R._ v. _Sands Motor Hotel Ltd._[106] we are not persuaded that every creditor can bring himself within the

[106] Footnote 83, supra.

category of complainant. In two of the four separate problems that section 42 attempts to regulate, it is the creditors who are our primary concern. We have grave doubts that a court would extend the fiduciary duty owed by the directors to their corporations and its shareholders to embrace the entirely new class of the corporation's creditors. We believe that businessmen and their advisors would be appalled if the court did so.

8.39 Subsection (3) of the present section 42 was an attempt to protect and save harmless the lender or third party dealing with the corporation. We are not convinced that it is effective to do so. We will later suggest that there should be effective protection for the third party, as originally intended. If this recommendation is followed it must be in the clearest language, and include even those cases in which the lender or third party had knowledge that the section was being transgressed. If there is no such provision, then we suggest that the courts will almost certainly apply the principle in Rolled Steel Products,[107] that if the directors apply the funds or assets of the corporation in breach of their fiduciary duty, a third party who received the funds or assets with knowledge either actual or constructive of the director's breach becomes a constructive trustee of the misapplied funds or property and must return them to the corporation.

8.40 Returning now to the problems that arise with the necessary and consequential repeal of section 113(3). Section 113(3) serves two purposes. It imposes a joint and several

[107] Footnote 11, supra.

liability upon all of the directors who consent to the transaction, not only the director who received the financial assistance. We are not sure that a court would do so if the fiduciary duty under 117 is the only sanction. Section 113 serves two other purposes which we believe businessmen and their advisors heartily approve of. Subsection (3) limits the liability of the directors to the amount not otherwise recovered by the corporation. Without section 113(3) an enthusiastic judge may expand this liability far beyond the amount not recovered to full or partial satisfaction of all creditors' claims in the event that the corporation founders. This might particularly be so if the judge could be persuaded that the financial assistance given was one of the causes of the collapse of the corporation. Subsection 113(9) imposes a statutory limitation period of two years, which in the light of the recent decision of the Supreme Court of Canada in Central and Eastern Trust Company v. Rafuse[108] must surely be preferable to the unlimited time period that would result if the only sanction was the fiduciary duty contained in section 117.

8.41 Our most serious reservation with respect to the repeal of the section arises from the hazy parameters of the fiduciary duty. Not only are the boundaries indefinite, they are constantly shifting. In an era in which the courts are retreating from some of the more absolute aspects of the fiduciary duty,[109] yet extending the duty in other directions in order to be able to impose a constructive trust, we hesitate to

[108] [1986] 2 S.C.R. 147.

[109] See the recent Court of Appeal decision in Hanson v. Lorenz and Jones, reported in the New Law Journal, November 14, 1986, at p. 1088.

recommend reliance on the fiduciary duty as a control mechanism. We believe that businessmen who own non-distributing corporations and their advisors would be much happier with a provision that is simple and certain, and that in any event a legislative balance is required.

(ii) Solvency as a Control Mechanism

8.42 In theory, a requirement that the corporation be solvent both at the time of a transaction and until all of the corporation's obligations under the transaction have been discharged, is an ideal control mechanism. A shareholder who feels aggrieved has his remedies. If the corporation is, and remains solvent, no creditor will suffer. In practice the problem of devising a satisfactory solvency test has proven difficult, if not impossible, and has produced great uncertainty in the law. We have considered several and have yet to find a satisfactory answer for the purposes of section 42.

8.43 If solvency is used as the control mechanism, and it applies after the transaction as well as at the time of the transaction, it requires 20-20 foresight on the part of the directors. There are always external risks in any business. A major supplier or customer may fail. A new product may displace the corporation's product. The whole area of the economy in which the corporation is operating may suffer a severe downturn. Alberta has become all too familiar with the failure of small businesses in certain areas of our economy. There is no evidence to suggest that these failures were caused by breaches of the prohibited transactions in section 42 rather than a downturn of the economy. Then too, if directors are required to foretell the future, for how long must they do so? One year? Two years? Or for so long as the debt or obligation of the corporation remains in existence? Earlier in this paper we have pointed out the difficulties imposed by the solvency test contained in section 42(1)(d) and (e). Most of these difficulties centre on the underlying asset test contained in paragraph (e). We are not aware that the current liquidity test in paragraph (d) has created any problems. For the reasons stated we feel it is necessary to permit non-distributing corporations to enter into loans to their directors. We do not think it unreasonable to require that the corporation be solvent at the time that it does so, and to provide that the transaction wili not result in the corporation becoming insolvent.

RECOMMENDATION No. 12

> That a non-distributing corporation shall not give financial assistance to a director of the corporation unless there are reasonable grounds for believing that the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due.

(iii) The Use of General Terms

8.44 Two other suggestions were made to us recommending the use of a general formula as a precondition to validity and we record them here in case others should think them more appropriate than the foregoing recommendations. The first is that the transaction must be "in the best interests of the corporation". The fiduciary duty under section 117(1)(a) already imposes this requirement and it seems redundant to repeat the requirement in section 42. The problem seems to us to be the reverse. Can the fiduciary duty in section 117(1)(a) be used to expand the scope of any proposed regulation under section 42? Put another way, if we design section 42 to permit certain transactions, can section 117 then be used to impose liability upon directors even though they have acted within the bounds of section 42? We are inclined to doubt that this would be so on the grounds that the specific provision will take precedence over the general provision. As we have suggested, one of the main purposes of section 42 is to limit the application of the fiduciary duty in this area. We do not therefore recommend the suggestion.

8.45 The second suggestion is to impose a requirement that any of the transactions presently regulated under section 42 be permitted only if they are entered into "for a proper business purpose" or some slight variation of that phrase. This, we think, would be to set sail on uncharted waters. We have no idea what the courts would eventually determine the phrase to mean. Whatever the final destination, it would only be achieved at the expense of litigants. Further, we have no idea how long it would take before the courts finally resolved the phrase. We do not recommend the use of a general phrase of this kind as a control mechanism.

(iv) A Pragmatic Approach

8.46 Minority shareholders of a non-distributing corporation have a variety of remedies. Given an adequate disclosure section, we do not believe that the minority shareholder needs anything more. The problem is therefore reduced to providing some reasonable protection for the creditors of the corporation. One possibility would be to limit the solvency test to a requirement that the corporation be solvent at the time of the transaction, and impose an onus upon the directors to prove, in the event the corporation foundered, that the transaction had not been the cause of the corporation's downfall. But this would be onerous, and require the directors to prove a negative.

8.47 That abandoned concept did, however, contain the seeds of another concept, namely, that the corporation should be able to meet its obligations as they fall due at the time of the transaction and following the transaction for some specific and certain period. If the corporation foundered within a specific period such as one or two years after the transaction, then the directors would be required to comply with section 113, namely, to restore to the corporation any amount that the corporation was unable to otherwise recover. The length of the period should, in theory, be sufficient that in the great majority of cases the corporation has been able to carry on notwithstanding the financial assistance. If the corporation has not foundered within that period but does so afterwards, it is a fair assumption that the financial assistance was not the cause of the downfall. The longer the period the more valid the assumption. Any period chosen would be, to some extent, arbitrary. The length of the period should balance the estimated number of cases in which it would be effective against the continuing contingent liability on the part of the directors (which might seriously hamper business decisions). We suggest that any period beyond two years is excessive.

8.48 If this is an acceptable proposal, the question then becomes one of method. The concluding words of section 113(3) limit the liability of the directors to the amount required to restore to the corporation the amount or the value of the property not recovered by the corporation. We agree with this limitation of liability. If the directors have taken money from the corporation, and the corporation founders, they should put the money back. In this respect we recommend no change to section 113(3).

8.49 Section 113(9) imposes a two year limitation period within which an action may be commenced against the directors for any breach of the provisions of section 42. Left unchanged the subsection would set the period at two years in which the directors would be required to put the money back, or to restore any property to the corporation which it had been otherwise unable to recover. To use a different period for the provisions of section 42 from that used with regard to the other transactions mentioned in section 113(3) seems to us to be unnecessarily complex and we do not recommend any change.

8.50 There is however one small point that concerns us. Both subsections (3) and (9) of section 113 refer to the date of the resolution authorizing the transaction. No doubt the vast majority of distributing corporations conduct their affairs with meticulous formality and there will be a proper resolution authorizing the transaction. We suspect that the directors of the majority of non-distributing corporations are inclined to ignore such formalities, and there may not be a resolution at all, another example of the practical differences between distributing and non-distributing corporations. We suggest that the date from which time should run in both subsections (3) and (9) should be the date of the resolution or the effective date of the transaction, whichever occurs first.

RECOMMENDATION No. 13

That the limitation period contained in section 113(9) should expire two years after the date of the resolution or the date of the transaction whichever is the earlier.

(c) The Regulated Transactions

8.51 In our recommendations regarding distributing corporations we recommended a basic structure of absolute prohibition with exceptions. We have explained why an absolute prohibition regarding loans in a non-distributing corporation flies in the face of reality, and why we are recommending a different basic structure, that of regulation rather than prohibition. It is the fact that many non-distributing corporations do advance money to their owners that has led us to this conclusion. It immediately raises the question whether other forms of financial assistance such as a guarantee by the corporation should be treated in the same manner. We admit to a bias at the start. We would prefer, if at all practical, that the same provisions apply to all forms of financial assistance to try and achieve simplicity. The basic theory behind requiring solvency as a pre-condition and imposing a limited liability in the event that anything goes wrong is designed for the protection of creditors. There is a question however, whether the provisions we have suggested, designed for the protection of creditors with regard to loans by the corporation, are sufficient to protect the creditors when applied to other forms of financial assistance such as a guarantee given by the corporation.

8.52 The factor which causes us concern is the time factor. Loans by a corporation to its directors are normally repaid within two or three years. In fact most loans are paid shortly after the end of the fiscal year. In any event the provisions of the Income Tax Act (Canada) will normally ensure that the loan is repaid within two years. A guarantee of the indebtedness of a director, or a charge upon the corporation's assets may however enure for a considerably longer period of time. The limitation period of two years in which the directors would be held jointly and severally liable would therefore have expired. A guarantee or a charge upon the assets however may have no affect on the profit and loss account or statement of change of financial position until such time as the corporation is called upon to honour the guarantee or the charge. This may well be at some period beyond the two year period, in which case the creditors of the corporation could suffer. Creditors could be aware of any charge granted by the corporation if it is registered in some public registry. If they choose to advance credit with knowledge of such a charge that is their business. The only serious problem that we can see arises in the case of the guarantee. There is no public record of a guarantee and there is no telling when it will fall in to be paid.

8.53 How then do we treat the guarantee? There are three alternatives. Firstly, the problem could be ignored in the hope that the two year period will be effective in most cases, that within that time the corporation will have been called upon to honour the guarantee, and therefore liability will fall upon the directors. The second would involve prohibiting a guarantee. If this were done it would force businessmen to adopt one of two alternate structures, since the prohibition would of necessity apply to associates of the director. Assuming that non-distributing corporation A owns all of the shares of non-distributing corporations B and C, corporation A could guarantee the indebtedness of corporations B or C or both. If however Tom, Dick and Harry own corporation A as a holding corporation which holds the real estate, and they also own corporation B which is the operating corporation, and corporation C which is the sales corporation, then corporation A cannot guarantee the indebtedness of either corporation B or C, because they are associates of Tom, Dick and Harry. A third alternative is to treat the amount of the guarantee as the equivalent of a loan for the purposes of the solvency test. In other words, the test could require that the corporation be able to meet its liabilities as they fall due, and to assume there is a call upon the guarantee immediately after it had been executed. The advantages of this provision would be that it would prevent the lurking time bomb of an unlimited guarantee. Commercial lenders may not be entirely happy with this, but we think it an acceptable trade off for both certainty and the protection which we propose for the third party or lender.

8.54 It is the unlimited guarantee by a corporation of the obligation of its directors that has caused us the gravest concern. If the problems posed by the unlimited guarantee are not as serious as we have mentioned, then there is no need to make a special provision regarding guarantees. Other than the unlimited guarantee, normally a specific obligation of a director guaranteed by the corporation will have a repayment schedule by the director so that the two year period will prove effective to determine whether or not the corporation will be called upon to pay it. We acknowledge that we have no empirical information to guide us. We do not know how many, if any, non-distributing corporations have failed as a result of their executing an unlimited guarantee in favour of one or more of its directors. If, however, the practising Bar feels that there is a serious problem in this regard, we can only suggest the third alternative. Of the three alternatives, we hesitate to recommend absolute prohibition with regard to a non-distributing corporation unless there is no other acceptable and workable solution. We are inclined towards either the first alternative, to make no special provision, or towards the third, treating the guarantee for the purposes of the solvency test as though it fell in to be paid immediately following execution.

8.55 Before making our final choice to recommend either the first or the third alternative, we pause to consider one other aspect of the matter. We have suggested in Recommendation No. 13 that the solvency test should be limited to the current liquidity test. The main reason for requiring a solvency test at all is to bring in to play the provisions of section 113(3) and (9). If alternative no. 3 is adopted, it will provide a means for the precise measurement of the effect of a guarantee on current liquidity. On the whole therefore we are inclined to favour Recommendation No. 3, but once again we remind the reader that this is a Report for Discussion and that we are anxious to receive comment.

RECOMMENDATION No. 14

That a non-distributing corporation shall not give financial assistance to a director of the corporation by means of a guarantee or charge upon its assets unless there are reasonable grounds for believing that the corporation is, or after having given the financial assistance would be, unable to pay its liabilities as they become due, if the corporation were required to pay the amount due under the guarantee or secured by a charge upon its assets on the day following the execution of either or both.

(d) Disclosure

8.56 Shareholders of a non-distributing corporation will normally be fully aware of any financial assistance given to a director by the corporation. In our recommendations regarding financial assistance to the directors of distributing corporations, we suggested that disclosure was unnecessary, but this recommendation is a logical result of our recommendations that distributing corporations be prohibited from granting financial assistance to their directors subject to some exceptions. We also felt that the exceptions did not warrant the burden of disclosure beyond that that is already required under section 3840.13 of GAAP.

8.57 Since our recommendations for non-distributing corporations permit financial assistance to directors under certain conditions, disclosure becomes a more important consideration, particularly in those cases in which a shareholder or shareholders are not aware that the corporation has given financial assistance to one of its directors. Under section 42(4) the corporation is required to disclose full details of any financial assistance that it has given in its financial statements if it has not otherwise done so. The problem is one of timing. It is possible that there may be a time lag of up to 18 months before shareholders will receive this information and it may be longer if a shareholder must compel the corporation to provide the financial statements. Since the liability imposed under section 113 has a two year limitation period, there may well be cases arise in which an aggrieved shareholder will have very little time indeed to commence his or her action.

8.58 Shareholders of a non-distributing corporation may waive the requirement of an audit under section 157, but the corporation must still prepare annual financial statements and they must be prepared in accordance with GAAP. The disclosure requirements in section 3840.13 of GAAP are almost identical to those contained in section 42(4). The important distinction is that under the GAAP provision only the relationship need be disclosed, not the identity of the person receiving the financial assistance. We suggest that in the non-distributing corporation, the identity of the person receiving the financial assistance is of prime importance and that therefore the specific items of disclosure contained in 42(4) should be maintained. The burden of providing this information to the shareholders of a non-distributing corporation is not particularly heavy since there are few shareholders who must receive the information. We suggest therefore that subsection (4) could be considerably simplified if, in those cases where disclosure had not otherwise been made by the corporation, the corporation were to provide the details presently required under the subsection within 90 days of the transaction.

<u>RECOMMENDATION No. 15</u>

That subsection (4) of section 42 be amended to require a non-distributing corporation to 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.

(e) Exceptions

8.59 The structure of the present section 42 contains a curious anomaly. It provides that solvency be the sole control mechanism for all corporations, but contains within its structure the tacit admission that the solvency test is well nigh incomprehensible. It therefore goes on to provide exceptions in which the corporation need not meet the solvency test. Just why a corporation should be permitted to lend money to a shareholder or director for living accommodation, or to do any of the other acts contained in the exceptions when the corporation is insolvent seems to defeat the purpose of the section to a very large extent. We recommended exceptions that were necessary in the light of the absolute prohibition imposed upon distributing corporations. If the solvency test advanced above is applied to non-distributing corporations, we do not believe that any exceptions are necessary. The basic approach that we have recommended with regard to non-distributing corporations is that if the corporation is solvent it may enter into any of these transactions to benefit its directors, and if the corporation later founders, then the directors must restore the money so lost. Under these circumstances we do not see the need for any exceptions.

5. FINANCIAL ASSISTANCE BY A DISTRIBUTING CORPORATION IN CONNECTION WITH A PURCHASE OF ITS SHARES

8.60 The problems associated with a distributing corporation granting financial assistance in connection with a purchase of its shares, either issued or to be issued, will only arise in connection with a take-over bid, whether friendly or hostile, or an issuer bid by a distributing corporation to purchase its own shares.

8.61 We can think of no particular branch of corporation law that is currently the subject of more concern amongst managers and directors and their advisors, to more proposals from regulators, or to more discussion by academics than the general issue of regulation of take-overs. As a general rule, businessmen wish for no legislative restraint and preach the efficacy of the market as providing an adequate control for their conduct. By their desire to impose detailed regulation of one kind or another, regulators are tacitly stating their conviction that the market is imperfect and the market theory inadequate. Academics span the entire spectrum depending upon their basic attitude.

8.62 We know of no reported case in Canada where it is the creditors of a distributing corporation who have suffered in a transaction of the kind addressed by the present section. In the only two reported cases in England dealing with public companies, the Malaysian Rubber Company cases of <u>Selangor</u>[110] and <u>Karak</u>,[111] it was not the creditors who were adversely affected. While both

---

[110] Footnote 25, supra.

[111] Footnote 27, supra.

companies failed, both were described as inactive and simply investing their funds. Both cases were commenced at the instigation of the Board of Trade. We do not know what led the Board of Trade to do so, but we suspect that it was following complaints by the Trustee in Bankruptcy of the principal architect of the two transactions. When one examines all of the current cases reported in the press rather than the law reports, it is the shareholders who may suffer, not the creditors.

8.63 If there is to be any regulation at all in this area there are two choices; either we impose a general rule, or we impose extensive and detailed regulation. If we impose a general rule it is probably impossible to do so without prohibiting some legitimate transactions. For example, under the present section 42 a corporation must meet the complex solvency test both before and after the transaction if it chooses to issue a convertible debenture that charges the corporation's assets. Technically this is a charge on the assets of the corporation in connection with the issuance of its shares. Such long term financing may certainly be desirable, and in some cases almost essential, in order for the corporation to thrive.

8.64 If on the other hand we were to endeavour to recommend detailed regulation we would be doing so in advance of changes that are inevitably going to come about in securities law with regard to take-over bids. We doubt that there is a perfect answer to this question. We suspect that there will be a fairly prolonged period of trial and error before an acceptable balance is achieved. This is an area of law encountered daily by the various Security Commissions and the administrators of Canada's various stock exchanges. It is they who have the practical experience and who are best equipped to suggest appropriate legislation or regulation. To a very large degree, financial assistance by a distributing corporation in connection with a purchase of its shares is now controlled by the provisions of Part 13 of the Alberta Securities Act. That Part provides a comprehensive regulatory regime applicable to both takeover bids by an outsider and to issuer bids in those cases in which a distributing corporation proposes to purchase any significant number of its own shares.

8.65 Further to those considerations, we have earlier pointed out the various remedies available to minority shareholders. The minority shareholders of large distributing corporations are undoubtedly composed, to a certain extent, of private investors, but to a far greater degree substantial blocks of their shares are held by professional investors, the administrators of pension funds or other substantial pools of money. It is no longer a case of one small shareholder battling the large corporation. Substantial sums of money may be involved and the professional advisors are quick off the mark to exert their rights. A striking example which comes to mind is Domglas Inc. v. Jarislowsky.[112] This judgment was affirmed by the Quebec Court of Appeal.[113]

8.66 Our tentative thinking under this head is therefore that the ABCA should not contain any provision relating to the regulation of financial assistance by a distributing corporation

---

112 (1981) 13 B.L.R. 135.

113 (1983) 138 D.L.R. (3d) 521.

in connection with a purchase of its shares. We would recommend however that the Department of Consumer & Corporate Affairs and the Alberta Securities Commission should identify any abuses that may be apparent arising out of transactions of the kind under consideration here, and endeavour to secure the amendment of the Alberta Securities Act as may be appropriate to address same.

8.67 If the foregoing course of action does not find favour with the administration, the Bar, and other interested parties, it presently appears to us that a solvency test - in both limbs, viz., liquidity and balance of assets - should probably be maintained.

RECOMMENDATION No. 16

(a) That 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.

(b) That 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.

6. FINANCIAL ASSISTANCE BY A NON-DISTRIBUTING CORPORATION IN CONNECTION WITH A PURCHASE OF ITS SHARES

(a) Introduction

8.68 We have found this issue to be one of considerable difficulty, both as a matter of policy, and as to appropriate technical solutions.

8.69 First, there is the issue of policy. Why should there be a proscription at all in this area? In the case of distributing corporations we suggested that creditors - so far as we have presently been able to determine - are probably not adversely affected. Such abuses as are revealed by the law reports relate to take-overs, and as we have suggested, may be more appropriately the subject of securities law regulation. In the case of non-distributing corporations, it is possible that there may be unsecured creditors who could be adversely affected by the transaction, although the incidence of this seems impossible to determine. Even if that is so, however, there is still the question: Why should the position of creditors be addressed in a provision of this kind, rather than by some other vehicle, if their position is to be looked to at all? Perhaps the most pragmatic answer that can be given to that question is that the position of creditors may be best addressed at the time the shares (assets) of a company are being disposed of. On the other hand, there is some real force in the argument - increasingly being heard - that piecemeal statutory provisions for the protection of creditors should be abolished in favour of a new impeachable transactions regime. In what follows, we assume that there is a sound case, as a matter of policy, for protection of creditors by legislative proscription with respect to transactions of this kind. However, we would welcome further comment on that basic policy issue.

8.70 If, as a matter of policy, trade creditors are to be protected in this context, how should that be done? Essentially this comes down to the question: Who should bear the burden of protection? This question can best be understood in a transactional context - that is, through an appreciation of the position of the several parties to a transaction of this kind. Having undertaken such a description we will then canvass the solutions which presently occur to us.

8.71 We start with the proposition that the shareholders of a non-distributing corporation who sell their shares have every right to do so. Indeed they, or their personal representatives after their death, may be bound to do so pursuant to an agreement with the remaining shareholders. It may often be necessary to structure the sale so that payments are made over a period of time in order to provide an orderly transition between generations or in the event of the death or retirement of a shareholder. In any of these transactions there are three parties directly involved, the buyers, the unsecured creditors and the person who has been granted financial assistance by the corporation to assist the sale, whether it be the vendors of the shares or a third party who has advanced money to the buyers in order that the vendors may be paid in full.

(b) The Nature and Effect of the Financial Assistance

8.72 We do not believe that all forms of financial assistance are presently prohibited by section 42. If Canadian courts follow the decision in the Wellington Publishing case,[114] a dividend under section 40, a redemption of shares under section 34, a corporate buy back of the corporation's own shares under section 32 or a reduction of capital under section 36 could all be used to assist in the purchase of the corporation's shares. There is no reason why this should not be so since each of those

[114] Footnote 30, supra.

sections has a built-in protection for the creditors of the corporation.

8.73 The form of assistance generally given is either a guarantee by the corporation that the unpaid balance owing to the selling shareholders will be paid, or a charge on the assets of the corporation as security for payment, or both. If financing has been arranged through a third party or lender in order to pay the selling shareholders in full, then either or both of these forms of security will usually be given to whoever puts up the money. In the event that only a guarantee is given by the corporation the effect on the unsecured creditors is not as serious as in the case of a charge upon its assets. If the corporation founders and is called upon to pay the guarantee, the obligation ranks equally in priority with the claims of the unsecured creditors. If however, the corporation has granted a charge upon its assets in favour of either the unpaid vendors or in favour of a third party whose money has been used to pay off the selling shareholders, the charge will take priority over the unsecured creditors. The dispute then becomes a priority battle between various classes of creditors.

(c) The Parties Concerned in the Transaction

8.74 In the usual kind of case, that is, one in which the buyer wishes to pay the balance of the purchase price over time and security for payment has been given by a charge on the corporation's assets either to the vendors or to a third party who is financing the transaction, there may be five different parties involved in, or affected by, the transaction. They are; the unsecured creditors of the corporation, the vendors of the shares, the third party lender if there is one, the buyers of the shares, and the directors of the company. We now turn to a consideration of the position of each arising from the transaction.

(i) The Unsecured Creditor

8.75 Shares in a non-distributing corporation are not freely bought and sold in the marketplace. Transactions come about under two separate sets of circumstances. They are either the result of a buy/sell arrangement among the shareholders in the event of death or retirement of one of them, or the result of an arm's length transaction. The buy/sell agreements may take one of two common forms. Either the continuing shareholders agree to buy the retiring or deceased shareholder's shares, or the corporation agrees to buy back the retiring or deceased shareholder's shares. In the latter case the transaction can only be completed if the corporation can meet the requirements of section 32. These are not the cases that have caused any great problems and nothing further need be said about them.

8.76 An arm's length transaction involving the purchase and sale of shares in a non-distributing corporation will involve considerable prior negotiation and the execution of a complex agreement. The buyer, properly advised, needs to know the precise value represented by the piece of paper called a share certificate before agreeing to buy it. The keystone of any share sale agreement is a set of financial statements coupled with several pages of warranties. The agreement may require the purchaser to pay off the trade creditors at or immediately after closing, or they may not be paid off and are simply a continuing obligation of the corporation. If the agreement is so structured that the trade creditors are to be paid off by the vendors, it seems highly improbable that the trade creditors will not realize that there has been a change in the ownership of the corporation. Hence there is an argument that if they continue to do business with the corporation without making enquiries, they do so at their own risk.

8.77 Even in those cases in which the obligation of the corporation to its trade creditors continues we doubt that the trade creditors will not know of the change of ownership within a fairly short period of time. There are not that many people involved in the management of non-distributing corporations. Within a relatively short period of time the trade creditors will realize that there has been a change in the ownership and management of the corporation. Admittedly, this knowledge may be of little use to them if during that period the corporation has executed a charge upon its assets that will take priority over their claims. Nowhere in the judgments of the trial judge, the Nova Scotia Court of Appeal or the Supreme Court of Canada in <u>Irving Oil Ltd.</u> v. <u>Central and Eastern Trust Co.</u>[115] is there any indication of the length of time in which Irving Oil Ltd. had been dealing with the corporation, Stonehouse Motel Ltd. The closing date for the sale was December 31, 1968. Judgment was given by the trial judge in the foreclosure action on November 25, 1977. There must have been a period of eight years between the date of the transaction and commencement of foreclosure proceedings. We can make one of two assumptions. Either Irving

[115] For trial decision see (1978) 81 D.L.R. (3d) 495. N.S.C.A. decision (1979) 89 D.L.R. (3d) 374. Supreme Court of Canada, footnote 55, supra.

Oil Ltd. dealt with Stonehouse Motel before the transaction and continued to do so, or it commenced dealing with Stonehouse Motel some time after the transaction. If it had been dealing with the motel before the transaction it would have been paid its debt in full shortly after the closing date, since this was one of the obligations of the vendor. If it had been dealing with the motel before the closing date it must certainly have been aware of the change of ownership. If it dealt with the motel for the first time after the closing date it was certainly open to it to discover that the motel was subject to a substantial mortgage.

(ii) The Vendors of the Shares

8.78 If the vendors of the shares are prepared to take partial payment and the balance over time, secured by a charge on the corporation's assets, then their position is analogous to that of the third party or lender who finances the transaction on the basis of receiving security for the monies advanced. We leave any further discussion of their position under these circumstances to our discussion of the third party or lender who advances money for the purposes of a sale on the basis of receiving security for repayment. In those cases in which the selling shareholders have parted with their shares upon condition that they be paid in full, should the law impose any obligation upon them with respect to the corporation's obligations to its unsecured creditors? In those cases in which the selling shareholders do not pay off the trade creditors, the outstanding obligations have been taken into account to reduce the price for which they sold. Leaving for the moment any consideration of their position in the event they have taken security for the unpaid balance, and providing that the sale is an arm's length transaction, it seems difficult to see why the selling shareholder should bear any burden in favour of the unsecured creditors.

8.79 We have excepted the non-arm's length transaction for a specific reason. If we did not do so, it would be possible for a holding corporation to cause one of its subsidiaries to sell all of its shares to another subsidiary on a time basis, taking as security for payment a charge on the assets of the corporation whose shares are being sold. Thus the unsecured creditors of the corporation whose shares are being sold could be defeated.

(iii) The Third Party Lender

8.80 We include in this category selling shareholders who have a balance owing to them and who have taken a charge on the corporation's assets to secure payment. In this situation there is an issue as to whether it should be the secured or the unsecured creditor who is favoured by the law. At present the law favours the unsecured creditor. And it does so to an extraordinary degree. In Irving Oil Ltd. v. Central and Eastern Trust Co.,[116] Irving Oil was favoured in its claim totalling slightly over \$10,500 at the expense of Central and Eastern Trust Co. whose mortgage at the time of the commencement of the foreclosure action was just under \$218,000. In Thibault[117] the vendor who parted with his business only on condition that he would receive security for the unpaid balance ended up receiving some \$16,500 out of a total purchase price of \$90,000, to the

[116] Footnote 55, supra.

[117] Footnote 45, supra.

benefit of the unsecured creditors of the corporation some three years after the transaction. It may be thought that the elevation of the unsecured creditor's rights in this way is unjustified - at least as against a secured creditor.

(iv) The Buyer of the Shares

8.81 Buyers of shares enter into the transaction of their own free will, and routinely without the necessary funds to complete. They assume control of the corporation's affairs. If the corporation fails some time after the transaction, it is either because their management has been inadequate or because of economic factors over which they have no control. If it is the latter, undoubtedly one may sympathize with their plight, but this is a risk that they assumed when they bought the shares.

8.82 Either the transaction was structured so that the selling shareholders paid off the trade creditors up to the date of closing, or the buying shareholders got a reduction in the purchase price of the shares through their undertaking that the corporation would do so after the transaction. As we have noted in the first case, the creditors do not need protection. They have been paid off. Creditors dealing with the corporation after the transaction do so at their own risk. By obtaining a reduction in the purchase price in those cases in which the creditors were not paid off at the time of the transaction, the buyers have implicitly undertaken to do so. In these circumstances it is arguable that if it is a trade creditor who is to be favoured and protected, it should be at the expense of the buyers, not at the expense of the selling shareholders, whether they have taken security for an unpaid balance or not, or at the expense of the third party lender who has advanced money only on the basis that the advance will be secured by a charge on the corporation's property. One of the extraordinary results in the Irving Oil case is that the buyers of the shares ended up with a corporation owning a very substantial asset that is not subject to any major financing. In addition to the Central and Eastern Trust mortgage there was an additional second mortgage of $50,000 involved in the transaction. Presumably this too fell by the wayside. It seems an extraordinary result that the law would create such a magnificent windfall for the buyers who did not have sufficient funds to close the transaction in the first place.

(d) Possible Solutions

8.83 There seem to us to be several possible approaches which might be adopted for the protection of unsecured creditors with respect to non-distributing corporations. Again we note that this assumes the case for protection is made out, and the question now being asked is therefore a technocratic one.

8.84 The first possibility is to maintain a prohibition (as under the present law) against these transactions unless the company is solvent - however the term "solvent" is defined. (Totally prohibiting all such transactions seems altogether too Draconian.)

8.85 A second possibility is to allow the transaction to proceed regardless of solvency but to place an obligation upon the buyers of the shares to reimburse creditors within some set period of time, if their debts are not property discharged. We will call this, for convenience, an "insurance" analogy.

8.86 A third possibility is to maintain a prohibition (with a solvency exception) and, in the event of breach, to require whatever financial assistance is improperly granted to be restored to the company by specified parties. This would most likely be the directors of the company who sanctioned the arrangement.

8.87 The Institute's position on these possibilities is tentative at this time. It has some reservations as to whether unsecured creditors should be protected at all in this context. However, if creditors are to be protected, it is highly desireable that the technique chosen be one which lends itself readily to field application and the giving of reasonably precise legal and accounting advice. The Board is tentatively in favour of the third possibility (para. 8.86, supra) but wishes to hear representations on this issue before expressing a definitive view. It may now be useful to say something in more detail about each of these possibilities, and the advantages and disadvantages of each.

(e) The Solvency Approach

8.88 This would involve a continuation of the present technique: the transaction is prohibited unless the company could be said to be - on some defined basis - solvent at the time the transaction was entered into. There are problems under this approach of both definition and application and the question of what solvency should mean for the purpose of this exercise has been canvassed at earlier points in this report. On the advantages side, this test is party neutral - that is, it says that if the financial condition of the corporation is X, then it may do Y, but an overt preference for the position of a particular party after the fact is avoided.

(f) The Restorative Approach

8.89 If a prohibition is to be maintained, it would be possible to require somebody to restore to the company the measure of any financial assistance improperly advanced with respect to the purchase of shares.

8.90 There are at least two obvious problems with such an approach. What is meant by the "measure" in such a case? That sum of money actually advanced? Or perhaps even that sum of money actually advanced together with any collateral benefits derived therefrom? And, who should do the restoring? The directors? Or the selling shareholders? Or both?

8.91 If the directors (who will routinely also be the major shareholders in these cases) are required to restore funds to the company that will have at least two effects. First, it puts the funds back into the company pool, for whatever advantage may flow to both secured and unsecured creditors. Second, it would operate as a powerful disincentive to a breach of the proscription against provision of assistance.

8.92 This approach is as party neutral as could be formulated, in that it is supportive of the *ex ante* positions of secured and unsecured creditors. It is they who have put themselves into the positions they in fact occupy. This proposal would therefore represent a sharp redirection of the law away from the (perhaps inadvertent) present protection of unsecured creditors, and would represent, in practice, an improvement in the lot of the secured creditor.

8.93 Several Board Members, as presently advised, favour this approach. We would particularly welcome comments on any difficulties that this suggestion might give rise to in practice.

(g) An Insurance Analogy

8.94 We have noted that, in practical terms, transactions of this kind occur because the buyer needs financial assistance to close the deal. It could be suggested - and has been to us - that the burden of protecting unsecured creditors should therefore fall on the buyer of shares. The thesis is, essentially, that the person who takes the benefit should also take the burden.

8.95 Assuming that that thesis is accepted as a matter of principle, there are two subsidiary questions which would arise. First, the length of time in which the transaction could reasonably be considered to have adversely affected the unsecured creditor. Second, the quantum for which the buyers are liable.

8.96 As to the first matter, trade creditors will normally supply goods and services on a continuing basis. If they have done so for two years and have been paid during that period it is not their debt at the time of the transaction that is involved; that debt has long since been replaced by a current debt. As we have mentioned we think that a solvency test is difficult and inappropriate. If the buyers can keep the corporation functioning for two years, then the trade creditors will likely have been paid their original debt, and will have made some profit on those transactions during that period. We think that the two year limitation period presently contained in section 113(9) should be a sufficient length of time to protect those who were trade creditors at the time of the transaction.

8.97 What should be the extent of the buyer's liability? There are alternatives. Should the buyers be absolved once the original debt of the unsecured creditor has been paid, should there be some form of proportional abatement over the two year period, or should the buyers remain liable during the two year period for the total amount of the debt owed to the trade creditors at the time of the transaction? These cases only arise under circumstances in which the buyers have agreed that the corporation will continue to be responsible for the debts owing to the trade creditors. In so doing they have discounted the purchase price. We think on the whole therefore that if this thesis is adopted that the buyers of the shares should be liable for the full extent of the trade creditor's debt at the time of the transaction for the full two year period. We confess that we are somewhat tentative in this recommendation. We would appreciate comment.

8.98 There is a further minor question under this head. Should the buyers be liable for debts of trade creditors who were not trade creditors at the time of the transaction, but started dealing with the corporation at some time after the transaction? Our first reaction was to think not. Such persons are in a like position to any creditor dealing with any corporation. If the amounts are fairly large they will certainly take some precautions before advancing the credit, or will seek some security before they do so. There is however one small problem, particularly in relation to the corporation giving a charge upon its assets. The charge will normally be registered in a public registry and is available to the cautious and diligent creditor. The problem arises because of a short time lag. A creditor who deals with the corporation during the period from the date of the sale and the date of registration of the charge cannot discover any charge on the corporation's assets because it has not been registered during that period. We have wondered whether an exception should be made for the new trade creditor who deals with the corporation within 90 days of the date of the transaction. We are not sure that the extra complexity that would be involved is worth the doing. We therefore make no specific recommendation in this regard, but raise the matter for comment.

8.99 A final point concerns the identity of the buyer. The buyer of the shares may be another corporation having few or insufficient assets to meet any liability owed to the unsecured creditors. We therefore suggest (if this approach is adopted) that the directors of the corporation who authorize the financial assistance should be jointly and severally liable together with the buyers. In those cases in which the buyers are individuals who become the new directors, there will be no extra liability. The provisions would only take effect if the buyer was another corporation.

RECOMMENDATION No. 17

(a) That there should be a prohibition against financial assistance by a corporation in connection with a purchase of its shares unless there are reasonable grounds for believing that the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due, and

(b) That where the prohibition is breached the directors of the corporation should be required to restore to the corporation whatever financial assistance was improperly given.

(h) Indirect Assistance

8.100 Earlier in this report we discussed two English cases, Selangore United Rubber Estates Ltd. v. Craddock and Others[118] and Karak Rubber Co. Ltd. v. Burdon.[119] In both of these cases the buyer, immediately after acquiring the shares of the corporation, caused the corporation to lend all, or substantially all, of its liquid assets to another corporation controlled by the buyers. In neither case was any security taken for the loan, and it was obviously improvident since the borrowing corporation had no real means of repaying the money that it had borrowed. Both of the cases deal with companies that were listed on the London Stock Exchange. Neither would occur today since it is highly improbable that either would be approved by the Take Overs and Mergers Panel of the London Stock Exchange, recently described in R. v. Panel on Takeovers and Mergers *ex parte* Dataf as that "truly remarkable body perched on the 20th floor of the Stock Exchange Building in the City of London".[120]

[118] Footnote 25, supra.

[119] Footnote 27, supra.

[120] New Journal Law Reports, Dec. 19, 1986, 1207 at p. 1207. See the official report at [1987] 2 S.L.R. 699 and Note, (1987) 50 M.L.R. 372.

The panel is a self-regulating body, it is unincorporated and has no *de jure* basis for its existence. That case however did establish that its decisions are reviewable by a court.

8.101 With regard to distributing corporations, in Alberta we have the Alberta Securities Commission. With regard to non-distributing corporations, we wonder whether there is any need for any statutory regulation. When examined closely, both of these transactions involved a conflict of interest which, under Alberta section 115, could hardly be called a reasonable transaction from the point of view of the corporation, and neither could it be described as being "in the best interests of the corporation" as required under section 117. We do not think that an Alberta court would have any difficulty in fixing liability upon the buyers under such extraordinary circumstances. We do not think therefore that it is necessary to provide any statutory regulation.

(i) Disclosure

8.102 If the only restriction on transfer of shares in a non-distributing corporation was a requirement that any proposed transfer must be subject to the approval of the directors before becoming effective, and one shareholder was not a director, or if the shareholder was a corporation but was not represented on the board of directors, it is possible that a shareholder might not be aware of the purchase of the corporation's shares until after the event. Should we be concerned about the possibility? We think not, for two reasons. The first is a constant problem in law reform. How much regulation should a statute impose to protect the unwary? Too heavy a harness imposes an unwarranted additional burden upon legitimate transactions. On the whole we are reluctant to recommend regulation in any case in which a reasonably intelligent citizen has the means to protect himself. The other reason is that we do not think the end result is all that severe. It seems highly improbable that the remaining shareholder would be the majority shareholder and not know what is going on, but even if this were true, the consequences are not serious. If the remaining shareholder is a minority shareholder that person will have his remedies if the new majority's conduct of the corporation is oppressive or unfairly prejudicial to his interests. On the whole therefore we do not think that disclosure to the shareholders is a matter of crushing concern but any provision should match those that we have suggested regarding loans and financial assistance to directors.

8.103 Disclosure to the unsecured creditors before the event is not of much help to them unless it is coupled with a remedy. We have considered a scheme similar to the requirements of the Bulk Sales Act[121] if the corporation sells its assets rather than the shareholders selling their shares. We do not think this cumbersome mechanism is necessary providing that the burden of liability falls directly upon the purchasers and the directors who authorize the transaction.[122]

8.104 We also considered, as a prerequisite to the validity of the transaction, some form of application to the court, notice of which would be served upon all creditors. Such a provision

---

121 R.S.A. 1980, c. B-13.

122 We note that the Law Reform Commission of British Columbia in its Report No. 67 issued in October of 1983 recommended the repeal of that Act. The British Columbia legislature implemented this recommendation in 1985.

would be redundant since an application of this nature may be made to the court under the provisions of section 186. No doubt in any such application the court would impose appropriate conditions.

8.105 The only remaining question therefore is whether the corporation should notify all of its unsecured creditors following any transaction in which it has given financial assistance regarding a purchase of its shares. If the corporation has already granted the financial assistance, the only practical benefit might be that the trade creditors could refuse to advance any further credit. We are doubtful as to whether such a requirement should be necessary. For the purposes of this report for discussion we make the following recommendation. We solicit comment.

> RECOMMENDATION No. 18
>
> That in any case in which a corporation has granted financial assistance in connection with a purchase of its shares, the corporation be required to notify all of its unsecured creditors that it has done so within 90 days of the date of the transaction.

7. THE POSITION OF THE THIRD PARTY OR LENDER

8.106 The original intention of Section 42(3) was to protect the third party or lender. We agree with that policy but we doubt that it accomplishes this purpose under its present wording. The section presently reads as follows:

> **42**(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.

8.107 Before discussing the position of a third party we point out that the present section may fulfill another purpose, namely, that a contract made by a corporation in breach of the section may nevertheless be enforced by the corporation. The courts have exercised a good deal of ingenuity in permitting a corporation to recover money that it has loaned to a director in contravention of the section. They usually do so through the mechanism of the constructive trust. We feel that it is a much simpler method to provide a clear statutory mechanism permitting the corporation to collect any debt owed to it, even if the debt was incurred in breach of the section. We therefore recommend that the corporation continue to be able to enforce a contract even if it is made in breach of the section.

RECOMMENDATION No. 19

> That a contract made by a corporation in contravention of the section may nevertheless be enforced by the corporation.

8.108 We have said that we doubt that the section as presently worded is adequate to protect the third party who enters into a transaction in contravention of it even though the present section does not impose an absolute prohibition. Our recommendations regarding loans and other forms of financial assistance to a director of a distributing corporation impose an absolute prohibition subject to some specific exceptions. While there may be a lingering doubt that a court would hold the contract to be void under the present section, there seems little doubt that it would certainly do so when faced with an absolute prohibition. We think therefore that something more is needed. We therefore suggest that the opening words of subsection (3) should run "notwithstanding any rule of law or equity to the contrary...".

8.109 It is the concluding words of the section, namely, "in good faith without notice of the contravention" that give rise to our doubts that the section as presently worded does not serve to protect the lender. Section 128 of the British Columbia Company Act exempts, "a bona fida lender for value without notice". In Royal Bank v. Stewart[123] the court held that because the Royal Bank had notice of the purpose of the loan it could not claim the protection of the section. It seems to us to be totally unrealistic in today's times to believe that any lender will not demand to know the purpose for which the loan is being made. The only cases in which the present section would serve to protect a lender would be those in which it was deliberately deceived regarding the purpose of the loan. The first suggestion we considered in order to strengthen the position of the third party was to simply delete the closing words of the section. While we are still of the opinion that this should be done, we do not think it sufficient in the face of an absolute prohibition. We therefore suggest that there be added to the section the opening words that we referred to in para. 8.108, and that there be deleted from the section the closing words to which we have referred above.

RECOMMENDATION No. 20

That notwithstanding any rule of law or equity to the contrary, a contract made by a corporation or by a lender for value in contravention of this section may be enforced by the corporation or a lender for value.

---

[123] Footnote 54, supra. At the time of the decision (1980) this was s. 125 of the BCCA.

PART III. SUMMARY OF RECOMMENDATIONS

RECOMMENDATION No. 1

That, subject to the exceptions later discussed, a distributing corporation be prohibited from granting financial assistance by means of a loan, guarantee or otherwise to a member of the prohibited class.

RECOMMENDATION No. 2

That the prohibited class of director include a director of an affiliated body corporate.

RECOMMENDATION No. 3

That section 1(c)(i) be amended by striking out the figure of 10% and substituting the figure of 33 1/3%.

RECOMMENDATION No. 4

That section 1(c)(iv) be amended by adding immediately after the word "spouse", the words "or child".

RECOMMENDATION No. 5

That the prohibition in Recommendation No. 1 should apply to an associate of a director, an associate of a director of an affiliated body corporate and to any body corporate in which the director of the corporation together with an associate or associates of that director, directly or indirectly, controls more than 33 1/3% of the voting securities of that other body corporate.

RECOMMENDATION No. 6

That no exception to recommendation 1 be made for lending corporations.

RECOMMENDATION No. 7

That advances to a director on account of expenditures to be incurred on behalf of the corporation be excepted from the prohibition in recommendation 1.

RECOMMENDATION No. 8

That an advance on salary to a director who is a full time employee be excepted from the prohibition in recommendation 1.

RECOMMENDATION No. 9

That financial assistance by way of a loan, guarantee or otherwise by a distributing corporation to a director who is a full time employee of the corporation, or any of its affiliates, to enable the director to purchase or erect living accommodation for his or her own occupation be excepted from the prohibition in recommendation 1.

RECOMMENDATION No. 10

That notwithstanding section 25, a corporation be permitted to lend money to a director who is a full time employee of the corporation, or any affiliate of the corporation, to enable such a director to purchase shares of the corporation or of any of its affiliates either directly or to be held by a trustee.

RECOMMENDATION No. 11

That no disclosure be necessary with regard to the excepted loans and financial assistance to directors of a distributing corporation.

RECOMMENDATION No. 12

That a non-distributing corporation shall not give financial assistance to a director of the corporation unless there are reasonable grounds for believing that the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due.

RECOMMENDATION No. 13

That the limitation period contained in section 113(9) should expire two years after the date of the resolution or the date of the transaction whichever is the earlier.

RECOMMENDATION No. 14

That a non-distributing corporation shall not give financial assistance to a director of the corporation by means of a guarantee or charge upon its assets unless there are reasonable grounds for believing that the corporation is, or after having given the financial assistance would be, unable to pay its liabilities as they become due, if the corporation were required to pay the amount due under the guarantee or secured by a charge upon its assets on the day following the execution of either or both.

RECOMMENDATION No. 15

That subsection (4) of section 42 be amended to require a non-distributing corporation to 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.

RECOMMENDATION No. 16

(a) That 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.

(b) That 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.

RECOMMENDATION No. 17

(a) That there should be a prohibition against financial assistance by a corporation in connection with a purchase of its shares unless there are reasonable grounds for believing that the corporation is, or after giving the financial assistance would be, unable to pay its liabilities as they become due, and

(b) That where the prohibition is breached the directors of the corporation should be required to restore to the corporation whatever financial assistance was improperly given.

RECOMMENDATION No. 18

That in any case in which a corporation has granted financial assistance in connection with a purchase of its shares, the corporation be required to notify all of its unsecured creditors that it has done so within 90 days of the date of the transaction.

RECOMMENDATION No. 19

That a contract made by a corporation in contravention of the section may nevertheless be enforced by the corporation.

RECOMMENDATION No. 20

That notwithstanding any rule of law or equity to the contrary, a contract made by a corporation or by a lender for value in contravention of this section may be enforced by the corporation or a lender for value.

PART IV. APPENDICES

APPENDIX 1

Companies Act, 1948 (U.K.)

190.--(1) It shall not be lawful for a company to make a loan to any person who is its director or a director of its holding company, or to enter into any guarantee or provide any security in connection with a loan made to such a person as aforesaid by any other person:

Provided that nothing in this section shall apply either-

(a) to anything done by a company which is for the time being an exempt private company; or

(b) to anything done by a subsidiary, where the director is its holding company; or

(c) subject to the next following subsection, to anything done to provide any such person as aforesaid with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company; or

(d) in the case of a company whose ordinary business includes the lending of money or the giving of guarantees in connection with loans made by other persons, to anything done by the company in the ordinary course of that business.

(2) Proviso (c) to the foregoing subsection shall not authorise the making of any loan, or the entering into any guarantee, or the provision of any security, except either-

(a) with the prior approval of the company given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or

(b) on condition that, if the approval of the company is not given as aforesaid at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

(3) Where the approval of the company is not given as required by any such condition, the directors authorising the making of the loan, or the entering into the guarantee, or the provision of the security, shall be jointly and severally liable to indemnify the company against any loss arising therefrom.

APPENDIX 2

Companies Act, 1985 (U.K.)

330

(1) The prohibitions listed below in this section are subject to the exceptions in sections 332 to 338.

(2) A company shall not-

(a) make a loan to a director of the company or of its holding company;
(b) enter into any guarantee or provide any security in connection with a loan made by any person to such a director.

(3) A relevant company shall not-

(a) make a quasi-loan to a director of the company or of its holding company;
(b) make a loan or a quasi-loan to a person connected with such a director;
(c) enter into a guarantee or provide any security in connection with a loan or quasi-loan made by any other person for such a director or a person so connected.

(4) A relevant company shall not-

(a) enter into a credit transaction as creditor for such a director or a person so connected;
(b) enter into any guarantee or provide any security in connection with a credit transaction made by any other person for such a director or a person so connected.

(5) For purposes of sections 330 to 346, a shadow director is treated as a director.

(6) A company shall not arrange for the assignment to it, or the assumption by it, of any rights, obligations or liabilities under a transaction which, if it had been entered into by the company, would have contravened subsection (2), (3) or (4); but for the purposes of section 330 to 347 the

transaction is to be treated as having been entered into on the date of the arrangement.

(7) A company shall not take part in any arrangement whereby-

(a) another person enteres into a transaction which, if it had been entered into by the company, would have contravened any of subsections (2), (3), (4) or (6); and
(b) that other person, in pursuance of the arrangement, has obtained or is to obtain any benefit from the company or its holding company or a subsidiary of the company or its holding company.

331

(1) The following subsections apply for the interpretation of sections 330 to 346.

(2) "Guarantee" includes indemnity, and cognate expressions are to be construed accordingly.

(3) A quasi-loan is a transaction under which one party ("the creditor") agrees to pay, or pays otherwise than in pursuance of an agreement, a sum for another ("the borrower") or agrees to reimburse, or reimburses otherwise than in pursuance of an agreement, expenditure incurred by another party for another ("the borrower")-

(a) on terms that the borrower (or a person on his behalf) will reimburse the creditor; or
(b) in circumstances giving rise to a liability on the borrower to reimburse the creditor.

(4) Any reference to the person to whom a quasi-loan is made is a reference to the borrower; and the liabilities of a borrower under a quasi-loan include the liabilities of any person who has agreed to reimburse the creditor on behalf of the borrower.

(5) "Recognised bank" means a company which is recognised as a bank for the purposes of the Banking Act 1979.

(6) "Relevant company" means a company which-

(a) is a public company, or

(b) is a subsidiary of a public company, or
(c) is a subsidiary of a company which has as another subsidiary a public company, or
(d) has a subsidiary which is a public company.

(7) A credit transaction is a transaction under which one party ("the creditor")-

(a) supplies any goods or sells any land under a hire-purchase agreement or a conditional sale agreement;
(b) leases or hires any land or goods in return for periodical payments;
(c) otherwise disposes of land or supplies goods or services on the understanding that payment (whether in a lump sum or instalments or by way of periodical payments or otherwise) is to be deferred.

(8) "Services" means anything other than goods or land.

(9) A transaction or arrangement is made "for" a person if-

(a) in the case of a loan or quasi-loan, it is made to him;
(b) in the case of a credit transaction, he is the person to whom goods or services are supplied, or land is sold or otherwise disposed of, under the transaction;
(c) in the case of a guarantee or security, it is entered into or provided in connection with a loan or quasi-loan made to him or a credit transaction made for him;
(d) in the case of an arrangement within subsection (6) or (7) of section 330, the transaction to which the arrangement relates was made for him; and
(e) in the case of any other transaction or arrangement for the supply or transfer of, or of any interest in, goods, land or services, he is the person to whom the goods, land or services (or the interest) are supplied or transferred.

(10) "Conditional sale agreement" means the same as in the Consumer Credit Act 1974.

332

(1) Subsection (3) of section 330 does not prohibit a company ("the creditor") from making a quasi-loan to one of its directors or to a director of its holding company if-

(a) the quasi-loan contains a term requiring the director or a person on his behalf to reimburse the creditor his expenditure within 2 months of its being incurred; and
(b) the aggregate of the amount of that quasi-loan and of the amount outstanding under each relevant quasi-loan does not exceed £1,000.

(2) A quasi-loan is relevant for this purpose if it was made to the director by virtue of this section by the creditor or its subsidiary or, where the director is a director of the creditor's holding company, any other subsidiary of that company; and "the amount outstanding" is the amount of the outstanding liabilities of the person to whom the quasi-loan was made.

333

In the case of a relevant company which is a member of a group of companies (meaning a holding company and its subsidiaries), paragraphs (b) and (c) of section 330(3) do not prohibit the company from-

(a) making a loan or quasi-loan to another member of that group; or
(b) entering into a guarantee or providing any security in connection with a loan or quasi-loan made by any person to another member of the group,

by reason only that a director of one member of the group is associated with another.

334

Without prejudice to any other provision of sections 332 to 338, paragraph (a) of section 330(2) does not prohibit a company from making a loan to a director of the company or of its holding company if the aggregate of the relevant amounts does not exceed £2,500.

335

(1) Section 330(4) does not prohibit a company from entering into a transaction for a person if the aggregate of the relevant

amounts does not exceed £5,000.

(2) Section 330(4) does not prohibit a company from entering into a transaction for a person if-

(a) the transaction is entered into by the company in the ordinary course of its business; and
(b) the value of the transaction is not greater, and the terms on which it is entered into are no more favourable, in respect of the person for whom the transaction is made, than that or those which it is reasonable to expect the company to have offered to or in respect of a person of the same financial standing but unconnected with the company.

336

The following transactions are excepted from the prohibitions of section 330-

(a) a loan or quasi-loan by a company to its holding company, or a company entering into a guarantee or providing any security in connection with a loan or quasi-loan made by any person to its holding company;
(b) a company entering into a credit transaction as creditor for its holding company, or entering into a guarantee or providing any security in connection with a credit transaction made by any other person for its holding company.

337

(1) A company is not prohibited by section 330 from doing anything to provide a director with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company.

(2) Nor does the section prohibit a company from doing any thing to enable a director to avoid incurring such expenditure.

(3) Subsections (1) and (2) apply only if one of the following conditions is satisfied-

(a) the thing in question is done with prior approval of the company given at a general meeting at which there are disclosed all the matters mentioned in the next subsection;
(b) that thing is done on condition that, if the approval of the company is not so given at or before the next annual general meeting, the loan is to repaid, or any other liability arising under any such transaction discharged, within 6 months from the conclusion of that meeting;

but those subsections do not authorise a relevant company to enter into any transaction if the aggregate of the relevant amounts exceeds £10,000.

(4) The matters to be disclosed under subsection (3)(a) are-

(a) the purpose of the expenditure incurred or to be incurred, or which would otherwise be incurred, by the director,
(b) the amount of the funds to be provided by the company, and
(c) the extent of the company's liability under any transaction which is or is connected with the thing in question.

338

(1) There is excepted from the prohibitions in section 330-

(a) a loan or quasi-loan made by a money-lending company to any person; or
(b) a money-lending company entering into a guarantee in connection with any other loan or quasi-loan.

(2) "Money-lending company" means a company whose ordinary business includes the making of loans or quasi-loans, or the giving of guarantees in connection with loans or quasi-loans.

(3) Subsection (1) applies only if both the following conditions are satisfied-

(a) the loan or quasi-loan in question is made by the company, or it enters into the guarantee, in the ordinary course of the company's business; and

(b) the amount of the loan or quasi-loan, or the amount guaranteed, is not greater, and the terms of the loan, quasi-loan or guarantee are not more favourable, in the case of the person to whom the loan or quasi-loan is made or in respect of whom the guarantee is entered into, than that or those which it is reasonable to expect that company to have offered to or in respect of a person of the same financial standing but unconnected with the company.

(4) But subsection (1) does not authorise a relevant company (unless it is a recognised bank) to enter into any transaction if the aggregate of the relevant amounts exceeds £50,000.

(5) In determining that aggregate, a company which a director does not control is deemed not to be connected with him.

(6) The condition specified in subsection (3)(b) does not of itself prevent a company from making a loan to one of its directors or a director of its holding company-

(a) for the purpose of facilitating the purchase, for use as that director's only or main residence, of the whole or part of any dwelling-house together with any land to be occupied and enjoyed with it;

(b) for the purpose of improving a dwelling-house or part of a dwelling-house so used or any land occupied and enjoyed with it;

(c) in substitution for any loan made by any person and falling within paragraph (a) or (b) of this subsection,

if loans of that description are ordinarily made by the company to its employees and on terms no less favourable than those on which the transaction in question is made, and the aggregate of the relevant amounts does not exceed £50,000.

339

(1) This section has effect for defining

the "relevant amounts" to be aggregated under sections 334, 335(1), 337(3) and 338(4); and in relation to any proposed transaction or arrangement and the question whether it falls within one or other of the exceptions provided by those sections, "the relevant exception" is that exception; but where the relevant exception is the one provided by section 334 (loan of small amount), references in this section to a person connected with a director are to be disregarded.

(2) Subject as follows, the relevant amounts in relation to a proposed transaction or arrangement are-

(a) the value of the proposed transaction or arrangement,
(b) the value of any existing arrangement which-

(i) falls within subsection (6) or (7) of section 330, and
(ii) also falls within subsection (3) of this section, and
(iii) was entered into by virtue of the relevant exception by the company or by a subsidiary of the company or, where the proposed transaction or arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or any of its subsidiaries;

(c) the amount outstanding under any other transaction-

(i) falling within subsection (3) below, and
(ii) made by virtue of the relevant exception, and
(iii) made by the company or by a subsidiary of the company or, where the proposed transaction or arrangement is to be made for a director of its holding company or a person connected with such a director, by that holding company or any of its subsidiaries.

(3) A transaction falls within this subsection if it was made-

(a) for the director for whom the proposed transaction or arrangement is to be made, or for any person connected with that director; or
(b) where the proposed transaction or arrangement is to be made for a person connected with a director of a company, for that director or any person connected with him;

and an arrangement also falls within this subsection if it relates to a transaction which does so.

(4) But where the proposed transaction falls within section 338 and is one which a recognised bank proposes to enter into under subsection (6) of that section (housing loans, etc.), any other transaction or arrangement which apart from this subsection would fall within subsection (3) of this section does not do so unless it was entered into in pursuance of section 338(6).

(5) A transaction entered into by a company which is (at the time of that transaction being entered into) a subsidiary of the company which is to make the proposed transaction, or is a subsidiary of that company's holding company, does not fall within subsection (3) if at the time when the question arises (that is to say, the question whether the proposed transaction or arrangement falls within any relevant exception), it no longer is such a subsidiary. (6) Values for purposes of subsection (2) of this section are to be determined in accordance with the section next following; and "the amount outstanding" for purposes of subsection (2)(c) above is the value of the transaction less any amount by which that value has been reduced.

340

(1) This section has effect for determining the value of a transaction or arrangement for purposes of sections 330 to 339.

(2) The value of a loan is the amount of its principal.

(3) The value of a quasi-loan is the amount, or maximum amount, which the person to whom the quasi-loan is made is liable to reimburse the creditor.

(4) The value of a guarantee or security is the amount guaranteed or secured.

(5) The value of an arrangement to which section 330(6) or (7) applies is the value of the transaction to which the arrangement relates less any amount by which the liabilities under the arrangement or transaction of the person for whom the transaction was made have been reduced.

(6) The value of a transaction or arrangement not falling within subsections (2) to (5) above is the price which it is reasonable to expect could be obtained for the goods, land or services to which the transaction or arrangement relates if they had been supplied (at the time the transaction or arrangement is entered into) in the ordinary course of business and on the same terms (apart from price) as they have been supplied, or are to be supplied, under the transaction or arrangement in question.

(7) For purposes of this section, the value of a transaction or arrangement which is not capable of being expressed as a specific sum of money (because the amount of any liability arising under the transaction or arrangement is unascertainable, or for any other reason), whether or not any liability under the transaction or arrangement has been reduced, is deemed to exceed £50,000.

341

(1) If a company enters into a transaction or arrangement in contravention of section 330, the transaction or arrangement is voidable at the instance of the company unless-

(a) restitution of any money or any other asset which is the subject matter of the arrangement or transaction is no longer possible, or the company has been indemnified in pursuance of subsection (2)(b) below for the loss or damage suffered by it, or
(b) any rights acquired *bona fide* for value and without actual notice of the contravention by a person other than the person for whom the transaction or arrangement was made would be affected by its avoidance.

(2) Where an arrangement or transaction is

made by a company for a director of the company or its holding company or a person connected with such a director in contravention of section 330, that director and the person so connected and any other director of the company who authorised the transaction or arrangement (whether or not it has been avoided in pursuance of subsection (1)) is liable-

(a) to account to the company for any gain which he has made directly or indirectly by the arrangement or transaction; and
(b) (jointly and severally with any other person liable under this subsection) to indemnify the company for any loss or damage resulting from the arrangement or transaction.

(3) Subsection (2) is without prejudice to any liability imposed otherwise than by that subsection, but is subject to the next two subsections.

(4) Where an arrangement or transaction is entered into by a company and a person connected with a director of the company or its holding company in contravention of section 330, that director is not liable under subsection (2) of this section if he shows that he took all reasonable steps to secure the company's compliance with that section.

(5) In any case, a person so connected and any such other director as is mentioned in subsection (2) is not so liable if he shows that, at the time the arrangement or transaction was entered into, he did not know the relevant circumstances constituting the contravention.

342

(1) A director of a relevant company who authorises or permits the company to enter into a transaction or arrangement knowing or having reasonable cause to believe that the company was thereby contravening section 330 is guilty of an offence.

(2) A relevant company which enters into a transaction or arrangement for one of its directors or for a director of its holding company in contravention of section 330 is guilty of an offence.

(3) A person who procures a relevant company to enter into a transaction or arrangement knowing or having reasonable cause to believe that the company was thereby contravening section 330 is guilty of an offence.

(4) A person guilty of an offence under this section is liable to imprisonment or a fine, or both.

(5) A relevant company is not guilty of an offence under subsection (2) if it shows that, at the time the transaction or arrangement was entered into, it did not know the relevant circumstances.

343

(1) The following provisions of this section-

(a) apply in the case of a company which is, or is the holding company of, a recognised bank, and
(b) are subject to the exceptions provided by section 344.

(2) Such a company shall maintain a register containing a copy of every transaction, arrangement or agreement of which particulars would, but for paragraph 4 of Schedule 6, be required by section 232 to be disclosed in the company's accounts or group accounts for the current financial year and for each of the preceding 10 financial years.

(3) In the case of a transaction, arrangement or agreement which is not in writing, there shall be contained in the register a written memorandum setting out its terms.

(4) Such a company shall before its annual general meeting make available at its registered office for not less than 15 days ending with the date of the meeting a statement containing the particulars of transactions, arrangements and agreements which the company would, but for paragraph 4 of Schedule 6, be required by section 232 to disclose in its accounts or group accounts for the last complete financial year preceding that meeting.

(5) The statement shall be so made available for inspection by members of the

company; and such a statement shall also be made available for their inspection at the annual general meeting.

(6) It is the duty of the company's auditors to examine the statement before it is made available to members of the company and to make a report to the members on it; and the report shall be annexed to the statement before it is made so available.

(7) The auditors' report shall state whether in their opinion the statement contains the particulars required by subsection (4); and, where their opinion is that it does not, they shall include in the report, so far as they are reasonably able to do so, a statement giving the required particulars.

(8) If a company fails to comply with any provision of subsections (2) to (5), every person who at the time of the failure is a director of it is guilty of an offence and liable to a fine; but-

(a) it is a defence in proceedings against a person for this offence to prove that he took all reasonable steps for securing compliance with the subsection concerned, and
(b) a person is not guilty of the offence by virtue only of being a shadow director of the company.

(9) For purposes of the application of this section to loans and quasi-loans made by a company to persons connected with a person who at any time is a director of the company or of its holding company, a company which a person does not control is not connected with him.

344

(1) Section 343 does not apply in relation to-

(a) transactions or arrangements made or subsisting during a financial year by a company or by a subsidiary of a company for a person who was at any time during that year a director of the company or of its holding company or was connected with such a director, or
(b) an agreement made or subsisting

during that year to enter into such a transaction or arrangement,

if the aggregate of the values of each transaction or arrangement made for that person, and of each agreement for such a transaction or arrangement, less the amount (if any) by which the value of those transactions, arrangements and agreements has been reduced, did not exceed £1,000 at any time during the financial year.

For purposes of this subsection, values are to be determined as under section 340.

(2) Section 343(4) and (5) do not apply to a recognised bank which is the wholly-owned subsidiary of a company incorporated in the United Kingdom.

APPENDIX 3

Companies Act, 1929 (U.K.)

45.-(1) Subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company:

Provided that nothing in this section shall be taken to prohibit-

(a) where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business;

(b) the provision by a company, in accordance with any scheme for the time being in force, of money for the purchase by trustees of fully-paid shares in the company to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company;

(c) the making by a company of loans to persons, other than directors, *bona fide* in the employment of the company with a view to enabling those persons to purchase fully-paid shares in the company to be held by themselves by way of beneficial ownership.

(2) The aggregate amount of any outstanding loans made under the authority of provisos (b) and (c) to subsection (1) of this section shall be shown as a separate item in every balance sheet of the company.

(3) If a company acts in contravention of this section, the company and every officer of the company who is in default shall be liable to a fine not exceeding one hundred pounds.

APPENDIX 4

Companies Act, 1985 (U.K.)

151 Financial assistance generally prohibited

(1) Subject to the following provisions of this chapter, where a person is acquiring or is proposing to acquire shares in a company, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of that acquisition before or at the same time as the acquisition takes place.

(2) Subject to those provisions, where a person has acquired shares in a company and any liability has been incurred (by that or any other person), for the purpose of that acquisition, it is not lawful for the company or any of its subsidiaries to give financial assistance directly or indirectly for the purpose of reducing or discharging the liability so incurred.

(3) If a company acts in contravention of this section, it is liable to a fine, and every officer of it who is in default is liable to imprisonment or a fine, or both.

152 Definitions for this Chapter

(1) In this Chapter-

(a) "financial assistance" means-

(i) financial assistance given by way of gift,

(ii) financial assistance given by way of guarantee, security or indemnity, other than an indemnity in respect of the indemnifier's own neglect or default, or by way of release or waiver,

(iii) financial assistance given by way of a loan or any other agreement under which any of the obligations of the person giving the assistance are to be fulfilled at a time when in accordance with the agreement any obligation of another party to the agreement remains unfulfilled, or by way of the novation of, or the assignment or rights arising under, a loan or such other agreement, or

(iv) any other financial assistance given by a company the net assets of which are thereby reduced to a material extent or which has no net assets;

(b) "distributable profits", in relation to the giving of any financial assistance-

(i) means those profits out of which the company could lawfully make a distribution equal in value to that assistance, and

(ii) includes, in a case where the financial assistance is or includes a non-cash asset, any profit which, if the company were to make a distribution of that asset, would under section 276 (distributions in kind) be available for that purpose,

and

(c) "distribution" has the meaning given by section 263(2).

(2) In subsection (1)(a)(iv), "net assets" means the aggregate of the company's assets, less the aggregate of its liabilities ("liabilities" to include any provision for liabilities or charges within paragraph 89 of Schedule 4).

(3) In this Chapter-

(a) a reference to a person incurring a liability includes his changing his financial position by making an agreement or arrangement (whether enforceable or unenforceable, and whether made on his own account or with any other person) or by any other means, and

(b) a reference to a company giving

financial assistance for the purpose of reducing or discharging a liability incurred by a person for the purpose of the acquisition of shares includes its giving such assistance for the purpose of wholly or partly restoring his financial position to what it was before the acquisition took place.

153 Transactions not prohibited by s 151

(1) Section 151(1) does not prohibit a company from giving financial assistance for the purpose of an acquisition of shares in it or its holding company if-

(a) the company's principal purpose in giving that assistance is not to give it for the purpose of any such acquisition, or the giving of the assistance for that purpose is but an incidental part of some larger purpose of the company, and

(b) the assistance is given in good faith in the interests of the company.

(2) Section 151(2) does not prohibit a company from giving financial assistance if-

(a) the company's principal purpose in giving the assistance is not to reduce or discharge any liability incurred by a person for the purpose of the acquisition of shares in the company or its holding company, or the reduction or discharge of any such liability is but an incidental part of some larger purpose of the company, and

(b) the assistance is given in good faith in the interests of the company.

(3) Section 151 does not prohibit-

(a) a distribution of a company's assets by way of dividend lawfully made or a distribution made in the course of the company's winding up,

(b) the allotment of bonus shares,

(c) a reduction of capital confirmed by order of the court under section

137,

(d) a redemption or purchase of shares made in accordance with Chapter 7 of this Part,

(e) anything done in pursuance of an order of the court under section 425 (compromises and arrangements with creditors and members),

(f) anything done under an arrangement made in pursuance of section 582 (acceptance of shares by liquidator in winding up as consideration for sale of property), or

(g) anything done under an arrangement made between a company and its creditors which is binding on the creditors by virtue of section 601 (winding up imminent or in progress).

(4) Section 151 does not prohibit-

(a) where the lending of money is part of the ordinary business of the company, the lending of money by the company in the ordinary course of its business,

(b) the provision by a company in accordance with an employees' share scheme of money for the acquisition of fully paid shares in the company or its holding company,

(c) the making by a company of loans to persons (other than directors) employed in good faith by the company with a view to enabling those persons to acquire fully paid shares in the company or its holding company to be held by them by way of beneficial ownership.

154 Special restriction for public companies

(1) In the case of a public company, section 153(4) authorises the giving of financial assistance only if the company has net assets which are not thereby reduced or, to the extent that those assets are thereby reduced, if the assistance is provided out of distributable profits.

(2) For this purpose the following

definitions apply-

(a) "net assets" means the amount by which the aggregate of the company's assets exceeds the aggregate of its liabilities (taking the amount of both assets and liabilities to be as stated in the company's accounting records immediately before the financial assistance is given);

(b) "liabilities" includes any amount retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

155 Relaxation of s 151 for private companies

(1) Section 151 does not prohibit a private company from giving financial assistance in a case where the acquisition of shares in question is or was an acquisition of shares in the company or, if it is a subsidiary of another private company, in that other company if the following provisions of this section, and sections 156 to 158, are complied with as respects the giving of that assistance.

(2) The financial assistance may only be given if the company has net assets which are not thereby reduced or, to the extent that they are reduced, if the assistance is provided out of distributable profits.

Section 154(2) applies for the interpretation of this subsection.

(3) This section does not permit financial assistance to be given by a subsidiary, in a case where the acquisition of shares in question is or was an acquisition of shares in its holding company, if it is also a subsidiary of a public company which is itself a subsidiary of that holding company.

(4) Unless the company proposing to give the financial assistance is a wholly-owned subsidiary, the giving of assistance under this section must be approved by special resolution of the company in general meeting.

(5) Where the financial assistance is to be given by the company in a case where the acquisition of shares in question is or was an acquisition of shares in its holding company, that holding company and any other company which is both the company's holding company and a subsidiary of that other holding company (except, in any case, a company which is a wholly-owned subsidiary) shall also approve by special resolution in general meeting the giving of the financial assistance.

(6) The directors of the company proposing to give the financial assistance and, where the shares acquired or to be acquired are shares in its holding company, the directors of that company and of any other company which is both the company's holding company and a subsidiary of that other holding company shall before the financial assistance is given make a statutory declaration in the prescribed form complying with the section next following.

156 Statutory declaration under s 155

(1) A statutory declaration made by a company's directors under section 155(6) shall contain such particulars of the financial assistance to be given, and of the business of the company of which they are directors, as may be prescribed, and shall identify the person to whom the assistance is to be given.

(2) The declaration shall state that the directors have formed the opinion, as regards the company's initial situation immediately following the date on which the assistance is proposed to be given, that there will be no ground on which it could then be found to be unable to pay its debts; and either-

(a) if it is intended to commence the winding up of the company within 12 months of that date, that the company will be albe to pay its debts in full within 12 months of the commencement of the winding up, or

(b) in any other case, that the company will be able to pay its debts as they fall due during the year immediately following that date.

(3) In forming their opinion for purposes

of subsection (2), the directors shall take into account the same liabilities (including contingent and prospective liabilities) as would be relevant under section 517 (winding up by the court) to the question whether the company is unable to pay its debts.

(4) The directors' statutory declaration shall have annexed to it a report addressed to them by their company's auditors stating that-

(a) they have enquired into the state of affairs of the company, and

(b) they are not aware of anything to indicate that the opinion expressed by the directors in the declaration as to any of the matters mentioned in subsection (2) of this section is unreasonable in all the circumstances.

(5) The statutory declaration and auditors' report shall be delivered to the registrar of companies-

(a) together with a copy of any special resolution passed by the company under section 155 and delivered to the registrar in compliance with section 380, or

(b) where no such resolution is required to be passed, within 15 days after the making of the declaration.

(6) If a company fails to comply with subsection (5), the company and every officer of it who is in default is liable to a fine and, for continued contravention, to a daily default fine.

(7) A director of a company who makes a statutory declaration under section 155 without having reasonable grounds for the opinion expressed in it is liable to imprisonment or a fine, or both.

157 Special resolution under s 155

(1) A special resolution required by section 155 to be passed by a company approving the giving of financial assistance must be passed on the date on which the directors of that company make the statutory declaration required by that section in

connection with the giving of that assistance, or within the week immediately following that date.

(2) Where such a resolution has been passed, an application may be made to the court for the cancellation of the resolution-

(a) by the holders of not less in the aggregate than 10 per cent. in nominal value of the company's issued share capital or any class of it, or

(b) if the company is not limited by shares, by not less than 10 per cent. of the company's members;

but the application shall not be made by a person who has consented to or noted in favour of the resolution.

(3) Subsections (3) to (10) of section 54 (litigation to cancel resolution under section 53) apply to applications under this section as to applications under section 54.

(4) A special resolution passed by a company is not effective for purposes of section 155-

(a) unless the declaration made in compliance with subsection (6) of that section by the directors of the company, together with the auditors' report annexed to it, is available for inspection by members of the company at the meeting at which the resolution is passed,

(b) if it is cancelled by the court on an application under this section.

158 Time for giving financial assistance under s 155

(1) This section applies as to the time before and after which financial assistance may not be given by a company in pursuance of section 155.

(2) Where a special resolution is required by that section to be passed approving the giving of the assistance, the assistance shall not be given before the expiry of the period of 4 weeks beginning with-

(a) the date on which the special resolution is passed, or

(b) where more than one such resolution is passed, the date on which the last of them is passed,

unless, as respects that resolution (or, if more than one, each of them), every member of the company which passed the resolution who is entitled to vote at general meetings of the company voted in favour of the resolution.

(3) If application for the cancellation of any such resolution is made under section 157, the financial assistance shall not be given before the final determination of the application unless the court otherwise orders.

(4) The assistance shall not be given after the expiry of the period of 8 weeks beginning with-

(a) the date on which the directors of the company proposing to give the assistance made their statutory declaration under section 155, or

(b) where that company is a subsidiary and both its directors and the directors of any of its holding companies made such a declaration, the date on which the earliest of the declarations is made,

unless the court, on an application under section 157, otherwise orders.

APPENDIX 5

Northwest Territories Ordinance, 1886

66. No loan shall be made by the company to any shareholder; if such loan is made all directors and other offices of the company making the same or in anywise assenting thereto, shall be jointly and severally liable for the amount of such loan, with interest, to the company and also to the creditors of the company for all debts of the company then existing or contracted between the time of the making of such loans and that of the repayment thereof.

APPENDIX 6

Companies Act O.N.W.T. 1901

53. No loan shall be made by the company to any shareholder; and if such loan is made all directors and other officers of the company making the same and in anywise assenting thereto shall be jointly and severally liable to the company for the amount thereof and also to the third parties to the extent of such loan with legal interest for all debts of the company contracted from the time of the making of the loan to that of the repayment thereof; but this section shall not apply to a building society.

APPENDIX 7

Alberta Companies Act, 1929

14.-(1) No loan shall be made by a public company to any shareholder or director.

(2) This section shall not apply to a company which carries on the business of a loan company.

APPENDIX 8

Companies Amendment Act, 1934 (Alberta)

(3) Every company and person who contravenes this section shall be guilty of an offence against this Act, and the directors of the company shall be liable to compensate the company and any person injured for any loss, damage or costs which the company or such person may have sustained or incurred by a contravention of this section:

Provided that,-

(a) a director shall not be liable if he proves that the contravention was not due to any misconduct or negligence on his part; and

(b) proceedings to recover any such loss, damage or costs shall not be commenced after the expiration of two years from the date of the contravention.

APPENDIX 9

Companies Amendment Act, 1954 (Alberta)

14(1) A public company shall not make any loan to any of its shareholders or directors or give, whether directly or indirectly and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company.

(2) Nothing in subsection (1) shall be taken to prohibit

(a) the lending of money by the company in the ordinary course of its business when the lending of money is part of the ordinary business of the company,

(b) the making by a company of loans to persons *bona fide* in the employment of the company, whether directors or otherwise, with a view to enabling or assisting those persons to erect or purchase dwelling houses for their own occupation,

(c) the provision by a company, in accordance with any scheme for the time being in force, of money for the purchase by trustees of fully paid up shares in the capital stock of the company, to be held by or for the benefit of employees of the company, including any director holding a salaried employment or office in the company, or

(d) the making by a company of loans to persons in the employment of the company, including directors holding salaried employment, with a view to enabling those persons to purchase fully paid-up shares in the capital stock of the company, to be held by themselves by way of beneficial ownership.

(3) If a loan is made by a public company in contravention of subsection (1), all directors and officers of the company making it or assenting to it are, until repayment of the loan, jointly and severally liable to the

company and any person injured for any loss, damage or costs that the company or person sustained or incurred by reason of the contravention of subsection (1).

(4) Nothwithstanding subsection (3),

(a) the liability of the directors and officers of a company under this section is limited to the amount of the loan made in contravention of subsection (1) with interest at the rate, if any, stipulated for in the loan, and

(b) a director shall not be held liable for a contravention of subsection (1) if he proves that the contravention was not due to any misconduct or negligence on his part.

(5) Proceedings to recover any loss, damage or costs sustained or incurred by reason of a contravention of subsection (1) may not be commenced after the expiration of 2 years from the date on which the loss, damage or costs were sustained or incurred.

APPENDIX 10

New Brunswick, BCA Section 43

43(1) Except as permitted under subsection (3) or except where the Articles provide, a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise

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

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

if there are reasonable grounds for believing that

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

(d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan 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.

43(2) Except as permitted under subsection (3), a corporation or any of its affiliates shall not, directly or indirectly,

(a) make a loan to any person that is secured by a share of the corporation, or

(b) give financial assistance to any person, by means of a loan, guarantee or otherwise, for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation.

43(3) 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 incidental to the ordinary business of the corporation,

(b) to any person on account of expenditures 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 or for the benefit of 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 by a trustee.

43(4) 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.

APPENDIX 11

ABCA, Section 42

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 12

Ontario Business Corporations, 1970

16.--(1) Except as provided in subsection (2), a corporation shall not,

(a) make loans to any of its shareholders, directors or employees; or

(b) give, directly or indirectly, by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of, or in connection with, a purchase or subscription made or to be made by any person of any shares of the corporation.

(2) A corporation may,

(a) make loans to any of its shareholders, directors or employees in the ordinary course of its business where the making of loans is part of the ordinary business of the corporation;

(b) make loans to *bona fide* full-time employees of the corporation whether or not they are shareholders or directors, with a view to enabling them to purchase or erect dwelling houses for their own occupation, and may take from such employees mortgages or other security for the repayment of such loans;

(c) provide, in accordance with a scheme for the time being in force, money by way of loan for the purchase of or subscription for shares of the corporation by trustees, to be held by or for the benefit of *bona fide* employees of the corporation, whether or not they are shareholders or directors;

(d) make loans to *bona fide* employees of the corporation, other than directors, whether or not they are shareholders, with a view to enabling them to purchase or subscribe for shares of the corporation to be held by them by way of beneficial ownership; or

(e) if it is not offering its securities to the public, give directly or indirectly by means of a loan, guarantee, the provision of security or otherwise, financial assistance to any of its shareholders or directors with a view to enabling them to purchase issued shares of the corporation.

(3) The power mentioned in clause (2)(b), (c) or (d) may be exercised only under the authority of a special by-law.

APPENDIX 13

Ontario Business Corporations, 1982

20.(1) Except as permitted under subsection (2), a corporation or any corporation with which it is affiliated, shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise,

(a) to any shareholder, director, officer or employee of the corporation or affiliated corporation or to an associate of any such person for any purpose; or

(b) to any person for the purpose of or in connection with a purchase of a share, or a security convertible into or exchangeable for a share, issued or to be issued by the corporation or affiliated corporation,

where there are reasonable grounds for believing that,

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

(d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of any secured 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 its 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;

(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.

(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.

APPENDIX 14

British Columbia Company Act

126. No company shall give financial assistance to a person, directly or indirectly, by way of loan, guarantee, the provision of security, or otherwise, if,

(a) at the time of the giving of financial assistance the company is insolvent; or

(b) in the case of a loan, the giving of the loan would render the company insolvent,

and section 260 (2) applies, with the necessary changes and so far as is applicable, to this section.

127. (1) A company shall not give financial assistance to a person, directly or indirectly, by way of loan, guarantee, the provision of security, or otherwise,

(a) for the purpose of a purchase or subscription made or to be made by that person of, or for, shares of the company, or any debt obligations of the company carrying a right of conversion into or exchange for shares of the company;

(b) on the security, in whole or in part, of a pledge of or charge on shares of the company given by that person to the company; or

(c) in any other case, unless there are reasonable grounds for believing that, or the directors are of the opinion that, the giving of the financial assistance is in the best interests of the company.

indent both 2 2> (2) Notwithstanding subsection (1), a company, if previously authorized by special resolution, may, where there are reasonable grounds for believing that the giving of the financial assistance is in the best interests of the company,

(a) provide money, in accordance with a scheme for the time being in force, for the subscription for or purchase of shares or debt obligations of the company by trustees, to be held by or for the benefit of a *bona fide* employee of the company or of an affiliate of the company; and

(b) provide financial assistance to *bona fide* full time employees of the company, or of an affiliate, to enable them to purchase shares or debt obligations of the company to be held beneficially by them.

(3) Notwithstanding subsection (1), where the financial assistance

(a) is given in connection with an acquisition of shares made or to be made by a person either alone or with his associates and, after the acquisition, not less than 90% of the issued shares of each class of shares in the capital of the company will be owned by that person and his associates; and

(b) is authorized by special resolution before it is given.

a company that is not a reporting company may give financial assistance to or for the benefit of that person.

(4) Where a company proposes to give financial assistance under subsection (3), any member of the company may, until 2 days before the meeting at which approval is sought, give a notice of dissent to the company in respect of his shares and, in that event, section 231 applies.

(5) Notwithstanding subsection (1), financial assistance may be given to or for the benefit of

(a) a wholly owned subsidiary by its holding company; and

(b) its holding company by a wholly owned subsidiary.

128. Notwithstanding that a contract to which a company is a party is made in contravention of section 126 or 127, a *bona fide* lender for value without notice, or the company, may enforce the contract.

APPENDIX 15

CBCA Section 42

Following 1978-79 Ammendments

42. (1) Except as permitted under subsection (2), a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise

(a) to any shareholder, director, officer or employee of the corporation or of an affiliated corporation or to an associate of any such person for any purpose, or

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

where there are reasonable grounds for believing that

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

(d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form os 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; and

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

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

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

(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.