

**GOLDEN HANDSHAKES AND GOLDEN PARACHUTES
- SEVERANCE PACKAGES FOR CORPORATE EXECUTIVES -**

by

MATTHIAS NUSSBAUM

Dipl.-Jur. Univ., Ludwig-Maximilians-Universität, München, 2001

Ass. Jur., Ministry of Justice of the State of Bavaria, München, 2003

Member of the German Bar Association (Rechtsanwalt) in München

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ABSTRACT

GOLDEN HANDSHAKES AND GOLDEN PARACHUTES - SEVERANCE PACKAGES FOR CORPORATE EXECUTIVES -

Severance packages for corporate executives have recently caused public outrage in all parts of the world. Terms like “golden handshake” or “golden parachute” have been used in this context, but have remained somewhat uncertain as to their precise legal meaning.

This thesis examines the legitimacy of executive severance packages in the three major areas of contract law, employment law and corporate law including supplementary regulation. Its intention is to determine whether the law imposes restrictions on the level of severance and constraints on the contracting parties’ bargaining behaviour.

An introduction to the area of severance packages and “golden handshakes” in the corporate realm is delivered by a brief presentation of the recent “Mannesmann Affair” that occurred in Germany early in 2000. The case involved generous “golden handshakes” for members of the management who were terminated as a result of a takeover of the corporation and resulted in criminal proceedings against members of the board of directors and the management. In light of the confusing use of the different terms with regards to severance pay, the thesis develops its own definitions for further purposes of study. The thesis then proceeds in three main parts.

First, the basic principles arising from contract law and employment will be discussed in relation to the agreements concluded between the executive and the board of directors acting on behalf of the corporation. The main focus lies on the principle of freedom of contract and the notion of reasonable notice, both of which govern the executive severance agreement. Secondly, after a brief presentation of the structure of the Canadian corporation and the inherent potential for managerial self-dealing, the following chapter analyzes the impact of corporate law and other regulation on executive severance packages and managerial bargaining behaviour in general. Based on a comparative study of the Canadian and the German legal system, the thesis concludes with an assessment of the effectiveness of the present regime to impose limits on executive severance packages and takes a look on potential considerations for reform.

TABLE OF CONTENTS

ABSTRACT.....	<i>ii</i>
TABLE OF CONTENTS	<i>iii</i>
PREFACE.....	<i>viii</i>
INTRODUCTION	<i>1</i>
I. The German „Mannesmann Affair“ on Executive Severance Packages	<i>3</i>
II. Spectacular Severance Packages in North America	<i>8</i>
III. Approach of the Thesis	<i>13</i>
CHAPTER 1 Executive Severance Terminology.....	<i>20</i>
I. Severance.....	<i>20</i>
1. Categories of Termination at Common Law.....	<i>21</i>
a) Termination with advance notice.....	<i>21</i>
b) “Garden leave”	<i>22</i>
c) Contractual Termination Provision.....	<i>23</i>
d) Payment in Lieu of Notice as Damages for Wrongful Dismissal.....	<i>24</i>
2. Severance as Advanced Settlement Payment.....	<i>25</i>
3. Statutory Severance.....	<i>26</i>
4. The Executive Severance Package.....	<i>27</i>
II. Golden Handshake	<i>29</i>
III. Golden Parachute	<i>32</i>
IV. Executive	<i>34</i>
V. Chapter Summary.....	<i>36</i>

CHAPTER 2 The Legal Framework for Executive Severance.....	37
I. Contract Law: Severance Agreement	38
1. The Executive Service Contract.....	38
a) The Need for an Executive Service Contract.....	38
b) The Formation of the Executive Service Contract.....	41
c) The Contents of the Executive Service Contract	43
(1) Severance Provision.....	44
(2) Golden Parachute Provision.....	45
2. The “Golden Handshake” Agreement.....	48
a) Rescission of the Executive Service Contract	49
b) Variation of Contract	50
(1) Severance Package.....	51
(2) “Golden Parachute”	52
3. Judgment of the Court.....	57
4. Conclusion for Contract Law	57
II. Employment Law: Compensation for Dismissal.....	58
1. Damages for Wrongful Dismissal at Common Law.....	59
a) The Law of Wrongful Dismissal.....	60
(1) Dismissal for cause	60
(2) Dismissal without cause.....	62
b) The Length of Notice of Termination.....	65
(1) Indeterminate Duration of Employment Contract	65
(i) Reasonable Notice	65
(ii) Contractually Determined Notice	70
(2) Fixed term contract	71
c) The Heads of Damages.....	73
(1) Contractual Salary.....	75
(2) Bonus entitlements.....	75
(3) Stock Options.....	77
(4) Perquisites.....	78
(5) Contributions to a Pension Plan.....	80
(6) Aggravated Damages.....	81
2. Statutory Employment Standards Legislation.....	84
3. Conclusion for Employment Law	85
III. Chapter Summary	87

CHAPTER 3 Legal Constraints on Executive Severance Packages	88
I. The Issue of “Managerial Self-Dealing”	89
1. The Separation of Ownership and Control and The Agency Problem	90
2. Two Approaches to Corporate Governance.....	95
a) Optimal Contract Approach.....	96
b) Managerial Power Approach	98
3. The Legal Regime Governing Contracts between Executives and the Corporation...	101
a) Presence of Inside Directors	103
b) Compensation Committee.....	104
c) Compensation Consultants.....	107
4. Impact on Executive Severance Packages and “golden parachute” provisions.....	110
II. Legal Constraints	111
1. The Fiduciary Duty (Duty of Loyalty).....	112
a) The Concept of the Fiduciary Duty in Corporate Law	112
b) Mandatory Disclosure of Conflict of Interests.....	118
c) The “Reasonableness and Fairness” Test	120
(1) <i>Cannaday v. McPherson</i>	122
(2) <i>Rooney v. Cree Lake Resources Corp.</i>	124
(3) <i>UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.</i>	125
(4) Conclusion	126
d) The “Proper Purpose Test” for “Golden Parachutes”	127
(1) The “Proper Purpose Test”	128
(2) “Golden Parachute” Provisions.....	130
e) Conclusion	139
2. The Duty of Care.....	139
a) The Standard of Care at Common Law	140
b) The Statutory Duty of Care.....	141
c) The Business Judgment Rule.....	143
d) Severance Agreements and “Golden Parachutes”	149
3. Disclosure Requirements Under Securities Legislation.....	150
a) Introduction of Disclosure Rules to Canadian Securities Legislation	152
b) The New National Instrument 51-102 On Continuous Disclosure.....	155
c) Implications of Mandatory Disclosure.....	158
4. Corporate Governance Guidelines	163
a) TSX Guidelines for Effective Corporate Governance	163
b) Proposed Changes to Corporate Governance Guidelines	164
(1) NI 58-101 Disclosure of Corporate Governance	166
(2) NP 58-201 Corporate Governance Guidelines	167

TABLE OF CONTENTS

c) Estimated Implications for the Future.....	169
5. Tax Deductibility Restrictions	170
a) Limited Deductibility of Executive Severance Packages	170
b) Tax Deductibility Caps under United States Tax Legislation	172
(1) § 162(m) Internal Revenue Code regarding executive compensation	173
(2) § 280G Internal Revenue Code regarding “golden parachutes”	174
6. Criminal Law	178
a) Misappropriation of Money held under Direction, S. 332 CCC.....	179
b) Criminal Breach of Trust, S. 336 CCC	180
c) Fraud, Section 380 CCC	183
7. Conclusion	186
III. Shareholder Rights and Remedies	188
1. Shareholder Approval	189
2. Non-Compliance with Disclosure Obligations	191
3. Derivative Action.....	194
a) The Common Law Rule in Foss v. Harbottle	194
b) Scope of the Statutory Derivative Action	195
c) Derivative Action against Executive Severance Agreements.....	198
4. The Oppression Remedy.....	199
a) Scope of the Oppression Remedy	199
b) Oppression Remedy against Executive Severance Agreements	204
5. Application to Set Aside the Contract, Section 120(8) CBCA	204
6. Conclusion	205
IV. Chapter Summary	205
 CHAPTER 4 Assessment of the Effectiveness of the Legal Regime	209
I. Managerial Behaviour and Corporate Law Theory	209
1. <i>Berle and Means’</i> Conception of the Corporation as a Management Power Structure.....	210
2. The Corporation as a Nexus of Contracts	213
3. The Role of Corporate Law	217
II. Analysis of the Effectiveness of the Canadian Regime	219
1. Market Mechanisms.....	220
a) The Capital Market	220
b) The Product Market	224
c) The Managerial Market.....	226
d) The Market for Corporate Control.....	229

TABLE OF CONTENTS

e) Conclusion	232
2. Legal Constraints	233
a) Balance between Freedom of Contract and Fiduciary Duty	233
b) Dependence of the Effectiveness on the Availability of Information.....	236
III. Comparative Study of the German and European Union Legal Regime	239
1. The Capital Structure of the German Aktiengesellschaft	239
2. Independence of the Supervisory Board: The German Two-Tier System.....	240
3. Fiduciary Duty of Corporate Insiders	244
a) The Duty to Act in the Interests of the Business	244
b) Statutory Requirement of Reasonableness of Executive Compensation	246
c) Shareholder Remedies	247
4. Disclosure.....	249
5. Special Takeover Legislation with Respect to “Golden Parachutes”	252
a) The New German Takeover Law	252
b) The European Takeover Directive	254
6. Tax Law	256
IV. Conclusion and Chapter Summary	257
 CONCLUSION.....	 260
 BIBLIOGRAPHY.....	 264
 TABLE OF CASES.....	 279
 TABLE OF STATUTES AND REGULATION.....	 298

PREFACE

In recent years, compensation for corporate executives has increasingly been in the spotlight of concern and discussion. Generous salaries for top managers of well-known corporations have caused public outrage and have given rise to a controversy about the principles and possible limits of remuneration for executives in all jurisdictions. Until today, the criticism has not come to an end.

This thesis, however, is not designed to serve as yet another contribution addressed to the general issue of executive compensation. Rather than that, its intention is to examine the aspects of severance payment for executives at the time of the termination of the employment relationship as a separate issue of the overall topic. Terms like “golden handshake” or “golden parachute” have been quite common in the United States and Canada since the 1980s, but are yet to be elaborately scrutinized from a legal perspective.

Most recently, enormous severance packages for top managers finally reached worldwide public attention. In Europe, the takeover of former German telecommunication giant Mannesmann AG by the even bigger British Vodafone AirTouch PLC in early 2000 caused a change in control of Mannesmann AG. Former Mannesmann chief executive officer *Dr. Klaus Esser* received a severance package of approximately 60 Million German Marks for his early departure from office. As soon as the figures had been published, just another controversy about the moral limits of executive compensation evolved, this time in the alternative of executive severance payment.

Subsequently, the matter was even brought before the courts in Germany and, ever since then, it is referred to as the so-called “*Mannesmann Affair*”. Apparently for the first time German courts had to deal with severance payment for top executives. Even more astonishingly though, proceedings were held before a German criminal court, as the department of public prosecution of Düsseldorf had accused several participants of a breach of fiduciary duties owed to their company Mannesmann AG.

Lucrative executive severance packages have recently also been experienced in Canada. In this thesis I examine the legal framework for executive severance agreements as provided by the present Canadian legal regime. I assess whether the three main areas of law, contract law, employment law and corporate law are sufficiently effective to impose limits on the structure and

PREFACE

the level of executive severance packages for executives of Canadian corporations as to protect shareholders or even to avoid public outrage. My evaluation includes a comparative study of the German and the Canadian legal systems as a basis for considerations for future reform.

This thesis has been the major part of the LL.M. program at the Faculty of Law of the University of British Columbia in Vancouver, Canada, in the academic year 2004/2005. Thus, the legal analysis concentrates on the Canadian common law system. Most of the case law and statute law referred to represents Canadian law. However, since generous executive severance agreements and “golden parachutes” had their origin in the United States, U.S. case law has also been applied where appropriate. The comparative part states German law as well as supplementary legislation of the European Union.

Despite all my own efforts, this thesis would not have been possible without the help of a number of people. Accordingly, I wish to gratefully acknowledge the substantial assistance of Prof. Dr. *Ronald B. Davis*, LL.B., S.J.D., University of British Columbia, who not only provided me with essential background information regarding Canadian corporations law, but also spared his time for valuable reflections of thoughts and subsequent discussions. Additionally, this undertaking could not have succeeded without the very assistance of my German colleague Dr. *Bernhard Trappehl*, Rechtsanwalt & Abogado, Baker & McKenzie LLP, München, who contributed to this project by providing important input to my research as well as truly appreciated other means of assistance.

Very special thanks I owe to my loved parents *Ingeborg* and *Michael* who always inspired me and profoundly supported me in one way or another, and to my partner *Julia Spilker*, whose love, encouragement and contributions have been vital to the success of this project. I would also like to thank *Ute Stein* for her incredible and mostly appreciated work in proofreading this thesis, and *Joanne Chung*, Graduate Secretary of the Faculty of Law, University of British Columbia, for her time and patience with yet another German graduate student. Last but not least, I would like to acknowledge the inestimable support I have received from all other friends and colleagues, especially from *Nao Araya Kashiwagi*, LL.M., and *James Sultanum*, during my stay in Vancouver.

Matthias Nussbaum

Vancouver, B.C., April 20, 2005

To my parents

and

Julia

INTRODUCTION

“Golden Handshake of 60 Million for Esser!”

Statements like this¹ or similar² were the dominant headlines in the German media in February of 2000, shortly after it had become known to the public that former chief executive officer³ of Germany's telecommunication giant Mannesmann AG, *Dr. Klaus Esser*, had received a generous severance package of about 60 Million German Marks for his early departure from the Mannesmann group's management.⁴

In the immediate aftermath, the message of *Esser's* multi-million severance entitlements gave rise to a broad public discussion about executive compensation in German corporations.⁵ A criminal information⁶ finally led to a preliminary criminal investigation carried out by the department of public prosecution in Düsseldorf⁷ against several executives and board members of Mannesmann AG involved in the severance deal.⁸ By the end of its investigation, on February 17, 2003, the prosecution preferred criminal charges against *Esser* himself as well as against five

¹ The original headlines in the German language read “*Goldener Handschlag für Esser*”, see, for example, the following German newspaper articles and online-media releases: *Frankfurter Allgemeine Zeitung* (February 12, 2000); *Die Welt* (February 12, 2000); *manager-magazin.de* (February 11, 2000) <<http://www.manager-magazin.de>> (last visited on Oktober 24, 2004).

² See, for example, headlines such as “*Sweet Departure: Esser gets severance pay of 60 Million Marks*” („*Süßer Abschied: Esser bekommt 60 Millionen Mark Abfindung*“) *Spiegel Online* (February 11, 2000) <<http://www.spiegel.de>> (last visited on September 29, 2004); “*Esser gets 60.5 Million Marks as severance*” (“*Esser bekommt 60,5 Millionen DM Abfindung*“) *Financial Times Deutschland* (February 11, 2000); “*Klaus Esser gets 60 Million Marks*” (“*Klaus Esser bekommt 60 Millionen Mark*“) *Handelsblatt* (February 14, 2000).

³ The term chief executive officer will be referred to hereinafter as “C.E.O.”

⁴ At that time, the German Mark was still the valid currency in Germany. Therefore, all media reports mentioning a severance package of “60 Million” referred to the respective amount in German Marks. This amount also includes the so-called “appreciation award” of approximately 31 Million German Marks Esser received upon the takeover.

⁵ For example, German popular news magazin *Der Spiegel* asked if the severance payments had been a rip-off, see “*Abfindungen: Mannesmann-Chef Klaus Esser ein Abzocker?*” *Der Spiegel* (No. 7/2000, February 14, 2000) at 96. In the following, publications that critically dealt with executive compensation were frequently being released, see, for example, “*Die Vergütungen der Vorstände bleiben geheim*” *Frankfurter Allgemeine Zeitung* (May 8, 2001); “*Transparenz bei Vorstandsgehältern gefordert*” *Financial Times Deutschland* (December 19, 2001); “*Schamlose Vorstandsgehälter*” *Frankfurter Allgemeine Zeitung* (June 7, 2002); “*Raffke-Mentalität in deutschen Vorstandsetagen*” *Welt am Sonntag* (June 16, 2002); “*Dollarzeichen in den Augen der Chefs*”, *DIE ZEIT* (No. 28/2002); “*Selbstbedienung in den Vorstandsetagen*” *Die Welt* (June 25, 2003).

⁶ “Strafanzeige”.

⁷ “Staatsanwaltschaft Düsseldorf”. See Staatsanwaltschaft Düsseldorf, Az.: 28 Js 159/00, hereinafter referred to as “the prosecution”.

⁸ Criminal information had been laid by the German law firm Binz & Partner on February 23, 2000.

INTRODUCTION

members of the board of directors⁹ due to reasonable suspicion of criminal offences in terms of serious breach of shareholders' trust or aiding and abetting to it, respectively.¹⁰ The Regional Criminal Court of Düsseldorf admitted the charges for trial¹¹ on September 18, 2003¹² and the opening of the trial was ordered.¹³

As a result, the severance agreement between the board of directors of Mannesmann AG on behalf of the corporation and Esser triggered off the „most spectacular criminal proceedings in German business history“. ¹⁴ Most recently, on July 22, 2004, the Criminal Court rendered its verdict and acquitted the accused of all charges.¹⁵ As of today, however, the case has not been concluded since the prosecution immediately appealed against the sentence.¹⁶ The matter will now be dealt with in final instance by the German Federal Supreme Court of Justice.¹⁷

But what exactly had happened for this severance matter to surprisingly end up in criminal trials before German courts?¹⁸ Is there reason to believe that severance agreements for top executives are not always justified?

⁹ Among these were Prof. Dr. Joachim Alexander Funk, Klaus Zwickel, Jürgen Ladberg, Dr. Dietmar Droste, as well as recent C.E.O. of Deutsche Bank AG, Dr. Josef Ackermann.

¹⁰ See the press release by the Presiding Attorney General Henke of February 25, 2003 (Staatsanwaltschaft Düsseldorf, Az. 28 Js 159/00).

¹¹ "Landgericht Düsseldorf", referred to hereinafter as "the Criminal Court". See Landgericht Düsseldorf, Az. XIV-5/03.

¹² Regarding the three accused executives Funk, Esser and Droste, only modified charges had been admitted by the Criminal Court. With respect to Esser, the Düsseldorf Criminal Court only permitted an accusation of the offence of aiding and abetting ("Beihilfe zur Untreue"), see the Official Committal for Trial by the Criminal Court of September 18, 2003 (Landgericht Düsseldorf, Az. XIV – 5/03, Eröffnungsbeschuß v. 18.09.2003).

¹³ See the press release No. 7/2003 issued by the Criminal Court on February 22, 2003 (Landgericht Düsseldorf, Az.: XIV-5/03). Regarding the criminal charges and proceedings. See also David Olive, "Bountiful kiss-offs abundant in North America" The Toronto Star (September 24, 2003) at E01 Business.

¹⁴ See the press articles published prior to the proceedings, such as "Der Mannesmann-Fall spaltet die Fachwelt" Die Welt (January 20, 2004); "Mannesmann-Prozess: Tarnen, täuschen und taktieren" manager-magazin.de, *supra* note 1; "Manager und Millionen – der Prozess" Hamburger Abendblatt (January 22, 2004).

¹⁵ See Landgericht Düsseldorf, Az. XIV 5/03, Urt. v. 22.07.2004, LG Düsseldorf, NJW 2004, 3275.

¹⁶ See press release by the prosecution of July 23, 2004 (Staatsanwaltschaft Düsseldorf, Az. 28 Js 159/00). See also "Staatsanwaltschaft legt Revision gegen Mannesmann-Urteil ein" Frankfurter Allgemeine Zeitung (February 23, 2004).

¹⁷ "Bundesgerichtshof in Strafsachen".

¹⁸ In fact, the result that the deal ended in criminal proceedings rather than in civil action proceedings appears quite astonishing at first sight. However, it can be better understood when having looked closer at the German legal system governing corporate governance and shareholder rights, see *infra* Chapter 4, III.

I. The German „Mannesmann Affair“ on Executive Severance Packages

On February 3, 2000, after a duration of three months, the „most spectacular takeover war in German business history“¹⁹ finally came to an end.²⁰ *Esser*, in his position as C.E.O. of Mannesmann AG, and *Sir Chris Gent*, C.E.O. of British Vodafone AirTouch PLC,²¹ had agreed upon the takeover of Mannesmann by Vodafone with a symbolic handshake.²²

Ever since the receipt of the first unfriendly takeover bid by Vodafone of approximately 100 Billion Euro on November 4, 1999 *Esser* had refused all offers by the British group. His defence strategy had apparently caused an increase of the value of a Mannesmann share from the initial 144 EURO to 209.90 EURO. Even after Vodafone had increased its offer to a total of 124 Billion EURO on November 19, 1999 – representing the highest takeover bid a German company had ever received in history²³ – *Esser* still had refused to consent.

Finally, however, *Esser* gave up resistance on February 3, 2000 and agreed to the takeover considering a package of Vodafone shares of a volume of about 190 Billion EURO. As was revealed later, *Canning Fok*, the representative of Mannesmann's largest institutional shareholder Hutchison Whampoa Ltd. of Hong Kong, had suggested to grant *Esser* an “appreciation award”²⁴ of 10 Million £²⁵ in order to officially recognize *Esser's* success in enormously increasing the market value of Mannesmann in the course of the takeover-war. That appreciation award was indeed given to *Esser*, although finally not borne by the acquirer

¹⁹ “Die spektakulärste Übernahmeschlacht der deutschen Wirtschaftsgeschichte”, see, for example, “Chronik einer Übernahmeschlacht” Frankfurter Allgemeine Zeitung (February 17, 2003); “Tatort Chefetage” Stern (No. 16/2003 of April 10, 2003) at 188; “Was von den Vorwürfen übrig ist” Handelsblatt (April 13, 2004).

²⁰ In fact, since Mannesmann's management team opposed Vodafone's takeover offers for that large period of time before ultimately accepting Vodafone's takeover bid, this publicly qualified as the first successful openly contested hostile takeover in Germany ever, see Neal E. Boudette, “Vodafone Deal Shows Market Forces Have Undercut Nationalism in Europe” Wall Street Journal (February 7, 2000) at A29.

²¹ Hereinafter, the two corporations are simply referred to as “Mannesmann” and “Vodafone”.

²² In the following, the takeover process is briefly summarized for introductory purposes. For a complete reproduction of all facts and the exact schedule of the takeover, please confer to the authorities cited *supra*, at note 19 as well as to “Chronik einer Übernahme-Affäre” manager-magazin.de, *supra* note 1. All important agreements and resolutions by the board of directors in connection with the takeover are in German language only and can be found in a legal opinion rendered by Professor Dr. Uwe Hüffer on behalf of Deutsche Bank AG, see Uwe Hüffer, “Mannesmann/Vodafone: Präsidiumsbeschlüsse des Aufsichtsrats für die Gewährung von ‘Appreciation Awards’ an Vorstandsmitglieder” (2003) 43 Betriebsberater Beilage 7 (BB 2003, Beil. 7).

²³ See “Chronik einer Übernahme-Affäre” manager-magazin.de, *supra* note 1.

²⁴ As the takeover negotiations between Vodafone and Mannesmann were pursued in the English language, the actual term used was “appreciation award”. As the term was unprecedented at German law, the English term has also been used by German commentators ever since its first appearance.

²⁵ This amount is equivalent to about 32 Millionen German Marks or approximately 16.5 Millionen EURO.

INTRODUCTION

Vodafone, but paid out of Mannesmann's own assets²⁶. Both *Gent* as well as Mannesmann's board of directors had agreed to the award before the board officially consented to the takeover by resolution on February 4, 2000.

Shortly after that, on February 11, 2000, rumour had it that already on December 10, 1999 *Esser* had signed an agreement that granted him salaries and bonuses in the amount of his contractual remuneration entitlements until the end of his contract in June of 2004 in the event he would depart earlier as a result of the potential takeover.²⁷

After having changed position from C.E.O. of Mannesmann to member of the Vodafone board of directors on June 5, 2000, Vodafone announced *Esser's* departure from the company effective September 30, 2000.²⁸ At least at this time, it was obvious that the handshake concluded between *Esser* and *Gent* on February 3, 2000 not only had meant the final success of Vodafone's takeover efforts. In fact, it had also been a symbolic "golden handshake" for *Esser*, who despite his defeat in the takeover battle and the early termination of his office as C.E.O. was now entitled to receive millions in terms of severance payment.

In particular, *Esser* allegedly received pay in lieu of notice of about 15.2 Million German Marks contemplating the remaining time of his contract, an additional bonus of some 12.6 Million Marks as well as the mysterious appreciation award of approximately 31 Million Marks. The total of about 58.8 Million Marks²⁹ is still regarded as the "highest amount, the C.E.O. of a German company has ever received in return for his premature resignation from office".³⁰

First reactions regarding the spectacular severance package varied. Whereas a spokesman of Vodafone announced that the amount was likely to be insufficient considering the high

²⁶ According to the written accusations of February 17, 2003, the "appreciation award" was granted not only to former C.E.O. *Esser*, but also to former Chairman of the board of directors, *Funk*, as well as to four other former executives, see Landgericht Düsseldorf, *supra* note 12; Hüffer, *supra* note 22 at 2.

²⁷ See "*Esser bekommt 60,5 Millionen DM Abfindung*" *Financial Times Deutschland*, *supra* note 2, and all other authorities cited *supra* notes 1 and 2. Although at that point of time no payment had been executed because *Esser* was still remaining within the Vodafone group, all those press releases cited were already being published. However, no distinction was made between the contractually agreed severance payments and the additional appreciation award due at the time of the acquisition of the majority of the outstanding Mannesmann shares by Vodafone.

²⁸ See the official press release by Vodafone of September 26, 2000, available online under Press Releases on the Vodafone website <<http://www.vodafone.com>> (last visited on October 24, 2004).

²⁹ This amount is equivalent to approximately 30 Million EURO.

³⁰ "[...] die höchste Summe, die ein Vorstand eines deutschen Unternehmens jemals für seinen vorzeitigen Abgang erhalten hat"), see "Goldener Handschlag für *Esser*" *Die Welt*, *supra* note 1. See also "Managergehälter in der Kritik" *Handelsblatt* (June 26, 2000); and the chart "*Der Goldene Handschlag - Millionen-Abfindungen für Top-Manager*" *Frankfurter Allgemeine Sonntagszeitung* (February 16, 2003)

INTRODUCTION

increase of shareholder value in the course of the takeover negotiations,³¹ other commentaries criticized the amount as “inappropriate”³² or even called it a “rip-off”.³³ Not surprisingly, the matter caused an intense discussion about the appropriateness of remuneration and severance payment for German top executives. When in September 2000 the information against *Esser* and the other responsible persons was laid, Germany was about to experience its “largest business scandal after World War II”,³⁴ also referred to in a more legally prescription as the “Mannesmann affair”.³⁵

Until the Mannesmann affair, large severance payments to executives had been unprecedented not only in Germany, but even in Europe as a whole. Generally speaking, most of the European national jurisdictions had not provided for any transparency and disclosure of executive compensation.³⁶ Accordingly, shareholders and the public had not had broad knowledge of the amounts executives were being compensated with. Consequently, ever since the Mannesmann affair, executive severance packages have not been well received by the European public – and especially by the shareholders. For example, upon his resignation from office in 2002, *Jean-Marie Messier*, at that time C.E.O. of French entertainment conglomerate Vivendi Universal S.A., claimed a severance package of EURO 20.6 Million that was supposed to be due according to his employment contract, which was governed by employment law of the United States.³⁷ Since the company’s shares had lost more than 80 per cent of their value as *Messier* ran the company into billions of dollars of debt and left it close to bankruptcy, Vivendi Universal withheld the severance payment arguing that *Messier* was not owed the money

³¹ See “*Goldener Handschlag für Esser*” *Die Welt*, *supra* note 1.

³² This was the actual wording of the criminal information of February 23, 2000, see *supra* note 6. See also Hermann Josef Schmidt, former chairman of the works council of German ARCOR GmbH, in “*Mannesmann und die Millionenabfindung*” Report Mainz (August 5, 2002). The report is published online at <<http://www.swr.de/report/archiv/sendungen/020805/02>> (last accessed on November 10, 2004). Shortly after the opening of the criminal trial, German Corporate Law Professor Dr. Holger Altmeyden regarded the amount as “inappropriate”, see Holger Altmeyden, “*Abfindungen im Fall Mannesmann*” *Süddeutsche Zeitung* (January 27, 2004) at 3.

³³ “*Abzocke*”. See “*Abfindungen: Mannesmann-Chef Klaus Esser ein Abzocker?*” *Der Spiegel*, *supra* note 5.

³⁴ See “*Eine Frage von Ehre und Ehrlichkeit*” *Manager Magazin* (Volume 4, April 24, 2003) at 56.

³⁵ See “*Mannesmann-Affäre: Staatsanwälte rechnen mit Verurteilung*” *Financial Times Deutschland* (February 26, 2003). See also “*Staatsanwälte prüfen die Beschwerde*” *Die Welt* (September 23, 2003); “*Große Namen auf der Anklagebank*” *Süddeutsche Zeitung* (September 20, 2003).

Accordingly, I will also use the term “Mannesmann affair” when referring to the payments for former Mannesmann executives in connection with the takeover of Mannesmann by Vodafone.

³⁶ See also Heather Timmons, “*Other Shoe Drops in Deal For Aventis: Severance*” *The New York Times* (April 28, 2004) W Column 6 Business/Financial Desk. 1.

³⁷ The United States will be referred to hereinafter as “U.S.”.

INTRODUCTION

because he had resigned voluntarily.³⁸ Both the ousted C.E.O. and the company spent 18 months in judicial proceedings before U.S. courts, only for *Messier's* claim to be finally³⁹ turned down at the end of 2003.⁴⁰

In April 2004, when the US\$ 65.5 billion takeover deal between French Sanofi-Synthelabo S.A. and French-German drug company Aventis S.A. had just been sealed, news spread that the deal would result in the payout of some of the highest severance packages awarded in Europe in recent years.⁴¹ According to a document Aventis had filed with the U.S. Securities and Exchange Commission shortly before the closing of the deal, among others, Aventis' chairman and C.E.O. *Igor Landau* was entitled to as much as EURO 24 million in terms of nearly five years' compensation together with 1.5 times his bonus as well as pension and life insurance, regardless whether he stayed as C.E.O., was asked to leave or chose to go.⁴² Unlike other European companies, Aventis had been more open and had disclosed each individual executive's compensation in an annual 20F-filing with the U.S. Securities Exchange Commission because it traded its securities on the New York Stock Exchange as American depository receipts.⁴³

As one of the most important implications of the Mannesmann affair, European national legislations have recently implemented changes as to the policy regarding the disclosure of executive compensation. Germany, for instance, in 2002 introduced the German Corporate Governance Code according to which all executive compensation shall be disclosed in the annual report of any publicly-held corporation.⁴⁴ As a result of increasing shareholder pressure against pay packages for British executives considered to be overgenerous, Great Britain in 2003 established a new investor-protection law requiring companies to report much more information than before about executive compensation and giving shareholders an opportunity to reject to the

³⁸ See Sarah Moore, "Vivendi's ex-CEO awarded \$32 million" *The Toronto Star* (July 1, 2003) Business C02. The company is also reported to have expressed that Vivendi Universal's board of directors had not approved the contract.

³⁹ *Messier* firstly had prevailed before a New York arbitration Court that granted him the "golden parachute", see *Ibid.* at C02. See also Olive, *supra* note 13 at E01.

⁴⁰ See Timmons, *supra* note 36 at 1.

⁴¹ *Ibid.*

⁴² *Ibid.*

⁴³ See Timmons, *supra*, note 36, at Pg. 1.

⁴⁴ The German Corporate Governance Code will be discussed in detail *infra* at Chapter 4 III. 4.

board's salary recommendations.⁴⁵

However, as European boards still seem to be quite generous in determining executive compensation and severance payments, aggrieved shareholders have begun to take up their own actions and challenge specific compensation agreements. In March 2003, as a first reaction to the new British investor-protection law, shareholders of GlaxoSmithKline PLC of London, the world's Number 2 drug maker, voted to reject the proposed pay package for the company's C.E.O. *Dr. Jean-Pierre Garnier* and other top executives.⁴⁶ The component of the compensation plan that drew the most criticism was a severance provision that would have entitled *Garnier* to US\$ 23.7 million in bonus salary and stock if he had resigned or had been dismissed any time through 2007.⁴⁷

Moreover, the constantly increasing public criticism of executive compensation has caused some C.E.O.s to even reimburse their former companies for benefits previously received. For example, *Pierre Bilger*, former C.E.O. of Alstom S.A., received a severance payment of CDN\$ 4.6 million when he left the French engineering giant in March of 2002.⁴⁸ When it turned out that a major acquisition by Alstom had resulted in a ruinous loss of about 90 per cent of Alstom's share value, in August 2003 *Bilger* chose to return the complete amount of severance package he had received upon his departure in 2002.⁴⁹ Like *Bilger*, several other former C.E.O.s of European companies that suffered substantial business losses waived all or part of their retirement payouts. Among these were *Robin Jeffrey* of British Energy PLC who agreed to surrender as much as CDN\$ 628,000, *Graham Wallace* of Cable & Wireless PLC who returned about CDN\$ 1.6 million, *Percy Barnevik* of Swedish-Swiss conglomerate ABB Ltd. who paid back not less than CDN\$ 63.5 million in retirement benefits as well as *Lukas Muehleemann* of Credit Suisse Group who waived all of his severance received.⁵⁰

⁴⁵ See Statutory Instrument 2003 No. 2822, "The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.3) Order 2003" of November 6, 2003, effective December 1, 2003. For more detail, see Jonathan Fisher, Jane Bewsey, Malcolm Waters, Elizabeth Ovey, *The Law of Investor Protection* (London: Sweet & Maxwell, 2003).

⁴⁶ See Olive, *supra* note 13, at E01; Timmons, *supra* note 36, at 1.

⁴⁷ See Timmons, *supra* note 36 at 1.

⁴⁸ *Ibid.*

⁴⁹ See Olive, *supra* note 13 at E01: *Bilger* explained that he wanted „not to be an object of scandal for the hundred thousand employees I had the honour to direct”.

⁵⁰ *Ibid.* Since those executives never publicly gave reason for their doing so, it can only be assumed that they intended to avoid shareholder litigation and negative publicity.

II. Spectacular Severance Packages in North America

While the judicial controversy has just been launched by the Mannesmann affair in Germany and has already hit other jurisdictions in Europe, large severance packages for top executives seem to have been the norm quite frequently in other parts of the World such as North America over the past years without seriously being questioned.⁵¹

High lump-sum payments for leaving executives and new terms like "golden parachute" were first noticed in the U.S. in the early 1980s⁵² and soon reached neighbouring Canada.⁵³ Although there has been criticism of some kind over the past 20 years,⁵⁴ the wave of indignation was by far not as high as it is in Europe at present.⁵⁵ Even more, no case has ever been reported

⁵¹ For the U.S. generally see *ibid.*

⁵² For example, William Agee received a US\$ 4 million golden parachute payment when he resigned as C.E.O. of Bendix Corporation following the takeover battle between Bendix Corporation, Martin Marietta, Allied Corporation, and United Technologies, see Tamar Lewin, "Using Golden Parachutes" *New York Times* (November 30, 1982) at D2. See also the following news articles of that period by Wendy Cooper, "Mergers and Acquisitions: The Spread of Golden Parachutes" *Institutional Investor* (August 1982) at 65-68; W. John Moore, "Golden Parachute Agreements Shelter Displaced Executives" *Legal Times of Washington* (October 25, 1982) at 5; Ann Morrison, "Those Executive Bailout Deals" *Fortune* (December 13, 1982) at 82, 86; Andrew C. McLaughlin, "The Myth of the Golden Parachute: What Every Dealmaker Should Know" (1982) 17 *Mergers & Acquisitions* 47. One first scholarly contribution was delivered by Robert H. Winter and Mark Stumpf, eds., *Shark Repellents and Golden Parachute* (Aspen Pub, 1983).

⁵³ See, for example, James B. Noonan, "Golden Parachutes" in: *Employment Contracts* (Toronto: Insight Press, 1988) at 2.

⁵⁴ See, for example, Martin Riger, "On Golden Parachutes - Ripcords or Ripoffs? Some Comments on Special Termination Agreements" (1982) 3 *Pace L. Rev.* 15; Stephen Greenhouse, "Golden Chutes Under Attack", *New York Times* (December 10, 1985) at D2; John A. Byrne, R. Grover, and T. Vogel, "Cover Story: Is the Boss Getting Paid Too Much?" *Business Week* (May 1, 1989) at 46; Frederick C. Klein, "A Golden Parachute Protects Executives, But Does it Hinder or Foster Takeovers?" *Wall Street Journal* (December 8, 1982) at 56; David V. Maurer, "Golden Parachutes - Executive Compensation or Executive Overreaching?" (1984) 9 *J. Corp. L.* 954.

Early U.S. cases that indirectly involved the topic of golden parachutes were *Lewis v. Anderson*, 453 A.2d 474 (Del. Ch., 1982) at 480; *Smachlo v. Birkelo*, 576 F.Supp. 1439 (D. Del., 1983) at 1441; *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163 (3rd Cir. 1984) at 167; *Wolgin v. Simon*, 722 F.2d 389 (8th Cir. 1983) at 393; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. Sup. Ct., 1985) at 957. The first case a court had to directly deal with the merits of golden parachute contracts was *Koenings v. Joseph Schlitz Brewing Co.*, 126 Wis.2d 349, 377 N.W.2d 593 (Wisc. 1985). Subsequent cases are *Worth v. Huntington Bancshares, Inc.*, 43 Ohio St.3d 192, 540 N.E.2d 249 (1989) and *Gaillard v. Natomas Co.*, 208 Cal.App.3d 1250, 256 Cal. 702 (1989).

Also, in 1984 the U.S. introduced its first "anti-golden parachute legislation" as part of the 1984 Tax Reform Act, see Henry F. Johnson, "Those 'Golden Parachute' Agreements: The Taxman Cuts The Ripcord" (1985) 10 *Del. J. Corp. L.* 45 at 56.

⁵⁵ The arising public concern in the U.S. over the high rates of executive compensation in general led to a pledge by the Democratic Presidential Candidate Bill Clinton in his 1992 presidential campaign to curb excessive compensation practices should he be elected President, see "Presidential Candidates Divide on Executive Compensation Caps" 24:42 *Securities Regulation and Law Report* 1634 (October 23, 1992), as cited in Mark Salky, "The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?" (1995) 49 *U. Miami L. Rev.* 795 at 826.

INTRODUCTION

in neither of these jurisdictions of severance payments being subject to criminal investigation. In fact, here it long seemed to be an uncontested rule to pay out top executives at the time they were fired or for companies to provide their management with gracious severance clauses in order for them to – figuratively speaking – take the golden parachute directly into retirement.

However, several reports on severance payments for C.E.O.s over the last years have obviously caused Americans as well as Canadians to at least think twice as the figures constantly grew higher. As a result, various firms have been accused of paying out inappropriately generous severance packages to executives who are supposed to not having delivered good value to their shareholders. For instance, in 1997 Walt Disney Corp. was confronted by shareholder criticism and finally sued by its shareholders after former C.E.O. *Michael Ovitz* had left the U.S. company in 1996 taking home a severance package of about US\$ 140 million in cash and stock options after little more than one year of tenure.⁵⁶ Shareholders accused the directors of failing to watch out for shareholder interests, leading to the squandering of company assets when *Ovitz* received his rich severance deal.⁵⁷ In 1998, former Bank of America C.E.O. *David Coulter* was ousted after his bank had been taken over by NationsBank Corp. of Charlotte, N.C. *Coulter* received a huge severance package valued between US\$ 50 million and US \$100 million that not long after drew a massive protest from shareholder advocates, causing Bank of America to give shareholders a veto power over large severance payments in 2002.⁵⁸

Notwithstanding, at the beginning of the new millennium yet another wave of huge severance packages upset investors who had suffered heavy losses on their respective stocks. Mattel Co.'s C.E.O. *Jill Barad* received what is publicly regarded as “perhaps the most lucrative exit package for an underperforming C.E.O.”⁵⁹ a US\$ 50 million “golden handshake” severance

⁵⁶ See Christopher Carey, “*Hilbert raised Compensation Bar; Although \$74 million package upset investors, severance clause has been part of his contract*” *The Indianapolis Star* (May 3, 2000) Business 01C; Richard Verrier, “*Ovitz Case Haunts Disney Board*” *Los Angeles Times* (September 20, 2004) Business C1. *Ovitz*’ severance package is still regarded as the largest “golden parachute” ever awarded to a corporate executive, see Timmons, *supra* note 36 at 1.

⁵⁷ See Verrier, *supra* note 56 at 1. See also Christopher Parkes, “*Eisner’s Princely Ways Cut No Ice With Shareholders*” *Financial Times* (U.S. Edition) (March 3, 1997) at 17. Regarding the litigation, see *Brehm v. Eisner*, 746 A.2d 244 (Del. Sup. Ct., 2000), affirming in part *sub nom Re Walt Disney Co. Derivative Litigation*, 731 A.2d 342 (Del. Ch., 1998). For a summary of the facts, see Vladimir S. Korolev, “*Brehm v. Eisner, or Some Reflections about the Disney Case*” (2001) 26 Del. J. Corp. L. 1105 at 1106.

⁵⁸ See E. Scott Reckard, “*BofA Ex-Chief Heading to L.A.; David Coulter will lead J. P. Morgan Chase’s private equity businesses and drum up corporate clients*” *Los Angeles Times* (September 22, 2004) Business C2.

⁵⁹ See Gary Strauss, “*Forget brass rings – execs grab for gold, Golden’ contracts give bigwigs beaucoup bucks to stay ... or sometimes to go*”, *USA TODAY* (March 20, 2001) at Money 1B.

INTRODUCTION

package when being fired in January 2000.⁶⁰ In February 2000, after just two years in office, *M. Douglas Ivester* departed as C.E.O. of The Coca-Cola Company with a severance package of US\$ 120 million in cash and stock.⁶¹ In total, Coca-Cola has paid out severance of more than US\$ 200 million between 2000 and 2004 to departing executives.⁶² Not surprisingly, the company has faced a number of shareholder resolutions aimed at compensation reform.⁶³ *Steven C. Hilbert*, as C.E.O. of Consecro Inc., received a US\$ 72.4 million payment when he resigned from office and left Consecro in April 2000 after the board had concluded that investors had lost faith in him⁶⁴. *Hilbert's* employment contract had contained a clause guaranteeing him five times his annual salary and bonus for the loss of his job and, in addition to his termination payment, granting him new options to buy 2 million shares of the company stock at US\$ 5.75 a share.⁶⁵ Ironically, in the same week that *Hilbert* was ranked among the highest-paid executives in Forbes annual compensation survey, his name was also added to the list of corporate America's biggest severance packages.⁶⁶

Regardless of that, as shows the case of former General Electric C.E.O. *Jack Welch*, severance benefits can be still far greater for executives who are believed to have served to the investors' benefits by substantially increasing shareholder value. *Welch*, who resigned voluntarily in 2000 rather than being ousted like other executives at that time, received US\$ 16.7 million in pay and bonus as well as a reward for his 20 years of leadership for the company consisting of restricted stock worth US\$ 48 million, stock options valued at up to US\$ 274 million and a lifetime annual pension valued at US\$ 9 million per year.⁶⁷ General Electric also provided *Welch* a lifetime consulting contract for up to a month of consulting services a year at about US\$ 300,000 annually. During *Welch's* tenure as C.E.O., General Electric's market value

⁶⁰ See E. Scott Reckard, "Big Perks Put Seven CEOs in a Whole 'Other' Club; Insurance, forgiven loans, corporate jet travel, and gross-ups' are key features of their million-dollar packages" Los Angeles Times (June 6, 2004) Business C4; Carey, *supra* note 56 at 01C.

⁶¹ See Carey, *supra* note 56 at 01C.

⁶² See "Another Coke Classic" The New York Times (June 16, 2004) Editorials/Op-Ed.

⁶³ In the meantime, however, it was reported in summer 2004 that the company's recent C.E.O. Stephen Heyer would receive a severance pay of at least US\$ 24 million after a disappointing three-years tenure, see *ibid*.

⁶⁴ See Carey, *supra* note 56 at 01C. See also Thomas P. Wyman, "Indiana's Top Executives; Firms' poor performances put new focus on pay" The Indianapolis Star (May 7, 2000) Business 01E; Bill W. Hornaday, "Consecro chairman's pay is one of a kind; Nonexecutive's \$20.6 million deal loaded with stock, has its critics" The Indianapolis Star (December 14, 2003) Business 01D.

⁶⁵ See Carey, *supra* note 56 at 01C.

⁶⁶ *Ibid*.

⁶⁷ See Strauss, *supra* note 59 at 1B.

INTRODUCTION

increased by US\$ 460 billion. Compensation experts say *Welch* might be one of the few C.E.O.s who actually deserved his „golden goodbye“.⁶⁸

In what might have been the richest payout in history when measured in severance dollars per hours worked,⁶⁹ the Boston University's trustees in 2003 offered former NASA administrator *Daniel S. Goldin* a US\$ 1.8 million severance package before *Goldin* ever reported to work.⁷⁰ In March 2003, *Richard Brown* received retirement benefits, stock options and cash worth 37.4 million when he left Electronic Data Systems Corp. as C.E.O.⁷¹ In September 2003, *Dick Grasso* resigned from his job as head of the New York Stock Exchange with an overall pay package of US\$ 188 million.⁷² Since it was not clear whether he departed for good reason or as a victim of wrongful dismissal, the severance portion of his package was estimated between as little as US\$ 9 million or as much as US\$ 57 million.⁷³ At the end of 2003, *Jeffrey J. Steiner*, chairman and chief executive of Fairchild Corp., received US\$ 3.1 million without even bailing out after a subsidiary of Fairchild Corp. had been sold to Alcoa Corp.⁷⁴ While Fairchild, at the same time, reported a loss of US\$ 53.2 million for its fiscal year that ended June 30, 2003, *Steiner* also received a US\$5.2 million bonus from Fairchild for his work on the deal. Fairchild officially reported that contracts of its executives entitled them to change of control payments if the company sold "substantially all of our assets".

The latest news of large severance payments in the U.S. is that of golden parachute payments in connection with an acquisition of Walt Disney Corp. by Comcast Corp. When takeover negotiations became public in February 2004, it was reported that Walt Disney C.E.O. *Michael Eisner* was likely to collect up to US\$ 24 million as a golden parachute payment in

⁶⁸ *Ibid.*

⁶⁹ See Rob Weisman, "BU Presidency / Golden Parachute; University's Severance Package for Goldin called Unprecedented" *The Boston Globe* (November 1, 2003) Metro/Region B5.

⁷⁰ Timothy K. Cutler, as quoted in by Weisman, *supra* note 69 at B5, called the deal "a new wrinkle in the golden parachute, [... since] the plane never took off the ground."

⁷¹ See Timmons, *supra* note 36 at 1.

⁷² See Landon Thomas, Jr., "Officials in 2 States Urge Big Board Chief to Quit" *New York Times* (September 17, 2003) A1.

⁷³ See Olive, *supra* note 13 at E01.

⁷⁴ See David S. Hilzenrath, "Lucrative Cash Package Came as Fairchild Reported \$53.2 Million Loss" *The Washington Post* (August 16, 2004) Financial E01: Although, according to documents filed with the SEC, *Steiner's* employment contract linked any change of control payment to the termination of his contract, *Steiner* received this change of control payment without giving up his position at Fairchild. The company had concluded a new deal with its C.E.O., allowing him to receive half of his US\$ 6.2 million change of control payment in 2003 and the remainder at the time of expiry of his his. In return, *Steiner* agreed to stay on the job after the business had been sold to Alcoa.

INTRODUCTION

addition to his right to execute US\$ 500 million in stock options if he left Walt Disney as a result of the takeover.⁷⁵

As for Canada, *George Kosich* who had been appointed C.E.O. of T. Eaton Co. Ltd. in 1997 received a CDN\$ 1 million severance package after 18 months of service on December 15, 1998, although having failed in improving the business of the economically struggling department store chain. *Kosich*, who requested even more, filed a lawsuit claiming CDN\$ 8 million for wrongful dismissal that subsequently was dismissed by the Court.⁷⁶ The Canadian public was finally alerted to the fact that reasonable business results did not seem to be essential for generous executive compensation when *Bill Fields*, formerly a well-performing C.E.O. of Wal-Mart Stores Inc., left The Hudson Bay Co. in 1999 with a CDN\$ 5.95 million severance package for his 21 months of leadership, leaving behind disastrous results for the company.⁷⁷

When *Stephen Bachand* retired as C.E.O. of Canadian Tire Corp. in August 2000 after almost seven years of service, he received a package of CDN\$ 10.3 million plus CDN\$ 15.5 million upon exercising his stock options.⁷⁸ In 2001, after four years of service as C.E.O. for Sears Canada Inc., *Paul Walters* walked away from the company with a CDN\$ 6.4 million-severance package.⁷⁹ In addition to his two-year's base salary pay of about CDN\$ 1.6 million, *Walters* was awarded CDN\$ 4.8 million as part of his termination settlement. In 2002, public attention in Canada was drawn to *Eleanor Clitheroe*, former C.E.O. of Hydro One Inc., when it was revealed that she would receive a severance package of CDN\$ 6 million when being fired from office.⁸⁰ Ontario's Premier *Ernie Eves* called the deal „inappropriate and unreasonable“⁸¹ whereas Ontario's Energy Minister *Chris Stockwell* regarded it as „far too generous“considering that she was alleged by the company to have abused her powers.⁸²

When in early 2003 CGI Group Inc. acquired Canadian Cognicase Inc. for CDN\$ 329 million in cash and stock, a deal that also included the assumption of CDN\$ 48.1 million in debt,

⁷⁵ See Carolyn Said, „*Eisner on shaky ground; Roy Disney says Comcast affirms his stand*“ The San Francisco Chronicle (February 13, 2004) Business B1.

⁷⁶ See Steven Theobald, „*Walters well paid to leave*“ The Toronto Star (March 15, 2001) Business C01.

⁷⁷ *Ibid.*

⁷⁸ *Ibid.*

⁷⁹ *Ibid.*

⁸⁰ See Ian Urquhart, „*Hydro One not secretive about numbers*“ The Toronto Star (June 8, 2002) B02; Richard Brennan, „*Hydro One fires CEO; claims spending abuses*“ The Toronto Star (July 20, 2002) A01.

⁸¹ See Richard Brennan, „*Hydro board quits*“ The Toronto Star (June 5, 2002) A01.

⁸² See Urquhart, *supra* note 80 at B02.

Cognicase founder and C.E.O. *Ronald Brisebois* as well as several senior executives agreed to leave the company, collectively taking with them a payment of CDN\$ 14.8 million in golden parachutes.⁸³ And finally, in connection with the recent merger between Canada's largest brewery Molson Inc. and U.S. brewery Adolph Coors Co. in June 2004,⁸⁴ company documents filed with the U.S. Securities and Exchange Commission revealed that Molson's C.E.O. *Dan O'Neill* was supposed to receive a US\$ 2.3 million golden parachute payment even though *O'Neill* was to stay on with the new company as vice-chairman.⁸⁵ Quebec's pension plan, the Caisse de depot et placement du Quebec, holding 3 % of Molson class A shares, appealed directly to Molson's chairman *Eric Molson*, strongly urging him to drop the provisions regarding the „excessive“ payments to the company's executives. In reply to that, Molson agreed to perform revisions in accordance with its shareholders' concerns.⁸⁶

III. Approach of the Thesis

The latest developments of increasing figures of executive severance packages in all different jurisdictions and the reaction by the public and the shareholders give rise to a legal analysis of the present legal regime governing those payments. Several questions arise. For example, what are the legal grounds for executive severance payments? Does the law impose limits on those payments? And, if those payments can be excessive, how can they be challenged?

In part, those questions give new light to the controversy about general executive compensation agreements.⁸⁷ That issue has already been in the center of public attention in North

⁸³ See Tyler Hamilton, „*Heads begin to roll as CGI absorbs rival*“ The Toronto Star (February 20, 2003) Business C05.

⁸⁴ See the press release by Molson Coors Brewing Company issued on June 22, 2004, available online at <<http://www.molsoncoors.com>> (last visited on November 11, 2004).

⁸⁵ See Dana Flavelle, „*Caisse fighting Molson merger*“ The Toronto Star (September 23, 2004) Business C01.

⁸⁶ *Ibid.*

⁸⁷ Despite all the early criticism, the compensation of chief executive officers of those U.S. corporations that were listed among the 500 largest American corporations (the „Fortune 500“ as compiled by Fortune magazine) still rose 481% during the 1990s, see Mary Diebel, „*Stock Options are Making a Lot of Fat Cats Fatter*“ Treasure Coast Business Journal (Vero Beach, Florida) (November 2, 1999) at A9. In 2000, C.E.O.s of 730 publicly-held U.S. corporations received an average of 550 per cent more than their 1990 counterparts, see Louis Lavelle, Frederick F. Jespersen, and Michael Amdt, „*Executive Pay*“ Business Week (April 15, 2002) at Special Report. On average, these C.E.O.s gained US\$ 13.1 million in 2000, see Louis Lavelle and Frederick F. Jespersen, „*Executive Pay*“ Business Week (April 17, 2002) at Special Report.

America since the 1980s⁸⁸ and, therefore, has also been subject to intense scholarly scrutiny.⁸⁹ In common law jurisdictions such as the U.S. and Canada, scholars have used two principle theoretical tools to analyse the issues concerning executive compensation.⁹⁰ Whereas mainly financial economists have first approached the topic of executive compensation by looking at it as a means that optimal aligns the interests of executives and shareholders,⁹¹ others have based their proposals for governance improvements on the theory that executives have the power to use executive compensation agreements to generate personal benefits.⁹² The discussion about the present system of executive compensation has now also reached European jurisdictions, mainly caused by the German Mannesmann affair. Here, the debate to a great extent is still driven by mere moral concerns raised primarily by the popular media, asserting that the amounts of compensation for executives have become “excessive” or “outrageous”, especially when compared with the amounts of salary of individual employees of the same company.⁹³ That criticism from the moral standpoint regrettably lacks profound consideration of the legal framework of executive compensation and, subsequently, a material discussion thereof.

⁸⁸ See, for example, Carol Loomis, “*The Madness of Executive Compensation*” *Fortune* (July 12, 1982) 42 at 42-46; John A. Byrne, “*The Flap over Executive Pay*” *Business Week* (May 6, 1991) 90 at 90-96; Judith H. Dobrzynski, “*Directors’ Pay Is Becoming an Issue, Too*” *Business Week* (May 6, 1991) 94. For Canada, see, for example, Jade Hemeon, “*Bosses get 18% raises*” *The Toronto Star* (September 7, 1995) B1; John McNeil, “*Why make executives disclose their salaries?*” *The Globe and Mail* (October 29, 1993) A33; Jeffrey Simpson, “*Corporate Bosses are continuing to reward themselves handsomely*” *The Globe and Mail* (April 16, 1996) A18.

⁸⁹ See, for example, Edward M. Iacobucci with Michael J. Trebilcock, *Value for Money: Executive Compensation in the 1990s* (Toronto: C. D. Howe Institute, 1996), delivering a general overview of the different approaches and further references. See also John M. Abowd and David S. Kaplan, “*Executive Compensation: Six Questions that Need Answering*” (1999) 13 *J. Econ. Perspectives* 145; Kevin J. Murphy, “*Top Executives are Worth Every Nickel They Get*” (1986) *Harv. Bus. Rev.* 125; Kevin J. Murphy, “*Executive Compensation*” in: Orley Ashenfelter and David Card, eds., *The Handbook of Labor Economics* (Amsterdam: Elsevier 1999) at 2485; Tod Perry and Marc Zenner, “*CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*” (2000) 35 *Wake Forest L. Rev.* 123 at 145.

⁹⁰ At this point, I will only briefly mention the leading two theoretical approaches on executive compensation, as they will be discussed in detail in the course of this thesis, see *infra* at Chapter 3, I. 2. and Chapter 4, I.

⁹¹ This approach is referred to as the “optimal contract approach”. Among important contributors were, for example, Frank H. Easterbrook, “*Managers’ Discretion and Investors’ Welfare: Theories and Evidence*” (1984) 9 *Del J Corp L* 540; Daniel R. Fischel, “*The Corporate Governance Movement*” (1982) 35 *Vand. L. Rev.* 1259; Nicholas Wolfson, “*A Critique of Corporate Law*” (1980) 34 *U. Miami L. Rev.* 959; Robert Thomas, “*Is Corporate Executive Compensation Excessive?*” in M. Bruce Johnson, ed., *The Attack on Corporate America: The Corporate Issues Sourcebook* (New York: McGraw Hill 1978) at 276. For more detail, see *infra* at Chapter 3, I. 2. a).

⁹² This so-called “managerial power approach” was mainly developed by Lucien A. Bebchuk, Jesse M. Fried, and David Walker, “*Managerial Power and Executive Compensation*” (2002) 69 *U. Chicago L. Rev.* 751; Lucian A. Bebchuk and Jesse M. Fried, “*Executive Compensation as an Agency Problem*” (2003) 17 *J. Econ. Persp.* 71; Kevin J. Murphy, “*Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*” (2002) 69 *U. Chicago L. Rev.* 847. This view is described *infra* at Chapter 3, I. 2 b).

⁹³ See especially the collection of news press publications cited *supra* notes 1, 2, 5, 30, and 34.

INTRODUCTION

However, the recourse to moral standards as a potential limit to compensation can at least be regarded as having served well to alert the public and legislators that something indeed might be wrong with the system.

With respect to general executive compensation, the latest concerns raised by aggrieved shareholders have caused scholars to suggest that executive compensation be linked closer to performance and be disclosed to the public in more detail.⁹⁴ With respect to performance-based pay, in particular the tendency to provide executives with stock options has been substantially criticized,⁹⁵ although stock options have long been regarded as one of the strongest tools for compensation under the optimal contract approach.⁹⁶ Stock options capture at least some element of executive performance as they give an incentive to run the company in a manner which ensures that the company's equity has a value higher than the price the options have been granted at.⁹⁷ On the other hand, however, as the value of stock options that are granted at the current share price strongly responds to actual stock market trends and, generally, increases with the passage of time, they will most likely provide the executive with substantial earnings, even if the executive's corresponding performance turns out to have failed or not been a factor to the increase in share price. Thus, a popular statement has been that the average executive is "handsomely rewarded when a company's share price goes up but endures few negative consequences when equity values have declined".⁹⁸

As a first result, some jurisdictions have incorporated into their corporate laws or corresponding securities laws specific rules requiring shareholder approval of all stock option plans for executives.⁹⁹ Additionally, in an attempt to provide more transparency, several countries have responded to the latest corporate governance discussions by introducing stricter

⁹⁴ A good summary of the debate about performance-linked compensation is provided by Lucian A. Bebchuk and Jesse Fried, *Pay for Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge: Harvard University Press, 2004).

⁹⁵ See, for example, Bebchuk *et al.*, *supra* note 92 at 775.

⁹⁶ See Benjamin Alarie, "Executive Compensation and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s" (2003) 61 U. T. Fac. L. Rev. 39 at 56.

⁹⁷ See Brian R. Cheffins, "The Metamorphosis of 'Germany Inc.': The Case of Executive Pay" (2001) 49 Am. J. Comp. L. 497 at 507.

⁹⁸ See Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Clarendon Press, 1997) at 657.

⁹⁹ For the U.S., see Randall S. Thomas and Kenneth J. Martin, "The Determinants of Shareholder Voting on Stock Option Plans" (2000) 35 Wake Forest L. Rev. 46 at 46-51. For Canada, see *infra* note 1052

INTRODUCTION

disclosure rules with special attention to executive compensation.¹⁰⁰ Furthermore, forced by investor advocacy organizations for better corporate governance,¹⁰¹ the directors of essentially all large publicly-held U.S. corporations now tend to establish special compensation committees that mainly or completely consist of independent directors to which the responsibility to determine the executive compensation is delegated to.¹⁰² Since many corporations are struggling to establish themselves in competitive and volatile industries in the present economy, it has also been perceived that the boards of directors themselves return to be more independent and more willing to fire executives who are performing poorly.¹⁰³ In the U.S., the average tenure of C.E.O.s has decreased from seven years to about five years during the last twenty years.¹⁰⁴ In turn, as a measure to insure themselves against financial loss arising from unemployment, executives have responded to that new tendency by negotiating employment contracts that guarantee high severance packages even if their performance should turn out to have failed.¹⁰⁵ Accordingly, given that the controversy about overall executive compensation, corporate governance and shareholder value has caused some precautions on the part of the executives, separate executive severance agreements now have become a crucial feature of the general issue of executive compensation. Also, the increasing amount of corporate takeovers has led to an

¹⁰⁰ The regulatory movements in this arena undertaken recently in Canada will be discussed in more detail *infra* at Chapter 3, II. 3. For Germany, see *infra* at Chapter 4, III. 4.

¹⁰¹ The Teachers Insurance and Annuities Association/College Retirement Equities Fund ("TIAA/CREF"), for example claimed for a policy that "compensation committees should be independent, knowledgeable, and willing to use an outside compensation consultant in negotiating CEO compensation", see "*Fund Toughens on Executive Pay*" Investor Rel. Bus. (April 3, 2000) at 17, as cited in Bebchuk *et al.*, *supra* note 92 at note 16.

¹⁰² See Kenneth A. Bertsch, Rachel Leahey, and Hawie Haun, "*Board Practices (1998): The Structure and Compensation of Boards of Directors at Sandp Super 1500 Companies*" (Washington, D.C.: Investor Responsibility Research Center, Inc., 1998) at 6, reporting that in 1998 the average percentage of independent directors on compensation committees ranged from 83.5 percent among S&P Small Cap 600 firms to 91.9 percent among S&P 500 firms. According to Bertsch *et al.*, a director is considered as independent if not employed by the firm or "affiliated". A director is considered "affiliated" if he is a former employee, a relative, a representative of a charity that receives contributions from the firm, a service provider, a supplier, a customer, or an interlocking director.

¹⁰³ See Luke Timmerman, "*Tallying the costs of soft landings for C.E.O.s.*" The Seattle Times (June 20, 2004) Business and Technology 1.

¹⁰⁴ See Tom Neff and Dyton Ogden, "*Anatomy of a CEO*" Chief Executive (February 1, 2003) at 3032. See also Denis B. K. Lyons, "*CEO Casualties: A Battlefront Report*" Directors & Boards (Summer 1999) 43, reporting that the percentage of Fortune 100 companies whose C.E.O.s have tenure of five years or less has increased from 46 per cent in 1980 to 58 per cent in 1998.

¹⁰⁵ According to a survey pursued by the Corporate Library in 2003, more than half of 367 large U.S. companies declared they would pay their C.E.O.s total compensation for three years or more upon termination, whereas fewer than two per cent of all companies asked would pay less than a year's remuneration, see The Corporate Law Library, "*The Corporate Library's CEO Pay Survey – CEO Pay 2003*", available online at <<http://www.thecorporatelibrary.com/Products-and-Services/store/publications/default.asp>> (last accessed on November 23, 2004).

INTRODUCTION

increase in the draft of separate “golden parachute” provisions, granting the executive additional benefits in the event of a takeover.

The intention of this thesis is to focus on the current issue of severance payments for corporate executives apart from the broader discussion about executive compensation in general. An attempt is being made to address the different aspects and questions raised in connection with executive severance packages from a legal perspective rather than from a merely moral standpoint. My goal is to determine the legal grounds for the different kinds of severance packages as well as, if any, the restrictions imposed by the law with regards to the structure and, most importantly, to the amount. Once that legal framework has been established, I will examine and assess the effectiveness of the means by which corporate outsiders like the shareholders can challenge executive severance packages in order to possibly make proposals for future reform. For the most part, the legal system analysed will be the current Canadian corporate law regime. However, the law of other jurisdictions will also be considered where it is believed to contribute to a specific issue. Especially, given the tremendous impact of the Mannesmann affair on the issue of executive severance pay, the German law will be applied for a comparative study in an attempt to assess the effectiveness of the Canadian system. Accordingly, this thesis proceeds as follows.

First, in the course of my research I have noticed a remarkable inconsistency regarding the use of specific terms in the field of executive severance. Apparently, some commentators do not conceive of the different available terms with the same meaning as do others. For instance, whereas some authors use the term “golden handshake” to describe a payment in the event of a takeover, others refer to it as a general severance payment.¹⁰⁶ Also, even the term “severance” is being used both as a general term for the overall payments made to an executive upon the termination of his contract as well as a description of one single component of benefits received. Before a legal examination in this area can be conducted, it is essential to previously determine the different terms to an extent that prevents any ambiguity or uncertainty as to their legal meanings. Therefore, in the first Chapter of the thesis, I will define and clarify the various terms that have so far been observed in practise in connection with severance payments to corporate

¹⁰⁶ Compare, for example, Alarie, *supra* note 96 at 49, explaining that “golden handshake” provisions guarantee that the executive be generously compensated in the case of a change in control of the company, and Cheffins, *supra* note 97 at 523, referring to “golden handshakes” generally as a severance payment for executives. In fact, as we will see, neither uses the term in its correct meaning distinct from severance agreement and “golden parachute” agreement.

executives. I will show that it is essential for the following legal analysis to distinguish between contractual agreements concluded before the termination of the executive's contract and subsequent arrangements.

Chapter 2 then deals with the basic legal framework for the different kinds of executive severance packages. I will present the specific legal grounds executive severance agreements, "golden parachutes" and "golden handshakes" can be based on. I will argue that the contracting parties, from a contract law perspective, in light of the principle of freedom of contract are mainly free to negotiate whatever agreement they might find suitable with respect to their respective interests. Following that, the thesis will focus on the impact of employment law provisions and show how the law of dismissal sets out minimum standards as to the components and the level of executive severance payments for the event of early termination. Since the common law concepts of employment law deviate to a large extent from the existing German civil law system, I will explore the relevant Canadian principles such as the notion of reasonable notice in more detail.

Chapter 3 considers the impact of Canadian corporate law and its supplementary laws as potential constraints on the structure and the level of executive severance agreements. It begins with an explanation of the perceived problems the corporate governance systems in North America have to cope with. The first part begins with a look at the separation of ownership and control in corporation with widely dispersed shareholdings and the agency problems within the corporation that have been claimed to be the source for conflicts of interests and managerial self-dealing. I will present and discuss the two competing theoretical approaches to those problems with respect to executive compensation agreements. In the next Part, I will describe the means provided by current Canadian law to control the contractual arrangements of corporate executives and directors – „the insiders“ –, and subsequently will assess the effectiveness of those means to prevent corporate insiders from improperly diverting corporate assets through executive severance agreements. I will argue that the present legal regime provides several powerful restrictions on managerial misbehaviour and establishes effective remedies for shareholders to challenge allegedly improper executive severance and "golden parachute" agreements.

Chapter 4 includes a comparative study of the Canadian and German legal systems for the purpose of an assessment whether certain legislative modifications to the present system are necessary. Part I of this Chapter places the recent Canadian regime in the context of its underlying legal theory, as an understanding of the theoretical background is inevitable for

INTRODUCTION

further legislative initiative. The next part evaluates the different economic market factors that are claimed by some scholars to serve as sufficient constraints to the bargaining powers of corporate insiders. In Part III, I will briefly present the main characteristics of the German legal regime including aspect of European Union law that are, apart from economic mechanisms, of importance in the field of executive severance agreements. The results will be compared to the conclusions drawn earlier with regards to the Canadian regime. On the basis of that comparative study, I will discuss whether further regulatory steps should be taken.

Finally, the thesis will close with a reconsideration of the basic results of each Chapter and with a critical outlook into the future.

CHAPTER 1

EXECUTIVE SEVERANCE TERMINOLOGY

The diverse media coverage of the latest spectacular cases of ousted corporate executives has stressed the different kind of payments that are possible in relation to the termination or resignation of an executive. Moreover, what has also become clear is that the respective terms are not always used in a uniform way to describe the same sort of payment in a specific case. Whereas some reports have announced a “generous severance package” for a leaving executive, other commentators have used terms such as “termination pay” or “parachute payment”.¹⁰⁷ Further articles refer to the same event as a “golden handshake” offered to the executive by his corporation.¹⁰⁸ Each term, however, is apparently aimed to describe one and the same payment received by the executive at the time he leaves the corporation.

The perceived inconsistency in the use of these terms makes it essential to primarily eliminate any ambiguity and establish a definition on the basis of which the legal framework can be examined and further argumentation can be conducted as to the legitimacy of such payments. I have broken down the discussion of the different definitions into four main categories: general severance, “golden handshakes”, “golden parachutes”, and “executive severance packages”. For each category, I will describe the general term and then define its legal meaning in relation to the legal framework of employment and corporate law. Additionally, I will briefly determine the exact meaning of the word executive as used in the course of the thesis. Accordingly, for the purposes of this thesis, the following terms shall be understood only as defined hereinafter.

I. Severance

In common practice, the term “severance” is often used to describe any payment or all payments made to an employee at the time of termination.¹⁰⁹ However, at common law the employee is not necessarily always entitled *per se* to receive a certain severance payment from

¹⁰⁷ For illustration, see the different headlines and articles indicated *supra* at Introduction I. and II.

¹⁰⁸ See *supra*, note 106.

¹⁰⁹ See, for example, Randall Scott Echlin and Christine M. Thomlinson, *For Better Or For Worse: A Practical Guide to Canadian Employment Law* (2nd ed., Aurora: Aurora Professional Press, 2003) at 115.

his employer at the time of termination of the employment relationship.¹¹⁰ In order to determine what constitutes a severance pay, regard must be made to the different situations in which such payments may occur as a result of the termination of the employment contract. In general, the following categories of termination of employment need to be distinguished.¹¹¹

1. Categories of Termination at Common Law

a) Termination with advance notice

At common law, it is an implied term of the employment contract that in the absence of cause for termination the employer may terminate an employment relationship of undetermined duration only by giving notice of termination reasonably in advance of that termination.¹¹² Moreover, in the Canadian federal jurisdiction and every Canadian province except for British Columbia and New Brunswick, statutory minimum notice periods for the termination of individual employees have been introduced.¹¹³ Accordingly, unless the employment agreement itself expressly provides for a specific notice period, the employer can only terminate the employment contract lawfully by giving the employee reasonable notice of termination. If he does so, the employee will not be entitled to any additional payment at the time the termination becomes effective.

In contrast, if the parties have entered into a fixed-term employment agreement, the employment relationship cannot be terminated without cause prior to the automatic expiration at the end of the definite term.¹¹⁴ Since the parties originally agreed upon a fixed term, no party can

¹¹⁰ See also *ibid.* at 257.

¹¹¹ In the following, a brief introduction will be given to the different possible ways of termination of an employment relationship at Common Law. A more detailed survey of the notion of reasonable notice and payment in lieu thereof will be provided at some later point of the work, see *infra* at Chapter 2 II. 1.

¹¹² This common law principle has been set out by a number of Canadian cases, see *infra* notes 316 to 325.

¹¹³ For a general overview of the different legislations see Geoffrey England, *Individual Employment Law* (Toronto: Irwin Law, 2000) at 228-234. A more detailed illustration is provided by Geoffrey England, Innis Christie, and Merran Christie, *Employment Law in Canada* (3rd ed., Toronto and Vancouver: Butterworths, Loose-leaf) at Volume 2 § 14.9.

¹¹⁴ *Groulx v. Commission Municipale de Québec*, D.T.E. 90T-739 (Que. S.C.); *Tinker-Labrecque v. Corp. de l'Hôpital d'Youville de Sherbrooke*, [1986] R.J.Q. 1283 (C.A.); *United Talmud Torahs of Montreal Inc. v. Dulude*, D.T.E. 84T-41 (Que. S.C.); *Dombrowski v. Dalhousie University* (1974), 55 D.L.R. (3d) 268 (N.S.S.C.), affirmed 79 D.L.R. (3d) 355 (C.A.); *MacLeod v. Dominion (Town) Board of Education* (1958), 16 D.L.R. (2d) 587 (N.S.S.C.). See also England, *supra* note 113 at 223.

unilaterally terminate such contract by way of reasonable notice of termination.¹¹⁵ Any termination prior to the expiration will entitle the employee to damages for wrongful dismissal.¹¹⁶

b) "Garden leave"

At common law, the employer is under no general obligation to provide work to his employee.¹¹⁷ Therefore, the employer may give proper notice of termination and at the same time release the employee from his contractual obligation to attend his workplace during the notice period even if the employment contract does not expressly provide the right for the employer to do so. This procedure is commonly referred to as granting the employee "garden leave".¹¹⁸ However, the employee is not released from his entire employment contract. Therefore, sending the employee on "garden leave" is an adequate measure where the employer intends to terminate an employee who is in possession of confidential or strategic information. While the employee is released from the duty to work, the terms regarding confidentiality and fidelity continue.¹¹⁹

Since the employment contract does not cease to exist until the actual end of the notice period, the employee, in return, remains fully entitled to all wages. In practice, the wages due are either paid as a lump-sum payment at the time notice is given or they are continued to be paid according to the contractually agreed frequent basis.¹²⁰ Garden leave is also a possible way to terminate a fixed-term employment contract. Here, the employee is entitled to continued

¹¹⁵ *Mainville v. Brasserie Michel Desjardins Ltée*, D.T.E. 88T-292 (Que. S.C.), appeal abandoned September 16, 1988, C.A.M. 500-09-000185-884; *Paddon v. Phillips Barratt Kaiser Engineering Ltd.* (1987), 18 B.C.L.R. (2d) 170 (B.C.S.C.); *Hawkins v. Ontario* (1985), 8 C.C.E.L. 183 (Ont. H.C.J.); *Landry v. Radio du Pontiac Inc.*, D.T.E. 83T-200 (Que. S.C.); *O'Callaghan v. Transair Ltd.* (1975), 58 D.L.R. (3d) 80 (Man. C.A.); *Walker v. Copp Clark Publishing Co.*, [1962] O.R. 622 (H.C.J.).

¹¹⁶ *Zaglanikis v. Dana West Hotels Ltd. and Courtyard Inns Ltd.* (1980), 3 A.C.W.S. (2d) 461 (B.C.S.C.); *Clark v. Babcock & Wilcox Canada Ltd.* (1981), 9 A.C.W.S. (2d) 189 (H.C.J.), affirmed 15 A.C.W.S. (2d) 40 (Ont. C.A.); *Meyer v. Carstairs* (1984), 52 A.R. 206, 3 C.C.E.L. 258 (Alta. Q.B.); *Stevens v. LeBlanc's Welding & Fabricating Ltd.* (1982), 40 N.B.R. (2d) 389 (N.B.Q.B.); *Riddell v. City of Vancouver* (1985), 11 C.C.E.L. 288 (B.C.C.A.); *Vondette v. Vancouver Port Corp.* (1987), 21 B.C.L.R. (2d) 209 (B.C.S.C.); *Savoie v. Les Entreprises de Tabac Bernard (1976) Ltd.* (1983), 47 N.B.R. (2d) 179 (N.B.C.A.); *Shiozaki v. Expo 86 Corp.* (1986), 2 A.C.W.S. (3d) 130 (B.C.S.C.); *McDowell v. Sunshine Coast Community Services Society* (1987), 15 C.C.E.L. 284 (B.C.Co.Ct.); *Brown v. Kinden* (1987), 3 A.C.W.S. (3d) 185 (N.B.Q.B.), varied 89 N.B.R. (2d) 387 (N.B.C.A.); *Gardner v. Stan-Canada Inc.* (1989), 13 A.C.W.S. (3d) 411 (H.C.J.), supplementary reasons 15 A.C.W.S. (3d) 348.

¹¹⁷ *Burmeister v. Regina Multicultural Council* (1985), 8 C.C.E.L. 144 (Sask. C.A.).

¹¹⁸ See, for example, Anthony Korn, *Compensation for Dismissal*, (London: Blackstone Press Limited, 1993) at 19; Cheffins, *supra* note 98 at 109 note 275.

¹¹⁹ See Cheffins, *supra* note 98 at 109 note 275.

¹²⁰ See Korn, *supra* note 118 at 19.

payment of wages until the expiration of his fixed-term contract.¹²¹ Alternatively, the employee may also consent to an immediate lump-sum payment in the amount of all wages outstanding until the end of the employment contract.¹²²

c) Contractual Termination Provision

Notwithstanding the existing obligation for the employer to provide reasonable notice of termination,¹²³ the parties to the employment contract are free to include a provision stating expressly that the employment contract can be terminated upon notice or with payment in lieu thereof.¹²⁴ Where the period of notice is not specifically determined in the contract, reasonable notice must be given. If the employer decides not to terminate upon notice, he then is obliged to pay in lieu of notice either the specific amount agreed upon and established in the contract or, in absence thereof, an amount equivalent to the reasonable notice period.¹²⁵ In order to prevent any dispute about what constitutes a reasonable period of notice or reasonable amount of payment in lieu of notice in the specific case, the parties are free to mutually determine the respective amounts in the employment contract.¹²⁶

Since the parties have agreed to a termination either upon notice or subject to a payment in lieu of notice, a termination without prior notice will not result in a breach of contract, provided the employer instead pays the equivalent amount to the employee.¹²⁷ Such provision enables the employer both to terminate lawfully by making only the payment and to continue to enforce any contractual provisions that take effect after the termination, such as, e.g., restrictive covenants.¹²⁸ Accordingly, where a payment in lieu of notice is provided for by the contract itself and automatically payable in the event of an early termination without being tied to the performance

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ See *supra* note 117 and accompanying text.

¹²⁴ England, *supra* note 113 at 223; England, Christie, and Christie, *supra* note 113 at § 12.12.

¹²⁵ For the introductory purpose of defining the different terms, it is not necessary at this point to comment on the issue of what constitutes reasonable notice of termination and reasonable payment in lieu of notice. The topic will be discussed in detail later, see *infra* at Chapter 2 II. 1.

¹²⁶ In fact, the parties to an employment agreement are strongly encouraged to do so in order to eliminate potential lawsuits subsequent to the termination. Especially service contracts between a corporation and the executive should contain a provision expressly stating the period of notice of termination, as the corporation for reputation reasons will be highly interested in avoiding a lawsuit with the former executive claiming for damages for wrongful termination. However, the issue will be of less importance if, as is the case in practice, the executive agrees to serve for a fixed-term period. For more detail, see *infra*, Chapter 2, II. 1. b).

¹²⁷ See, for example, Howard A. Levitt, *The Law of Dismissal in Canada* (2nd ed., Aurora: Canada Law Book, 1992) at 3.

¹²⁸ Korn, *supra* note 118 at 19.

of work, the payment cannot be regarded as damages for wrongful dismissal.¹²⁹

The same applies to a fixed-term contract. The parties to a fixed-term contract can negotiate a provision into their contract that allows the employer to prematurely terminate the contract before expiration of the term while at the same time giving the employee the entitlement to receive a specific amount as a contractual entitlement.¹³⁰ As the agreed payment is payable as a money debt automatically upon early termination rather than as a compensation for breach of contract, no duty to mitigate arises for the employee.¹³¹

d) Payment in Lieu of Notice as Damages for Wrongful Dismissal

Subject to any written provision as set out *supra* at c), the employer may only terminate the employment contract without providing notice if there is cause for dismissal. If no cause for dismissal exists, any termination without notice is deemed to be a breach of contract and the employee is entitled to damages.¹³² The employee's remedy under common law is a lawsuit for wrongful dismissal claiming these damages. The courts will award damages with regard to the reasonable period of notice that has not been observed and the employee's remuneration payable during that notice period.¹³³

In order for the employer to avoid liability for damages for wrongful dismissal, he can tender a payment in lieu of notice at the time of termination. Such payment is intended to compensate the prejudice caused by the abrupt termination of the employment contract without respecting the notice of termination.¹³⁴ Therefore, it is regarded to be a payment of damages for wrongful dismissal in advance of a respective court decision.¹³⁵ It cannot be seen as a payment of wages since the employer has actually breached his contractual obligations to pay wages during

¹²⁹ See, for example, *Borkovich v. Canadian Membership Warehouse Ltd.* (1991), 34 C.C.E.L. 42 (B.C.S.C.); *Paquin v. Gainers Inc.* (1991), 37 C.C.E.L. 113 (Alta. C.A.) especially at 115; *Neilson v. Vancouver Hockey Club* (1988), 25 B.C.L.R. (2d) 235 (B.C.C.A.).

¹³⁰ England, *supra* note 113 at 223; England, Christie, and Christie, *supra* note 113 at § 12.12.

¹³¹ *Supra* note 129.

¹³² *Olson v. Sprung Instant Greenhouse Ltd.* (1985), 12 C.C.E.L. 8 (Alta. Q.B.); *Lang v. Modern Garment Co.*, [1950] R.L. 296 (Que. S.C.); *Mongeau & Robert & Cie Ltée v. Raby* (1933), 55 B.R. 243 (Que. C.A.).

¹³³ *Supra*, note 132. See also *Sylvester v. British Columbia* (1997), 146 D.L.R. (4th) 207 (S.C.C.).

¹³⁴ See, generally, Stikeman, Elliott (firm), ed., *Executive Employment Law* (Markham: LexisNexis Canada Inc., Loose-leaf) at § 11.63 with further references.

¹³⁵ *Ibid.*

the mandatory notice period and is liable for damages under the law of wrongful dismissal.¹³⁶

2. Severance as Advanced Settlement Payment

If reasonable or contractually determined notice of termination is given there is no need for the employer to offer any additional payment to the employee.¹³⁷ By contrast, in each alternative of early termination described *supra* under b) to d), the payment made by the employer to its employee can be regarded as severance pay.

Although the rationale for the payment varies in each constellation in terms of continued payment of wages in the case of garden leave, contractually agreed payment in lieu of notice or advanced payment of damages for breach of contract, all of these payments are made by the employer in order to comply with his common law obligations and to avoid any subsequent lawsuit for wrongful dismissal. The employer's intention for the payment in each case is to terminate the employment contract with immediate effect, regardless of whether there is cause for dismissal or not. By providing the employee with a payment at the time of termination, the employer longs to settle a potential lawsuit for wrongful dismissal in advance. Depending on the amount offered to the employee, he either complies with his obligations arising from common law in terms of paying what the employee is entitled to receive upon wrongful termination or gives the employee a reason to pursue a lawsuit for wrongful dismissal.

Accordingly, the term severance pay cannot be viewed as a technical legal term only for either advanced damages for wrongful dismissal or payment of contractually owed wages at the time of termination. Rather than that, it needs to be determined in a broader sense as every payment made by the employer to his employee at the time of early termination of the employment contract in order to compensate for any remaining contractual rights or potential claims arising from the law of wrongful dismissal. Thus, the severance payment is an advanced settlement payment by way of either a lump-sum payment or any other method of payment agreed upon by the parties. Its intention is not to reward the employee for his loyalty to the employer, his long term of service or any other achievement the employer might intend to

¹³⁶ Although the amounts paid as advanced damages might be identical to the amounts that would have been paid under a contractual provision, *supra* c), the consequences of both alternatives can be quite different. One important distinction is the tax treatment for the payments received. Whereas contractual pay in lieu of notice is regarded as regular wages under tax law, payment as advanced damages for breach of contract will, as a general rule, be exempt from taxation. Another important distinction is the personal liability of directors for the pay of employee wages in contrast to a lack of personal liability for damages for breach of contract by the corporation.

¹³⁷ See *supra* at a).

honour by way of an extra monetary benefit.

3. Statutory Severance

Thus defined, the term severance must be distinguished from statutory severance pay that has been introduced by two Canadian jurisdictions, i.e. Ontario¹³⁸ and the federal government.¹³⁹ Both the Ontario Employment Standards Act as well as the Canada Labour Code provide that certain employees may be entitled to receive an extra "severance payment" in addition¹⁴⁰ to any other payment due to the employee upon termination pursuant to the general individual termination provisions of the law of dismissal.

"Severance Payment" in these statutes is merely a lump-sum payment which the employer must pay to the employee whose employment contract is permanently ended, usually for causes beyond the employee's control.¹⁴¹ This kind of severance payment has been regarded by the courts as an *ex gratia* "windfall" for the employee rather than a vested entitlement as deferred wages or as compensation for lost property in the job.¹⁴² As recently held by the Supreme Court of Canada, a statutory severance payment is an allowance paid by the employer to the employee in recognition of the employee's long years of service for the employer.¹⁴³

This rationale becomes apparent when looking at the relevant provisions of the statutes. According to the Canada Labour Code, all employees with 12 consecutive months of service are entitled to statutory severance pay of the greater of two days' pay for each completed year of service or five day's pay.¹⁴⁴ Statutory severance payments in Ontario are also based on service and closely approximate one additional week's pay for each year of service, up to a maximum of 26 weeks' additional pay.¹⁴⁵ Furthermore, all severance payments under the Ontario Employment Standards Act are restricted to those employees with five or more years of

¹³⁸ Employment Standards Act, S.O. 2000, c. 41, as amended (hereinafter referred to as "ESA"), Section 64.

¹³⁹ Under the federal jurisdiction, the Canada Labour Code, R.S.C. 1985, c. L-2, as amended (hereinafter referred to as "CLC"), has been amended as to the inclusion of statutory severance provisions, see Sections 235 to 237 CLC.

¹⁴⁰ See explicitly Section 65(7) ESA; Section 235(1) CLC.

¹⁴¹ See also England, Christie and Christie, *supra* note 113 at § 14.55

¹⁴² See, for example, *Mattocks v. Smith and Stone (1982) Inc.* (1991), 34 C.C.E.L. 273 (Ont. Ct. (Gen. Div.)); *Brown v. Black Clawson-Kennedy Ltd.* (1989), 29 C.C.E.L. 92 (Ont. Dist. Ct.). See also *Stevens v. Globe & Mail* (1996), 19 C.C.E.L. (2d) 153 (Ont. C.A.), where the court clarified that those payments are deductible from damages for wrongful dismissal.

¹⁴³ *Re Rizzo & Rizzo Shoes Ltd.*, [1998] 1 S.C.R. 27 (S.C.C.).

¹⁴⁴ Section 235(1) CLC.

¹⁴⁵ Section 65 ESA.

service.¹⁴⁶

With respect to the definition of severance pay developed earlier in this thesis, the statutory severance payments provided by the Canada Labour Court and the Ontario Employment Standards Act need to be regarded as a single item of the overall severance package. Once a terminated employee falls under the scope of either one of the statutes, he might be entitled to this kind of severance payment in addition to any other entitlement in relation to his termination.¹⁴⁷

4. The Executive Severance Package

The general definition of severance payment developed so far does apply to all employees, no matter of their seniority or level of hierarchy. The law of dismissal evolved from the respective case law establishes that any employee who has been terminated with reasonable notice must be treated in the same way as any employee who has been terminated without reasonable notice.¹⁴⁸ Accordingly, like any employee of the corporation, the executive is entitled to severance pay in terms of remuneration throughout the period of reasonable notice.

However, as far as the structure and level of the severance payment is concerned, some particularities exist in relation with severance payments to executive arising from the structure executives are remunerated in contrast to non-executive employees of the corporation. In contrast to those employees, a corporate executive in most cases does not simply receive fixed wages in return for his services rendered to the corporation. Instead, executive compensation usually consists of a number of different items including fixed base salary and several other items that are normally not granted to non-executive employees such as, for example, stock options.¹⁴⁹ In view of those different items, the remuneration for executives is commonly referred to as a "compensation package".¹⁵⁰

Accordingly, the severance payment to an executive also consists of or takes into

¹⁴⁶ Section 64(1) ESA.

¹⁴⁷ For a more detailed discussion of the statutory severance pay, see *infra* at Chapter 2, II. 2.

¹⁴⁸ See *infra* at Chapter 2, II. 1. a) for more detail.

¹⁴⁹ However, note that it has become more frequent among large corporations to also offer employees stock options as part of their wages. For the different components the executive remuneration can typically consist of, see *infra* at Chapter 2 II. 1. c).

¹⁵⁰ Innumerable commentators frequently use the term "executive compensation package" when referring to the remuneration of corporate executives. For example, see only Linda J. Barris, "The Overcompensation Problem: A Collective Approach to Controlling Executive Pay" (1992) 68 Ind. L. J. 59 at 61 with a nice overview of the historic development; Bebhuk *et al.*, *supra* note 92 at 762; Cheffins, *supra* note 97 at 520.

consideration more than simply the executive's base salary as payment in lieu of notice as compensation for the loss of contractual entitlements. In fact, since a proportionate part of the contractual remuneration has to be paid as severance, the executive severance payment can also be regarded as a collection of all the executive's individual entitlements that form part of his overall compensation package. Consequently, most executives receive an overall severance package that proportionally includes all different components of his compensation package rather than just a severance payment of representing base salary only.¹⁵¹ Based on the executive's entitlements arising from the contract with the corporation, from common law and, eventually, from statute law,¹⁵² an executive severance package can consist of virtually any kind of benefit.¹⁵³

For the purpose of the following discussions, the term "executive severance package" therefore shall stand for any payment made by the corporation to a departing executive at the time of the termination in order to prematurely settle all mutual entitlements arising from the executive's contract with the corporation, regardless of it being contractually determined in the contract or subsequently offered at the time of termination. That severance package can either provide for a lump-sum payment, for instalments or any other benefits such as pensions flowing from the corporation to the executive.

¹⁵¹ Certain components such as stock options, however, are not paid out or granted separately through the severance package. Rather, they form part of the severance package by way of inclusion of their market value as compensation for the breach to continuously grant those items in the future.

¹⁵² I have mentioned earlier that those employees who are subject to the Canada Labour Code or the Employment Standards Act under the jurisdiction of Ontario may be entitled to additional statutory severance pay, see *supra* at 3. As far as executives are concerned, any additional statutory severance entitlement depends on their status as employee of the corporation. This aspect will be discussed *infra* at Chapter 2, II. 1.

¹⁵³ The assumption that the corporation can include virtually anything into a severance package arises from the general notion of freedom of contract of the parties. One issue that will be addressed in the following is whether the law imposes limits as to the parties freedom of choice to design the executive severance agreement.

II. Golden Handshake

The term “golden handshake” is not a formal legal term. The expression arose in the last quarter of the twentieth century when severance packages were frequently offered to resigning executives.¹⁵⁴ In the recent past, there have been numerous news releases reporting of “golden handshakes” to corporate executives.¹⁵⁵ Quite surprisingly, however, the exact meaning of the term has remained somewhat undefined and uncertain.

Although some authorities have officially dealt with “golden handshakes”, no court has ever tried to generally define the expression from a legal perspective.¹⁵⁶ In *Kesselring v. United Technologies Corp.*¹⁵⁷ the “golden handshake” was understood by the court as another expression for a retirement incentive offered by the company to certain employees aged fifty-eight and older. In other cases, the courts accepted the term as presented by one of the parties as a synonym for severance payment without further discussion.¹⁵⁸ Whereas the courts seemingly regard the meaning of the term as a general meaning for any severance payment, several differing definitions have been furnished in the secondary literature.

Firstly, the term “golden handshake” has been defined as a “large payment made by a company to a senior executive upon termination of employment before the contract ends”.¹⁵⁹ In

¹⁵⁴ See E. D. Hirsch, Jr., Joseph F. Kett, and James Trefil, *The New Dictionary of Cultural Literacy: What Every American Needs to Know* (3rd ed., Boston: Houghton Mifflin, 2002) at “golden handshake”, also available online at <<http://www.bartleby.com>> (last accessed on March 15, 2005)

The rise of the use of the term “golden handshake” is reflected by its introduction into several law dictionaries in the 1990s. For example, whereas it was not included in the 6th edition of *Black's Law Dictionary* (Henry Campbell Black, ed., *Black's Law Dictionary* (6th ed., St. Paul: West Publishing Co., 1990)), it has been adopted by the 7th edition of the work in the meaning of “An employee dismissal that includes generous compensation”, see *Black's Law Dictionary* (7th ed., St. Paul: West Group, 1999) at “golden handshake”.

¹⁵⁵ See, for example, the authorities cited *supra* notes 1 and 2. See also the table “Golden Handshakes” published in Business Week Online (January 2, 2001) <http://www.businessweek.com/2001/01_02/c3714064.htm> (last visited March 15, 2005).

¹⁵⁶ For Canada see, for example, *Rathbone v. Imperial Oil Ltd.* (2001), O.T.C. LEXIS 2447 (Ont. S.C.J.) at 6; *Maddocks v. British Columbia Hazardous Waste Management Corp.* (1995), 52 A.C.W.S. (3d) 810 (B.C.S.C.) at 6; *Wright v. Wright* (1994), 51 A.C.W.S. (3d) 676 (B.C.S.C.). For the U.S. see, for example, *Caputo v. Pfizer, Inc.*, 267 F.3d 181 (2d Cir. 2001); *Burke v. Bodewes*, 250 F.Supp. 2d 262 (WDNY 2003); *Mullins v. Pfizer, Inc.*, 147 F.Supp. 2d 95, 103 (D. Conn., 2001); *Hudson v. General Dynamics Corp.*, 118 F.Supp. 2d 226, 233 (D. Conn., 2000).

¹⁵⁷ *Kesselring v. United Technologies Corp.*, 753 F.Supp. 1359, 1362 (D. Ohio, 1991) at 3.

¹⁵⁸ *Rathbone v. Imperial Oil Ltd.*, *supra* note 156 at 6; *Maddocks v. British Columbia Hazardous Waste Management Corp.*, *supra* note 156; *Caputo v. Pfizer, Inc.*, *supra* note 156.

¹⁵⁹ See explicitly investorwords.com, online at <[http://investorwords.com/2200\(golden_handshake.html\)](http://investorwords.com/2200(golden_handshake.html))> at “golden handshake” (last visited on November 6, 2004); To the same extent, see also *Blacks Law Dictionary*, 7th ed., *supra* note 154 at “golden handshake”; Daphne A. Dukelow and Betsy Nuse, *The Dictionary of Canadian Law* (Scarborough: Thomson Professional Publishing Canada, 1991) at “golden handshake”; MoneyGlossary, online at <<http://www.moneyglossary.com>> at “golden handshake” (last viewed on November 6, 2004).

this sense, the term has no further legal meaning as it is only used as a synonym for the factual payment of severance benefits to the executive at the time of termination. No regard is made to the legal grounds upon which the payments are made. As I have shown earlier, a severance payment can arise from a contractual agreement in the employment contract.¹⁶⁰ Furthermore, it can also be offered unilaterally at any time by the party facing a breach of contract. However, the term has been used also by some scholarly commentators in this mere objective-factual meaning as a synonym for any kind of severance payment.¹⁶¹

Secondly, and in contrast, some authorities have amended that explanation slightly by using the phrase “[...], typically as an inducement to retire”.¹⁶² By adding a subjective element to the term, the “golden handshake” must be viewed in the context of the intentions of the parties. A retirement of an executive cannot be achieved by a unilateral act of the employer. Where the contract provides for an indeterminate term, the contract can only be terminated upon notice or payment in lieu thereof. Moreover, in the event of a fixed-term contract, premature termination is only possible upon the payment of all benefits for the balance of the remaining term. Accordingly, where the parties have not contractually agreed upon a specific amount of severance pay in advance, the employee needs a financial incentive to agree to an early resignation from office together with the termination of his contract. The employer must approach the employee with an offer that he believes is likely to have the employee agree to the early termination and refrain from legal proceedings. If the employee is not satisfied with the amount offered to him by his employer, he is entitled to a claim for wrongful dismissal. Thus, the employer can only achieve his primary goal of early settlement of all remaining entitlements

¹⁶⁰ See *supra* at I.

¹⁶¹ Ryan P. Barry, “ERISA’s Purpose: The Conveyance of Information from Trustee to Beneficiary” (1991) 31 Conn. L. Rev. 735 at note 93.

¹⁶² See, for example, American Heritage Dictionaries, ed., *The American Heritage[®] Dictionary of the English Language* (4th ed., Boston: Houghton Mifflin, 2000) at “golden handshake”; TheFreeDictionary, online at <<http://www.thefreedictionary.com>> at “golden handshake”; Hyperdictionary.com, online at <<http://www.hyperdictionary.com>> at “golden handshake” (last visited on November 6, 2004).

Note that this amendment has now also been introduced by the 8th edition of Black’s Law Dictionary, see Bryan A. Garner, ed., *Black’s Law Dictionary* (8th ed., St. Paul: West, 2004) at golden handshake. The completely revised explanation now reads: “A generous compensation package offered to an employee, usually as an inducement to retire or upon dismissal.”

In this meaning, the term is also referred to by Cheffins, *supra* note 97 at 523; Mark R. Kravitz and Daniel J. Klau, “Developments in the Second Circuit: 2000-2001” (2002) 34 Conn. L. Rev. 833 at 970; *Burke v. Bodewes*, *supra* note 156 at 10, where the court delivers this expression as a synonym for “golden handshakes”.

arising from the contract by a post-contractual agreement with the employee.¹⁶³

In this respect the procedure differs from the alternative, where the parties have included a severance provision into the employment contract. In this case, no further incentive for the employee's consent to an early termination is necessary, as the employer is already contractually entitled to terminate the contract prematurely upon payment of the amount of severance contractually agreed upon. The severance payment needs not to be based on any post-contractual agreement. Since the employee nevertheless receives a severance payment in this alternative, too, even this constellation has been regarded as a "golden handshake", based on the assumption that the term stands for a "clause in an executive employment contract that provides the executive with a lucrative severance package in the event of their termination".¹⁶⁴

For the purpose of this thesis, the term "golden handshake" shall be used in the second alternative described above, as only this definition reflects also the symbolic meaning of the term "handshake". A handshake has always been a symbolic gesture for an agreement between two parties where no written contract was required. Therefore, the handshake represents the post-contractual agreement between employer and employee to prematurely end the contractual relations in return for specific benefits paid to the employee. The handshake symbolically is a "golden" handshake when the benefits flowing to the employee can be regarded as substantial. As shown earlier, the severance payments offered to the executive need to be of an extent inducing the executive to voluntarily consent to the early retirement and to agree upon him refraining from legal proceedings against the corporation. Additionally, the severance will most likely include all benefits the employee is entitled to under his compensation package. Thus, also depending on the length of notice or the remainder of the fixed-term contract, the severance package for the executive can indeed be of an extent that might be regarded by outsiders as "generous" or, in other words, as giving him a "golden" future.

As a result, in the course of this thesis a "golden handshake" is a subsequent agreement between the corporation and its executive whereby the executive agrees to the early termination

¹⁶³ The "golden handshake", in this alternative, is not the factual payment itself, but rather the agreement between the parties over the amount of severance pay in return for the executive's consent to early resignation or termination. This meaning of "golden handshake" is also represented by Kevin A. Kordana and Eric A. Posner, *"A Positive Theory of Chapter 11"* (1999) 74 N.Y.U. L. Rev. 161 at note 161: "agreement of generous severance benefits". See also TheFreeDictionary, *supra* note 162 at "golden handshake" (last visited on November 6, 2004).

¹⁶⁴ The Corporate Library Glossary, online at <<http://www.thecorporatelibrary.com/Help/glossary/glossary.asp>> at "golden handshake" (last visited on November 6, 2004).

of his contract in return for a specific amount of severance pay. In practice, however, the corporation will most likely announce the executive's voluntary early retirement in order to prevent any bad reputation the publication of a termination might cause.

III. Golden Parachute

Another expression that has become fairly prevalent in the corporate world since the early 1980s is the term "golden parachute." Like the "golden handshake", the term "golden parachute" is not by itself legally significant nor legally conclusive for the purpose of legal analysis.¹⁶⁵ It is merely descriptive of the image of a corporate executive landing safely on neutral ground while his corporation falls into the arms of an acquirer.¹⁶⁶

"Golden parachutes" evolved as a by-product of the increasing number of corporate mergers and acquisitions in the 1980s.¹⁶⁷ They are designed and were first introduced in the U.S. as financial protection for corporate executives against the risk of a change in control incidental to a takeover.¹⁶⁸ The American concept of "termination at will"¹⁶⁹ enabled the corporation to terminate its contractual relationship with its executive without notice even in cases where no cause for termination existed.¹⁷⁰ As an implication of a takeover, many corporations experienced a change in control. Executives, on their part, were facing the risk of being replaced by new management selected by the new owners who believed that a change in management was necessary to increase the corporation's business success.

Soon, special termination agreements were formulated in order to shelter the executive from the uncertainty during a takeover period or, more importantly, from the crucial effects a

¹⁶⁵ *Royal Crown Cos. v. McMahon*, 183 Ga. App. 543 (Ga. Ct. App. 1987) at 545, 359 S.E.2d 379 at 381, asserting that "[a] severance contract by any other name would be just as enforceable." See also *Worth v. Huntington Bancshares, Inc.*, *supra* note 54 at 196; *Koenings v. Joseph Schlitz Brewing Co.*, *supra* note 54 at 599.

¹⁶⁶ Richard P. Bress, "Golden Parachutes: Untangling the Ripcords" (1987) *Stan. L. Rev.* 955 at 960; Noonan, *supra* note 53 at 1. See also *Koenings v. Joseph Schlitz Brewing Co.*, *supra* note 54 at 599.

¹⁶⁷ Peter Wilson and Allison Taylor, *The Corporate Counsel Guide to Employment Law* (Aurora: Canada Law Book, 1999) at 44.

In contrast to the term "golden handshake", the expression "golden parachute" can already be found in the 6th edition of Black's Law Dictionary, *supra* note 154 at "golden parachute", referring to *Koenings v. Joseph Schlitz Brewing Co.*, *supra* note 54: "An employment contract provision that that grants upper-level executive lucrative severance benefits – including long-term salary guarantees or onuses – if control of the company changes hands". See also *The Dictionary of Canadian Law*, *supra* note 159 at "golden parachute".

¹⁶⁸ Stikeman, Elliott, *supra* note 134 at § 11.67.

¹⁶⁹ For the concept of "termination at will", see *infra* note 316, and England, *supra* note 113 at 74.

¹⁷⁰ *Ibid.*

corporate takeover could finally have on their relationship with the corporation.¹⁷¹ Those agreements guaranteed the executive certain severance benefits in the event of a corporate takeover, such as lump-sum payments or other fringe benefits.¹⁷² In view of the high amounts of payments granted in practice caused by such provisions, those payments were regarded commonly as “golden parachutes”.¹⁷³ Thus, they have been perceived as a gift from the corporation rather than a quid pro quo bargain between a loyal and worthy executive and the grateful corporation.¹⁷⁴

Although their origin was in the U.S., golden parachutes are now also an integral part of the Canadian corporate culture, where they are regularly incorporated into executive service contracts.¹⁷⁵ If used in the original sense, the contract contains a two-triggered provision that enables the executive to pull on his parachute strings and claim the compensation provided for by the agreement.¹⁷⁶ The first trigger is a change in control provision that defines what constitutes a change in control in the specific case. Typical changes in control are a transfer of a certain percentage of company stock, a change in the leadership of the board of directors, or a merger.¹⁷⁷ The second trigger usually is the executive's loss of employment within a specific period of time following the change of control.¹⁷⁸ As for the kind of termination, the contractual clause can provide that not only a termination by the acquiring corporation, but also the voluntary early resignation by the executive for “good reason” will set off the parachute payment ensuring the executive's “golden landing”.¹⁷⁹ However, some golden parachute clauses are now even single-triggered, granting the executive the benefits as soon as a change in control occurs

¹⁷¹ Kenneth C. Johnsen, “Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review” (1985) 94 Yale L. J. 909 at 909.

¹⁷² Drew Harrison Campbell, “Golden Parachutes: Common Sense from the Common Law” (1990) 51 Ohio St. L. J. 279 at 280; *Worth v. Huntington Bancshares, Inc.*, *supra* note 54 at 14; *Schreiber v. Burlington Northern, Inc.*, *supra* note 54 at 3, note 2.

¹⁷³ *Schreiber v. Burlington Northern, Inc.*, *supra* note 54 at 3 note 2; Winter and Stumpf, *supra* note 52 at 425; Ann Marie Hanrahan, “Note: *Koenings v. Joseph Schlitz Brewing Co.: The Wisconsin Supreme Court Addresses Executive Termination Benefits In A Golden Parachute Contract*” (1987) Wis. L. Rev. 823 at 824.

¹⁷⁴ See Noonan, *supra* note 53 at 14. The issue of the golden parachute simply being a gift to the executive will be discussed later, see Chapter 3, II. 1. d) (2).

¹⁷⁵ See Stikeman/Elliott, *supra* note 134 at § 11.68.

¹⁷⁶ Bress, *supra* note 166 at note 12; Echlin and Thomlinson, *supra* note 109 at 75; Stikeman/Elliott, *supra* note 134 at § 11.69 and § 11.73; Bruce A. Wolk, “The Golden Parachute Provisions: Time for Repeal?” (2001) 21 Va. Tax Rev. 125 at 147.

¹⁷⁷ Winter and Stumpf, *supra* note 52 at 426.

¹⁷⁸ According to Noonan, *supra* note 53 at 1, that period usually ranges between 12 and 24 months following the change in control. See also Echlin and Thomlinson, *supra* note 109 at 74.

¹⁷⁹ See, for example, Stikeman/Elliott, *supra* note 134 at § 20.149; Echlin and Thomlinson, *supra* note 109 at 75.

whether or not his contract is terminated as a result thereof.¹⁸⁰ It is this kind of golden parachute clause that has raised the strongest indignation among shareholders and other opponents in the past.¹⁸¹

Thus, for further discussion in the course of this thesis, a “golden parachute” is a special category of severance agreement compensating an executive upon a change in control of the business that usually but not necessarily is followed either by the termination by the corporation or the resignation of the executive for “good reason”. The golden parachute differs from the traditional severance payment in the sense that it is activated only when there is a change of control of the corporation. Figuratively speaking, the parachute into golden benefits will not open until the change in control and, eventually, a termination has taken place.

IV. Executive

Finally, the expression “executive” will be used in this thesis as an equivalent for a person serving as an “officer” of a corporation.¹⁸²

At Canadian law “officers” are the individuals who have been appointed as an officer by the directors of the corporation to run the offices designated by the directors.¹⁸³ According to Section 121 CBCA, the directors of the corporation have the power to designate offices such as President and Secretary of the corporation, and to specify the duties of those offices, including

¹⁸⁰ Stikeman/Elliott, *supra* note 134 at § 11.72; Hanrahan, *supra* note 173 at note 3. See also Carol Bowie and Judy Fischer, “Have Parachutes Become More than Security Blankets” *Mergers & Acquisitions* (November/December 1996) at 21; Lawyers Weekly, “‘Golden Parachute’ Contracts Raise New Questions” (February 15, 1991) at 10.

¹⁸¹ For further discussion of the legitimacy of golden parachute provisions, see *infra* at Chapter 3, II. 1. d).

¹⁸² Without prejudice of the increasing presence of female individuals serving as officers of a corporation, I will for simplifying purposes refer to executives and all other persons in the male version only.

In Canada, a corporation can generally be formed under the federal legislation or under one of the business corporations or companies acts of one of Canada’s 10 provinces or three territories. Although there are some significant distinctions, most of the provincial and territorial corporate law statutes are similar to the federal Canada Business Corporations Act, R.S.C. 1985, c. C-44, as amended (hereinafter referred to as “CBCA”). For the purpose of this thesis, I will therefore generally refer to the federal legislation provided by the CBCA, but also note provincial or territorial particularities where applicable.

¹⁸³ See, for example, the definition provided by Section 2(1) CBCA: “‘officer’ means an individual appointed as an officer under section 121 CBCA, the chairperson of the board of directors, the president, the secretary, the treasurer, the comptroller, the general counsel, the general manager, a managing director of a corporation, or any other individual who performs functions for a corporation similar to those normally performed by an individual occupying any of those offices.”

delegating to them the power to manage the daily business and affairs of the corporation.¹⁸⁴ Usually, this delegation is done in a by-law passed at the time the corporation is organized just after incorporation or by a resolution of the directors.¹⁸⁵ After setting up the offices in this way, the directors may appoint certain people, the officers, to fill these offices. The directors may subsequently delegate further matters to the officers they have appointed.¹⁸⁶

Officers commonly occupy positions such as “Chairperson”, “President”, “Secretary”, “Treasurer”, “General Manager”, or any other position designated by a resolution of the board of directors or under the by-laws of the corporation.¹⁸⁷ Further common titles for officers include “Chief Executive Officer” or “C.E.O.”, “Chief Financial Officer”, and “Vice-President”, although a variety of other offices are also in use.¹⁸⁸ However, it is not the existence of a specific title, but rather the degree of power and control assigned to the office that determines whether or not someone is an officer, i.e. an executive of the corporation.¹⁸⁹ The officer must have actual authority to create a contractual relationship with a third party on behalf of the corporation as its principal.¹⁹⁰

Usually the highest executive office is that of the C.E.O. Although there are no fixed rules, a common corporate structure gives the C.E.O. overall responsibility for running the corporation's business, while the day-to-day operations are delegated to other officers who report to the C.E.O.¹⁹¹

¹⁸⁴ See *R. v. Bata Industries Ltd.* (1992), 9 O.R. (3d) 329, 70 C.C.C. (3d) 394, 7 C.E.L.R. (N.S.) 245 (N.S. Prov. Div.); *Regional Steel Works (Ottawa – 1987) Inc., Re* (1994), 25 C.B.R. (3d) 135 (Ont. Gen. Div. in Bkcty.); *Brandt v. A. Vimridge Manufacturing Sales & Service Ltd.* (1998), 81 A.C.W.S. (3d) 58 (Sask. Q.B.).

¹⁸⁵ *Regional Steel Works (Ottawa – 1987) Inc., Re*, *supra* note 184. See also J. Anthony VanDutzer, *The Law of Partnerships and Corporations*, (2nd ed., Toronto: Irwin Law, 2003) at 235.

¹⁸⁶ *R. v. Bata Industries Ltd.*, *supra* note 184. Such delegation is subject to two important limitations, see *Regional Steel Works (Ottawa – 1987) Inc., Re*, *supra* note 184: The directors cannot delegate the power and responsibility to supervise the management of the business and affairs of the corporation. Secondly, no delegation of powers is possible for those powers specifically excluded by Section 115(3) CBCA. These powers relate mostly to decisions regarding shares, including the power to issue shares, to declare dividends on shares, and to purchase or redeem shares. They also include decisions to approve financial statements, management proxy circulars, takeover bid circulars, and director's circulars.

¹⁸⁷ *Supra* note 183.

¹⁸⁸ See VanDutzer, *supra* note 185 at 234.

¹⁸⁹ Stikeman, Elliot, *supra* note 134 at § 20.26.

¹⁹⁰ *Freeman & Lockyer v. Buckhurst Park Properties (Mangal) Ltd.*, [1964] 1 All. E.R. 630; This decision was approved by the Supreme Court of Canada in *Canadian Laboratory Supplies Ltd. v. Engelhard Industries of Canada Ltd.* (1979), 97 D.L.R. (3d) 1 (S.C.C.) varied on rehearing, [1980] 2 S.C.R. 450 (S.C.C.) and *Rockland Industries Inc. v. Amerada Minerals Corp. of Canada* (1980), 108 D.L.R. (3d) 513 (S.C.C.). For this principle in general, see also *Hely-Hutchinson v. Brayhead Ltd.*, [1965] 3 All. E.R. 98 (Eng. C.A.).

¹⁹¹ VanDutzer, *supra* note 185 at 234.

V. Chapter Summary

Thus far, I have developed the following definitions for the main terms that will be in the focus of this thesis. First, the term “executive severance package” means any collection of payments to a departing officer of a corporation at the time of his resignation or termination of his employment relationship with the corporation. Those payments can either be contractually determined in the original contract between the executive and the corporation or be subsequently offered at the time of the executive’s departure. In the latter case, the construction can also be referred to as a “golden handshake”. Most likely, the executive severance package will be a lump-sum payment, but it can also provide for instalment payments or give entitlement for benefits other than cash payment.

A “golden parachute” is a special provision that entitles the executive to certain payments or other benefits upon a change in control of his corporation. In the alternative that it is contingent on the executive’s termination or resignation for “good cause” as a result of the change in control, it is a special form of executive severance. On the other hand, single-triggered “golden parachute” provisions can provide the executive with additional benefits even though he is not departing from his office as a result of a change in control.

CHAPTER 2

THE LEGAL FRAMEWORK FOR EXECUTIVE SEVERANCE

The increasing number of reports regarding enormous severance packages, “golden handshakes” and “golden parachutes” for corporate executives imply that those payments are admissible *per se* and, in view of the reported amounts, there seems to exist no legal limits as to their extent. This assumption, however, is by no means correct. Since executive severance packages of any kind are not borne by the assets of the directors who grant the payments on behalf of the corporation, but rather by the assets of the corporation, they must always be legally justified. Accordingly, any payment to a corporate executive must be based on a valid contractual agreement between the executive and the corporation, representing the corporations consent to the transfer of corporate assets to the executive. In addition to that, in order for the contractual agreement underlying the executive severance package to be legally enforceable, it must always comply with the constraints and restrictions imposed by the governing laws.

This Chapter delivers a summary of the basic legal framework for the different kinds of executive severance packages. In Part I, I will present the legal grounds with regards to general contract law executive severance packages, “golden parachute” payments, and “golden handshakes” can be based on. I will argue that, as a general principle, the executive and board of directors benefit from the principle of freedom of contract and, therefore, are basically free to bargain for whatever contractual agreement seems to be suitable with respect to their respective interests. Part II of the Chapter then determines the impact of specific employment law provisions and shows how particularly the law of dismissal sets out minimum standards as to the components and the level of executive severance payments if used as an advanced settlement of all remaining mutual entitlements arising from the executive service contract in connection with an early termination of the executive. I will especially focus on the common law concepts of employment law such as dismissal without cause and the notion of reasonable notice that to a large extent deviate from the present German civil law system. I will conclude that, once a valid severance agreement under contract law has been concluded, Canadian employment law dictates minimum levels of severance rather than imposing legal restrictions on the structure or the amount of executive severance packages. However, legal constraints deriving from other areas of the law will then be analyzed in the following Chapter 3.

I. Contract Law: Severance Agreement

Any payment of severance to the executive is a transfer of corporate assets. This transfer must be authorized by a valid contractual agreement between the corporation and the executive. In the absence of such an agreement, the executive is not entitled to receive any benefits from the corporation and, thus, will not be able to successfully claim judicial enforcement.

The basic elements of the executive severance package can be negotiated at the time the executive is hired by the company. In fact, in most cases, the original contract entered into by the executive and the corporation contains a clause determining the essentials of the severance payment.¹⁹² On the other hand, if no such agreement regarding future severance entitlements is included into the contract, the parties are basically free to agree upon the terms of a severance payment at any later point of time. In this case, their subsequent agreement can also be referred to as a “golden handshake”, provided the benefits for the executive arising from that agreement reach a certain level that can be regarded as “golden benefits” for the executive.

1. The Executive Service Contract

The corporation and the executive are free to negotiate the terms for severance packages as early as the corporation asks the executive to serve as an officer for the corporation. However, the mere fact of an appointment as an officer does not guarantee the executive to receive benefits for his services as an officer of the corporation. A respective provision concerning the general entitlements for remuneration needs to be included in an individual contract between the executive and the corporation apart from the unilateral appointment as officer.

a) The Need for an Executive Service Contract

The appointment as officer of the corporation does not create any contractual relationship between the corporation and the executive. The appointment is a unilateral act executed at the sole discretion of the board of directors. The unilateral act of appointment simply authorizes the individual to act as an agent on behalf of the corporation.¹⁹³ At the same time, certain rights and obligations arising from the position as an officer of the corporation by virtue of the law are

¹⁹² Professor Catherine Carey of Indiana University, Bloomington, stated that “[t]he problem [with executive’s severance, *scil.*] doesn’t exist at the back end. It exists at the front end.”, cited in Carey, *supra* note 56 at 01C

¹⁹³ Bruce Welling, *Corporate law in Canada: the governing principles* (Toronto: Butterworths, 1991) at 327.

conferred onto the executive.¹⁹⁴ Thus, since there is technically no offer, no acceptance of the individual appointed as officer is necessary to carry out the powers inherent to the specific office. In fact, even if the individual decides to refuse the appointment and does not serve as an officer, he will remain an appointed officer of the corporation until he is finally removed from that position or he resigns from the office.¹⁹⁵

In practice, hardly any individual appointed as an officer will carry out the powers of the office without a closer determination of further rights and obligations arising from the appointment for both the corporation and the individual. The appointed individual will especially want to be certain to be remunerated for his services rendered to the corporation as an officer. In order to determine the exact scope of services owed by the individual and the kind of consideration borne by the corporation, most importantly in terms of the amount of compensation, the corporation and the executive will have to enter into a special contract setting out these terms in addition to those contained in the resolution of the board of directors appointing the executive.¹⁹⁶

It is important to always distinguish the relationship created by the appointment of

¹⁹⁴ The most important obligations arising from the appointment as officer of a corporation are the duty of care and the fiduciary duty towards the corporation, see, for example, Section 122(1)(a) and (b) CBCA and the similar provisions of Canadian provincial and territorial corporate law statutes. Officers owe the same fiduciary relationship to the corporation as do the directors, see *Canadian Aero Service Ltd. v. O'Malley*, [1974] S.C.R. 592, 40 D.L.R. (3d) 371 (S.C.C.). The fiduciary duty and the duty of care will be discussed *infra* at Chapter 3, II. 1. and 2.

¹⁹⁵ Such a refusal may require the directors as an exercise of their fiduciary duty to immediately remove the individual from office. In light of this, the directors may also be under an initial obligation arising from their duty of care to ensure the prior consent of the appointee before passing the board's resolution. For a detailed discussion of the fiduciary duty and the duty of loyalty owed by the directors, see *infra* at Chapter 3, II. 1. and 2.

¹⁹⁶ Compared to the other "regular" employees of the corporation, the officer serving as an agent of the corporation carries out services that are distinct from the work of the employees. Indeed, it is not clear and remains to be seen whether the officer can be regarded as "employee" under the different statutory severance provisions, see *infra* at II. 2. Unfortunately, however, the contract concluded by the executive and the corporation quite frequently is referred to as "employment contract". For the purpose of the distinction of this contract from an employment contract between "regular" employees and the corporation, the contract will be referred to hereinafter as "executive service contract".

Commentary on the legal relationship created by the appointment as officer and the need for a separate contract between the officer and the corporation is not extensive. Bruce Welling, Lionel Smith, E. Richard Gold, and Leonard I. Rotman, *Canadian Corporate Law: Cases, Notes & Materials* (2nd ed., Toronto and Vancouver: Butterworths, 2001) at 256, VanDutser, *supra* note 185 at 234, and Stikeman, Elliot, *supra* note 134 at § 3.39 are at least aware of the fact that officers frequently have individual service contracts. Also, Section 133(5) of the British Columbia Business Corporations Act, *infra* note 610, acknowledges the existence of the officer's executive service contract by stating that "the removal of an officer without cause is without prejudice to the officer's contractual rights, but the election or appointment of an officer does not of itself create any contractual rights".

someone to serve as an officer of the corporation and the individual contractual relationship that person may have with the corporation.¹⁹⁷ While entitled to act as an agent on behalf of the corporation, the officer is at the same time contractually obliged to the corporation to stay within the terms of his service contract.¹⁹⁸ On the other hand, any individual entitlement against the corporation that goes beyond the executive's rights implied by the act of appointment as officer can only derive from his service contract, not from the unilateral act of appointment.

In practice, the principle situation where the distinction between the appointment and the service contract become essential is the termination of the executive's involvement with the corporation. In general, an officer can be removed at any time by a decision of the board of directors.¹⁹⁹ It is common for corporations to clarify expressly in their by-laws that officers hold office at the pleasure of the board of directors.²⁰⁰ Like the appointment, the removal also constitutes a unilateral act of the corporation. No cause is necessary for the removal from office. The executive service contract, by contrast, is subject to the general principles of contract law and employment law.²⁰¹ If the contract is of an indeterminate term, the rule is that it may be terminated only for cause or with reasonable notice, unless otherwise provided in the contract.²⁰² For example, in *McGuire v. Wardair Canada Ltd.*,²⁰³ a provision of the corporation's by-laws established that "[A]ll officers, in the absence of an agreement to the contrary, shall be subject to removal by resolution of the board at any time with or without cause." No reference was made to notice of termination. However, the judge held that the provision of reasonable notice was an implied term of the executive service contract, and therefore awarded one year's salary in lieu of notice.

In the absence of cause or notice, the early termination of the service contract will be a breach of contract, regardless of whether the corporation had the right to unilaterally remove the officer with immediate effect.²⁰⁴ The same applies where the service contract was entered into for a fixed-term and the officer is removed prior to the expiration of the term.

¹⁹⁷ VanDutzer, *supra* note 185 at 235.

¹⁹⁸ Welling, *supra* note 193 at 327.

¹⁹⁹ Carol Hansell, *Directors and Officers in Canada: Law and Practice* (Scarborough: Carswell, Loose-leaf) at 2-18.

²⁰⁰ VanDutzer, *supra* note 185 at 236.

²⁰¹ For the impact of employment law, see *infra*, at II.

²⁰² Therefore, express provisions concerning the termination of the service contract are one important issue that the parties will want to address in the executive service contract.

²⁰³ *McGuire v. Wardair Canada Ltd.* (1969), 71 W.W.R. 705 (Alta. S.C.).

²⁰⁴ *Southern Foundries (1926) Ltd. v. Shirlaw*, [1940] A.C. 701 H.L.

b) The Formation of the Executive Service Contract

The legal relationship between the executive and the corporation in terms of the executive service contract is subject to the basic requirements and constraints of the law of contract.²⁰⁵ At common law, to ensure that a contract withstands legal scrutiny and challenge, certain requirements must be met. The contract must be entered into voluntarily with the intention to create legal relations and exhibit the basic attributes of offer, acceptance and the exchange of consideration.²⁰⁶

The law of contracts is governed by the principle of freedom of contract.²⁰⁷ The freedom of contract presupposes that each party to the contract is advancing its own interests resulting in a bargain that is to the mutual advantage of the parties. According to this principle, the parties of a contract are regarded to be the best judges of their own interest.²⁰⁸ The general rule is that the parties not only are free to enter into a contract at the time they may think fit, but also that they “are free to determine for themselves what primary obligations they will accept”.²⁰⁹ However, the parties’ freedom to contract is limited to the extent that they are obliged to act in accordance with the common law and obey any statutory or equity law applicable to their kind of contract.²¹⁰ One general limit to the freedom of contract arising from general contract law is the doctrine of

²⁰⁵ Stikeman, Elliot, *supra* note 134 at § 3.39. See also Wilson and Taylor, *supra* note 167 at 33; Brian A. Grosman, “The Executive Firing Line: Wrongful Dismissal and the Law” (Toronto, New York, London, Sydney, Auckland: Carswell/Methuen, 1982) at 91 for general employment contracts.

²⁰⁶ For more details regarding the basic requisitions of a valid contract at common law, the reader is referred to the general literature on the law of contract, such as Gerald H. L. Fridman, *The Law of Contract in Canada* (4th ed., Toronto: Carswell/Thomson Canada Limited, 1999); The Common Law Library, ed., *Chitty on Contracts*, Volume 1 (29th ed., London: Sweet & Maxwell, 2004); Sir Guenter Treitel, *The Law of Contracts* (11th ed., London: Thomson Sweet & Maxwell, 2003); Michael P. Furmston, *Cheshire, Fifoot and Furmston’s Law of Contract* (14th ed., Markham: Butterworths LexisNexis, 2001); Hugh Collins, *The Law of Contract*, (14th ed., Markham: LexisNexis Butterworth, 2003).

²⁰⁷ The freedom of contract evolved in the nineteenth century and was philosophically justified in the “will theory” of contract as well as economically justified by the laissez faire liberalism, see The Common Library, *supra* note 206 at 1-011, citing Dicey, *Law and Opinion in England* (2nd ed., 1914), at 150-158; *Printing and Numerical Registering Co. v. Sampson* (1875), L.R. 10 Eq. 462, 465; *Manchester, Sheffield and Lincolnshire Ry. v. Brown* (1883), 8 App. Cas. 703 at 716-720; *Salt v. Marquis of Northampton*, [1892] A.C. 1 at 18-19.

The principle of freedom of contract is a fundamental principle of both the civil and the common law system, see *Place Lebourgneuf Inc. v. Autodrome de Val Belair Inc.*, [1985] C.A. 364 at 368, Nichols J.

²⁰⁸ The Common Library, *supra* note 206 at 1-011.

²⁰⁹ *Photo Production Ltd. v. Securicor Transport Ltd.*, [1980] A.C. 827 at 848. See also *Suisse Atlantique Societe d’Armement Maritime SA v. N.V. Rotterdamsche Kolen Centrale*, [1967] 1 A.C. 361 at 399; *Eurico SpA v. Phillip Brothers*, [1987] 2 Lloyd’s Rep. 215 at 218.

²¹⁰ See, for example, M. P. Furmston, *supra* note 206 at 19; Stikeman, Elliot, *supra* note 134 at § 3.34. In general, many of these limitations are of public order and cannot be renounced. Consequently the parties should not insist in their negotiations upon the inclusion of provisions that are in violation of these legal standards. The applicable constraints to the parties’ freedom of contract regarding executive severance agreements are discussed *infra* at Chapter 3, II.

unconscionability.²¹¹ According to this equitable doctrine, a contract may be rescinded where the court is concerned that the behaviour of one contracting party was unconscionable in terms of that the other party was unable to act in its own best interests.²¹² The avoidance of a contract for drunkenness or any other mental incompetence that would qualify as instances of situations where the other party might be characterized as behaving unconscionably if he knows of such impairment,²¹³ as well as the avoidance of a contract for undue influence or duress, all examples for unconscionability in a wider sense, must be distinguished from the rescission for unconscionable behaviour.²¹⁴ Under the doctrine of unconscionability, it is not the consent of the potential victim that is impugned, but the reasonableness of the bargain, the conscientiousness of the other party, the equitable character of the transaction.²¹⁵ Also, the doctrine of unconscionability tries to remedy an inequality of bargaining power that results in a bargain that can be regarded as unfair.²¹⁶

Based on the principle of freedom of contract, like any contractual agreement, the service contract between the executive and the corporation is arrived at by negotiation of the parties involved. Accordingly, the strength of the contract will depend upon both the executive's as well as the corporations's respective bargaining powers, knowledge of the terms that would serve their interests and knowledge of their legal rights.²¹⁷ With respect to the doctrine of unconscionability, it is merely unlikely that such executive agreement between the executive and the board of directors acting on behalf of the corporation will be subject to rescission on the

²¹¹ For a detailed discussion of the doctrine of unconscionability, see, for example, Stephen M. Waddams, "Unconscionability in Contracts" (1976) 39 Mod. L. Rev. 601; Steven R. Enman, "Doctrines of Unconscionability in Canadian, English and Commonwealth Contract Law" (1987) 16 Anglo-Am. L. Rev. 191; John A. Manwaring, "Unconscionability: Contested Values, Competing Theories and Choices of Rules in Contract Law" (1993) 25 Ottawa L. R. 235; Michael J. Trebilcock, "The Doctrine of Inequality of Bargaining Power" (1976), 26 U. T. L. J. 359.

²¹² *Atlas Supply Co. of Canada v. Yarmouth Equipment Ltd.* (1991), 103 N.S.R. (2d) 1 (N.S.C.A.), leave to appeal to S.C.C. granted (1991), 108 N.S.R. (2d) 270n (S.C.C.), appeal to S.C.C. discontinued April 1, 1992. See also *Miller v. Lavoie* (1966), 63 W.W.R. 359 (B.C.S.C.); *Stepper v. Laurel Credit Plan Ltd.* (1968), 63 W.W.R. 168 (Sask. Dist. Ct.).

²¹³ See, for example, *Black v. Wilcox* (1977), 70 D.L.R. (3d) 192 (Ont. C.A.); *Hall v. Grassie* (1982), 16 Man. R. (2d) 399 (Man. Q. B.); *Stubbs v. Erickson* (1981), 34 B.C.L.R. 45 (B.C.S.C.); *Tweedie v. Geib* (1982), 19 Sask. R. 48 (Sask. Q.B.); *Dominion Home Improvements Ltd. v. Knuude* (1986), 20 C.L.R. 192 (Ont. Dist. Ct.); *Bertolo v. Bank of Montreal* (1986), 33 D.L.R. (4th) 610 (Ont. C.A.); *Thom v. Saltner*, [1989] 1 W.W.R. 456 (Man. Q.B.).

²¹⁴ *Morrison v. Coast Finance Ltd.* (1965), 54 W.W.R. 257 (B.C.C.A.). See also *Cougle v. Maricevic*, [1992] 3 W.W.R. 475 (B.C.C.A.).

²¹⁵ *Campbell v. Campbell* (1990), 83 Nfld. & P.E.I.R. 340 (Nfld. U.F.C.).

²¹⁶ *Lloyds Bank v. Bundy*, [1974] 3 All. E.R. 757.

²¹⁷ Regarding the employment contract in general, see Howard A. Levitt, *supra* note 127 at 423.

grounds of unconscionability, as the negotiations will be pursued between parties that are, in most cases, familiar with the business environment and the process of bargaining for their best interests and rights.

The executive service contract does not have to be in writing in order to be valid and legally enforceable.²¹⁸ If there is no written contract, it is sometimes difficult to determine what is the extent and content of the contract. Not only can a written contract provide the parties with greater certainty of terms during the existing relationship, but also upon the termination of the relationship. A written contract also provides the parties with greater flexibility and creativity over their relationship than they would otherwise have at common law, as they can include express terms that differ from the standard terms implied by common law. However, the great majority of "regular" employment contracts are not embodied in a written document.²¹⁹ In contrast, in practice most of the executives have comprehensive written contracts in order to inject a larger degree of certainty and flexibility into their relationship with the corporation.²²⁰ It may also provide them with greater security and comfort over their futures in a changing business environment.

c) The Contents of the Executive Service Contract

According to the principle of freedom of contract, the corporation and the executive are generally free to include into the service contract literally anything that they believe may suit their purposes. Wherever the contracting parties do not want to rely on the basic terms implied into the contract under common law, or where they intend to deviate from the minimum standards provided by the law or set out in the by-laws of the corporation, they can negotiate a provision more appropriate with a view to the office.

The standard components of executive service contracts are provisions regarding the term of the contract, giving a detailed description of the powers and obligations of the executive, determining the executive's compensation as well as provisions concerning confidentiality and disclosure obligations.²²¹ Depending on the circumstances in each particular case, there may be a

²¹⁸ See Stikeman, Elliot, *supra* note 134 at § 3.81.

²¹⁹ *Ibid.*, at § 3.43 and § 3.81.

²²⁰ See Barry Kuretzky, "Employment contracts protect both parties" *The Lawyers Weekly* (April 2, 1999) at 18; Wilson and Taylor, *supra* note 167, at 35.

²²¹ See also Jonathan M. Ocker and Gregory C. Schick, "Employment Agreements for New Economy Chief Executives" (2000) 23 *Los Angeles Lawyer* 21 at 21.

need to include several other provisions into the executive service contract.

(1) Severance Provision

I have already mentioned earlier that at common law the executive service contract, in contrast to the sole removal as officer, can be terminated only with cause or in the absence of cause upon reasonable notice.²²² Any early termination not complying with these requirements would constitute a breach of contract and entitle the executive to damages in lieu of notice. There is a large amount of uncertainty as to what exactly constitutes justifiable cause for termination without notice and, in the case of an undetermined executive service contract, as to the length of notice.²²³ A dispute about the justification of the termination may easily result in an action for wrongful dismissal pursued by the terminated executive.

In order for both parties to avoid a large degree of uncertainty and potential legal proceedings in connection with the termination of the executive, they are free to determine all relevant factors in a special termination provision as part of their service contract. Such provision can contain special situations or grounds that would constitute a cause for termination. In addition, the parties may agree upon a determined length of notice or, alternatively, upon a formula for determination of the length of notice.

Furthermore, based on the freedom of contract, the corporation and the executive may even agree upon the possibility of an early termination without cause and notice, coinciding with the removal of the executive from office. In this case, the termination would not be regarded as a breach of contract as the contract entitles the corporation to serve termination without notice. However, since the executive would generally be entitled to payment in lieu of notice, he might ask for consideration in terms of severance payment in return for his consent to the corporation's contractual right of early termination without notice. As far as the details are concerned, such as the amount of the severance payment, the parties also are basically free to agree upon whatever they may believe to serve as consideration.²²⁴ In practice, the terms of such severance provision always depend on the bargaining power of both parties.

²²² See *supra* at Chapter 1, I.1., especially note 112.

²²³ The notice must be of reasonable length. For a discussion of the principle of reasonable notice and for the relevant case law, see *infra* at II. 1.

²²⁴ For the limitations arising from the notion of unconscionability, see *supra* at b), particularly notes 211 to 217 and accompanying text.

(2) Golden Parachute Provision

Another significant factor that has impacted upon the growing trend towards the use of executive service contracts is the changing dynamics of the corporate environment. In recent years, there has been an increasing merger and acquisition activity including, in some cases, hostile takeovers.²²⁵ This activity has created some uncertainty in the continuity of the executives' positions and careers as officers. In today's vastly changing corporate environment the termination of employment has adopted a new meaning, since removal and termination of executives have increasingly occurred as a result of a merger or an acquisition of the corporation by another company and not because of any particular dissatisfaction with an executive's performance.²²⁶

In order to also avoid any uncertainty as to the future of the executive upon the occurrence of such business activity, the corporation and the executive generally can negotiate and include into the original service contract a "golden parachute" provision. Again, based on the principle of freedom of contract and freedom of terms, the parties are free as to the contents of the "golden parachute" provision. However, to be enforceable as a valid contractual provision, the "golden parachute" must clearly define the conditions for the parachute to open and precisely state the benefits flowing to the executive. In other words, the contract must determine specific events that trigger the "golden parachute".

As for a first triggering event, the "golden parachute" requires a change in control or any similar organizational change of the corporate leadership.²²⁷ There is no uniform definition of what constitutes a change in control. The courts have held that commonly a change of control might be the acquisition of 50 % of the corporation's stock by an outsider.²²⁸ However, a control of the corporation can be obtained in many cases with less than a majority of the shares.²²⁹ There

²²⁵ Takeovers have been quite frequent in North America since the 1980s. In Europe, one first major hostile takeover was the takeover of Mannesmann by Vodafone in 2000, see *supra* note 20. For details regarding the takeover, see *supra* at Introduction, I.

²²⁶ See Kuretzky, *supra* note 220 at 18.

That new tendency has resulted in an increase of uncertainty and risks for executives as the activities regarding mergers and acquisitions can be prompted by a number of external factors that are beyond the executive's control and irrespective of his performance.

²²⁷ Johnson, *supra* note 54 at 60.

²²⁸ See, for example, *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962).

²²⁹ See, for example, the early work in this area by Adolph A. Berle, Jr., "Control' in Corporate Law" (1958) 58 Colum. L. Rev. 1212. See also Johnson, *supra* note 54 at note 19.

are several events that can mean a change in control, such as the accumulation of a certain percentage of the corporation's issued and outstanding shares, a change in directors comprising a majority of the board, the sale of all or a substantial part of the assets of the business, the privatization of the business or a combination of any of the above-mentioned events.²³⁰ The parties can also stipulate that only a hostile takeover will serve as a trigger for the "golden parachute".²³¹ Considering the potential broad scope of the notion of change in control, the parties must carefully define in the contractual provision what future events will result in a change in control. This element of the "golden parachute" provision is commonly referred to as the "change in control" clause.²³²

Secondly, the corporation and the executive are free to determine further triggers for the "golden parachute" that focus on an event subsequent to the change in control.²³³ As has been noted earlier, a second trigger usually is the loss of the executive's position as officer of the corporation.²³⁴ In this case, the provision must specify in a so-called "termination clause" the way the executive's involvement with the corporation needs to be terminated. Usually, this will be a termination of the executive's service contract as the new directors' business decision resulting from the change in control.²³⁵ The termination clause has the effect that the change of control is regarded as cause for termination.²³⁶

In addition, or alternatively, the parties may stipulate in the termination clause that even a

The Supreme Court of Canada has recently stated that in the corporate and tax law area, it is essential to obtain *de jure* control of a corporation rather than *de facto* control only, see *Duha Printers (Western) Ltd. v. Canada*, [1998] 1 S.C.R. 795 (S.C.C.), [1998] S.C.J. No. 41 at para. 35. At paras. 38 to 84 the Supreme Court also delivers a summary of the different ways to acquire *de jure* control of the corporation, analyzing particularly the nature of a unanimous shareholder agreement.

²³⁰ Stikeman, Elliott, *supra* note 134 at § 11.69; Harrison Campbell, *supra* note 172 at 280.

²³¹ Stikeman, Elliott, *supra* note 134 at § 11.71. A hostile takeover is understood to be a bid directly to the shareholders of the corporation without prior negotiations with the management of the corporation. In contrast, a takeover is regarded to be friendly when the management of the offering corporation negotiates the terms of a takeover with the management of the target corporation.

²³² See, for example, Bress, *supra* note 166 at 957; Harrison Campbell, *supra* note 172 at 280; For practical examples of change in control clauses, see Winter and Stumpf, *supra* note 52 at 437-46; John Tarrant, *Perks and Parachutes* (New York: The Stonesong Press, Inc., 1985).

²³³ Many, if not most of the current "golden parachute" provisions are double-triggered, see Wolk, *supra* note 176 at 147.

²³⁴ See *supra* Chapter 1, III. Also note that although the so-called second-triggered "golden parachute" has been the general rule in practice for years, it has now been perceived that there are also provisions that are only "single-triggered", see *supra* note 180. At this point, the general rule that applies to all those kinds of "golden parachutes" is that the parties are free to negotiate the conditions of their contract. For a discussion of the legitimacy with regards to corporate law, see *infra* at Chapter 3, II. 1. d).

²³⁵ Harrison Campbell, *supra* note 172 at 281.

²³⁶ *Ibid.*

voluntary resignation by the executive for “good reason” will qualify as termination under the provision.²³⁷ “Good reason” typically refers to the kinds of changes to the terms and conditions of the executive’s service contract that would allow the employee to take the position that he has been constructively dismissed.²³⁸ Events that constitute a constructive dismissal in the context of change in control may include, for example, any unilateral modification of contractual terms such as the reduction of the executive’s compensation or level of responsibilities, a forced geographical relocation, or any modification in the corporate structure of the business that negatively affects the executive’s position in the company’s hierarchy.²³⁹ Based on the notion of constructive dismissal, the parties can also agree that not only the actual loss of job, but also any such diminution of the executive’s contractual status or rights resulting unilaterally from the change of control trigger the “golden parachute”.²⁴⁰ In the termination clause, the parties will also have to set out a certain period of time following the event qualifying as change in control within which the second and any additional triggers must occur.

Finally, the parties must stipulate a so-called “compensation clause” determining the type and amount of benefits provided to the executive once the “golden parachute” is triggered.²⁴¹ The compensation clause can provide the executive either with a lump-sum payment or a continuation for a determined period of all or some benefits of his compensation package.

Most of the “golden parachutes” currently in effect consist of all three major clauses, a change of control clause, a termination clause, and a compensation clause.²⁴² However, the parties in each case are free to determine the contents of their contractual “golden parachute provision”. It depends on the parties’ intentions and the individual bargaining power whether the “golden parachute” is single- or double-triggered and what benefits will be granted to the executive at the time the triggering event(s) occur. If a “golden parachute” provision is included in the original service contract from the beginning, the issue of consideration is not of great importance. The “golden parachute” in this context is part of the overall executive compensation

²³⁷ In fact, the resignation will most likely not be voluntary when the new management forces the executive to leave the corporation to the benefit of a new executive preferred by the new management. In practice, however, for reputation reasons the management will prefer to announce the resignation of the former executive although, legally, he might have been constructively dismissed or even terminated without cause.

²³⁸ Stikeman, Elliott, *supra* note 134 at § 11.74.

²³⁹ *Ibid.*

²⁴⁰ Harrison Campbell, *supra* note 172 at 281.

²⁴¹ *Ibid.*

²⁴² Johnsen, *supra* note 171 at 910; Bress, *supra* note 166 at 957.

in return for services rendered. Thus, the “parachute clause” will be enforceable at the time it is triggered.²⁴³

2. The “Golden Handshake” Agreement

Not every executive service contract contains a provision regarding severance payment or, in particular, a “golden parachute” provision, be it because the parties did not intend or just forgot to establish such provision at the time the contract was originally concluded. In such cases the parties’ choices of action are not limited by the common law means regarding the termination of the contract and all consequences arising therefrom. Instead, they have different possibilities to modify their existing contractual rights and obligations.

As a general rule, once the parties have agreed upon all terms, that is once acceptance has been communicated, the contract comes into existence. The parties are legally bound by their contractual commitments.²⁴⁴ Accordingly, neither party can back out of such a contract without giving the other party due notice of termination, or wages in lieu thereof.²⁴⁵ Regardless, the dynamic nature of the contractual relationship between the corporation and its executive may cause the need for one or both of the parties to change the terms of the contract during the course of its term.²⁴⁶ Furthermore, the contracting parties may even long for a termination of the contract releasing the parties from their obligations prior to the contemplated expiration or regardless of a notice period either provided for in the contract or arising from common law. The parties also may wish to suspend their obligations rather than sever the employment relationship.

Based on the principle of freedom of contract, contract law grants the parties the right to amend, suspend or terminate the contract at any time.²⁴⁷ Generally, the law offers two different methods for modification of an existing contract: rescission and variation.

²⁴³ By contrast, if the original contract does not contain a “golden parachute” clause and the parties subsequently include that provision by mutual agreement, the general rule is that fresh consideration is required, see *infra* notes 264 through 267 and accompanying text. This may cause a problem in the case the “golden parachute” provision is only single-triggered and not contingent on the termination of the contract by the corporation. This aspect will be examined *infra* at 2. b) (2).

²⁴⁴ *Johnstone v. Harlequin Enterprises Ltd.* (1991), 36 C.C.E.L. 30 (Ont. Ct. (Gen. Div.)).

²⁴⁵ *Horvath v. Joytec Ltd.* (1989), 27 C.C.E.L. 269 (Sask. Q.B.).

²⁴⁶ See also England, *supra* note 113 at 30.

²⁴⁷ For amendment, see *Stilk v. Myrick* (1809), 2 Camp. 317, 170 E.R. 1168 (C.P.); *Gilbert Steel Ltd. v. University Construction Ltd.* (1976), 67 D.L.R. (3d) 606 (Ont. C.A.). For Suspension, see *Morin v. Honeywell Ltée.*, D.T.E. 90T-529 (Que. S.C.), appeal abandoned July 3, 1990, C.A.M. 500-09-000517-904; For termination, see *Lees v. Arthur Greaves Ltd.*, [1974] I.C.R. 501 (C.A.); *Sloan v. Union Oil Co. of Canada*, [1955] 4 D.L.R. 644 (B.C.S.C.) at 679; *Maier v. E & B Exploration Ltd.*, [1986] 4 W.W.R. 275 (Alta. C.A.) at 281-82.

a) Rescission of the Executive Service Contract

Where a contract has been partially executed, that is where there are still obligations on both sides that remain unperformed, the contract can be rescinded by mutual agreement of the parties.²⁴⁸ The object of “rescission” is to release the parties from the contract.²⁴⁹ Thus, the effect of a valid rescission agreement is that the contract is completely discharged and cannot be revived.²⁵⁰ Like every contract, there must be consideration of both parties in order for the rescission agreement to be valid and enforceable.²⁵¹ As for consideration regarding the rescission, it has been noted that the rescission agreement will generate its own consideration:

*„The effectiveness in law of an agreement between employer and employee to terminate their contract of employment, reached subsequently to the making of the contract, is not in doubt. The consideration is provided by the release of mutual future obligations.“*²⁵²

Thus, the corporation and the executive can mutually extinguish their contractual relationship by way of rescission, promising to abandon all outstanding obligations and rights to performance against the other party or damages, respectively. However, of course, once the contract has been rescinded, the parties may, at any time, enter into a new contract.²⁵³

Additionally, even the alteration of the contract may amount to a rescission of the contract. A rescission of the contract will be implied where the parties have effected such an alteration of the terms as to substitute a new contract relating to the same subject matter in place of the original contract.²⁵⁴ However, the modification will only be regarded as an effected rescission if the original contract is implicitly extinguished.²⁵⁵ A rescission will, therefore, only be presumed when the parties enter into a new agreement that is completely inconsistent with the old one.²⁵⁶

²⁴⁸ The Common Library, *supra* note 206 at 22-025.

²⁴⁹ Treitel, *supra* note 206 at 99.

²⁵⁰ *R. v. Inhabitants of Gresham* (1786), 1 Term. Rep. 101.

²⁵¹ Regarding the necessity of consideration in general, see *supra* note 206.

²⁵² *Lees v. Arthur Greaves Ltd.*, *supra* note 247 at 506D, Stamp L.J., as cited in Mark R. Freedland, *The Contract of Employment* (Oxford: Clarendon Press, 1976) at 189; *Scarf v. Jardine* (1882), 7 App.Cas. 345 at 351; *Raggow v. Scougall & Co.* (1915) 31 T.L.R. 564; See also Treitel, *supra* note 206 at 99; England, *supra* note 113 at 31.

²⁵³ See also The Common Library, *supra* note 206 at 22-016, note 92.

²⁵⁴ *Thornhill v. Neats* (1860), 8 C.B. (N.S.) 831; *Hunt v. S.E. Ry* (1875), 45 L.J.Q.B. 87; *Williams Bros. v. Aguis Ltd.*, [1914] A.C. 510 at 527; *Raggow v. Scougall & Co.* *supra* note 252; *Morris v. Baron & Co.*, [1918] A.C. 1; *British & Beningtons Ltd. v. N.W. Cachar Tea Co. Ltd.*, [1923] A.C. 48 at 69; *Rose & Frank Co. v. J.R. Crompton & Bros. Ltd.*, [1925] A.C. 445. Generally, see Treitel, *supra* note 206 at 101.

²⁵⁵ *Compagnie Noga D'Importation et D'Exportation S.A. v. Abacha*, [2003] EWCA Civ 1100; [2003] All E. R. (D) 400 (Jul) at para. 57.

²⁵⁶ *British & Beningtons Ltd. v. N.W. Cachar Tea Co. Ltd.*, *supra* note 254 at 62.

The change must be of fundamental extent, reflecting the parties' intention to rescind the old contract by a substitution of a completely new agreement.²⁵⁷ In this context, if there is consideration for the rescission, there will also be consideration for the new promises as "the same consideration which existed for the old agreement is imported in to the new agreement, which is substituted for it."²⁵⁸ However, whenever the original contract is not explicitly extinguished, it must be distinguished whether the modification amounts to rescission or rather constitutes a variation of the contract.

b) Variation of Contract

Alternatively, the parties are free to alter the terms of the contract at any time by means of "variation". In contrast to the rescission of the contract, if a variation is effected the original contract continues to exist in an altered form.²⁵⁹ Any such variation of the contract requires a mutual agreement.²⁶⁰ No one party can unilaterally alter the contract.²⁶¹ Concerning employment contracts in general, the doctrine of constructive dismissal protects employees who resign under the threat of dismissal or because of unjustified unilateral changes in the terms and conditions of their employment.²⁶²

An agreement that varies the earlier contract will be valid to the extent to which it is itself an enforceable agreement.²⁶³ Thus, unless the variation is contained in a document under seal, the variation agreement must also provide fresh consideration.²⁶⁴ In most cases, consideration can be found in the mutual abandonment of existing rights or the conferment of new benefits by

²⁵⁷ *Ibid.*, at 62 and 67.

²⁵⁸ *Stead v. Dawber* (1839), 10 A. & E. 57 at 66. See also Treitel, *supra* note 206 at 101.

²⁵⁹ *Compagnie Noga D'Importation et D'Exportation S.A. v. Abacha*, *supra* note 255 at para. 57.

²⁶⁰ *Robinson v. Page* (1826), 3 Russ. 114; *Goss v. Lord Nugent* (1833) 5 B. & Ad. 58 at 65; *Stead v. Dawber*, *supra* note 258 at 65; *Dodd v. Churton*, [1897] 1 Q.B. 562; *Fenner v. Blake*, [1900] 1 Q.B. 426; *Royal Exchange Assurance v. Hope*, [1928] Ch. 179; *Dugdale v. Yates* (1976), 39 M.L.R. 680. For Canada, see *Hyslip v. MacLeod Savings & Credit Union Ltd.* (1988), 62 Alta. L.R. (2d) 152 (Alta. Q.B.); *Bartolic v. Canada Safeway Ltd.* (1998), 34 C.C.E.L. (2d) 1 (B.C.S.C.).

²⁶¹ *Ibid.*

²⁶² For constructive dismissal, see *infra* at II. 1. a) 0.

²⁶³ *Fridman*, *supra* note 206 at 578. A variation must not result in illegality, see *Nischk v. Brcic* (1998), 164 Sask. R. 238 (Sask. Q.B.).

²⁶⁴ *Stilk v. Myrick*, *supra* note 247; *Gilbert Steel Ltd. v. University Construction Ltd.*, *supra* note 247; *Besta International Corp. v. Watercraft Offshore Canada Ltd.* (1994), 19 B.L.R. (2d) 257 (B.C.S.C.), additional reasons at (1995), 19 B.L.R. (2d) 257 (B.C.S.C.); *Guillaume v. Stirton* (1978), 88 D.L.R. (3d) 191 at 203 (Sask. C.A.), Hall J.A.; *Blomidon Mercury Sales Ltd. v. John Piercey's Auto Body Shop Ltd.* (1981), 129 D.L.R. (3d) 630 (Nfld. T.D.); *Hyslip v. MacLeod Savings & Credit Union Ltd.*, *supra* note 260; *St. Elizabeth Hospital v. Three Lakes No. 400 (Rural Municipality)* (1995), 135 Sask. R. 215 (Sask. Q.B.); *Gregorio v. Intrans-Corp.* (1994), 115 D.L.R. (4th) 200 (Ont. C.A.), additional reasons at (1994), 15 B.L.R. (2d) 109 (Ont. C.A.).

each party on the other.²⁶⁵ In the context of employment contracts, fresh consideration can be found in the forbearance of the employee to exercise his privilege of lawfully resigning or, more importantly, in the forbearance of the employer of giving lawful notice of termination.²⁶⁶ Alternatively, consideration may be found in the assumption of additional obligations or the incurring of liability to an increased detriment.²⁶⁷

The position is more difficult in the case of an agreement whereby one party undertakes an additional obligation, but the other party is merely bound to perform his existing obligations, or an agreement whereby one party undertakes an additional obligation, but for the benefit of that party.²⁶⁸

Accordingly, if the original contract does not include a severance provision, the corporation and the executive can modify the service contract and agree upon severance payment at any later occasion. The decision whether the "golden handshake" has been effected technically by way of rescission or variation will depend on the intention of the parties to discharge existing rights and obligations and substitute the terms through a subsequent agreement or to just alter the terms or the contract.²⁶⁹ Whichever of the above mentioned methods is invoked to enforce the new contractual relationship, it is clear that both parties to the contract must have full knowledge of the scope and nature of the change in question and must voluntarily consent to it without duress or coercion in order for the modification to be legally binding.²⁷⁰

(1) Severance Package

If the corporation intends to remove the executive from his office and to prematurely terminate the contractual relationship, the corporation will most likely offer the executive to rescind the service contract. The executive, who would be entitled to damages for wrongful

²⁶⁵ *Re William Porter & Co. Ltd.*, [1937] 2 All E.R. 361.

²⁶⁶ *Sloan v. Union Oil Co. of Canada*, *supra* note 247 at 679 (B.C.S.C.); *Maier v. E & B Exploration Ltd.*, *supra* note 247 at 281-282.

²⁶⁷ *North Ocean Shipping Co. Ltd. v. Hyundai Construction Co. Ltd.*, [1979] Q.B. 705.

²⁶⁸ The problem whether there is sufficient fresh consideration especially occurs in the event the parties agree to modify the executive service contract to the extent that a "golden parachute" provision is included. It has been argued that such provision only benefits the executive and, therefore, the variation of contract is not enforceable since no fresh consideration for the corporation is provided. This aspect will be discussed in more detail *infra* at (2).

²⁶⁹ *United Dominion Trust (Jamaica) Ltd. v. Shoucair*, [1969] 1 A.C. 340; *Compagnie Noga D'Importation et D'Exportation S.A. v. Abacha*, *supra* note 255 at para. 57.

²⁷⁰ *Hill v. Peter Gorman Ltd.* (1957), 9 D.L.R. (2d) 124 (Ont. C.A.) at 136; *Sagkeeng Education Authority Inc. v. Guimond*, [1996] 1 F.C. 387 (T.D.) at 399-400; *Chilgan v. Island Lake Band No. 161*, [1994] 5 W.W.R. 308 (Sask. Q.B.) at 316.

dismissal if no agreement were made, has no incentive to agree to the offer for immediate rescission without asking for a severance package as consideration for the abandonment of his contractual entitlements for compensation or, eventually, damages for wrongful dismissal. Instead, he will ask for and negotiate an individual severance package. Where the executive accepts the severance package offered as a final settlement of his contractual claims, the acceptance will be regarded as a binding agreement not to sue in respect of the outstanding common law claims, and therefore precludes a claim for any further sums due.²⁷¹ Although new obligations arise from this “golden handshake” for both parties, the modification of the original contract is sufficiently fundamental as for the mutual settlement agreement to be regarded as a valid rescission of the contract in terms of the law.

In contrast, however, the severance package does not necessarily have to be agreed upon at the time of removal and discharge. The parties may at any time alter the service contract to the extent that a severance provision will be included in view of a potential future termination. This agreement, that will technically not constitute a “golden handshake” in the meaning set out earlier, can be regarded as a variation of contract rather than a rescission as the original contract will not be extinguished or fundamentally changed. The parties’ intention is not to discharge any existing obligations, but just to include an additional provision in order to ensure more certainty for the future. The variation also delivers fresh consideration as it benefits both parties to the contract. Like in the case of the “golden handshake” by rescission, the corporation agrees to pay a certain severance package to the executive in return for his consent to accept the termination as lawful and to refrain from an action for wrongful termination once the corporation decides to prematurely terminate the contract.

(2) “Golden Parachute”

As in the case of a subsequent severance package, if the original contract does not contain a “golden parachute” provision, the parties are free to accordingly modify the original contract at any later time. The modification will most likely be effected by an agreement to insert an additional provision into the existing contract. The intention of the parties will not be to extinguish or completely replace the original executive service contract. Therefore, the modification cannot be regarded as sufficiently fundamental as to amounting to a rescission of

²⁷¹ See *supra* note 266

the contract, but rather will constitute a variation of contract.²⁷²

As for the validity of such variation, common law requires that the new agreement is supported by fresh consideration of both parties.²⁷³ Some commentators have asserted that “golden parachute” agreements are not supported by fresh consideration, arguing that the executives are inadequately compensated with additional benefits in return for the exercise of duties and obligations they already owe to the corporation, such as objectivity towards takeover bids in the best interests of the corporation.²⁷⁴ In view of the inadequate consideration provided by the executive, it has been claimed in the U.S. that “golden parachute” agreements rather constitute a waste of corporate assets as they serve improper purposes.²⁷⁵ However, regardless of the motive the parties may have to provide “golden parachutes” and the different functions and purposes they may serve,²⁷⁶ it is at this point important to distinguish between the notion of consideration under contract law and the doctrine of waste of corporate assets as a legal constraint established by U.S. corporate law and its Canadian equivalent.²⁷⁷ The notion of consideration generally requires that a legal detriment must be bargained for and suffered in exchange for a promise.²⁷⁸ As long as there is some kind of detriment in exchange for the benefits, the contract is regarded to be supported by consideration and it is irrelevant for the validity and enforceability of the contract under contract law whether the consideration provided is reasonable or adequate.²⁷⁹ Thus, the assertion that the consideration received by the

²⁷² See *supra* notes 255 through 257 and accompanying text.

²⁷³ See *supra* note 264.

²⁷⁴ See, for example, Riger, *supra* note 54 at 25-35; William H. Painter, *Problems and Materials in Business Planning* (2nd ed., St. Paul: West Publishing Co., 1984) at 748; Henry F. Johnson, “Anti-Takeover Actions and Defenses: Business Judgment or Breach of Duty?” (1982) 28 Vill. L. Rev. 51 at 70.

²⁷⁵ Painter, *supra* note 274 at 748.

²⁷⁶ The different functions will be discussed in detail *infra* at Chapter 3, II. 1. d) (2).

²⁷⁷ In *Michelson v. Duncan*, 407 A.2d 211 (Del. S.C., 1979), one argument of the case was that stock options were granted without consideration and, therefore, constituted a gift or waste of corporate assets. At 217 the court defined the essence of gift as “a transfer without consideration” and the essence of waste of corporate assets as the “use of corporate assets for improper or unnecessary purposes”. The doctrine of corporate waste as established in U.S. corporate law does not exist as an accepted doctrine in Canadian corporate law. Here, the same legal issues arise in the context of the fiduciary duties of the directors in terms of compliance with the standard of reasonableness and fairness and, with special regards to “golden parachutes”, by the “improper purpose test”. Those issues will be discussed *infra* at Chapter 3, II. 1. c) and d).

²⁷⁸ See, generally, *supra* note 206. U.S. cases that deal with the issue of consideration are, for example, *Baehr v. Penn-O-Tex Oil Corp.*, 258 Minn. 533 at 539, 104 N.W.2d 661 (1960) at 665; *Fisher v. Jackson*, 142 Conn. 734 at 737, 118 A.2d 316 (1955) at 317; *Keith & Hastings v. Miles*, 39 Miss. 442 (1860).

²⁷⁹ As what is commonly also referred to as the “peppercorn principle”, common law early developed the principle that consideration need not be adequate. For that principle in general and its limitations, as well as relevant case law, see Treitel, *supra* note 206 at 74. For Canada, see Fridman, *supra* note 206 at 98.

corporation in return for its promise to pay certain compensation benefits to the executive by way of a "golden parachute" is not sufficient or rather inadequate does not render the agreement unenforceable due to a lack of consideration. To the same extent, even where the agreement is entered into for improper purposes, the agreement can still result in some benefit for the party, rendering the agreement enforceable under contract law.

Accordingly, it is essential that the "golden parachute" agreement is supported by fresh consideration by the executive in return for the corporation's promise to grant additional benefits. Other than in the case of a "golden parachute" provision contained in the original contract, that new consideration cannot always be found in the waiver of potential future entitlements arising from the law of wrongful dismissal. Depending on the kind of the "golden parachute" provision agreed upon in the specific case, the consideration can be different and needs to be clearly determined for each individual alternative.

Firstly, as far as a "golden parachute" is concerned that is at least double-triggered,²⁸⁰ fresh consideration can be found even in a subsequent amendment agreement in the terms of the executive's promise of forbearance of his entitlements under the notion of wrongful dismissal.²⁸¹ This will always be the case if the termination clause provides for the possibility for the corporation to prematurely terminate the executive service contract within a specific period of time following the change in control. The promise to accept the change of control as a cause for termination and not to pursue action against the corporation is a legal detriment that serves as consideration for the benefit of receiving as stipulated damages for the breach of the contract the predetermined or determinable amount of severance pay.²⁸² Furthermore, even if the parties stipulate the executive's right to resign for "good cause" in the aftermath of a change in control, the agreement can be regarded as being supported by consideration. A change in control can cause unilateral changes as to the relationship between the corporation and the executive. In general, the executive is protected against unjustified unilateral changes by means of constructive dismissal. His consent to a right to voluntary resignation in the event of a change of control has the effect of a promise not to claim his rights under the law of constructive dismissal. Thus, since a double-triggered "golden parachute" agreement confers new obligations on both

²⁸⁰ For the definition of double-triggered "golden parachute" provisions, see *supra* at Chapter 1, III.

²⁸¹ See *supra* note 266.

²⁸² See Susan L. Martin, "Platinum Parachutes: Who's Protecting the Shareholders" (1986) 14 Hofstra L. Rev. 653 at 661.

parties, it is supported by consideration and enforceable even if it is subsequently inserted into the executive service contract by way of variation of contract.

The situation is more difficult in the case of a “single-triggered” “golden parachute” where the benefits are due as soon as the change in control has occurred. Whereas the consideration moving from the corporation to the executive is apparent in terms of the agreed benefits, the same is not true for consideration moving from the executive to the corporation.²⁸³ If the “golden parachute” is “single-triggered”, only the corporation undertakes an additional obligation whereas the executive is merely bound to perform his existing obligations.²⁸⁴ Corporate executives have a pre-existing duty to give the proper attention and dedication to their corporate duties by virtue of statutes, their service contracts, and basic business ethics.²⁸⁵ As a general proposition, courts have held that when a party promises to do what it is already legally obligated to do, that party does not incur detriment and, thus, is not giving consideration.²⁸⁶ Therefore, the argument that the executive’s promise to act objectively and dispassionately in the best interests of the corporation serves as fresh consideration has not been accepted by these authorities.²⁸⁷ However, a more liberal approach has been adopted in some recent cases and the courts have been prepared to find consideration and enforce the agreement where it has conferred some benefit upon the promisor.²⁸⁸ Especially on the analogy of the reasoning of *Williams & Roffey Bros. v. Nicholls (Contractors) Ltd.*,²⁸⁹ it is arguable also for the case of “golden parachutes” that the variation may be supported by consideration if, although capable of conferring a legal benefit on only one party, it can also confer a factual benefit on the other party.²⁹⁰

Although the principle of the fiduciary duty requires that the management of the corporation considers the effects of a prospective change in control for the corporation and the shareholders

²⁸³ See also Noonan, *supra* note 53 at 21.

²⁸⁴ For the general difficulty to determine consideration in such situations, see The Common Library, *supra* note 206 at 22-035.

²⁸⁵ Martin, *supra* note 282 at 666; Riger, *supra* note 54 at 26.

²⁸⁶ Early case law includes, among others, *Stilk v. Myrick*, *supra* note 247; *Vanbergen v. St. Edmund's Properties Ltd.*, [1933] 2 K.B. 233. See also *Syros Shipping Co. S.A. v. Elaghill Trading Co.*, [1980] 2 Lloyd's Rep. 390.

²⁸⁷ *Ibid.* See also, for the U.S., As for the U.S., *Keith & Hastings v. Miles*, *supra* note 278; *Ruffin v. Mercury Record Prod., Inc.*, 513 F.2d 222 (6th Cir. 1975).

²⁸⁸ *Williams v. Roffey Bros. & Nicholls (Contractors) Ltd.*, [1991] 1 Q.B. 1; *Anangel Atlas Compania Naviera S.A. v. Ishikawajima-Harima Heavy Industries Co. Ltd. (No.2)*, [1990] 2 Lloyd's Rep. 526; *Simon Container Machinery Ltd. v. Emba Machinery AB*, [1998] 2 Lloyd's Rep. 429 at 434-435.

²⁸⁹ *Supra* note 288.

²⁹⁰ See Treitel, *supra* note 206 at 102, for the example of a buyer's promise to pay more than the originally agreed price in order to ensure eventual delivery when strict insistence on the original contract would have led to nothing but litigation.

only,²⁹¹ the potential for conflicts between the executive's personal interests and the interests of the shareholders should not be ignored.²⁹² Even if no termination clause is agreed upon, a change in control can cause nonpecuniary or pecuniary losses for the executive. In general, the executive is faced with the risk of being forced out of office as a result of a change in control. Faced with the uncertainty concerning his standing, the executive might tend to prefer his personal interest over the interests of the corporation and its shareholders. The benefits provided by the "golden parachute" can make him indifferent between remaining in office and supporting a takeover that is likely to result in his termination.²⁹³ This state of indifference will, in theory, enable him to perform his fiduciary duties with less distraction and free him to seek the best outcome for the shareholders.²⁹⁴

Further, in *Taupo Totara Timber Co. Ltd. v. Rowe*²⁹⁵ it was held by the Privy Council that the "golden parachute" provided the corporation with the benefit of discouraging its executives from seeking work elsewhere. Here, the "golden parachute" clause provided for the executive to receive an amount equal to five times his annual salary, plus benefits, should a corporate change occur. It provided that the executive could trigger this provision within 12 months after the corporate change. On behalf of the Privy Council, Lord Wilberforce noted:

*"The view that inclusion of a provision giving protection in the event of a takeover was in the interests of the company, was clearly one that reasonable and honest directors might take. In its absence, the staff might be likely to go elsewhere. In the case of the respondent, [...] an agreement in substantially similar form had been entered into in 1969 and there could be nothing suspicious, or open to criticism, in replacing that agreement in 1971 when he became a managing director. [...] there is explicit power in the articles to appoint a managing director on such terms as the directors, acting of course bona fide, think fit."*²⁹⁶

Accordingly, on the grounds of the more recent case law, where the party receives any factual benefit in return for its legal promise, the agreement cannot be considered a gift. Rather it is a valid agreement supported by consideration. The factual benefit that the executive's dedication to his assigned duties and responsibilities is reinforced and encouraged by the "golden

²⁹¹ See, for example, Bress, *supra* note 166 at 958. For the fiduciary duty to act in the best interests of the corporation, see *infra* at Chapter 3, II. 1.

²⁹² *Ibid.* See also *Dynamics Corp. of America v. CTS Corp.*, 794 F.2d 250 (7th Cir. 1986) at 254, discussing the unavoidable conflict of interests between corporations and their managers when the corporation is faced with a tender offer.

²⁹³ Cooper, *supra* note 52 at 65-68

²⁹⁴ Bress, *supra* note 166 at 959.

²⁹⁵ *Taupo Totara Timber Co. Ltd. v. Rowe*, [1977] 3 All.E.R. 123 (P.C.).

²⁹⁶ *Ibid.* at 128

parachute” renders the agreement valid and enforceable.

3. Judgment of the Court

Finally, a severance package for the executive can also result from a judgment of the court as a consequence of litigation for wrongful dismissal of the executive. Although technically constituting damages for wrongful dismissal, the awards granted by the court may also be referred to as severance pay, since they represent benefits in connection with the premature termination of the executive service contract.

In contrast to litigation for wrongful dismissal between the employer and a “regular” employee, such litigation in practice is not common between a corporation and its executive. The rule rather is that the executive leaves the corporation either by invoking a contractual severance clause or upon a somewhat lucrative “golden handshake” with the corporation.

A severance package granted by judgment of the court apparently is not a result of negotiations between two parties. Although a judgment may be appealed to some extent, it is not subject to conflicts of interest, undue influence or any other behaviour by either party that may cause subsequent legal scrutiny or cause public outrage regarding an allegedly excessive amount. For that reason, severance packages that result from a judgment rendered by a court for wrongful dismissal will not be in the focus of this thesis.

4. Conclusion for Contract Law

This Part has shown the legal framework established by contract law for executive severance packages and “golden parachute” payments. Generally, the executive and the corporation must have entered into a valid agreement for the payments to be legally valid and enforceable. There are two different choices for the parties to agree upon entitlements for severance or “golden parachute” payments.

As a first alternative, a specific severance or “golden parachute” provision can be included in the original executive service contract which includes all individual obligations and rights in connection with the executive serving as an officer of the corporation. In accordance with the principle of freedom of contract, both the executive as well as the board of directors acting on behalf of the corporation are basically free to agree upon whatever terms as long as there is mutual consideration. Thus, they are not limited by contract law to include provisions that provide the executive with a severance package in the event of his termination or a change in control of the corporation. I have argued that, from the contract law perspective, the parties are

even free to agree upon a contractual “golden parachute” provision that is contingent only on a change in control regardless of the executive being terminated or resigning as a result of the change in control. In this alternative, consideration by the executive will always flow from his promise to render services as an officer of the corporation.

Secondly, even if the executive service contract does not provide for a severance package or “golden parachute” payments, contract law allows the parties to agree upon such payments at any later time. That subsequent agreement can be symbolically referred to as a “golden handshake”. It will be a valid agreement if it constitutes fresh consideration for both parties. That will be the case if the agreement provides for a severance package in return for the executive’s consent to a premature termination of his service contract without cause. Additionally, the “golden handshake” can also be used to subsequently provide the executive with “golden parachute” entitlements that are contingent on a change in control. In this context, I have established that the necessary fresh consideration by the executive can be any actual benefit for the corporation arising from that new agreement such as an reinforcement of the executive’s duty to objectively assess the effects of a change in control and react with a view to the best interests of the corporation.

Contract law sets out the basic principles for the validity of the bargain only. It does not impose any restrictions as to the structure or the amount of executive severance packages or “golden parachute” payments. Any legal restrictions must therefore be looked for in different areas of the law. Next, I will analyze whether employment law establishes limits for general executive severance packages and specific “golden parachute” payments.

II. Employment Law: Compensation for Dismissal

Most of the recent criticism concerning executive severance packages has been raised against the enormous amounts of the latest packages. In this part, I will assess to what extent Canadian employment law contributes to the area of executive severance packages. In a first step, this Part gives an introduction to the law of dismissal that governs all employment contracts including the executive service contract. Special attention will be drawn on the leading principle of reasonable notice as evolved at common law and its consequences for the design of executive severance packages. Following that, this Part will also discuss the impact of statutory employment legislation on executive severance packages. It will conclude with the statement that employment law in terms of the law of dismissal rather than imposing limits on the design of those packages sets out legal minimum standards concerning the structure and the level of

severance pay.

As a general implication of employment law as evolved at common law, the executive can be entitled to damages for wrongful termination in the case of a premature termination without cause of the executive service contract by the corporation. Furthermore, if the executive can be considered as an employee under the applicable employment standards legislation, he might also have certain statutory severance entitlements. By contrast, an executive who renders his services based on a contract that explicitly specifies the amount that will be paid to him upon the termination is not subject to the traditional common law remedies under the law of wrongful dismissal.²⁹⁷ Consequently, the main reason for the executive and the corporation to agree upon a severance package – either as a provision in the original service contract or by way of a “golden handshake” – will be the intention to settle any potential claims for damages under the law of wrongful dismissal.

Where the party to be terminated early would have certain rights under common law, the terminating party needs to provide an incentive for the that party to consent to the early termination and the settlement of outstanding rights and obligations. Thus, unless the corporation asserts “just cause” for the premature termination, the determination of a figure that is offered to the executive by way of a specific severance package will typically involve the assessment of the executive’s potential entitlements arising from the law of wrongful dismissal. In the following sections I will prove that the executive’s entitlements as damages in lieu of notice depend both on the length of notice of termination as well as on the different components and the respective amount of his general compensation package and, therefore, determine the design of the executive severance packages.

1. Damages for Wrongful Dismissal at Common Law

Besides being an agent for the corporation, the executive is also an employee of the corporation.²⁹⁸ By entering into his service contract with the corporation, he promises to render

²⁹⁷ Levitt, *supra* note 127 at 3.

²⁹⁸ Welling, *supra* note 193 at 327; Stikeman, Elliott, *supra* note 134 at § 20.27; Grosman, *supra* note 205 at 17. In contrast, a director is not an employee and no notice need to be provided to terminate the position, see *Phil Lloyd’s Restaurants Ltd. and Kormish v. North Forty Restaurants Ltd.* (1983), 25 Sask. R. 40, 47 C.B.R. (N.S.) 128 (Sask. Q.B.); *Lawrey v. Dorset House College Inc.* (1987), 5 A.C.S.W. (3d) 166 (B.C.S.C.).

specific services to the corporation.²⁹⁹ The executive's function is to run the day-to-day operations of the corporation within the long-range policies laid down by the board of directors.³⁰⁰ It is obvious, that these services are different from the work of "regular" employees. Regardless of the higher level of services, the relationship the executive enters into with the corporation is still regarded an employment relationship, even if of higher level.

Although executives may not relish the thought, their status as an employee has considerable value.³⁰¹ It provides them entry into the realm of the common law of wrongful dismissal with all the rights and protection that that entails.³⁰² Thus, even executives as officers of the corporation will be entitled to damages for wrongful dismissal if their termination by the corporation happens to have been unlawful.³⁰³

a) The Law of Wrongful Dismissal

In Canada, the courts have expanded general contract law through employment law cases. They have consistently held that every contract of employment, whether in writing or not, includes an implied term to the effect that no employee will be dismissed without reasonable notice or compensation unless the employer can establish justifiable cause for termination without notice. Common law, therefore, distinguishes between lawful dismissals, characterized as "just cause" terminations, and unlawful dismissals, called "wrongful" terminations. The consequences flowing from the presence or absence of "just cause" are quite different for the parties involved.

(1) Dismissal for cause

When the corporation has just cause for dismissal, the executive service contract can be terminated without notice of termination.

As for the presence of just cause it has been held by the courts that "[if] an employee has been guilty of misconduct, habitual neglect of duty, incompetence, or conduct incompatible with his duties, or prejudicial to the employer's business, or if he has been guilty of wilful

²⁹⁹ For the distinction between the appointment as officer and the contractual agreement establishing certain additional rights and obligations of both the corporation and the executive, see *supra* at I. 1. a).

³⁰⁰ Welling, *supra* note 193 at 300.

³⁰¹ Grosman, *supra* note 205 at 17.

³⁰² "The remedy of damages for wrongful dismissal is the most important remedy given by the common law [...] for the protection of the job security of the employee", see Freedland, *supra* note 252 at 244.

³⁰³ Grosman, *supra* note 205 at 23. Directors, in contrast, are not employees of the corporation. They are entitled to damages of any kind for dismissal from the position as director.

disobedience to the employer's orders in a matter of substance, the law recognizes the employer's right summarily to dismiss the delinquent employee.³⁰⁴ Accordingly, an employer has just cause for termination when the employee fails to fulfil his obligations arising from the employment contract or his conduct is inconsistent with the express or implied terms of employment.³⁰⁵ The causes which are sufficient to justify dismissal vary with the nature of the employment and the circumstances of each case.

The courts have held that the executive's misconduct must be of a serious nature for cause to exist.³⁰⁶ Dismissal is an extreme measure, and not to be resorted to for trifling causes. The applicable test for just cause is whether the fault is something a reasonable employer could not be expected to overlook, having regard to the nature and the circumstances of the employment.³⁰⁷ A court will examine the circumstances of each case to determine whether or not there exists just cause for termination. The factors the court will consider include the length of service, the past conduct, the executive's duties and responsibilities within the organization.³⁰⁸ Cases that constitute cause are, for example, theft, fraud, dishonesty, insubordination and breach of company rules or policies.

Incompetence, too, can be just cause for termination. However, executive incompetence is not established on the basis of employer dissatisfaction with an executive's performance.³⁰⁹ Rather, the approach of the courts is to apply an objective standard in determining whether an executive has been incompetent in the performance of his or her duties.³¹⁰ The courts will

³⁰⁴ *R. v. Arthurs, ex p. Port Arthur Shipbuilding Co.* (1967), 62 D.L.R. (2d) 342 (Ont. C.A.) at 348; revised on other grounds [1969] S.C.R. 85.

³⁰⁵ *Commission scolaire de Sept-Iles v. Club de ski Gallix*, D.T.E. 91T-653 (Que. S.C.); *Bilodeau v. Bata Industries Ltd.*, [1986] R.J.Q. 531 (C.A.); *Charlton v. B.C. Sugar Refining Co.*, [1925] 1 W.W.R. 546 (B.C.C.A.); *Denham v. Patrick* (1910), 20 O.L.R. 347 (C.A.); *Smith v. Kamloops & District Elizabeth Fry Society* (1996), 20 C.C.E.L. (2d) 303 (B.C.C.A.).

³⁰⁶ *McIntyre v. Hockin* (1889), 16 O.A.R. 498 (C.A.). See also *Campbell v. J.I. Case Canada* (1990), 75 Alta. L.R. (2d) 292 (Alta. Q.B.); *MacDonald v. Richardson Greenshields of Canada Ltd.* (1985), 69 B.C.L.R. 58 (B.C.S.C.).

³⁰⁷ *Mothersole v. Gulf Canada Resources Ltd.*, [2003] 4 W.W.R. 717 (Alta. Q.B.); *McIntyre v. Hockin*, *supra* note 306 at 501.

³⁰⁸ *Durand v. Quaker Oats Co. of Canada Ltd.* (1990), 45 B.C.L.R. (2d) 354 (B.C.C.A.); *Brown v. OK Builders Supplies Ltd.* (1985), 11 C.C.E.L. 243 (B.C.S.C.); *Risi v. Benson & Hedges (Canada) Inc.*, [1986] O.J. No. 2044 (Ont. Dist. Ct.).

³⁰⁹ *Woodward v. Sound Insight Ltd.* (1986), 73 N.S.R. (2d) 396 (N.S.S.C.); *Coyes v. Ocelot Industries Ltd.* (1984), 33 Alta. L.R. (2d) 102 (Alta. Q.B.); *Carveth v. Railway Asbestos Packing Co.* (1913), 24 O.W.R. 151 (Ont. H.C.J.); *Jeykal v. Nova Scotia Glass Co.* (1888), 20 N.S.R. 388 (N.S.C.A.).

³¹⁰ *Cheetham v. Barton*, [1990] CarswellOnt 2975 (Ont. Dist. Ct.); *Longpré v. Carrière & Lefebvre (1978) Inc.* (1989), 28 C.C.E.L. 277 (Que. S.C.); *Stevens v. Electrolux Canada* (1985), 6 C.C.E.L. 254 (N.B.Q.B.); *Matheson v. Matheson International Trucks Ltd.* (1984), 4 C.C.E.L. 271 (Ont. H.C.J.).

consider the mission that was given to the executive. In addition, they will consider whether the employer established reasonable objectives for performance and informed the executive of these objectives,³¹¹ whether the executive was warned that failure to meet the standard would result in termination³¹² and whether he or she was afforded a reasonable period of time to correct his situation.³¹³ Economic difficulties or company reorganization will not constitute cause for dismissal.³¹⁴ The power to terminate for cause on the basis of those business reasons has been held to be incompatible with fixed-term hiring that is not contingent on general economic developments. Instead, the inherent power to terminate a contract is merely for causes relating to the conduct of the employee.³¹⁵

(2) Dismissal without cause

If the facts do not support a lawful dismissal for “just cause” or unless the parties have agreed to the contrary in terms of a fixed-term contract, the common law presumes that the parties to an employment contract intend their agreement to be for an indefinite term that can only be terminated lawfully by either party upon due notice of termination.³¹⁶ In Canada, this

³¹¹ *Rogers v. Canadian Acceptance Corp.* (1982), 50 N.S.R. (2d) 537 (N.S.S.C.); *Gorman v. Westfair Foods Ltd.* (1996), 114 Man. R. (2d) 228, 24 C.C.E.L. (2d) 273 (Man. Q.B.).

³¹² *Scholler v. Samario Construction* (1984), 25 A.C.W.S. (2d) 86 (Ont. Co. Ct.); *Robson v. General Motors of Canada Ltd.* (1982), 37 O.R. (2d) 229 (York Co. Ct.); *Coventry v. Nipawin & District Nursing Home* (1981), 12 Sask. R. 40 (Sask. Q.B.); *Hansen v. Viking Sprinkler Co.* (1981), 7 A.C.W.S. (2d) 508 (B.C.S.C.); *Lee v. Parking Corp. of Vancouver*, (1998), 56 B.C.L.R. (3d) 170 (B.C.S.C.).

³¹³ *Frankcom v. Tandy Electronics Ltd.* (1984), 4 C.C.E.L. 40 (Ont. H.C.J.); *Hemmingway v. South Huron & District Assn. For the Mentally Handicapped Inc.* (1982), 17 A.C.W.S. (2d) 242 (Ont. Co. Ct.); *Robson v. General Motors of Canada Ltd.*, *supra* note 312; *Ferguson v. Spalding Co-operative Assn.* (1980), 9 Sask. R. 303 (Sask. Q.B.); *Manning v. Surrey Memorial Hospital Society* (1975), 54 D.L.R. (3d) 312 (B.C.S.C.).

³¹⁴ *Young v. Okanagan College Board* (1984), 5 C.C.E.L. 60 (B.C.S.C.); *Baker v. United Grain Growers Ltd.*, [1978] 5 W.W.R. 370 (Alta. S.C.); *Sublet v. Faco-Addo Canada Ltd.* (1977), 16 O.R. (2d) 791 (Ont. H.C.J.); *Burton v. MacMillan Bloedel Ltd.*, [1976] 4 W.W.R. 267 (B.C.S.C.); *Gillespie v. Bulkley Valley Forest Industries Ltd.* (1974), 50 D.L.R. (3d) 316 (B.C.C.A.), *affirming*, 39 D.L.R. (3d) 586 (B.C.S.C.); *Paterson v. Robin Hood Flour Mills Ltd.* (1969), 68 W.W.R. 446 (B.C.S.C.); *Swinamer v. Unitel Communications Inc.* (1996), 17 C.C.E.L. (2d) 59 (N.S.S.C.).

³¹⁵ See *Dyer v. Kekinda Snyder Partnership Inc.* (1998), 35 C.C.E.L. (2d) 200 (Ont. Ct. (Gen. Div.)), *Fedak J. citing Paddon v. Phillips Barratt Kaiser Engineering Ltd.*, *supra* note 116 at 176-177.

³¹⁶ This presumption was finally incorporated into English common law by *Richardson v. Koefod*, [1969] 1 W.L.R. 1812 (C.A.). See *Freedland*, *supra* note 252 at 146. For Canada, see *infra* note 317.

This contrasts with the position in the U.S., where hiring is presumed to be an “at will” basis so that either side can terminate the relationship without giving notice, see *England*, *supra* note 113 at 74.

principle has been confirmed by the courts in *Chadburn v. Sinclair Canada Oil Co.*³¹⁷

"Where no express term has been agreed upon for the duration of the contract, and where no implication can be made of yearly hiring, either by inference from the circumstances or by applying the presumption as to yearly hiring, the contract will be one for an indefinite hiring. It is in fact an implied term of such a contract that reasonable notice will be given; and, to exclude this term, express language must be used by the parties. Thus a statement that the contract is terminable "at the option" of the employer will not exclude the implied term of reasonable notice."

The default position, therefore, is that the employer must, in the absence of a clear mutual agreement to the contrary, provide the employee with reasonable notice to terminate the employment relationship.³¹⁸ Reasonable notice is intended to provide the employee with paid time to find new employment.³¹⁹

The requirement for reasonable notice also applies to executive employment contracts.³²⁰ Thus, unless otherwise provided, there is an implied term in the executive service contract that the executive is entitled to reasonable notice of dismissal.³²¹ In contrast, there is no implied term that the employer may pay wages or salary in lieu of notice.³²² Thus, failure to provide notice of termination constitutes a breach of the corporation's contractual obligations which entitles the executive to claim as damages the remuneration that would have been earned had he continued working through the respective notice period.³²³

³¹⁷ *Chadburn v. Sinclair Canada Oil Co.* (1966), 57 W.W.R. (Alta. N.S.) 447, as cited in Gerald H. L. Fridman, *Modern Law of Employment* (London: Stevens & Sons Ltd., 1963) at 468-469. See also *Wallace v. United Grain Growers Ltd.*, [1997] 3 S.C.R. 701 (S.C.C.); *Roe v. Western Printing & Publishing Co.* (1955), 37 M.P.R. 113 (Nfld. S.C.); *Pollard v. Gibson*, [1924] 4 D.L.R. 354 (Ont. C.A.); *Baker v. Canadian Tygard Engine Co.* (1922), 23 O.W.N. 81; *Henderson v. Canada Timber & Saw Mills Ltd.* (1904), 12 B.C.R. 294 (B.C.C.A.).

³¹⁸ *Carter v. Bell & Sons (Canada) Ltd.*, [1936] O.R. 290 (Ont. C.A.).

³¹⁹ *Wilson and Taylor*, *supra* note 167 at 205.

³²⁰ *Rioux v. Pharmacie Edmuston Ltée.* (1980), 34 N.B.R. (2d) 416 (N.B.Q.B.).

³²¹ *Soupes Campbell Ltée v. Cantin*, D.T.E. 91T-741 (Que. C.A.); *Carter v. Bell & Sons (Canada) Ltd.*, *supra* note 318. See also *Stikeman, Elliott*, *supra* note 134 at § 12.42.

³²² *Dunlop v. B.C. Hydro & Power Authority* (1988), 32 B.C.L.R. (2d) 334 (B.C.C.A.) at para. 14: "The implied term is a term to the effect that each party must give reasonable notice of termination to the other. The implied term is not a term to the effect that the employer may give pay in lieu of notice. There are a number of reasons why the latter term is not implied from the employment relationship as part of the employment contract. [...] It would mean that the employer would comply with the contract by giving pay in lieu of notice. The contract would require the full payment immediately. [...] When an employer gives pay in lieu of notice, he does so as an attempt to compensate for his breach of the contract of employment, not as an attempt to comply with an implied term of the contract of employment."

³²³ *Thomas v. Surveyer, Nenninger, Chênevert Inc.*, [1989] 34 Q.A.C. 61 (Que. C.A.); *Perron v. Cie Minière Québec Cartier*, D.T.E. 89T-290 (Que. S.C.); *Gardner v. Rockwell Int. of Canada Ltd.* (1975), 9 O.R. (2d) 105 (Ont. H.C.J.); *Dowling v. Halifax (City)* (1998), 158 D.L.R. (4th) 163 (S.C.C.); *Olson v. Sprung Instant Greenhouse Ltd.*, *supra* note 132; *Lang v. Modern Garment Co.*, *supra* note 132; *Mongeau & Robert & Cie Ltée v. Raby*, *supra* note 132.

The employer cannot characterize any payment in lieu of notice as compliance with an implied term of the contract although such payment may be the rule in practice.³²⁴ When the employer terminates the employment contract prematurely offering the employee a certain amount as severance payment in lieu of notice, the procedure must rather be considered as liquidated damages for what is, technically speaking, a breach of the employment contract in failing to provide the required notice of termination.³²⁵ If the amount offered by the employer reaches or exceeds the amount of damages a court would grant the employee, the employee will most likely have sufficient incentive to consent to the procedure of premature termination in order to avoid lengthy court proceedings.

Constructive Dismissal

The law of wrongful dismissal also applies to events that amount to constructive dismissal.³²⁶ Constructive Dismissal of an executive occurs when the corporation abruptly and unilaterally alters one or several fundamental conditions of the executive service relationship.³²⁷ In practice, one of the most relevant unilateral changes identified as constructive dismissal is a substantial reduction in salary or executive compensation, respectively.³²⁸ If the executive does not accept the abrupt change or if the employer threatens the employee with discharge unless he agrees to resign and as a result thereof the employee resigns, he will be entitled to damages for

For the determination of "reasonable" notice and the special case of fixed-term contracts see *infra* at b).

³²⁴ In *Iacobucci v. WIC Radio Ltd.* (1999), 47 C.C.E.L. (2d) 163 (B.C.C.A.) the court held that the right to benefits during the period of reasonable notice may not be extinguished by a payment in lieu of notice let alone by a salary continuance.

³²⁵ Although there is no complete Canadian judicial analysis, this conclusion is supported by *Lacouvee v. McGavin Foods Ltd.* (1993), 47 C.C.E.L. 131 (B.C.S.C.) at 135; *Spooner v. Ridley Terminals Inc.* (1991), 39 C.C.E.L. 65 (B.C.S.C.) at 71; *Gillespie v. Bulkley Valley Forest Industries Ltd.*, *supra* note 314.

³²⁶ *Côte v. Placements M & A Brown Inc.*, D.T.E. 87T-956 (Que. Prov. Ct.); *Ewasiuk v. Estevan Area Home Care District 9 Inc.* (1985), 9 C.C.E.L. 267 (Sask. Q.B.); *Buchanan v. Continental Bank of Canada* (1984), 58 N.B.R. (2d) 333 (N.B.Q.B.); *Landry v. Comterm Inc.*, J.E. 84-451 (Que. S.C.); *Re Gillingham and Metropolitan Toronto Board of Commissioners of Police* (1979), 26 O.R. (2d) 77 (Ont. Div. Ct.); *Johnson, Drake and Piper Int. Corp. v. Robert*, [1958] B.R. 378 (Que. C.A.); *Smith v. Campbellford Board of Education* (1917), 39 O.L.R. 323 (Ont. C.A.).

³²⁷ *Farber v. Royal Trust Co.*, [1997] 1 S.C.R. 846 (S.C.C.); *Henderson v. Westfair Foods Ltd.* (1990), 32 C.C.E.L. 152 (Man. Q.B.); *Poole v. Tomenson Saunders Whitehead Ltd.* (1987), 18 C.C.E.L. 238 (B.C.C.A.); *Moore v. University of Western Ontario* (1985), 8 C.C.E.L. 157 (Ont. H.C.J.); *Reber v. Lloyds Bank Int. Canada* (1985), 61 B.C.L.R. 361 (B.C.C.A.); *Orth v. Macdonald Dettwiler & Associates Ltd.* (1986), 16 C.C.E.L. 41 (B.C.C.A.).

³²⁸ See, for example, *Boyd v. Whistler Mountain Ski Corp.* (1990), 20 A.C.W.S. (3d) 518 (B.C.S.C.); *Farquhar v. Butler Brothers Supplies Ltd.* (1988), 23 B.C.L.R. (2d) 89 (B.C.C.A.); *Pearl v. Pacific Enercon Inc.* (1985), 7 C.C.E.L. 252 (B.C.C.A.).

wrongful dismissal as if he were unlawfully terminated without cause.³²⁹

In these cases, the resignation cannot be regarded as voluntary. In determining whether a resignation was voluntary, the courts will consider the substance of the termination, not just its form.³³⁰ However, a resignation can be free and voluntary even where the only other option is dismissal.³³¹

b) The Length of Notice of Termination

The first step for the courts in determining the damages for wrongful dismissal of the executive would be the determination of the length of notice of termination. Accordingly, the assessment of the length of the period of notice of termination will be as decisive for the severance offer by the corporation as it will be for the courts to award the damages for wrongful dismissal. Depending on the circumstances and contractual provisions in each case, the length of the notice period is likely to differ from case to case. For the assessment of the notice period distinction must be made between contracts of indeterminate duration and fixed-term employment contracts.

(1) Indeterminate Duration of Employment Contract

At common law, any employment contract such as the service contract between the corporation and the executive can be concluded either for a fixed term or for an indeterminate period.³³² The employment contract is presumed to be in force for an indeterminate period unless proven otherwise.³³³ In the case of a contract of indeterminate duration, the employment relationship can be terminated upon reasonable notice or the notice contractually agreed upon by the parties.

(i) Reasonable Notice

The notion of "reasonable notice" is an indefinite and unprecise term. In general, the

³²⁹ See *supra* note 326. For a more detailed discussion of the notion of constructive dismissal, see England, *supra* note 113 at 222.

³³⁰ *Assouline v. Ogivar Inc.* (1991), 39 C.C.E.L. 100 (B.C.S.C.); *Carrick v. Cooper Canada Ltd.* (1983), 2 C.C.E.L. 87 (Ont. H.C.J.); *Robson v. General Motors of Canada Ltd.*, *supra* note 312.

³³¹ *Kordyban v. Riso Canada Inc.*, 2000 BCSC 550.

³³² *Stikeman, Elliott*, *supra* note 134 at § 12.2.

³³³ See, for example, *Mattson v. ALC Airlift Canada Inc.* (1993), 18 C.P.C. (3d) 310 (B.C.S.C.); *MacDonald v. White Rock Waterworks Co.* (1973), 38 D.L.R. (3d) 763 (B.C.S.C.); *Richardson v. Koefod*, *supra* note 316; *Chadburn v. Sinclair Canada Oil Co.*, *supra* note 317; *Henderson v. Canada Timber & Saw Mills Ltd.*, *supra* note 317.

purpose of reasonable notice is to provide the executive with sufficient time to find comparable employment.³³⁴ When determining what constitutes “reasonable notice” concerning employment contracts in general, the courts still refer to the “reasonable test” in *Bardal v. Globe & Mail Ltd.*³³⁵

*“There can be no catalogue laid down as to what is reasonable notice in particular classes of cases. The reasonableness of the notice must be decided with reference to each particular case, having regard to the character of employment, the length of service of the servant, the age of the servant and the availability of similar employment, having regard to the experience, training and qualifications of the servant.”*³³⁶

In accordance with the *Bardal* test, “each judge must determine, and from his own experience of life, what appears to be logical, judicious, fair, equitable, sensible and not excessive.”³³⁷ Among the broad range of policy considerations necessary in each particular case are, for example, to cushion the worker against the blow of unemployment, to recognize the worker's seniority, to protect the employee who has been induced to leave a secure job to work for the employer, to discourage employers from handling terminations in an unprofessional manner, to reward the employee for good prior service and penalize him or her for poor service, to reward employees in high-status occupations, and to relieve the costs of termination for employers who are facing a financial exigency.³³⁸

All employees in the corporate hierarchy are not equal. At the law of wrongful dismissal, such inequality exists in the entitlement of differing levels of employees to distinctly different standards of reasonable notice.³³⁹ Although every Canadian jurisdiction has employment standards legislation which provides a minimum notice period with respect to the termination of employment,³⁴⁰ reasonable notice of termination for an executive is much longer than statutory

³³⁴ *Jeffrey v. Plant Forest Products Corp.* (1990), 32 C.C.E.L. 237 (Sask. Q.B.); *Misovic v. Acres Davy McKee Ltd.* (1985), 7 C.C.E.L. 163 (Ont. C.A.).

³³⁵ *Bardal v. Globe & Mail Ltd.* (1960), 24 D.L.R. (2d) 140 (Ont. H.C.J.), McRuer C.J. The approach in *Bardal v. Globe & Mail Ltd.* is the most frequently cited approach as to the assessment of reasonable notice, see *Machtinger v. HOJ Industries Ltd.*, [1992] 1 S.C.R. 986 (S.C.C.) at para. 22, Iacobucci J. See also *Cronk v. Canadian General Insurance Co.* (1995), 25 O.R. (3d) 505 (Ont. C.A.); *Dey v. Valley Forest Products Ltd.* (1995), 162 N.B.R. (2d) 207 (N.B.C.A.).

³³⁶ *Bardal v. Globe & Mail Ltd.*, *supra* note 335 at 145. Empirical evidence on the relative importance of the various factors is provided by Steven L. McShane and David C. McPhillips, “Predicting Reasonable Notice in Canadian Wrongful Dismissal Cases” (1987) 41 Industrial and Labour Relations Review 108.

³³⁷ *Erskind v. Viking Helicopter Ltd.* (1991), 35 C.C.E.L. 322 (Ont. Ct. (Gen. Div.)) at 326.

³³⁸ *Bardal v. Globe & Mail Ltd.*, *supra* note 335 at 145.

³³⁹ Grosman, *supra* note 205 at 77.

³⁴⁰ Employment standards legislation will be discussed *infra* at 2. For statutory severance under the employment standards legislations see also *supra* at Chapter 1, I. 3.

notice for "regular" employees.³⁴¹ The early case of *Morrison v. Abernethy School Board* proposed that

*"the higher the position held by the employee, the more likely the court will be inclined to conclude that reasonable notice amounts to the extended time required to find replacement employment in a similar or equivalent position."*³⁴²

Senior executives may find that considerable time is required before an equivalent position paying a similar salary is obtained.³⁴³

The length of reasonable notice to be given to an executive can only be determined by the merits of each case. Rules like one month of notice per year of service do not have binding precedential value.³⁴⁴ Furthermore, although case law shows that a twelve-month period of notice has in practice become the minimum notice period for executives,³⁴⁵ the courts have stated that there is no legal minimum or maximum period of reasonable notice.³⁴⁶ Instead, in accordance with the approach in *Bardal v. Globe & Mail Ltd.*,³⁴⁷ the courts focus on a number of individual factors in determining the length of the notice period, including the circumstances of the hiring, the nature and importance of the position held at the time of dismissal, the length of service with the employer, and the age of the executive.³⁴⁸ Additional factors include the presence or absence of inducement to leave previous stable employment, the intentions of the contracting parties at the time of the formation of the contract and the difficulty the executive

³⁴¹ Stikeman, Elliott, *supra* note 134 at § 12.43

³⁴² *Morrison v. Abernethy School Board* (1876), 3 Sc Sess Cas, 4th series at 945, as cited in *Chadburn v. Sinclair Canada Oil Co.*, *supra* note 317 at para. 31.

³⁴³ Further cases demonstrate the trend towards awarding greater periods of notice to managerial employees: *Neyland v. Genstar Ltd.* (1977), 76 D.L.R. (3d) 697 (B.C.S.C.); *Markou v. Water Refining Co. Ltd.* (1980), 2 A.C.W.S. (2d) 210 (Ont. H.C.J.); *Turner v. Canadian Admiral Corp.* (1980), 3 A.C.W.S. (2d) 163 (Ont. H.C.J.); *Wilkinson v. Ronyx Corp.* (1981), 9 A.C.W.S. (2d) 476 (Ont. H.C.J.); *Douglas v. Sandwell & Co.*, [1978] 1 W.W.R. 439, 81 D.L.R. (3d) 508 (B.C.S.C.); *Robertson v. Equivest Securities Ltd.* (1980), 19 B.C.L.R. 274 (B.C.S.C.).

³⁴⁴ *McKay v. Eaton Yale Ltd.* (1996), 31 O.R. (3d) 216 (Ont. Ct. (Gen. Div.)).

³⁴⁵ *Robinson v. Canadian Acceptance Corporation* (1973), 43 D.L.R. (3d) 301 (N.S.S.C.). See also *supra* note 343.

³⁴⁶ *Birney v. B.C. Automobile Association*, [1988] B.C.W.L.D. 1664 (B.C.S.C.), affirmed (1989), 40 B.C.L.R. (2d) 76 (B.C.C.A.); *Suttie v. Metro Transit Operating Co.* (1985), 2 B.C.L.R. (2d) 145 (B.C.C.A.), affirming [1983] 42 B.C.L.R. 234 (B.C.S.C.); *Lamberton v. Vancouver Temperance Hotel Co.* (1904), 11 B.C.R. 67 (B.C.C.A.).

However, courts have cited a range between 18 and 24 months as a maximum unless "exceptional circumstances" exist, see, for example, *Webster v. B.C. Hydro & Power Authority* (1992), 42 C.C.E.L. 105 (B.C.C.A.); *Sorel v. Tomenson Saunders Whitehead Ltd.* (1987), 16 C.C.E.L. 223 (B.C.C.A.); *Locke v. Avco Financial Services Canada Ltd.* (1987), 85 N.B.R. (2d) 93 (N.B.Q.B.); *Ansari v. B.C. Hydro & Power Authority* (1986), 2 B.C.L.R. (2d) 33 (B.C.S.C.), affirmed 1986 B.C.J. No. 3006 (B.C.C.A.); *Domnelly v. B.C. Hydro & Power Authority*, 1986 B.C.J. No. 1722 (B.C.S.C.).

³⁴⁷ *Supra* note 335.

³⁴⁸ See, for example, *Arcand v. Denharco Inc.* (1996), 32 C.C.E.L. (2d) 24 (Que. S.C.).

may have in finding an equivalent position.³⁴⁹

In order to determine the length of the reasonable notice for a particular executive, the courts often look beyond his or her title to determine the character of the employment,³⁵⁰ since the actual responsibilities and duties which the executive exercised more accurately determine his position in the employer's organization.³⁵¹ However, a few courts have stated that the parties should be held to their characterization of the job.³⁵² In general, a senior, upper-level management executive is entitled to a longer period of notice than a junior executive.³⁵³

The same applies to the age of the executive. An older executive is entitled to a longer notice period since it is assumed that he or she will have greater difficulty finding subsequent employment.³⁵⁴ However, the courts are undecided as to whether special treatment for executives starts at the age of 40³⁵⁵ or at 50³⁵⁶ years of age. Finally, if an older executive is employed for a relatively short period, his age will be of less significance in determining the notice period.³⁵⁷

If an employer induced an executive to leave previous stable employment, a court may award a longer period of notice assuming that the executive would not have left his former job

³⁴⁹ *Bardal v. Globe & Mail Ltd.*, *supra* note 335; *PCL Construction Management Inc. v. Holmes* (1994), 8 C.C.E.L. 192 (Alta. C.A.); *Wiebe v. Central Transport Refrigeration*, [1994] 6 W.W.R. 305 (Man. C.A.).

³⁵⁰ *Magnusson v. Laing Property Corp.* (1991), 35 C.C.E.L. 248 (B.C.S.C.); *Landry v. Canadian Forest Products Ltd.* (1991), 34 C.C.E.L. 37 (B.C.S.C.); *Findlay v. Kershaw Mfg. Canada Ltd.* (1989), 29 C.C.E.L. 10 (Ont. H.C.J.); *Rose v. Herman Miller of Canada Ltd.* (1989), 30 C.C.E.L. 33 (Ont. Dist. Ct.); *Plummer v. W. Carsen Co.* (1985), 10 C.C.E.L. 19 (Ont. Dist. Ct.); *George v. Muller Sales & Services Ltd.* (1984), 31 Sask. R. 201 (Sask. Q.B.).

³⁵¹ *Stikeman, Elliott*, *supra* note 134 § 12.46

³⁵² *Robertson v. B.F. Goodrich Canada Inc.*, 1986 WL 601884 (Ont. H.C.J.); *Sullivan v. Mack Maritime Ltd.* (1982), 39 N.B.R. (2d) 298 (N.B.Q.B.).

³⁵³ *Cronk v. Canadian General Insurance Co.*, *supra* note 335. See also *Birney v. B.C. Automobile Association*, *supra* note 346; *McKay v. Eaton Yale Ltd.*, *supra* note 344; *Johnston v. Algoma Steel Corp.* (1989), 24 C.C.E.L. 1 (Ont. H.C.J.); *Heinz v. Cana Construction Co.* (1987), 55 Alta. L.R. (2d) 382 (Alta. Q.B.); *De Freitas v. Canadian Express & Transportation Ltd.* (1986), 16 C.C.E.L. 160 (Ont. H.C.J.); *Bohemier v. Storwal Int. Inc.* (1983), 44 O.R. (2d) 361 (Ont. C.A.); *Cringle v. Northern Union Ins. Co.* (1981), 24 D.L.R. (3d) 22 (B.C.S.C.).

³⁵⁴ *Stikeman, Elliott*, *supra* note 134 at § 12.48.

³⁵⁵ *McGraw v. Canadian Forest Products Ltd.* (1989), 17 A.C.W.S. (3d) 542 (B.C.S.C.); *Kelly v. Monenco Consultants Ltd.*, 1987 CarswellOnt 1770 (Ont. H.C.J.).

³⁵⁶ *McKee v. NCR Canada Ltd.* (1986), 10 C.C.E.L. 128 (Ont. H.C.J.); *Sorel v. Tomenson Saunders Whitehead Ltd.*, *supra* note 346; *MacDonald v. White Rock Waterworks Co.*, *supra* note 333; *Johnston v. Northwood Pulp Ltd.*, [1968] 2 O.R. 521 (H.C.J.).

³⁵⁷ *Findlay v. Kershaw Mfg. Canada Ltd.*, *supra* note 350; *Habitations Populaires Desjardins de Lanaudière Inc. v. Boyer*, [1988] R.L. 315 (Que. C.A.).

unless there had been an implied term of reasonable job security with the new employer.³⁵⁸ This factor is especially influential if the executive was employed for a short duration before being dismissed.³⁵⁹ Inducement is properly included among considerations which tend to lengthen the notice requirements because there is a need to safeguard the employee's reliance and expectation interests in inducement situations.³⁶⁰ However, where the executive has been employed for a significant period, the prejudicial effect of any inducement is dissipated and may cease to be a factor in determining the period of notice.³⁶¹ On the other hand, when an employee was terminated after three weeks of employment after having been induced to leave a former employer who would have provided him with approximately six months notice, the employee was entitled to 7.5 months notice even though he had actually worked for less than a month.³⁶²

As a general rule, the length of reasonable notice increases in proportion to the length of the executive's continuous service.³⁶³ The courts tend to believe that an executive who has been in one job or with one employer for a number of years will have received narrower experience and will be less employable.³⁶⁴ Short service, on the other hand, may also result in a greater notice period, especially where it would not be unreasonable in view of the fact that the executive had previously declined a competing offer.³⁶⁵

If an executive is expected to have difficulty finding similar employment, a longer notice period may be required considering the time it will take the executive to find new employment.³⁶⁶ Among the factors which may affect an executive's ability to find similar

³⁵⁸ See *Saint John Shipbuilding Ltd. v. Perkins* (1989), 24 C.C.E.L. 106 (N.B.C.A.); *Reynolds v. First City Trust Co.* (1989), 27 C.C.E.L. 194 (B.C.S.C.); *Jackson v. Makeup Lab Inc.* (1989), 27 C.C.E.L. 317 (Ont. H.C.J.); *Chang v. Simplex Textiles Ltd.* (1985), 6 C.C.E.L. 247 (Ont. C.A.); *Brisbois v. Casteel Inc.* (1983), 2 C.C.E.L. 35 (Ont. H.C.J.); *Cringle v. Northern Union Ins. Co.*, *supra* note 353; *Cathcart v. Longines Wittnauer Watch Co.* (1980), 1 C.C.E.L. 287 (Ont. H.C.J.).

³⁵⁹ *Kennedy v. Gescan Ltd.* (1991), 41 C.C.E.L. 134 (B.C.S.C.); *Ansari v. B.C. Hydro & Power Authority*, *supra* note 346; *Martin v. International Maple Leaf Springs Water Corp.*, (1998), 38 C.C.E.L. (2d) 128 (B.C.S.C.).

³⁶⁰ *Wallace v. United Grain Growers Ltd.*, *supra* note 317.

³⁶¹ *Gillies v. Goldman Sachs Canada Inc.* (2000), 49 C.C.E.L. (2d) 236, 2000 C.L.L.C. 210-029 (B.C.S.C.); *Horton v. Rio Algom Ltd.* (1995), 9 C.C.E.L. (2d) 180 (Ont. Ct. (Gen. Div.)).

³⁶² *McIntosh v. C.T.F. Supply Ltd.*, 2001 CarswellOnt 4643 (Ont. S.C.).

³⁶³ *Roscoe v. McGavin Foods Ltd.* (1983), 2 C.C.E.L. 287 (B.C.S.C.); *Chotani v. Westinghouse Canada Inc.*, 1991 CarswellQue 1397 (Que. S.C.); *Habitations Populaires Desjardins de Lanaudière Inc. v. Boyer*, *supra* note 357; *Toupin v. Day & Ross Inc.*, 2001 CarswellQue 288 (Que. C.A.).

³⁶⁴ *Cook v. Royal Trust* (1990), 31 C.C.E.L. 6 (B.C.S.C.); *Durrant v. B.C. Hydro & Power Authority*, [1988] B.C.W.L.D. 1665 (B.C.S.C.); reviewed in part on other grounds (1990), 49 B.C.L.R. (2d) 263 (B.C.C.A.); *Bohemier v. Storwal Int. Inc.*, *supra* note 353; *Turner v. Canadian Admiral Corp.*, *supra* note 343.

³⁶⁵ See *Marshall v. Watson Wyatt & Co.* (2002), 57 O.R. (3d) 813 (Ont. C.A.).

³⁶⁶ *Meyer v. Jim Pattison Industries Ltd.* (1991), 38 C.C.E.L. 101 (B.C.S.C.); *Ostlick v. Novacorp Int. Consulting Inc.* (1989), 27 C.C.E.L. 286 (B.C.S.C.); *Ma v. Columbia Trust Co.* (1985), 9 C.C.E.L. 300 (B.C.S.C.).

employment are job characteristics, geographic location, economic climate, manner of dismissal, training qualifications and experience. For example, if the executive occupied a unique or very specialized, or high-level position in a limited industry, he may also be entitled to a longer notice period, since the number of similar positions available to the executive would be very limited.³⁶⁷

Analysis of the case law generally indicates that periods of notice awarded to dismissed employees are lengthened where exceptional circumstances exist. Persons with highly specialized skills such as corporate executives, facing re-employment markets known to be limited, will generally be entitled to longer periods.³⁶⁸ As a result, the general rule at common law is that there is no maximum limit on the appropriate period of notice of termination, but only in exceptional cases will a notice period in excess of 24 months be reasonable.³⁶⁹

(ii) Contractually Determined Notice

In practice, it will always be difficult for the parties to the contract to precisely predict the amount of reasonable notice of termination.

The common law requirement of reasonable notice may be overcome by a valid and effective contract which provides for a specific notice period³⁷⁰, unless a statute requires a different result.³⁷¹ Moreover, a written employment agreement is often desirable for both the company and its employee, as it will create greater certainty of terms between the parties, which may lessen the need for future litigation. Accordingly, companies are increasingly using written employment contracts to establish their employment relationships with employees. In fact, there seems to be a steady trend towards the use of written employment contracts in the business world, especially for senior executives.³⁷²

It is an axiom of contract law that express contractual terms always prevail over implied

³⁶⁷ *Hasler v. Spagnol's Wine & Beer Supplies Ltd.*, 1991 B.C.J. No. 3853 (B.C.S.C.); *Smith v. Pacific National Exhibition* (1991), 34 C.C.E.L. 64 (B.C.S.C.); *Stewart v. Standard Broadcasting Corp.* (1989), 29 C.C.E.L. 290 (Que. S.C.).

³⁶⁸ Stikeman, Elliott, *supra* note 134 at § 12.52.1.

³⁶⁹ *Veer v. Dover Corp. (Canada) Ltd.* (1997), 31 C.C.E.L. (2d) 119 (Ont. Ct. (Gen. Div.)), affirmed (1999), 45 C.C.E.L. (2d) 183 (Ont. C.A.), cited in *Baranowski v. Binks Manufacturing Co.* (2000), 49 C.C.E.L. (2d) 170 (Ont. S.C.) at 277, where the court awarded 30 months of notice and additional 6 months notice in the presence of spurious allegations raised by the employer for a total of 36 months of notice. See also *Silvester v. Lloyd's Register of North America*, [2004] N.S.J. No 37 (N.S.C.A.); *Gismondi v. Toronto (City)* (2003), 64 O.R. (3d) 688 (Ont. C.A.).

³⁷⁰ *Machtinger v. HOJ Industries Ltd.*, *supra* note 335.

³⁷¹ *Leerdam v. Stirling Douglas Group Inc.* (1999), 99 C.L.L.C. 210-027 (Ont. Ct. (Gen. Div.)).

³⁷² See Kuretzky, *supra* note 220 at 18.

terms.³⁷³ Strictly speaking, this principle applies to notice clauses in employment contracts, too, but most modern courts have recognized that the employer's superiority of bargaining power creates the danger that unduly harsh notice provisions may be included in an employment contract, which would be unfair to the employee if enforced.³⁷⁴ Accordingly, most, but by no means all, courts attempt to circumvent harsh termination clauses by various legal techniques and imply a reasonable notice period as the default position.³⁷⁵

Finally, an express termination clause that provides for less notice than required under the employment standards act will be avoided. In its place, the court must imply a reasonable notice period according to the usual factors without drawing any inference from the expunged notice clause that the parties intended a shorter than usual notice period.³⁷⁶

(2) Fixed term contract

Employment contracts concluded for a fixed period will automatically come to an end at the expiry of the term.³⁷⁷ At that time, neither notice nor reasons for termination need to be given by either party since there is no dismissal or resignation involved.³⁷⁸

An employee who has been hired for a definite term can only be terminated prematurely if there is just cause for his dismissal.³⁷⁹ The termination for cause in the nature of business reasons has been held to be incompatible with fixed term hiring. The inherent power to terminate is merely for cause relating to the conduct of the employee.³⁸⁰ If the employer unilaterally and without cause prematurely terminates a contract concluded for a fixed term prior to its expiration, or terminates a contract for specific undertaking prior to its completion, this

³⁷³ See England, *supra* note 113 at 239.

³⁷⁴ *Ibid.*

³⁷⁵ See *ibid.*

³⁷⁶ *Machtinger v. HOJ Industries Ltd.*, *supra* note 335.

³⁷⁷ *Groulx v. Commission Municipale de Québec*, *supra* note 114; *Tinker-Labrecque v. Corp. de l'Hôpital d'Youville de Sherbrooke*, *supra* note 114; *United Talmud Torahs of Montreal Inc. v. Dulude*, *supra* note 114; *Dombrowski v. Dalhousie University*, *supra* note 114; *MacLeod v. Dominion (Town) Board of Education*, *supra* note 114.

In order for a term of more than one year to be of binding effect, in most Canadian provinces the term must be in writing and signed by the company pursuant to the respective statute of frauds or the common law, see, for example, *Poole v. Chick Adam Ltd.* (1987), 5 A.C.W.S. (3d) 302 (Ont. Div. Ct.).

³⁷⁸ However, the protections of the Employment Standards legislations and the common law do not apply when the fixed-term contract expires. This is why the courts require unequivocal and explicit language to establish such a contract, and will interpret any ambiguities strictly against the employer's interest.

³⁷⁹ *Grosman*, *supra* note 205 at 15; *Stikeman, Elliott*, *supra* note 134 at § 12.41.

³⁸⁰ See *Dyer v. Mekinda Snyder Partnership Inc.* (1998), 35 C.C.E.L. (2d) 299 (Ont. Ct. (Gen. Div.)) at para. 50, *Fedak J. citing Paddon v. Phillips Barratt Kaiser Engineering Ltd.*, *supra* note 116 at 176-177.

constitutes wrongful dismissal.³⁸¹ The employer will be liable for payment of the executive's entire remuneration for the remainder of the term as damages for breach of contract.³⁸² However, as the damages are subject to the duty of mitigation, any income earned from any other employment which the employee, in minimizing damages, either obtained or should have reasonably obtained during the balance of the term, will be deducted from the damages for wrongful dismissal.³⁸³

This rule can be avoided by the parties either by a contractual provision in the original agreement expressly stating that the employee is entitled to receive an unequivocally identifiable severance payment in the event of an early termination or by a "golden handshake" agreement between the parties prior to or at the time of the termination. In such a case, no duty of mitigation will apply as the severance is owed as a money debt rather than damages.³⁸⁴

Some employment contracts additionally provide that the term of employment will renew automatically.³⁸⁵ Furthermore, a fixed-term contract of employment is tacitly renewed for an indeterminate term where the employee continues to carry on his work after the expiry of the term, without further agreement between the parties.³⁸⁶ As soon as the contract has been renewed to the extent of an indefinite term, the general principles concerning contracts of indeterminate duration apply. In practice, executive service contracts are generally entered into for a specific

³⁸¹ *Wollock v. Sochaczewski*, 1995 CarswellQue 1806 (Que. S.C.); *Occhionero v. Roy*, 1992 CarswellQue 1354 (Que. S.C.); *Laporte v. Sofati Ltée.*, [1992] 44 Q.A.C. 161 (Que. S.C.); *Gardner v. Stan-Canada Inc.*, *supra* note 116; *Paddon v. Phillips Barratt Kaiser Engineering Ltd.*, *supra* note 116; *Hawkins v. Ontario*, *supra* note 115. See also England, *supra* note 113 at 223.

³⁸² See *supra*, note 381. See also *Paddon v. Phillips Barratt Kaiser Engineering Ltd.*, *supra* note 116; *Hawkins v. Ontario*, *supra* note 115; *O'Callaghan v. Transair Ltd.*, *supra* note 115; *Walker v. Copp Clark Publishing Co.*, *supra* note 115; *Zaglanikis v. Dana West Hotels Ltd. and Courtyard Inns Ltd.*, *supra* note 116; *Stevens v. LeBlanc's Welding & Fabricating Ltd.* (1982), *supra* note 116; *Gardner v. Stan-Canada Inc.*, *supra* note 116; *Shiozaki v. Expo 86 Corp.* *supra* note 116; *McDowell v. Sunshine Coast Community Services Society*, *supra* note 116; *Brown v. Kinden*, *supra* note 116; *Riddell v. City of Vancouver*, *supra* note 116.

³⁸³ *Michaels v. Red Deer College*, [1976] 2 S.C.R. 324, 57 D.L.R. (3d) 386 (S.C.C.); *Lafayette Glass Co. v. Laplante*, [1967] B.R. 757 (Que. C.A.); *Millar v. Province of Alberta* (1980), 25 A.R. 560 (Alta. Q.B.); *Fawcett v. Ideal Equipment Co. Ltd.* (1980), 3 A.C.W.S. (2d) 382 (Ont. Co.Ct.); *Sinclair v. Canadian Ice Machine Co.*, [1955] S.C.R. 777, 5 D.L.R. 1 (S.C.C.); *Vondette v. Vancouver Port Corp.*, *supra* note 116. See also, generally, *Levitt*, *supra* note 127 at 3.

³⁸⁴ See *supra* note 129 and accompanying text.

³⁸⁵ *Stikeman, Elliott*, *supra* note 134 at § 6.49. Such renewal clauses are likely to cause problems for the courts to determine the amount for damages for wrongful dismissal or for the corporation to assess the reasonable amount of severance payment offered to the executive, see *infra* note 403 and accompanying text.

³⁸⁶ *Erlund v. Quality Communications Products Ltd.* (1972), 29 D.L.R. (3d) 476 (Man. Q.B.); *Hague v. St. Boniface Hospital*, [1936] 3 D.L.R. 363 (Man. Q.B.); *Normandin v. Solloway Mills & Co.* (1931), 40 O.W.N. 429 (Ont. H.C.J.); *Messer v. Barret Co.*, [1927] 1 D.L.R. 284 (Ont. C.A.); *Parker v. Beeching*, [1923] 4 D.L.R. 35 (Alta. C.A.).

term, most of which provide for a term of three to five years.³⁸⁷ For example, the employment agreement of the former C.E.O. of Walt Disney Co., *Michael Ovitz*, had an initial term of five years.³⁸⁸ In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*³⁸⁹ the executive employment agreement concluded between Repap Enterprises Inc. and the executive, *F. Steven Berg*, also had a term of five years.³⁹⁰

c) The Heads of Damages

Like damages for wrongful dismissal awarded by a court, severance payment also is intended to compensate the prejudice caused by the abrupt termination of the employment contract without respecting the notice.³⁹¹ For damages, this principle has been confirmed by the courts in *Husson v. Alumat Mfg.*³⁹²

*"A damage award for wrongful dismissal is not a fund of money to make the plaintiff feel better or to compensate him for his injured feelings or disappointment, but is merely to compensate him for breach of contract. Every expense incurred by a dismissed employee would not be recoverable, but where the loss flows [...] from the employment, then it is [...] properly recoverable as damages consequent upon the breach [of the employment contract]."*³⁹³

In the case of an unlawful premature termination, the damages for wrongful dismissal to

³⁸⁷ See, for example, Geoffrey S. Rehnert, "The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs" (1985) 37 Stan. L. Rev. 1147 at 1151.

³⁸⁸ *Brehm v. Eisner*, 746 A.2d 244 (Del. S.C., 2000) at 250. Ovitz's employment with Walt Disney could end in either one of three different ways, see Eric L. Johnson, "Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste" (2000) 26 Iowa J. Corp. L. 145 at 172: First, after the initial term of five years of the employment agreement was up, Walt Disney could decide not to offer him another contract in terms of not invoking the renewal clause. However, if Walt Disney decided to pursue this option, it would owe Ovitz a ten million dollar "termination payment". Second, Walt Disney could terminate Ovitz for "good cause", i.e. for gross negligence or malfeasance. In this scenario, Walt Disney would owe Ovitz no additional compensation. Finally, Walt Disney could terminate Ovitz without cause. This option "would entitle Ovitz to the present value of his remaining salary payments through September 30, 2000, a US\$ 10 million severance payment, an additional US\$ 7.5 million for each year remaining under the agreement, and the immediate vesting of the first three million stock options (the "A" Options)." The amount that Walt Disney would owe Ovitz under this option would amount in total to approximately US\$ 140 million dollars. The Board of Walt Disney had unanimously approved Ovitz's executive service contract.

³⁸⁹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* (2002), 27 B.L.R. (3d) 53, 214 D.L.R. (4th) 496 (Ont. S.C.J.), affirmed [2004] 183 O.A.C. 310, 42 B.L.R. (3d) 34 (Ont. C.A.).

³⁹⁰ *Ibid.* at para 4.

³⁹¹ See, for example, *Barrett v. Crabtree*, [1993] 1 S.C.R. 1027, 101 D.L.R. (4th) 66 (S.C.C.); *Edward v. Reinblatt*, 1995 CarswellQue 1936 (C.Q.); *Brown v. Shearer*, [1995] 6 W.W.R. 68 (Man. C.A.); *Vopni v. Groenewald* (1991), 84 D.L.R. (4th) 366 (Ont. Ct. (Gen. Div.)). Accordingly, severance pay, even if based upon an employment contract, does not constitute a debt for services rendered to the corporation, but rather a compensatory indemnity which cannot be recovered from the directors.

³⁹² *Husson v. Alumat Mfg.* (1991), 37 C.C.E.L. 252 (B.C.C.A.).

³⁹³ *Ibid.* at 254.

compensate the dismissed employee are calculated within the periods of time the employee is held to have been entitled to receive continued remuneration.³⁹⁴ This period will either be the reasonable notice period in the case of a contract of an indeterminate duration, or the remainder of the contract in the alternative case of a fixed-term contract. Generally, the courts will only award damages for the remuneration that would have accrued during the course of the employment until the lawful termination date.³⁹⁵ Put another way, the courts will award as damages not what the employee would have been paid if he had not been dismissed, but what he would have been paid during the period until the earliest lawful termination date.³⁹⁶ Hence, where an executive is entitled to one-year's notice of termination, he can claim the remuneration he would have received during this one-year period.

As for the severance package offered to the corporate executive, it will therefore be essential for the corporation to carefully determine the amount of remuneration the executive would have been entitled to receive during the applicable period until lawful termination. Remuneration has a broader meaning than salary. Salary usually refers to periodically paid fixed compensation, while remuneration designates any benefit or advantage having a pecuniary value to which the employee is entitled as a result of executing the work furnished by the employer.³⁹⁷ Over the past decades it has become increasingly common that an executive's remuneration is not composed only of base salary, but further elements of compensation. Therefore, the term executive compensation has been introduced to describe all different kinds of benefits that constitute the executive's remuneration in return for his services as an officer of the corporation.³⁹⁸ The typical executive compensation package is composed of contractual base salary, annual bonus entitlements, stock options, certain other perquisites as well as pension rights.³⁹⁹

³⁹⁴ *Dixon v. Merland Explorations Ltd.* (1984), 30 Alta. L.R. (2d) 310 (Alta. Q.B.); *Lyonde v. Canadian Acceptance Corp.* (1983), 3 C.C.E.L. 220 (Ont. H.C.J.); *Cathcart v. Longines Wittnauer Watch Co.*, *supra* note 358; *Turner v. Canadian Admiral Corp.*, *supra* note 343.

³⁹⁵ *Turner v. Canadian Admiral Corp.*, *supra* note 343; *Canadian Bechtel Ltd. v. Mollenkopf* (1978), 1 C.C.E.L. 95 (Ont. C.A.); *Sylvester v. British Columbia*, *supra* note 133.

³⁹⁶ See *Sandelson v. International Vintners Ltd.* (1987), 18 B.C.L.R. (2d) 86 (B.C.S.C.) at 90.

³⁹⁷ *Stikeman, Elliott*, *supra* note 134 at § 7.3.

³⁹⁸ At this point, the inevitable connection between executive compensation and severance pay is apparent. The severance package offered to a corporate executive will always be related to the components and amounts of his overall compensation package.

³⁹⁹ For more details on executive compensation, see Murphy, "Executive Compensation", *supra* note 89 at 2497-2517. A critical analysis of executive compensation with regards to performance is pursued by Bebhuk et al., *supra* note 92; and Bebhuk and Fried, *supra* note 94.

(1) Contractual Salary

The principle method of compensating executives still is payment of a fixed salary for the services rendered.⁴⁰⁰ The executive service contract generally establishes the executive's base salary and will often state that this amount cannot be decreased during the term of the agreement.⁴⁰¹ The executive will be entitled to receive the contractual base salary until the lawful date of termination. If the corporation keeps back any amounts due during the notice period or until the end of a fixed-term, it will be liable for breach of contract. On the other hand, the executive asking for base salary outstanding for the remainder of his term acts in accordance with the law. Therefore, when assessing the amount of a severance offer to the executive, the corporation should carefully consider any outstanding contractual salary entitlements of the executive. This will also include any vacation pay that the executive would have earned during the notice period or the remainder of his term had he not been prematurely dismissed.⁴⁰²

As noted earlier, some fixed-term executive service contracts provide for automatic renewal at the time of expiry of the term. Such renewal-clauses have caused uncertainty as to whether they are of pecuniary value for the assessment of damages or severance payment, respectively. An earlier judgment awarding compensation for the balance of the initial term and 50 % of the renewal term has been overruled to the finding that compensation should be paid only for the balance of the initial term.⁴⁰³ The courts have argued that it had not been foreseeable if the parties would have agreed on the renewal at the time of premature termination.⁴⁰⁴ As a result, on the basis of that case law, any potential base salary that would flow to the executive in the event of a renewal of his term does not need to be taken into consideration.

(2) Bonus entitlements

A bonus, whether a flat amount or a percentage of sales, profits, or even market

⁴⁰⁰ Stikeman, Elliott, *supra* note 134 at § 7.16 et seq.

⁴⁰¹ See Ocker and Schick, *supra* note 221 at 22.

⁴⁰² *Card Estate v. John A. Robertson Mechanical Contractors (1985) Ltd.* (1989), 26 C.C.E.L. 294 (Ont. H.C.J.); *Brown v. Black Clawson-Kennedy Ltd.*, *supra* note 142; *Mandell v. Apple Canada Inc.* (1990), 34 C.C.E.L. 319 (B.C.S.C.); *Cook v. Royal Trust*, *supra* note 364; *Stander v. B.C. Hydro & Power Authority* (1988), 25 B.C.L.R. (2d) 40 (B.C.C.A.); *Lefebvre v. Beaver Road Builders Ltd.* (1993), 49 C.C.E.L. 207 (Ont. Ct. (Gen. Div.)); *Koor v. Metropolitan Trust Co. of Canada* (1993), 48 C.C.E.L. 216 (Ont. Ct. (Gen. Div.)).

⁴⁰³ *Corriveau v. Québec (Procureur général)*, [1989] R.J.Q. 1 (Que. C.A.). See also *Gardner v. Stan-Canada Inc.*, *supra* note 116.

⁴⁰⁴ *Ibid.*

capitalization⁴⁰⁵ can be an integral part of the executive compensation structure.⁴⁰⁶ In corporate practice, bonus payments recently comprise the greater part of the executive's remuneration.⁴⁰⁷ Bonus entitlements can derive from an express provision in the executive service contract, a company bonus policy or plan or even from past practice.⁴⁰⁸

Damages may be awarded for the loss of a bonus which would have been paid during the notice period or balance of the term when there is evidence that the benefit formed an integral part of the executive's remuneration.⁴⁰⁹ To form an integral part of the executive's remuneration, the benefit must be one the executive anticipated he would have received had he not been prematurely terminated.⁴¹⁰ A bonus can be regarded as anticipated benefit when it is not a discretionary decision, such as when it is calculated according to an established bonus formula or practice, or when it is given with great regularity.⁴¹¹ In these instances, de facto payments of bonuses establishes a contractual basis to claim the bonus as a right. In contrast, if no contractual right exists, generally no bonus is due and payable to the executive.⁴¹²

A valid bonus entitlement will therefore be considered by the court when assessing damages for wrongful dismissal.⁴¹³ With respect to the quantum of damages to be awarded, the factors weighed include amounts paid to other executives,⁴¹⁴ amounts the executive would expect based on prior communication by the employer,⁴¹⁵ past practice,⁴¹⁶ discretion

⁴⁰⁵ See the so-called market capitalization bonus for F. Steven Berg in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁴⁰⁶ See *Poon, Wong & Associates Inc. v. Wong* [1991] B.C.W.L.D. 1186 (B.C.S.C.); *Sandelson v. International Vintners Ltd.*, *supra* note 396; *Clifton v. Ground Engineering Ltd.* (1982), 19 Sask. R. 181 (Sask. Q.B.).

⁴⁰⁷ *Stikeman, Elliott*, *supra* note 134 at § 7.41. The leading case regarding bonus entitlements is *Schumacher v. Toronto-Dominion Bank* (1999), 173 D.L.R. (4th) 577 (Ont. C.A.).

⁴⁰⁸ *Stewart v. Standard Broadcasting Corp.*, *supra* note 367; *Couture v. Volcano Inc.*, [1984] C.S. 546 (Que. S.C.); *CJMS Radio Montreal Ltée. v. Audette*, [1996] B.R. 756 (Que. C.A.).

⁴⁰⁹ *Hasler v. Spagnol's Wine & Beer Supplies Ltd.*, *supra* note 367; *Prins v. Lakeview Development of Canada Ltd.* (1990), 33 C.C.E.L. 155 (Ont. Ct. (Gen. Div.)); *Dixon v. Merland Explorations Ltd.*, *supra* note 394; *Koor v. Metropolitan Trust Co. of Canada*, *supra* note 402.

⁴¹⁰ *Stevens v. Globe & Mail*, *supra* note 142; *Prins v. Lakeview Development of Canada Ltd.*, *supra* note 409; *Speight v. Uniroyal Goodrich Canada Inc.* (1989), 97 N.B.R. (2d) 216 (N.B.Q.B.); *Jasmin v. Jean-Luc Surprenant Inc.*, 1983 WL 379798 (Que. S.C.).

⁴¹¹ *Reynolds v. First City Trust Co.*, *supra* note 358; *Sandelson v. International Vintners Ltd.*, *supra* note 396.

⁴¹² *Brock v. Matthews Group Ltd.* (1988), 20 C.C.E.L. 110 (Ont. H.C.J.), varied (1991), 34 C.C.E.L. 50 (Ont. C.A.); *Koor v. Metropolitan Trust Co. of Canada*, *supra* note 402.

⁴¹³ *Ryshpan v. Burns Fry Ltd.* (1995), 10 C.C.E.L. (2d) 235 (Ont. Ct. (Gen. Div.)), appeal dismissed (1996), 20 C.C.E.L. (2d) 104 (Ont. C.A.); *Roscoe v. McGavin Foods Ltd.*, *supra* note 363; *Gillespie v. Ontario Motor League Toronto Club* (1980), 4 A.C.W.S. (2d) 87 (Ont. H.C.J.).

⁴¹⁴ *Brock v. Matthews Group Ltd.*, *supra* note 412.

⁴¹⁵ *Cardwell v. Young Manufacturer Inc.* (1988), 20 C.C.E.L. 272 (Ont. Dist. Ct.).

⁴¹⁶ *Findlay v. Kershaw Mfg. Canada Ltd.*, *supra* note 350.

systematically exercised by the employer,⁴¹⁷ or what is a reasonable amount.⁴¹⁸ Accordingly, the same principles apply to the corporation when assessing the value of bonus entitlements as a part of the severance package to be offered to the executive.

(3) Stock Options

A component of executive compensation that has gained growing popularity as a part of executive compensation are stock options. Stock options have been proposed as a compensatory device to link executive compensation more closely to performance.⁴¹⁹ Currently, they comprise a higher percentage of the overall executive compensation than does the executive's base salary.⁴²⁰

When a corporation grants stock options as compensation to an executive, it grants to its executive the option to buy stock equity from the corporation at a certain price at a specific time in the future.⁴²¹ Typically, the purchase price offered by the corporation is roughly equivalent to the market value of the stock at the time the option is granted.⁴²² Such an offer is attractive only if the value of the stock is likely to rise, either through inflationary pressures or the hard work and diligence of the optionees. If the company's share price moves above the prescribed price, often called the "strike" or "exercise" price, the executive can exercise the option at the vesting date and make an immediate profit by selling the equity to the actual market value at the stock market.⁴²³

The incentive component which exists with such arrangements in light of performance pay is that the executive, being aware of the options, should be motivated to run the company in a

⁴¹⁷ *Reynolds v. First City Trust Co.*, *supra* note 358; *Sandelson v. International Vintners Ltd.*, 396; *Turner v. Canadian Admiral Corp.*, *supra* note 443.

⁴¹⁸ *Hillhouse v. Alexander Consulting Group Ltd.* (1989), 28 C.C.E.L. 73 (Ont. H.C.J.); *Arnot v. General Wire & Cable Co.* (1982), 2 C.C.E.L. 208 (Ont. H.C.J.).

⁴¹⁹ Although these option agreements are now a permanent part of American corporate practice, they produced considerable litigation at their initial appearance, the controversy focusing on sufficiency of consideration and corporate self-dealing, see, for example, *Kerbs v. California Eastern Airways, Inc.*, 33 Del. Ch. 69, 90 A.2d 652 (Del. S.C., 1952).

⁴²⁰ See Martin J. Conyon and Kevin J. Murphy, "The Prince and the Pauper? CEO Pay in the US and the UK" (2000) 110 (127) *Economic Journal*, Royal Economic Society F640 at F646-F647, available online at <<http://ideas.repec.org/a/ecj/econjl/v110Y2000i467pf640-71.html#download>> (last visited on March 20, 2005); Randall S. Thomas, "Should Directors Reduce Executive Pays" (2003) 54 *Hastings L. J.* 437 at 448.

⁴²¹ E. L. Johnson, *supra* note 388 at 146. See also *Black's Law Dictionary*, *supra* note 162 at "stock option" defining a stock option as "the right to buy a designated stock, if holder of option chooses, at any time within a specified period, at a determinable price. [...] Such options are often granted to management and key employees as a form of incentive compensation".

⁴²² See Harrison Campbell, *supra* note 172 at 288

⁴²³ Cheffins, *supra* note 97 at 506.

manner which ensures that the company's equity has a value higher than the strike price.⁴²⁴ However, since the executive has a mere option rather than being obliged to purchase the shares, in order to avoid any loss in the event the market value has unexpectedly decreased he is free to refrain from exercising his stock options.

Stock options need to be distinguished from so-called phantom stocks. The phantom stock plan is a monetary incentive plan in which the monetary award is determined in accordance with a formula based on actual stock prices and dividends.⁴²⁵ They are similar to common stock option plans except that they do not give a proprietary interest in the corporation.

With regard to an early termination of the executive, there are two possible implications for the severance package arising from stock options. If the stock options have been granted in view of a complete, fixed-term as executive of the corporation and if the stock options have already been vested prior to the termination of the executive, the corporation has the right to re-purchase the shares from the departing executive. The purchase price can either be paid separately to the executive or may be included as a part of the overall severance package in terms of a lump-sum payment. On the other hand, if the stock options have not been vested at the time the executive is prematurely terminated by the corporation, the executive will be entitled to compensation for the loss of future benefits arising from the potential vesting of the stock options. In this alternative, it will be difficult to determine the exact amount of compensation since the development of the market value cannot be predicted.

(4) Perquisites

Besides base salary, bonuses and stock options, the executive compensation can consist of further economic advantages that may not be paid in cash. Such perquisites include benefits such as the private use of company cars,⁴²⁶ corporate airplanes,⁴²⁷ club and membership fees paid for

⁴²⁴ However, stock options have been criticized in the past to the extent that they do not serve as an ideal incentive for better performance, see, for example, Cheffins, *Company Law*, *supra* note 98 at 114, 657, 686-687; Donald P. Delves, *Stock Options and the New Rules of Corporate Accountability: Measuring, Managing, and Rewarding Executive Performance* (New York: McGraw-Hill, 2003) and Bebchuk and Fried, *supra* note 94.

⁴²⁵ Stikeman, Elliott, *supra* note 134 at § 7.52.

⁴²⁶ For company cars, see also *infra* notes 433 through 435.

⁴²⁷ For a practical example, see Strauss, *supra* note 59 at 1B.

by the corporation for the executive's personal use,⁴²⁸ life insurance and other health benefits,⁴²⁹ special retirement payments,⁴³⁰ and forgiven loans.⁴³¹ In addition, the executive can benefit from the corporation paying the "gross-up", that is the taxes that executives otherwise would have to pay on all those perquisites.⁴³²

If corporate executives are provided with perquisites for both business and private use such as, for example, a company car, the value of the executive's personal use then forms part of his overall remuneration. In contrast, the value of the business use are general business costs for the corporation and, therefore, are deductible from corporate taxes.⁴³³ Once having been provided with a company car both for personal and business use, any removal of the vehicle or the allowance prior to the date of termination of the executive service contract is tantamount to a reduction in salary and, as such, the unilateral withdrawal will constitute a fundamental breach of the employment contract.⁴³⁴ In general, any restriction or withdrawal of a perquisite prior to the end of the executive's tenure constitute an unlawful reduction in remuneration. The loss of a benefit of such significant value will be held to constitute a constructive dismissal, entitling the executive to damages.⁴³⁵

Accordingly, if a company car was given to the executive for his personal use, an amount representing the loss of private use of the vehicle for the notice period or the remainder of the

⁴²⁸ *Carey v. F. Drexel Co.*, [1974] 4 W.W.R. 492 (B.C.S.C.); *Dixon v. Merland Explorations Ltd.*, *supra* note 394. On the other hand, such club dues can be intended to assist the employee in promoting the employer's business. In this context, they do not form part of the remuneration as perquisites, because they are a tool to carry on business, see *Douglas v. Sandwell & Co.*, *supra* note 343.

⁴²⁹ *Carey v. F. Drexel Co.*, *supra* note 428; *Nevin v. British Columbia Hazardous Waste Management Corp.* (1995), 129 D.L.R. (4th) 569 (B.C.C.A.); *Barrette v. Wabasso Inc.*, 1987 CarswellQue 789 (Que. S.C.); *Leduc v. Union Carbide du Canada*, 1984 WL 450292 (Que. S.C.).

⁴³⁰ For a practical example, see Reckard, *supra* note 60 at Business C4.

⁴³¹ For a practical example, see Strauss, *supra* note 427 at Money 1B.

⁴³² For a practical example, see Reckard, *supra* note 60 at Business C4.

⁴³³ *Salmi v. Greyfriar Developments Ltd.* (1983), 1 C.C.E.L. 82 (Alta. Q.B.), affirmed on this point (1985), 7 C.C.E.L. 80 (Alta. C.A.).

⁴³⁴ *Reilly v. Hotels of Distinction (Canada) Inc. (Hotel Le Grand/GrandHotel)*, [1987] R.J.Q. 1606, 18 C.C.E.L. 91 (Que. S.C.).

⁴³⁵ *Schwann v. Husky Oil Operations Ltd.* (1989), 27 C.C.E.L. 103 (Sask. C.A.); *Nerada v. Hobart Canada Inc.* (1982), 1 C.C.E.L. 116 (B.C.S.C.); *Brown v. OK Builders Supplies Ltd.* (1987), 14 C.C.E.L. xxxi (B.C.C.A.), affirming also *Reilly v. Hotels of Distinction (Canada) Inc. (Hotel Le Grand/GrandHotel)*, *supra* note 434.

The implications of a premature removal of a company car that has been provided also for the private use of the executive are similar under German contract and employment law, see Matthias Nussbaum and Larissa van Buerck, "Herausgabe des Dienstfahrzeuges während der Freistellung des Arbeitnehmers" (2002) 42 Betriebsberater 2278 (BB 2002, 2278).

term will usually be awarded as damages.⁴³⁶ Consequently, damages for the loss of any kind of perquisite will be properly included in an award of damages for wrongful dismissal.⁴³⁷ The main problem arising from this principle is the appropriate assessment of the damages of specific kinds of perquisites. For example, some courts have held that the evaluation of the loss of insurance and medical benefits shall be based on the cost to the employee to purchase similar benefits or coverage of equivalent insurance.⁴³⁸ Another way of determination would be the increase of the remuneration by the cost to the employer for such benefits over the notice period.

Regardless of the method of assessment, the appropriate value of the perquisites lost due to premature termination should also be included in any offer of severance as the executive is legally entitled to benefit therefrom for the contractually agreed term. The alternative to the offer of a lump-sum equivalent to the value of the benefit would be for the corporation to continue to provide the executive with the benefits for the promised term despite the early termination of his employment relationship.⁴³⁹

(5) Contributions to a Pension Plan

Finally, the executive may enjoy benefits in terms of the corporation's contributions to a pension plan on his behalf. Commonly, such pension benefits are paid for by salary deductions and are treated in the employment contract as part of the remuneration of employment.⁴⁴⁰

Claims by employees for pension benefits after termination from employment have met with success in the courts. If an employee is terminated without cause, he is entitled to compensation for loss of his future benefits under the pension plan.⁴⁴¹ In *Mosier v. Linden-Alimak Inc.*,⁴⁴² the court ruled that an implied term of the employee's pension plan was that employees terminated without cause prior to the retirement age are entitled to a pension

⁴³⁶ *Stevens v. Globe & Mail*, *supra* note 142; *Bruce-Vaughan v. Dalmys (Canada) Ltd.* (1992), 40 C.C.E.L. 112 (B.C.S.C.); *Brown v. Black Clawson-Kennedy Ltd.*, *supra* note 142; *Carle v. Comité Paritaire du Vêtement pour Dames* (1987), 22 C.C.E.L. 281 (Que. S.C.); *Wood v. Brown Boveri Canada Inc.* (1986), 15 C.C.E.L. 178 (B.C.C.A.); *Dixon v. Merland Explorations Ltd.*, *supra* note 394; *Blackburn v. Coyle Motors Ltd.* (1983), 3 C.C.E.L. 1 (Ont. H.C.J.); *Lefebvre v. Beaver Road Builders Ltd.*, *supra* note 402.

⁴³⁷ With regards to damages for the loss of insurance and medical plans, see *supra* note 429.

⁴³⁸ This is the favourite approach in British Columbia, see *Cooper v. MacMillan Bloedel Ltd.* (1991), 56 B.C.L.R. (2d) 341 (B.C.S.C.); *Sorel v. Tomenson Saunders Whitehead Ltd.*, *supra* note 346; *Wilks v. Moore Dry Kiln Co. of Canada* (1981), 32 B.C.L.R. 149 (B.C.S.C.); *Douglas v. Sandwell & Co.*, *supra* note 343; *Nevin v. British Columbia Hazardous Waste Management Corp.*, *supra* note 429. For Ontario, see *Addison v. M. Loeb Ltd.* (1986), 25 D.L.R. (4th) 151 (Ont. C.A.).

⁴³⁹ In fact, even the use of corporate airplanes by retired C.E.O.s is not unprecedented. For example, Eastman Kodak's C.E.O. George Fisher got limited use of the company jet for two years following his retirement in December 2000 and former Rockwell International C.E.O. Donald Beall has had use of the company jet for "business" travel ever since he retired in 1997, see Strauss, *supra* note 427 at Money 1B.

⁴⁴⁰ *Dickinson v. Northern Telecom Canada Ltd.* (1985), 7 C.C.E.L. 139 (Ont. Co. Ct.)

⁴⁴¹ *Mosier v. Linden-Alimak Inc.* (1985), 8 C.C.E.L. 45 (B.C.S.C.).

⁴⁴² *Ibid.*

calculated on full past service.

Thus, the value of the executive's lost or reduced pension benefits is another important factor to be considered in awarding damages for wrongful dismissal.⁴⁴³ This head of damages aims at compensating the executive for the reasonable expectation that, had he not been prematurely dismissed, he would have been entitled to greater pension benefits. Accordingly, the value of the executive's pension rights need also be considered by the corporation as part of the severance package in order to avoid damages for wrongful dismissal.

However, the courts have difficulties in assessing the value of the pension rights as part of the damages. Two methods of determination are applied by the courts. According to a first school of thought, the executive is entitled to an amount representing the contributions his employer would have made to the pension plan during the remaining period of employment with respect to which compensation is owed.⁴⁴⁴ This approach is opposed by the method that the executive must be compensated for the actual loss incurred in terms of benefits. He will receive an amount reflecting the difference between the pension benefits he will actually receive upon retirement and those he would have received had employment continued for the full term or through the notice period with regular contributions having been maintained.⁴⁴⁵ No matter what method might be held favorable in practice, the loss of future pension benefits will have to be considered as a part of the executive severance package if the corporation seeks to comply with all of the executive's contractual rights to compensation.

(6) Aggravated Damages

In addition to the classical heads of damages for wrongful dismissal mentioned above, the corporation as employer may be held liable for aggravated damages. In *Vorvis v. Insurance Corp. of British Columbia*,⁴⁴⁶ the Supreme Court of Canada confirmed the validity of claims for aggravated damages under appropriate circumstances in wrongful dismissal actions. Aggravated

⁴⁴³ *Boylan v. Canadian Broadcasting Corporation* (1994), 3 C.C.E.L. (2d) 64 (Alta. Q.B.); *Cook v. Royal Trust*, *supra* note 364; *Durrant v. B.C. Hydro & Power Authority*, *supra* note 364; *Bardal v. Globe & Mail Ltd.*, *supra* note 335.

⁴⁴⁴ *Thomas v. Surveyer, Nenninger, Chênevert Inc.*, *supra* note 323; *McKilligan v. Pacific Vocational Institute* (1979), 14 B.C.L.R. 109 (B.C.S.C.), varied [1981] 28 B.C.L.R. 324 (B.C.C.A.); *Fleming v. Safety Kleen Canada Inc.* (1996), 20 C.C.E.L. (2d) 140 (Ont. Ct. (Gen.Div.)); *Buerman v. Canada (Attorney General)* (1996), 19 C.C.E.L. (2d) 127 (Ont. Ct. (Gen.Div.)).

⁴⁴⁵ *Ansari v. B.C. Hydro & Power Authority*, *supra* note 346; *Doyle v. London Life Ins. Co.* (1985), 23 D.L.R. (4th) 443 (B.C.C.A.); *Turner v. Canadian Admiral Corp.*, *supra* note 343.

⁴⁴⁶ *Vorvis v. Insurance Corp. of British Columbia* (1989), 58 D.L.R. (4th) 193 (S.C.C.).

damages are awarded to compensate the terminated employee for injury arising from the termination.⁴⁴⁷ However, their scope in employment relations is limited. The Supreme Court of Canada concluded:⁴⁴⁸

“[The] rule long established [...] has generally been applied to deny [aggravated] damages [in] the employer/employee relationship [...]. [...] I would not wish to be taken as saying that aggravated damages could never be awarded in a case of wrongful dismissal, particularly where the acts complained of were also independently actionable [...].”

On these grounds, no claim for aggravated damages can be based on the conduct leading to the dismissal. Instead, aggravated damages will only be awarded contingent on the harsh manner in which the termination is effected or on any subsequent conduct, since each employee who has been dismissed is entitled to be treated in a candid, reasonable, honest and forthright fashion.⁴⁴⁹ Consequently, aggravated damages have been awarded in appropriate cases where the conduct of the employer constituted a separate wrong that was so egregious as to be deserving special censure.⁴⁵⁰ Accordingly, where the conduct of the corporation in dismissing the executive amounts to an independent cause of action causing harm to the executive, the executive may recover in aggravated damages.

However, the injury must not simply result from the dismissal itself but from the conduct of the employer such as failure to provide adequate notice in the event that the failure was deliberate or reckless and did not reflect a bona fide belief that it was adequate. Moreover, there must be some evidence that the employee suffered a material degree of genuine distress as a consequence of such treatment.⁴⁵¹ Intangible elements such as pain, anguish, grief, humiliation, wounded pride, damaged self-confidence or self-esteem, loss of faith in friends or colleagues, and similar matters that are caused by the conduct of the employer have all been regarded as sufficient injury as to award aggravated damages.⁴⁵²

In one case, aggravated damages of \$ 75,000 were awarded where the corporation acted in

⁴⁴⁷ *Ibid.* at para. 16.

⁴⁴⁸ *Ibid.* at paras. 21-22, considering *Addis v. Gramophone Co.* [1909], A.C. 488 (H.L.); and *Peso Silver Mines Ltd. v. Cropper*, [1966] S.C.R. 673 (S.C.C.).

⁴⁴⁹ *Wallace v. United Grain Growers Ltd.*, *supra* note 317.

⁴⁵⁰ *Vorvis v. Insurance Corp. of British Columbia*, *supra* note 446 at para 22; *Newlands v. Sanwa McCarthy Securities Ltd.* (1996), 12 O.T.C. 81 (Ont. Ct. (Gen.Div.)); *Hamer-Jackson v. McCall Pontiac Buick Ltd.* (1998), 38 C.C.E.L. (2d) 189 (B.C.S.C.), affirmed (2000), 3 C.C.E.L. (3d) 20 (B.C.C.A.).

⁴⁵¹ *Wilson and Taylor*, *supra* note 167 at 224.

⁴⁵² *Huff v. Price* (1990), 51 B.C.L.R. (2d) 282 (B.C.C.A.) at 294.

an improper, insensitive and high-handed manner in terminating a chief executive officer.⁴⁵³ The concerned C.E.O. had been terminated in a very public manner with public announcements by the corporation and the effect had been public humiliation, particularly in view of the fact that the allegations against him were unfounded.⁴⁵⁴ Furthermore, even where the corporation's conduct is something less severe but still amounts to bad faith or unfair dealings, the executive may recover damages through an extension of the notice period.⁴⁵⁵

Aggravated damages need to be distinguished from punitive damages. Punitive damages are intended to punish the employer rather than compensate the terminated employee.⁴⁵⁶ At common law, punitive damages are rarely awarded in cases of wrongful dismissal.⁴⁵⁷ The employer must be found to have conducted itself in a manner deserving punishment.⁴⁵⁸ Punitive damages are a means by which a court signals its disapproval of an employer that has treated the terminated employee in a harsh, dishonest, vindictive, reprehensible or malicious manner.⁴⁵⁹ A remarkable case where punitive damages were considered is *Bell v. Canada Development Investment Corp.*,⁴⁶⁰ where the plaintiff had been induced to leave his employment as Vice-President and Vice-C.E.O. to commence a five-year appointment as President and C.E.O. of the defendant corporation. The executive service contract was summarily terminated without cause three years prior to the expiry of the fixed term. Although the court disapproved of the conduct of the defendant corporation applying the test of *Vorvis v. Insurance Corp. of British Columbia*,⁴⁶¹ it did not hold that the conduct of the corporation's directors met the test and, therefore, did not award punitive damages.

⁴⁵³ *Hughes v. Gemini Foods Corp.* (1992), 45 C.C.E.L. 113 (Ont. Ct. (Gen. Div.)), affirmed (1997), 97 O.A.C. 147 (Ont. C.A.); See also *Brown v. Law Society of Upper Canada*, 1997 CarswellOnt 5934 (Ont. Ct. (Gen.Div.)); *Antonacci v. The Great Atlantic & Pacific Co. of Canada Ltd.* (1998), 35 C.C.E.L. (2d) 1 (Ont. Ct. (Gen. Div.)).

⁴⁵⁴ *Hughes v. Gemini Foods Corp.*, *supra* note 453.

⁴⁵⁵ See *Wallace v. United Grain Growers Ltd.*, *supra* note 317.

⁴⁵⁶ *Vorvis v. Insurance Corp. of British Columbia*, *supra* note 446 at para 16; See also *Marshall v. Watson Wyatt & Co.*, *supra* note 365. Another decision that excellently distinguishes between aggravated and punitive damages is *Huff v. Price*, *supra* note 452.

⁴⁵⁷ Punitive damages were awarded in *Makarchuk v. Midtransportation Services Ltd.* (1985), 6 C.C.E.L. 169 (Ont. H.C.J.); *Thom v. Goodhost Foods Ltd.* (1987), 17 C.C.E.L. 89 (Ont. H.C.J.). In turn, they were not awarded in *Colasurdo v. CTG Ing.* (1988), 18 C.C.E.L. 265 (Ont. H.C.J.); *Pierce v. Canada Trust Realtor, Division of Canada Trust Realty Inc.* (1986), 11 C.C.E.L. 64 (Ont. H.C.J.).

⁴⁵⁸ *Vorvis v. Insurance Corp. of British Columbia*, *supra* note 446 at para 59.

⁴⁵⁹ See *ibid.*

⁴⁶⁰ *Bell v. Canada Development Investment Corp.* (1990), 32 C.C.E.L. 16, 69 D.L.R. (4th) 178 (Ont. H.C.J.). See also *Squires v. Corner Brook Pulp and Paper Ltd.* (1994), 5 C.C.E.L. (2d) 206 (Nfld. S.C.).

⁴⁶¹ *Vorvis v. Insurance Corp. of British Columbia*, *supra* note 446 at para. 57.

2. Statutory Employment Standards Legislation

In addition to common law considerations, wrongful termination is governed in every Canadian province as well as the federal jurisdiction by statutory minimum notice requirements and, in the Ontario and federal jurisdiction, statutory severance.⁴⁶² These statutory requirements are minimum obligations and, in particular, do not displace the employee's common law entitlement to reasonable notice.⁴⁶³

First, as for the period of notice of termination, any notice required by the employment standards legislation must form the minimum base for notice in order to be an enforceable contractual term of the employment contract. Accordingly, any attempt to contract out of the minimum standards established by the Employment Standards Act is void. If an employment contract stipulates a period of notice less than that required by the applicable Employment Standards Act, the employee who was dismissed without cause is entitled to a reasonable notice period.⁴⁶⁴ The courts will imply a reasonable notice period according to the usual factors without drawing any inference from the expunged notice clause that the parties intended a notice period shorter than the usual notice period.⁴⁶⁵

Although the executive is subject to the applicable employment standard legislation, reasonable notice for an executive is much longer than the minimum statutory notice.⁴⁶⁶ Since the executive's entitlements to reasonable notice exceed the statutory minimum requirements, employment standards legislation can be neglected by the corporation when assessing the period of time the executive will be entitled to continued payment of compensation upon the premature termination of his service contract.

Secondly, if the executive is subject to the Federal or Ontario Jurisdiction, he might be entitled to statutory severance pay in addition to any severance payment offered by the corporation in lieu of notice as a settlement for outstanding claims.⁴⁶⁷ In Ontario and the federal jurisdiction, employment standards legislation provides that certain employees may be entitled to receive an extra statutory severance payment in addition to any other payment received upon

⁴⁶² For statutory severance, see also *supra* at Chapter 1, I. 3.

⁴⁶³ Wilson and Taylor, *supra* note 167 at 208.

⁴⁶⁴ *Machtinger v. HOJ Industries Ltd.*, *supra* note 335.

⁴⁶⁵ *Ibid.*

⁴⁶⁶ For the reasonable period of notice regarding corporate executives see *supra* at b).

⁴⁶⁷ See *supra* at Chapter 1, I. 3.

termination.⁴⁶⁸ That statutory termination pay is simply a lump-sum payment which the employer must pay on certain conditions to employees whose employment contract is permanently ended, usually for causes beyond the employee's control.⁴⁶⁹ With its main goal of appreciation of past services as an employee, statutory severance pay is designed to cushion the employee against the financial blow of unemployment rather than to compensate him for the loss of property in the job resulting from the dismissal.⁴⁷⁰

According to the Canada Labour Code, all employees with 12 consecutive months of service are entitled to statutory termination pay of the greater of two days' pay for each completed year of service or five day's pay.⁴⁷¹ In Ontario only those employers who terminate more than 50 employees in six months or less due to a plant or operation closing, or those who have a \$2.5 million or more payroll, are liable to pay statutory severance.⁴⁷² Furthermore, all severance payments under Ontario law are restricted to those employees with five or more years of service.⁴⁷³ Statutory termination payments in Ontario are also based on past service and closely approximate one additional week's pay for each year of service, up to a maximum of 26 weeks' additional pay.⁴⁷⁴

Whenever the executive falls under any of both jurisdictions and happens to comply with any of the applicable prerequisites for statutory termination pay, the respective amount should also be included in the severance package offered by the corporation. In order to avoid additional litigation, the corporation is advised to expressly state in the contractual severance provision or the "golden handshake" agreement that the amount awarded as severance payment also includes any entitlement under the Employment Standards legislation.

3. Conclusion for Employment Law

At common law, the corporation has an unfettered right to terminate the executive's

⁴⁶⁸ See Section 64 ESA, *supra* note 138; Sections 235 through 237 CLC, *supra* note 139. The term of severance pay used by those statutory provisions is likely to cause confusion. It must clearly be distinguished from the severance package voluntarily offered by the corporation in order to avoid action for wrongful dismissal. For better distinction, statutory severance pay will be referred to hereinafter as "termination pay".

⁴⁶⁹ England, Christie, and Christie, *supra* note 113 at § 14.55.

⁴⁷⁰ See, for example, *Mattocks v. Smith and Stone (1982) Inc.*, *supra* note 142; *Brown v. Black Clawson-Kennedy Ltd.*, *supra* note 142. See also *Stevens v. Globe & Mail*, *supra* note 142, where it was clarified that those payments are, therefore, deductible from damages for wrongful dismissal.

⁴⁷¹ See *supra* note 144.

⁴⁷² See Section 64(1) ESA.

⁴⁷³ See *supra* note 146.

⁴⁷⁴ See *supra* note 145.

employment with the corporation, subject only to the obligation to provide the executive with reasonable or contractually provided notice in the case where the executive is prematurely terminated without cause. Due to the executive's rank at the top of the corporation's hierarchy and given the special responsibilities conferred on him by the nature of his role as an officer of the corporation, the executive normally is at the high end of length of reasonable notice of termination.

The applicable period of notice can be replaced by a payment in lieu of notice, also referred to as severance payment. The severance package offered to the executive in lieu of notice should cover all those items of the individual executive compensation package that could have been included in a claim for damages for wrongful dismissal, such as outstanding base salary, bonuses, stock options and other benefits also known as perquisites. If the executive is entitled to statutory severance pay under the employment legislation of the federal jurisdiction of the jurisdiction of Ontario, the overall severance package should also include those mandatory severance payments.

As long as the corporation provides the executive with what he would be entitled to as damages for wrongful dismissal, it acts in accordance with the law and the severance package only complies with the minimum standards arising from contract and employment law. Thus, the executive severance package cannot be regarded as excessive or unlawful from this employment law perspective. Furthermore, provided that the corporation may wish to avoid litigation and, therefore, may wish the severance package to serve as an incentive for the executive to agree to an early settlement, it will have to consider a relatively generous severance package from the outset. In this event, even a severance package that reasonably exceeds the aggregated level of the executive's remaining contractual entitlements must be regarded as legally justified and, thus, as not excessive.

However, since the severance package will always be linked to the executive's overall compensation package, it is not surprising that the amounts of severance packages offered and awarded to corporate executives have recently raised more public concern. Critics should concentrate on the principles for the design of executive compensation packages rather than on the structure and amounts of the severance package strongly related to the compensation package. Any restriction as to the executive compensation package will implicitly result also in the decrease of the level of severance pay offered to the executive at the time of early departure, if the package is intended to serve as a compensation for the breach of the executive service contract.

III. Chapter Summary

In sum, this Chapter arrives at two main conclusions regarding the legal framework for executive severance and “golden parachute” packages. Contract law requires a valid contractual agreement between the executive and the corporation for any such package to be legally valid and enforceable. The parties generally have to choose to contractually agree upon the payment. They can either include a severance or “golden parachute” provision in the initial executive service contract. Alternatively, they have the right to conclude a separate agreement at any subsequent time. Such an agreement, which can also be referred to as a “golden handshake”, can be intended to serve as a settlement agreement that varies all existing rights and obligations under the original executive service contract, entitling the executive to a severance package in return for his consent to a premature termination of his employment relationship with the corporation. The agreement can also serve as an amendment of the existing contract, introducing a “golden parachute” provision that sets out additional entitlements for the event of a change in control of the corporation. All of those agreements are governed basically by the principle of freedom of contract, meaning that the parties are free to agree upon whatever terms they might think fit their purposes. Apart from the prerequisite of mutual consideration, contract law does not impose any limits on the structure or level of those agreements.

Secondly, I have shown that employment law neither provides any maximum restrictions for the parties’ freedom of contract with regards to the executive severance package. Instead, the law of dismissal sets out minimum standards for severance entitlements if the executive service contract is terminated prior to the expiry of its term or without notice in the absence of due cause. If the corporation intends to avoid an action for wrongful dismissal by the executive, it will need to comply with the minimum requirements for severance entitlements arising from employment law. The corporation, however, is free to agree upon an executive severance package that is in excess of those minimum standards from an employment law perspective.

Given that neither contract law nor employment law provide limits for executive severance packages and “golden parachutes” payments, the following Chapter will analyze if and to what extent legal constraints can be derived from corporate law and supplementary areas of the law.

CHAPTER 3

LEGAL CONSTRAINTS ON EXECUTIVE SEVERANCE PACKAGES

Thus far, I have shown that severance packages for executives can be based either on a provision in the original service contract or on a subsequent “golden handshake” agreement between the corporation and the executive. The same applies to “golden parachute” provisions as a special kind of severance benefits contingent on a change in control. According to contract law, all such severance agreements will be valid if they are supported by consideration.

As far as the structure and the amount of severance packages are concerned, those agreements are basically governed by the principle of freedom of contract. Freedom of contract presupposes that each party is advancing its own interests and that any resulting bargain is to their mutual advantage. The principle is only limited by the contract law doctrine of unconscionability where a court is concerned that one party is unable to act in its own best interests when bargaining. Accordingly, the design of an executive severance package strongly depends on the bargaining powers of both the executive and the corporation and, in principle, any contractual agreement between the executive and the corporation should be a result of arm's length negotiations. However, in the field of executive compensation and executive severance as such, the latest outrage about the amounts of executive severance packages suggests that the negotiation process between the executive and the corporation is remote from arm's length negotiations, resulting in what is called “excessive” executive compensation and severance agreements.

This Chapter discusses the impact of corporate law and supplementary laws and regulation on the bargaining process between the executive and the corporation with regards to severance and “golden parachute” provisions. In Part I, I will show that, especially in widely-held corporations, the interests of both parties involved in the bargaining process for general executive compensation and severance agreements are contrary rather than identical due to the existence of the agency problem caused by the separation of ownership and control. Whereas the corporation's interests will be to award the executive with as little compensation and severance as possible, the executive, on the other hand, will generally be interested in personal benefits deriving from his position as an officer of the corporation. I will argue that this problem causes a potential for managerial behaviour that is aimed at maximizing personal benefits rather than

shareholder value and, therefore, can result in severance packages that appear to be excessive. I will prove that under the current legal regime the executive disposes of sufficient managerial power to influence the contractual negotiations to his benefit, leading to what is called “managerial self-dealing” in terms of the diversion of corporate assets. However, as severance agreements are an essential part of the overall executive compensation package, they are only given within the jurisdiction’s framework of corporate law and its application.⁴⁷⁵ Based on these findings, I will then examine to what extent the law in terms of corporate governance and additional mechanisms imposes legal constraints on the bargaining behaviour of executives aimed at the improper diversion of corporate assets and, therefore, on the structure and the level of contractual severance and “golden parachute” provisions. Once I have established the main constraints imposed by the law, I will, in Part III of this Chapter, analyze the effectiveness of the different shareholder rights and remedies available under the present legal regime with the purpose to ensure optimal managerial bargaining behaviour or to enforce the corporation’s and the shareholders’ rights, respectively.

I. The Issue of “Managerial Self-Dealing”

Basically, any contract between the executive and the corporation is governed by the principle of freedom of contract. Accordingly, the exact design of a contractual severance provision or any subsequent “golden handshake” agreement depends on the bargaining powers of the parties involved. Except for any existing legal restrictions, the parties are free to bargain for their own best interests. If the process of negotiating the severance agreement were the result of arm’s length bargaining without any undue influence of any of the parties involved, one could hardly call the agreement “excessive” as the result of the bargaining process would only represent the combination of the best interests of the parties involved.

As far as the legal regime is concerned, the findings of Chapter 2 show that the prematurely terminated executive is entitled to a minimum of severance pay that is equivalent to the estimated damages for wrongful dismissal, if any. When bargaining for that minimum of severance pay, the executive’s bargaining behaviour can by no means be referred to as improper. If, however, the amount of severance agreed upon is perceived by shareholders or other parties as “excessive”, the focus will have to be on the process of reaching the overall compensation

⁴⁷⁵ See Iacobucci with Trebilcock, *supra* note 89 at 33.

package, as the structure and the amount of the severance package will to a great extent be linked to the structure and amount of the executive's compensation.

On the other hand, the law does not explicitly impose any limits as to the structure or the amount of executive severance packages. As a result, the contents of the executive severance package seems to depend only on how effective the parties are able to negotiate for their respective interests. As we will see, the interests and incentives of the executive negotiating for compensation or severance are not necessarily identical with the interests of the shareholders due to the existence of the agency problem in modern corporate law. If the executive had the potential to influence the bargaining process to the extent that he received compensation or severance in excess of the level that would result from arm's length negotiation, there would be a need for mechanisms of control of the executive behaviour in order to protect the interests of the corporation and its shareholders.

The starting point for the assessment as to whether the executive has the power to influence the bargaining process with the corporation and, consequently, as to whether there is a sufficient legal regime for control of managerial behaviour is the agency problem, caused by the separation of ownership and control in modern corporations, especially in corporations with dispersed shareholding.

1. The Separation of Ownership and Control and The Agency Problem

The main characteristic of a publicly-held corporation in North America is the separation of ownership and control.⁴⁷⁶ That separation causes contrary interests of the executive on one side and the corporation and the shareholders on the other side when negotiating executive contracts with respect to compensation in general. In their substantial work dating back to 1932, *Berle and Means* observed that the separation of ownership and control in the modern, publicly-held corporation led to opportunistic behaviour and unfettered discretion of corporate managers

⁴⁷⁶ Adolph A. Berle, Jr. and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: MacMillan Company, 1932, rev. ed. 1967) at 2-5. Berle and Means attributed that separation to the typical U.S. corporation which, at that time, typically consisted of widely-dispersed shareholders. Joel Bakan, *The Corporation: The Pathological Pursuit of Profit And Power* (Toronto: Penguin Books, 2004) at 6 states that, as early as 1776, that unique design was believed by many to be a recipe for corruption and scandal, referring to Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* [1770] (New York, Modern Library, 1937) at 100. The typical corporation in Canada, in contrast, is a closely-held corporation with one or a group of major shareholders, see *infra* in the following text. See also *infra* at Chapter 4, II. 1., especially note 1214 and accompanying text.

over corporate decisionmaking.⁴⁷⁷

Berle and Means discovered that the separation of ownership and control was caused by the wide dispersion of share ownership among institutional shareholders, a structure that, with regard to the U.S. corporate capital structure, still is of presence today. While dispersed shareholders “own” public corporations,⁴⁷⁸ corporate executives control them.⁴⁷⁹ The executives have substantial power and discretion to establish the future direction of the business and make the key strategic business decisions. The shareholders, in contrast, have virtually no power to control or influence the day-to-day-operation of their corporation or its long-term policies and rely on the executives to run the business in a way that generates a maximum of return for them. Shareholders essentially have no power to initiate corporate action and are entitled to approve or disapprove only a very few board actions. In economic terms, that separation creates a principal-agent-relationship between the shareholders being the principals and the executives as their agents.

As executives generally own only a small fraction of the firm’s equity,⁴⁸⁰ their interests in acting as an agent for the corporation are likely to diverge from the shareholders’ principle interests.⁴⁸¹ On the one hand, shareholders want their corporations to generate maximum profits and delegate broad discretion to executives to act in their best interests to do so. Executives, on the other hand, may run the company in a self-interested manner to maximize their own utility. The problem with such a divergence is that the executive, with only an attenuated interest in the firm’s profits, may manage in his own personal best interests rather than the firm’s best interests through attractive compensation packages, while the shareholders’ main concern is maximizing shareholder wealth through either stock appreciation or dividend income.⁴⁸² In other words, the

⁴⁷⁷ See *ibid.* at 2-5 and 84-89, describing how the separation of ownership and control in public corporation has led to effective control of the corporation by management rather than by shareholders.

⁴⁷⁸ As Stephen M. Bainbridge, “*The Business Judgment Rule as Abstention Doctrine*” (2004) 57 Vand. L. Rev. 83 at note 132 correctly points out, the corporation is in fact not a thing capable of being owned. Instead, per the most widely accepted theory of the corporation, the nexus of contracts model, the firm is a legal fiction representing a complex set of contractual relationships. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept under this model. See also Eugene F. Fama, “*Agency Problems and the Theory of the Firm*”, (1980) 88 J. Pol. Econ. 288 at 290.

⁴⁷⁹ See *Berle and Means*, *supra* note 476 at 2-5.

⁴⁸⁰ See Murphy, “*Executive Compensation*”, *supra* note 89 at 2490-93.

⁴⁸¹ Agency costs are the costs a principle faces as a consequence of suboptimal behaviour associated with outside capital, see Michael C. Jensen and William H. Meckling, “*Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*” (1976) 3 J. Fin. Econ. 305 at 307.

⁴⁸² See, for example, Edward M. Iacobucci, “*The Effects of Disclosure on Executive Compensation*” (1998) 48 U. T. L. J. 489 at 491.

separation of ownership and control opens the door wide to opportunistic behaviour by executives in terms of self-dealing, allowing them to operate the corporation to serve their own ends rather than those of the corporation's owners - the shareholders.⁴⁸³

Shareholders could limit the extent of those divergences by giving the managing executives appropriate incentives and by expending the resources to more efficiently monitor the executive's behaviour to curtail deviations.⁴⁸⁴ The executive may also expend bonding costs to guarantee that he will not undertake certain actions to harm the shareholders' interests or agree to compensate the shareholders if he does.⁴⁸⁵ Any remaining divergences between the executive's actual performance and the actions that the executive should have taken to maximize the shareholders' interests, are designated as residual losses.⁴⁸⁶ All those costs to shareholders associated with losses due to opportunistic behaviour by corporate executives and any expenditures by shareholders for the purpose of monitoring the executive behaviour or otherwise preventing these losses, are referred to as "agency costs".⁴⁸⁷ They are the costs associated with an agent managing the corporation in which the shareholder has his investment.⁴⁸⁸

The shareholders, however, with only a fractional interest in the profits of the firm, will not have enough incentive individually to monitor and discipline management.⁴⁸⁹ Shareholders will invest resources in monitoring only to the extent at which the marginal cost of monitoring equals the marginal benefit of reduced diversion by executives.⁴⁹⁰ In their leading work, *Berle and Means* put the problem in the following terms:

"The separation of ownership from control produces a condition where the interests of owner and ultimate manager may, and often do, diverge. [...] Those who control the destinies of the modern corporation own so insignificant a fraction of the company's stock that the returns from running the corporation profitably accrue to them in only a very minor degree. The stockholders, on the other hand, to whom the profits of the corporation go, cannot be motivated by those profits to a more efficient use of the property, since they have surrendered

⁴⁸³ Michael B. Dorff, "Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries" (2003) 51 Buffalo L. Rev. 811 at 813.

⁴⁸⁴ See Jensen and Meckling, *supra* note 481 at 308.

⁴⁸⁵ *Ibid.*

⁴⁸⁶ *Ibid.*

⁴⁸⁷ See *ibid.* at 307: "Agency costs are the costs a principal faces as a consequence of suboptimal behaviour associated with outside capital."

⁴⁸⁸ In any relationship where the principal and agent do not have the same interests, "agency costs" result. Agency costs include two components: first, the costs of the divergence between the agent's actual decisions and those decisions which would have maximized the principal's welfare (the "residual loss"); and second, those costs incurred by the parties in efforts to constrain this divergence, see *ibid.* at 308-309.

⁴⁸⁹ Iacobucci, *supra* note 482 at 491.

⁴⁹⁰ Alarie, *supra* note 96 at 47.

all disposition of it to those in control of the enterprise. The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use."⁴⁹¹

Put another way, the problem with minimal managerial ownership of the firm is that the executive does not bear the full costs of behaviour that, while privately beneficial to the manager, may be detrimental to the corporation and, thus, to the shareholder.⁴⁹² As the number of shareholders in a corporation increases and this separation between management and share ownership widens, the incentive for managers to engage in opportunistic behaviour also grows. If executives are shareholders at all, the size of their interest, typically, is very small relative to the aggregate of all shareholder interests, so the proportion of loss to them associated with acting in ways that further their own interests at the expense of the corporation's is correspondingly small.⁴⁹³

The agency costs associated with the separation of ownership and control of the corporation reduce the efficiency of corporate decision making and create the risk of inappropriate managerial behaviour.⁴⁹⁴ In general, there are two ways in which the executive may act to the detriment of the shareholders creating agency costs.⁴⁹⁵ First, the executive may actively divert corporate assets and income through self-dealing transactions.⁴⁹⁶ Alternatively, he may shirk his responsibilities or make poor business decisions.⁴⁹⁷ The risk of diversion and shirking is the price of operating the corporation through executives as agents.⁴⁹⁸ Thus, there is a need for control mechanisms in order to prevent executives from entering into contracts that are detrimental to shareholders as they cause excessive agency costs.

Before I turn to the different theoretical approaches that address the agency problem with a view to executive compensation, it should be noted that the capital structure of Canadian corporations fundamentally differs from that of the U.S. corporate culture. In contrast to the U.S.

⁴⁹¹ Berle and Means, *supra* note 476 at 7-9.

⁴⁹² Iacobucci, *supra* note 482 at 492; Jensen and Meckling, *supra* note 481 at 308.

⁴⁹³ See VanDutzer, *supra* note 185 at 252.

⁴⁹⁴ See, for example, Alan R. Palmiter, "Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence" (1989) 67 Tex. L. Rev. 1351 at 1367; Rehnert, *supra* note 387 at 1160; Jill E. Fisch, "Fundamental Themes in Business Law Education: Teaching Corporate Governance Through Shareholder Litigation" (2000) 34 Ga. L. Rev. 745 at 797.

⁴⁹⁵ Mark J. Roe, "Corporate Law's Limits" (2002) 31 J. Legal Stud. 233 at 242; Rehnert, *supra* note 387 at 1157.

⁴⁹⁶ See Ralph K. Winter, "State Law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 J. Legal Stud. 251 at 258.

⁴⁹⁷ Rehnert, *supra* note 387 at 1157.

⁴⁹⁸ Palmiter, *supra* note 494 at 1367.

structure of wide dispersion of shares, more than 70 per cent of Canada's public corporations are not legally or *de facto* controlled by the public, but rather by an individual or a family or another small group of shareholders.⁴⁹⁹ Also, a series of Canadian corporations are part of a larger corporate group with direct majority control over the affiliated corporation. Thus, the Canadian capital market consists of a majority of thinly-traded companies, with little or no institutional investment.⁵⁰⁰ According to a survey in 1990, of those companies that were listed on the Toronto Stock Exchange,⁵⁰¹ a majority had a single shareholder with legal control and more than three-quarters of the listed companies had either a single shareholder or a small group of three or less shareholders with either legal control or effective control of the corporation.⁵⁰² Moreover, in 1990 only 14 per cent of the companies listed on the TSX were widely held, and of all publicly traded companies on Canada's exchanges, only 5.4 per cent were widely traded and had significant institutional shareholder holdings.⁵⁰³ Additionally, in Canada, there is a much higher proportion of corporations with restricted voting or non-voting stock such that the owner of a minority of the equity owns the voting shares.

Given that different capital structure in Canada, the separation of ownership and control does not exist to the same extent as it does in the U.S. capital market. In Canada, the majority shareholder or group of shareholders are more likely to capture most of the gain from monitoring management, leading to a decrease of the disproportion between the costs and benefits of monitoring. In addition, since a single majority shareholder will possess legal or at least *de facto* control over the directors' election, the controlling shareholder can impose discipline on self-dealing managers by way of non-re-election or even removal from the board. Thus, for most of the publicly traded Canadian corporations, the problem is not the inability of widely dispersed shareholders to effectively monitor the managerial conduct, but rather that of an alliance between the management and a majority or controlling group of shareholders that might conduct the corporate affairs so as to the disadvantage of the minority shareholders or other corporate

⁴⁹⁹ Robert D. Brown, "Does Canada Have a Problem with Executive Compensation?" in Iacobucci with Trebilcock, *supra* note 89, 60 at 68. Also, a number of the most highly paid C.E.O.s of Canadian corporations are either individually or through family groups in control of their companies. See Jeffrey G. MacIntosh, "Executive Compensation: The Importance of Context" in Iacobucci with Trebilcock, *supra* note 89, 88 at 97.

⁵⁰⁰ Ronald J. Daniels and Jeffrey G. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991) 29 Osgoode Hall L. J. 863 at 873.

⁵⁰¹ The Toronto Stock Exchange will be referred to hereinafter as "TSX".

⁵⁰² Daniels and MacIntosh, *supra* note 500 at 884.

⁵⁰³ *Ibid.* at 877.

stakeholders.⁵⁰⁴ In Canadian capital markets, the conflict is not between managers and shareholders, but rather between controlling shareholders and non-controlling shareholders over transfers of wealth or use of the corporation for the non-pecuniary ends of the majority shareholder.⁵⁰⁵ Clearly, however, these differences do not lessen the need for corporate governance tools to protect the legitimate interests of minority shareholders and for securities regulation to protect market confidence and investors, as also in Canada executive compensation and severance agreements create agency costs that have implication on the shareholder value, be it that of a majority or a minority shareholder. Especially an inside director who is at the same time a shareholder of the corporation, might be inclined to divert corporate assets to himself by way of high compensation and severance agreements to the detriment of all minority shareholders who are unable to object that transaction through general shareholder participation due to the lack of necessary votes.

Therefore, when assessing the Canadian legal regime of control over executive severance agreements and “golden parachute”, special focus will have to lie on legal constraints with a view to the interests of that group of shareholders as well as to respective remedies.

2. Two Approaches to Corporate Governance

With respect to contracts regarding executive compensation in general or executive severance agreements in particular, in common law jurisdiction such as the U.S. and Canada legal scholars have used two different theoretical approaches as to the assessment of how effectively the agency problem is addressed through those agreements by contemporary corporate governance. In common law jurisdictions such as the U.S. and Canada, scholars have used mainly two theoretical tools to analyze the issues concerning executive compensation. Whereas mainly financial economists have first approached the topic of executive compensation by looking at it as a means that optimal aligns the interests of executives and shareholders,⁵⁰⁶ others have based their proposals for governance improvements on the theory that executives

⁵⁰⁴ Ronald B. Davis, “Fox in S-Ox North, a Question of Fit: The Adoption of United States Market Solutions in Canada” (2004) XXXIII (3) Stetson Law Review 955 at 982.

⁵⁰⁵ Ronald J. Daniels and Paul Halpern, “Too Close for Comfort: The Role of the Closely Held Public Corporation in the Canadian Economy and the Implications for Public Policy” (1991) 26 Can. Bus. L. J. 11; Daniels and MacIntosh, *supra* note 500 at 885.

⁵⁰⁶ “Optimal contract approach”, see *supra* note 91.

have the power to use executive compensation agreements to generate personal benefits.⁵⁰⁷ In the following, I will present the main arguments of each of the approaches as a basis for further discussions in the course of the thesis.

a) Optimal Contract Approach

Mainly financial economists have first approached that topic by the so-called “optimal contract approach”.⁵⁰⁸ According to that first approach, executive compensation arrangements, in general, are viewed as instruments used in the shareholders’ interest to address and, in the best case, eliminate the agency problem within the company.⁵⁰⁹ Proponents argue that the board of directors contributes to the attempt to maximize shareholder value by establishing optimal incentives for the executives in terms of the different features of their compensation package.⁵¹⁰ Therefore, executive compensation practices are regarded as a designated measure to minimize the agency costs and serve the management’s objective of maximizing shareholder value.

Under the optimal contract theory, an optimal executive compensation contract would be the result of at arm’s length negotiations between the board of directors and the executive. Such an optimal contract would be concerned with attracting and retaining highly qualified executives, providing executives with incentives to exercise sufficient efforts to generate maximum shareholder value, and to minimize the overall agency costs. Supporters of this approach claim that the parties involved in the bargaining process are constrained from deviating from optimal compensation in terms of influence by the different existing market forces. In their view, the markets for managerial labour, corporate control, capital and products effectively align executives’ and shareholders’ interests.⁵¹¹ Accordingly, no legal intervention in the corporate law arena is regarded to be necessary as the existing market mechanisms largely suffice to monitor

⁵⁰⁷ “Managerial power approach”, see *supra* note 92.

⁵⁰⁸ *Supra* note 91.

⁵⁰⁹ *Ibid.* See also other important early works such as Stephen A. Ross, “The Economic Theory of Agency: The Principal’s Problem” (1973) 63 Am. Econ. Rev. 134; James A. Mirrlees, “The Optimal Structure of Incentives and Authority within an Organization” (1976) 7 Bell J. Econ. 105; Bengt Holmstrom, “Moral Hazard and Observability” (1979) 10 Bell J. Econ. 74; Bengt Holmstrom, “Moral Hazard in Teams” (1982) 13 Bell J. Econ. 324; Steven Shavell, “Risk Sharing and Incentives in the Principal and Agent Relationship” (1979) 10 Bell J. Econ. 55; Sanford J. Grossman and Oliver D. Hart, “An Analysis of the Principal-Agent Problem” (1983) 51 Econometrica 7; Dilip Mookherjee, “Optimal Incentive Schemes with Many Agents” (1984) 51 Rev. Econ. Stud. 433.

⁵¹⁰ *Ibid.*

⁵¹¹ See, for example, Easterbrook, *supra* note 91 at 543-53; Daniel R. Fischel, “Race to the Bottom Revisited: Reflections on Recent Developments in Delaware’s Corporation Law” (1982) 76 Nw. U. L. Rev. 913 at 916-20; Fama, *supra* note 478 at 289.

executive behaviour and, thus, to prevent executives from diverting corporate assets by way of excessive compensation agreements.⁵¹²

First, it is argued that there exists a competitive labour market for executives imposing constraints on the degree to which executives can exercise control over contracts regarding their compensation. According to this view, there are three main ways in which the bargaining power of executives is restricted by the labour market. Not only are there many potential executives in the free labour market, but also is information about past performance easily available for corporations seeking new executives. Further, mandatory disclosure laws are regarded as a mechanism to publicize the prevailing market rates for executive compensation.⁵¹³ Secondly, supporters of the optimal contract theory argue that the market for corporate control serves as an effective constraint on the exercise of bargaining power by the executive.⁵¹⁴ They hold that if executive compensation is considerably excessive, competitors will recognize the potential of future profits if the compensation can be reduced by installing new executives as a result of a corporate takeover. Thirdly, a further potential constraint on managerial behaviour is regarded to be the product market. In a competitive product market inefficient managerial behaviour is regarded as likely to produce competitive disadvantage, shrinking profits and business failure.⁵¹⁵

Additionally, a payment of a specific amount of money to the executives is regarded as necessary in order to impress upon them the social costs and benefits associated with the quality of their performance⁵¹⁶. The incentive argument is that the benefits accruing to the executive by his compensation will have to be precisely offset by the increase in the value the executive generates with additional work effort.⁵¹⁷

Finally, in the event that compensation arrangements are viewed not to be optimal for shareholders, the optimal contract theory asserts that the existing shareholder remedies of corporate law are sufficient a mechanism to protect the shareholders' interests of maximum profit.⁵¹⁸ Accordingly, no further legal restrictions on managerial behaviour are necessary to prevent the executive from generating excessive personal benefits from his compensation

⁵¹² *Ibid.*

⁵¹³ Those three ways are summarized and discussed by Alarie, *supra* note 96 at 49.

⁵¹⁴ Easterbrook, *supra* note 91 at 564-70; Henry G. Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. Polit. Econ. 110.

⁵¹⁵ See Easterbrook, *supra* note 91 at 557.

⁵¹⁶ See Alarie, *supra* note 96 at 48.

⁵¹⁷ *Ibid.* at 50-51.

⁵¹⁸ The remedies available for shareholders will be discussed in more detail *infra* at III.

agreement.

b) Managerial Power Approach

Proponents of the “Managerial Power Approach”, in contrast, claim that executives have in fact the ability to influence their own compensation arrangements and that a broad array of legislation and regulation is necessary in order to appropriately constrain the executive’s behaviour.⁵¹⁹ Under the the managerial power approach, executive compensation is not regarded as a means to minimize the agency costs arising within the corporation, but rather as a part of the agency problem itself in terms that the executives use the compensation package to provide themselves with lucrative rents.⁵²⁰ Due to the high degree of power and influence of executives in the recent structures of corporate governance, the notion of an independent board of directors acting at arm’s length has been assumed by these commentators to be a mere legal fiction rather than being the rule in reality.⁵²¹

In their substantial work, *Bebchuk, Fried and Walker* bring forward a series of arguments to present the limitations of the optimal contract approach as support for their thesis that executives in fact have the power to influence the bargaining process with the board of directors.⁵²² The authors argue that, although some market constraints may exist, they do not constitute sufficient restrictions on managerial behaviour.⁵²³ As for the managerial labour market, their assertion is that there is no effective labour market for executives as most of the positions for executives are filled internally.⁵²⁴ Additionally, it is argued that, given the existence of some market for executives, the possibility of being hired for another executive position is unlikely to deter the executive from self-dealing.⁵²⁵ Concerning the market for corporate control, the authors propose that a takeover threat is unlikely to discourage managers from seeking to divert corporate assets to their own benefits, as the proportional relationship between the increase

⁵¹⁹ See, for example, Victor Brudney, “*The Independent Director – Heavenly City or Potemkin Village*” (1983) 95 Harv. L. Rev. 597 at 610; *Bebchuk et al.*, *supra* note 92 766-769.

⁵²⁰ “Rents” as used as in economic term under this approach has the meaning of a value in excess of that which executives would receive as compensation under the optimal contract approach, see *Bebchuk et al.*, *supra* note 92 at 784.

⁵²¹ One of the first critics of the traditional concept of corporate governance was Myles Mace, *Directors: Myth and Reality* (Cambridge: Harvard Business School Press, 1971).

⁵²² *Bebchuk et al.*, *supra* note 92 at 764-783.

⁵²³ *Ibid.* at 774-779.

⁵²⁴ *Ibid.* at 776, citing Melvin A. Eisenberg, “*The Structure of Corporation Law*” (1989) 89 Col. L. Rev. 1461 at 1495.

⁵²⁵ *Ibid.* at 776.

of the takeover risk and the reduction of firm value is rather small.⁵²⁶ Further, with respect to the potential constraint on managerial behaviour caused by product markets, *Bebchuk et al.* argue that the redistribution of firm profits from shareholders to executives has no significant effect on the operational efficiency of the corporation.⁵²⁷

As far as the optimal incentives for executive performance are concerned, several commentators have supported their approach against the optimal contract theory by delivering empirical evidence that executive compensation in the past corporate practice did not relate closely enough to performance.⁵²⁸ With respect to performance-based pay, in particular the tendency to provide executives with stock options has been heavily criticized, although stock options have long been regarded as one of the strongest tools for compensation under the optimal contract approach.⁵²⁹ In this context, *Bebchuk et al.* have especially criticized the rare use of so-called “reduced-windfall options”, i.e. options with features that screen out effects beyond managers’ control.⁵³⁰

Moreover, the supporters of the managerial power approach assert that the mechanisms available for shareholders to challenge executive compensation agreements are not sufficiently effective.⁵³¹ Neither the judicial review by way of the derivative action nor the ability for shareholders to vote against stock option plans are regarded sufficient to impose much of a constraint on the risk of managerial misbehaviour.⁵³² In fact, as we will see, the legal institution of the business judgment rule does impose an essential obstacle to judicial review of the transactions concerned.⁵³³ Furthermore, as the classical executive compensation scheme and, therefore, also the severance structure, consists of several parts of remuneration of which stock options are only one part, shareholder opposition by vote against the stock option plan indeed

⁵²⁶ *Ibid.* at 777.

⁵²⁷ *Ibid.* at 778. See also Eisenberg, *supra* note 524 at 1489.

⁵²⁸ See Michael C. Jensen and Kevin J. Murphy, “Performance Pay and Top-Management Incentives” (1990) 98 J. Pol. Econ. 225 at 227; Ramy Elitzur and Paul Halpern, “Executive Compensation and Firm Value” in Ronald J. Daniels and Randall Morck, eds., *Corporate Decision Making in Canada* (Calgary: University of Calgary Press, 1995); Xianming Zhou, “CEO pay, firm size, and corporate performance: evidence from Canada” (2000) 33 Can. J. Econ. 213 at 215.

⁵²⁹ *Supra* note 96.

⁵³⁰ *Bebchuk et al. supra* note 92 at 797.

⁵³¹ *Ibid.* at 779-783.

⁵³² Shareholder remedies such as derivative actions, however, do exist and are available for shareholders to challenge any agreement between the executive and the corporation. Their effectiveness as a remedy to prevent managerial self-dealing with respect to severance agreements will be examined in more detail *infra* at III. 3.

⁵³³ See *infra* at II. 2. c).

seems to be only of limited effectiveness in challenging the agreement as a whole.

The arguments brought forward so far by both theories may be subject to intense judicial debate. Especially the conclusion drawn by *Bebchuk et al.*, that executives use their managerial power to extract rents by way of compensation agreements has already been in the focus of criticism.⁵³⁴ And although one might agree with the proponents of the optimal contract approach that there exist certain market forces that might serve as restrictions to managerial behaviour regarding executive compensation, those forces do not seem likely to suffice as optimal constraints to managerial influence on the bargaining process. When comparing the concepts of both approaches, I am sympathetic with the conclusion that the approaches cannot be seen from an alternative perspective. In fact, executive compensation agreements can be regarded to be cumulatively shaped both by market forces that push towards shareholder value-maximizing outcomes, and by managerial influence that leads departure from the optimal model of arm's length bargaining to the direction favourable to the executive. As even *Bebchuk et al.* concede, "the managerial power approach merely implies that compensation practices cannot be adequately explained by optimal contracting alone".⁵³⁵

However, the hypothesis of the managerial power approach that executives have the power to influence both the level and the structure of their compensation is indisputable.⁵³⁶ The most compelling argument in favour of that conclusion has not been mentioned yet. According to the managerial power approach, most of the decisions concerning executive compensation are not made by truly independent boards in legitimate arm's length negotiation due to the deficiencies of the present regime of corporate law governing the process of setting executive compensation.⁵³⁷ Whereas the board of directors under the traditional model of corporate governance is supposed to establish the basic corporate objectives and policies, to critically analyze management and to select future executives of the company, empirical research has shown that none of these fundamental principles are duly respected in practice.⁵³⁸ Most of the

⁵³⁴ See Murphy, *supra* note 92.

⁵³⁵ *Bebchuk et al.*, *supra* note 92 at 755.

⁵³⁶ See also Murphy, *supra* note 92 at 851.

⁵³⁷ See *Bebchuk et al.*, *supra* note 92 at 765-774.

⁵³⁸ See, for example, Mace, *supra* note 521; Melvin A. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (Toronto: Little, Brown and Company, 1976) at 148-75; Brudney, *supra* note 519 at 597. This empirical evidence has been proven to remain the case recently by Anil Shivdasani and David Yermack, "CEO Involvement in the Selection of New Board Members: An Empirical Analysis" (1999) 54 (5) *Journal of Finance* 1829.

boards of directors delegate responsibility for setting performance targets, strategies and policies to their executives.⁵³⁹ Secondly, most directors reveal a tendency not to question the acts of management performed by the executives, except for those directors who own a substantial percentage of shares of the company supervised.⁵⁴⁰ As to the selection of new executives, research has shown that it is often the outgoing C.E.O. who recommends his successor to the board of directors.⁵⁴¹ Even more, as executives now also seem to be involved in director selection, the directors newly selected are likely to be less independent and to monitor executives less aggressively which can cause a serious conflict of interest.⁵⁴² All these developments illustrate that managers with power are able to negotiate executive compensation packages and lucrative severance agreements that might be in excess of what they would receive under optimal contracting circumstances.⁵⁴³

I will focus on the criticized principles for setting executive compensation in the following section. My finding there that the present regime creates certain conflicts of interests for the parties involved in the process will serve as a basis for the subsequent survey of the effectiveness of the existing constraints the law imposes on the bargaining behaviour of executives when exercising their powers.

3. The Legal Regime Governing Contracts between Executives and the Corporation

As a general rule, the board of directors exercises all corporate powers and is required to manage or supervise the management of the business and the affairs of the corporation.⁵⁴⁴ Accordingly, the legal responsibility for entering into a contract with an executive on behalf of the corporation rests upon the board of directors.⁵⁴⁵ Within its competence, the board of directors is charged with setting the executive compensation which also includes the responsibility for

⁵³⁹ Mace, *supra* note 521.

⁵⁴⁰ *Ibid.*

⁵⁴¹ *Ibid.* See also Myles Mace, "Directors: Myth and Reality -- Ten Years Later", (1979) 32 Rutgers L. Rev. 293 at 297.

⁵⁴² See Shivdasani and Yermack, *supra* note 538 at 1831.

⁵⁴³ See Bebchuk *et al.*, *supra* note 92 at 783.

⁵⁴⁴ See, for example, Section 102(1) CBCA.

⁵⁴⁵ See Section 125 CBCA.

negotiating severance or “golden parachute provisions” and “golden handshake” agreements.⁵⁴⁶ The decisions relating to both the structure and the level payable to executives are at the exclusive discretion of the board of directors.⁵⁴⁷ Unless otherwise provided in the corporate articles, by-laws or an unanimous shareholder agreement, directors of a corporation can establish the remuneration of executives without shareholder approval.⁵⁴⁸

When exercising its authority, the board of directors must act as a collective organ.⁵⁴⁹ The board is bound by the procedures set out in the corporate statute and must always comply with any notice and quorum requirements established for the decision making process.⁵⁵⁰ Thus, as a general principle, a resolution by the entire board of directors is necessary. The board usually acts by a majority vote at formally held meetings. Individual directors, in contrast, have no inherent authority to bind the corporation. However, pursuant to most corporate statutes, the articles, the by-laws or any unanimous shareholder agreement can provide for the delegation of that authority to a managing director, any other officer or a special board committee.⁵⁵¹

One of the leading principles of many corporate governance models is the independence of the board of directors from management. The importance of the independence of the board has developed from the conviction that directors who have no relationship with management and who do not owe their positions on the board to management are best able to monitor management's performance and to intervene when it is in the best interest of the corporation to do so.⁵⁵² Regarding the process of setting executive compensation, the optimal contract approach assumes that the directors act adversarially and independently only in the best interest of the shareholders.⁵⁵³ The board is viewed as serving shareholder interests exclusively by bargaining with the executive at arm's length. However, this optimal assumption of an independent board of directors is rebutted in practice due to the existence of several conflicts of interests and other

⁵⁴⁶ See also Laura Lin, “The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence” (1996) 90 Nw. U.L. Rev. 898 at 928.

⁵⁴⁷ See, generally, Stikeman, Elliott, *supra* note 134 at § 11.82.

⁵⁴⁸ *Ibid.* at § 20.147.

⁵⁴⁹ Mark Gillen, Brian Cheffins, Jeff MacIntosh, Ann McLean, Lisa Philipps, Jean Turgeon, and Mary Ann Waldron, *Corporations and Partnerships: Canada* (Deventer and Boston: Kluwer Law and Taxation Publishers, 1994) at s. 288 (p. 107).

⁵⁵⁰ *Giannotti v. Wellington Enterprises Ltd.* (1997), 69 A.C.W.S. (3d) 84 (Ont. Ct. (Gen. Div.)).

⁵⁵¹ See, for example, Section 125 CBCA. However, note that the power to delegate authority is restricted by Section 115(3) CBCA.

⁵⁵² Carol Hansell, *What Directors Need to Know: Corporate Governance* (Toronto: Carswell, 2003) at 70.

⁵⁵³ See Bebhuk et al., *supra* note 92 at 764.

deficiencies.⁵⁵⁴

a) Presence of Inside Directors

First, U.S. and Canadian corporate law allows directors to also be employees and, in particular, officers of the corporation.⁵⁵⁵ Directors who are also part of the management of the company are commonly referred to as “inside directors”, whereas directors who are not currently employed by the corporation as executives or otherwise are regarded as “outside directors”.⁵⁵⁶ As most of Canadian corporate law statutes only require some of the directors to be outside directors,⁵⁵⁷ most of the boards of directors in fact consist of both, inside and outside directors.⁵⁵⁸

The presence of inside directors creates an apparent conflict of interest as soon as the director is involved in the process of setting the compensation for himself as an executive of the corporation. Voting on his own compensation constitutes an excellent opportunity for self-dealing as the law does not distinguish between outside and inside directors. Rather, the board is responsible for the decision as a whole, not preventing the insider from participating in the voting process on his own compensation. Section 120(5)(a) CBCA allows the inside director to vote even though the resolution relates primarily to his own remuneration as a director, officer, or other sort of employee of the corporation. Thus, the insider may be inclined to favour his personal interests for profits over the shareholders’ interests receiving a maximum of shareholder value. In general, due to pure self-interest, inside directors are unlikely to participate independently and critically in effective evaluation and monitoring of executives, including the process of negotiating executive compensation agreements.⁵⁵⁹

⁵⁵⁴ In fact, executive compensation is regarded to be “probably the most frequently recurring conflict-of-interest situation with which the board [of directors] must deal.”, see Lin, *supra* note 546 at 905. See also Charles M. Yablon, “Bonus Question – Executive Compensation in the Era of Pay for Performance” (1999) 75 Notre Dame L. Rev. 271 at 271/272.

⁵⁵⁵ For Canada, see Section 102(2) CBCA *e contrario*. Case law includes *Montréla Public Service Co. v. Champagne*, (1916), 33 DLR 49 (P.C.); *Read v. Astoria Garage (Streatham) Ltd.* [1952] 1 Ch 637; *Southern Foundries (1926) Ltd. v. Shislaw* [1940] A.C. 701; *Shindler v. Northern Raincoat Co.* [1960] All E.R. 239 (C.A.); *Warren v. Superior Engravers Ltd.* [1941], 1 D.L.R. 323 (Ont. C.A.); *Motherwell v. Schoof*, [1949] D.L.R. 812 (Alta. S.C.); *Ringuet v. Bergeron* (1960) 24 D.L.R. (2nd) 449 (S.C.C.).

⁵⁵⁶ See Lin, *supra* note 546 at 900; Hansell, *What Directors Need to Know: Corporate Governance*, *supra* note 552 at 74.

⁵⁵⁷ See, for example, Section 102(2) CBCA.

⁵⁵⁸ See Iacobucci with Trebilcock, *supra* note 89 at 36. See also the annual reports of corporations listed on the Toronto Stock Exchange, disclosing the structure of their boards of directors. Many reports are available online through the Toronto Stock Exchange’s web site at <<http://www.tsx.com>>.

⁵⁵⁹ See Michael C. Jensen, “The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems” (1993) 48 J. Fin. 831 at 865.

b) Compensation Committee

The boards of directors of many North American corporations have addressed that potential conflict of interest by establishing special compensation committees. Corporate by-laws of those corporations assign the responsibility for setting executive compensation to a committee that consists of three to five outside directors.⁵⁶⁰ The rationale for that approach is that only outside directors shall be responsible for establishing the appropriate contracting structure, the level and mode of compensation, and the performance targets for top management and, accordingly, make independent recommendations regarding the board of directors as a whole.⁵⁶¹

Despite the nominal independence of most compensation committees, however, insider conflicts still exist that may result in self-dealing rather than in arm's length decisions. The major problem is the remaining influence of management over the composition and decision making process of the compensation committee. One reason for such influence is that usually the C.E.O. is a member of the compensation committee *ex officio*.⁵⁶² It is commonly not the committee who takes the initiative in designing executive compensation agreements, but rather the C.E.O. who makes the initial compensation suggestions to the compensation committee to deliberate.⁵⁶³ The compensation committee's role is typically limited to reviewing, analyzing, approving, or revising proposals recommended by the management.⁵⁶⁴ In addition, executives still have a remarkable influence over the process of selecting and appointing outside directors, who will form the pool of candidates for the compensation committee. Although formally the shareholders elect the directors by shareholder vote,⁵⁶⁵ the shareholders have little input into the proxy process

⁵⁶⁰ Iacobucci with Trebilcock, *supra* note 89 at 36; Bebchuk *et al.*, *supra* note 92 at 765; Randall S. Thomas and Kenneth J. Martin, "The Effect of Shareholder Proposals on Executive Compensation" (1999) 67 U. Cin. L. Rev. 1021 at 1026; In the U.S., for instance, nine out of ten large public companies have an executive compensation committee, see Rehnert, *supra* note 387 at 1150.

⁵⁶¹ Rehnert, *supra* note 387 at 1150

⁵⁶² Paul Milgrom and John Roberts, *Economics, Organization and Management* (Englewood Cliffs: Prentice Hall, 1992) at 434.

⁵⁶³ Iacobucci with Trebilcock, *supra* note 89 at 37; Rehnert, *supra* note 387 at 1150. The C.E.O. can also indirectly influence the decision by the compensation committee by retaining a compensation consultant on behalf of the company, see *infra* at c). The reliance on the report of the consultant may constitute a defence for the directors. However, the retention of those consultants increases the level of a potential conflict of interests and, therefore, requires additional and independent considerations of the board, see *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389. See also *infra* at c).

⁵⁶⁴ See Rehnert, *supra* note 387 at 1150.

⁵⁶⁵ See, for example, Section 106(3) CBCA.

for director appointment.⁵⁶⁶ In most cases, candidates for directorship are selected by a nomination committee, which is established by the board of directors.⁵⁶⁷ In most elections of directors in publicly-held corporations, shareholders simply vote for whomever is proposed by the board or the company's nominating committee.⁵⁶⁸ It has been found that, despite the increasing use of nominating committees chaired by an outside director, the C.E.O. of the corporation still has tremendous influence over the nomination of board members.⁵⁶⁹ Often, the C.E.O. formally serves on the nomination committee himself.⁵⁷⁰ And even where the C.E.O. does not sit on the nominating committee, his influence on the nomination process is still generally thought to be considerable as C.E.O.s have stronger economic incentives to dominate than boards have to resist that domination.⁵⁷¹ Accordingly, the C.E.O. can use his power and influence to encourage the appointment of independent directors who are rather unlikely to challenge his compensation.⁵⁷²

Even more, in many corporations the C.E.O. is also the chairman of the board of

⁵⁶⁶ Thomas and Martin, *supra* note 560 at 1027. With the exception of approval for stock option programs, shareholder can voice their opinions to the board of directors in a variety of ways before and after the package is approved, but this only indirectly affects the outcome of the process.

⁵⁶⁷ See Jayne W. Barnard, "Shareholder Access to the Proxy Revisited" (1990) 40 Cath. U. L. Rev. 37 at 38; Bebchuk *et al.*, *supra* note 92 at 767.

⁵⁶⁸ Stuart Rosenstein and Jeffrey G. Wyatt, "Outside Directors, Board Independence, and Shareholder Wealth" (1990) 26 J. Fin. Econ. 175 at 176-77.

⁵⁶⁹ See Dorff, *supra* note 483 at 844; Lin, *supra* note 546 at 913 note 80. See also Brian G. M. Main, Charles A. O'Reilly, III, and James Wade, "The CEO, the Board of Directors, and Executive Compensation: Economic and Psychological Perspectives" (1995) 4 (2) Industrial and Corporate Change 293 at 302; Brudney, *supra* note 519 at 610 note 39; Benjamin E. Hermalin and Michael S. Weisbach, "Endogenously Chosen Boards of Directors and Their Monitoring of the CEO" (1998) 88 Am. Econ. Rev. 96 at 97.

⁵⁷⁰ See Shivdasani and Yermack, *supra* note 538 at 1834; Carl T. Bogus, "Excessive Executive Compensation and the Failure of Corporate Democracy" (1993) 41 Buff. L. Rev. 1 at 34, citing a survey with an admittedly small sample size that found 90-100% of all directorial candidates were recommended by the C.E.O.; Perry and Zenner, *supra* note 89 at 135-36.

⁵⁷¹ Shivdasani and Yermack, *supra* note 538 at 1834, report that despite a trend of companies removing C.E.O.s from board nominating committees, C.E.O.s still have a significant impact on the nomination process. See also Perry and Zenner, *supra* note 89 at 135-36, quoting the findings of Shivdasani and Yermack; Main, *supra* note 569 at 302-03; Bebchuk *et al.*, *supra* note 92 at 767; Susan J. Stabile, "One for A, Two for B, And Four Hundred for C: The Widening Gap In Pay Between Executives And Rank And File Employees" (2002) 36 U. Mich. J.L. Ref. 115 at 128.

⁵⁷² Bebchuk *et al.*, *supra* note 92 at 767. Directors who sit on compensation committees have themselves admitted that the committees are "in the pocket of the C.E.O.s", see Stabile, *supra* note 571 at 128, quoting Laura S. Unger, "This Year's Proxy Season: Sunlight Shines on Auditor Independence and Executive Compensation" address before the Center for Professional Education (June 25, 2001), available online at <<http://www.sec.gov/news/speech/spch502.htm>> (last visited January 10, 2005), citing admission of directors sitting on executive compensation committees. See also Carol J. Loomis, "This Stuff Is Wrong" Fortune (June 25, 2001) at 72 quoting compensation committee members who suggest that they feel helpless to curb executive pay.

directors.⁵⁷³ This insider situation creates the most obvious conflict of interests as the C.E.O. has an extremely wide control over the composition of the board of directors and its respective special committees. Evidence has been found that executive compensation is higher in corporations where the C.E.O. is also the chairman of the board.⁵⁷⁴ Thus, having an executive with the dual capacity of chairman and C.E.O. has been compared to be “like grading your own papers”.⁵⁷⁵

As a result, in many cases the executives have a great deal of influence of the director selection process. As a matter of convenience, management may exercise its power and control in order to select people for directorship who, although formally considered to be independent outside directors, tend to defer to the C.E.O., allowing the latter to readily pursue private incentives. In fact, many outside directors are far from being independent. For instance, the influence of executives over the composition of the boards of directors has led to the phenomenon referred to as “interlocking directorships”.⁵⁷⁶ A large number of outside directors who serve on the compensation committee are also C.E.O. of other corporations on whose boards the C.E.O. serves as an outside director.⁵⁷⁷ In this situation, each director has a reciprocal interest in not challenging each other’s authority around the boardroom table.⁵⁷⁸ If, in their role as C.E.O., they want their own companies’ board to remain passive, they have only little incentive to oppose management’s desire when they sit on the board of directors of other corporations.⁵⁷⁹ Besides, by approving a relatively high compensation for their fellow C.E.O., those directors are likely to implicitly justify their own remuneration as C.E.O. of a different corporation or, at least, increase the comparable compensation baseline for future negotiations.⁵⁸⁰

⁵⁷³ Iacobucci with Trebilcock, *supra* note 89 at 37.

⁵⁷⁴ See Kevin Hallock, “Reciprocally Interlocking Boards of Directors and Executive Compensation” (1997) 32 J. Fin. & Quantitative Analysis 331 at 332.

⁵⁷⁵ See Brigid McMenamin, “Safety Valve” *Forbes* (May 23, 1994) at 143, quoting the General Counsel to the California Public Employees’ Retirement System.

⁵⁷⁶ See Iacobucci with Trebilcock, *supra* note 89 at 37; Hallock, *supra* note 574 at 332; Charles M. Elson, “Executive Compensation – A Board-Based Solution” (1993) 34 (5) *Boston Coll. L. Rev.* 937 at 942; Dorff, *supra* note 483 at 845.

⁵⁷⁷ Elson, *supra* note 576 at 942; Dorff, *supra* note 483 at 845.

⁵⁷⁸ VanDutser, *supra* note 185 at 255.

⁵⁷⁹ Dorff, *supra* note 483 at 845. Warren Buffet has famously stated that “[t]here is a tendency to put cocker spaniels on compensation committees, not Doberman pinschers.”, quoted in Keith Naughton, “The Perk Wars: As Jack Welch’s retirement deal sparks an investor backlash, perks could become the new stock options” *Newsweek* (September 30, 2002) at 44.

⁵⁸⁰ See Bebchuk *et al.*, *supra* note 92 at 769.

c) Compensation Consultants

Another problem with the potential influence of executives rests with the increasingly frequent use of compensation consultants who are supposed to assist the compensation committee.

Without a doubt, the design of the optimal executive compensation package is difficult. Due to the unique position of the C.E.O. and other top executives, most of the compensation committees have no internal reference to what is being a reasonable, if not optimal compensation for the executives of their corporation.⁵⁸¹ The only benchmark available is external in terms of compensation of executives of comparable companies.⁵⁸² Therefore, many compensation committees have outside compensation consultants compiling compensation surveys on the committees behalf.⁵⁸³ From the optimal contracting point of view, compensation consultants are considered to contribute expertise on the design of compensation agreements by conducting data that would not be shared directly among companies.⁵⁸⁴ The use of outside compensation consultants grants directors the psychological benefit that they can easily rationalize the amount of compensation both to themselves and shareholders as being the product of independent external advice.

However, it is obvious that hardly any board of directors believes its C.E.O. to deserve less than the average level of compensation and, therefore, is prepared to pay less compensation than comparable executives receive. In contrast, as an incentive for the executive to outstanding performance, the board might be willing to set up a compensation scheme that is slightly above the average compensation determined by the market survey.⁵⁸⁵ Thus, there is a risk that the use

⁵⁸¹ As compensation committees often are composed of uninformed directors who serve as executives in other corporations, they often lack technical expertise in compensation issues, see Barris, *supra* note 150 at 76.

⁵⁸² See Stabile, *supra* note 571 at 131.

⁵⁸³ See Dorff, *supra* note 483 at 855; Iacobucci, *supra* note 482 at 496. According to a recent study of the use of compensation benchmarking, at least 65 percent of U.S. corporations use compensation consultants, see John M. Bizjack, Michael L. Lemmon, and Lalitha Naveen, "Has the Use of Peer Groups Contributed to Higher Levels of Executive Compensation?" working paper (November 15, 2000), available online at <<http://papers.ssrn.com/id=252544>> (last visited on January 12, 2005) at 44.

⁵⁸⁴ Of course, companies participate in the compensation surveys only on the basis that individual firm data is kept confidential, see Bebchuk *et al.*, *supra* note 92 at note 95.

⁵⁸⁵ See Stabile, *supra* note 571 at 131-132 notes 64 and 65, citing authorities for empirical evidence for "boards ratcheting up their C.E.O.'s compensation".

of external comparison leads to a steady increase of executive compensation.⁵⁸⁶ In fact, empirical evidence suggests that the use of competitive benchmarking significantly contributed to the remarkable explosion of executive compensation in the 1990s,⁵⁸⁷ and that the “ratcheting” effect of the use of compensation surveys extends beyond the C.E.O. to other executives.⁵⁸⁸

The problem with the use of compensation consultants is aggravated by the fact that C.E.O.s, as in the case of selection of candidates for directorship, often are also strongly involved in the hiring of compensation consultants.⁵⁸⁹ Executives can either influence the process through which compensation consultants are retained or directly hire them on their own account.⁵⁹⁰ That relationship at least implicitly places enormous pressure on the consultants to please the executive with the perspective to also be involved with the corporation in the future,⁵⁹¹ which establishes remarkable obstacles to the objectivity of compensation consultants. The issue of repeated business in the future is likely to create a conflict of interest for the consultants as does the ability of the C.E.O. to indirectly punish disliked consultants by not hiring them for other lucrative businesses such as general human resources consulting. As a result, compensation surveys that seem justifiable as a means to deal with the difficulty of setting executive compensation without an internal referent, appear to be rather a tool to justify large compensation agreements than a means of establishing an optimal compensation level in order to minimize agency costs.⁵⁹²

A recent Canadian case underlines the findings that the concerns regarding manipulative behaviour of inside directors or executives in general over the process of establishing the

⁵⁸⁶ See Bebachuk *et al.*, *supra* note 92 at 790: “It is widely understood that the methodology of compensation consultants and boards in devising compensation plans results in a ‘ratcheting up’ of salaries.” See also Charles M. Yablon, “Overcompensating: The Corporate Lawyer and Executive Pay” (1992) 92 Colum. L. Rev. 1867 at 1878: “It is not difficult to see how, in a world in which every C.E.O. believes he should be paid at or around the seventy-fifth percentile of the range of compensation levels developed by the compensation consultant, a strong upward pressure on compensation will result.”; Dorff, *supra* note 483 at 855; Stabile, *supra* note 571 at 131; Susan J. Stabile, “Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform” (2000) 35 Wake Forest L. Rev. 153 at 173-74.

⁵⁸⁷ Bizjack, Lemmon, and Naveen, *supra* note 583 at 2-4.

⁵⁸⁸ *Ibid.* at 3.

⁵⁸⁹ Stabile, *supra* note 571 at 131; Bebachuk *et al.*, *supra* note 92 at 790; Loomis, *supra* note 572 at 72, discussing the view that consultants act on behalf of the managers who hire and rehire them; Iacobucci with Trebilcock, *supra* note 89 at 38; Graef S. Crystal, *In Search of Excess: The Overcompensation of American Executives* (New York: W.W. Norton, 1991) at 220.

⁵⁹⁰ According to Iacobucci, *supra* note 482 at 496, compensation consultants are usually hired by the executives to assist the compensation committee of the board.

⁵⁹¹ *Ibid.*; See also Bebachuk *et al.*, *supra* note 92 at 790; Stabile, *supra* note 571 at 132.

⁵⁹² Stabile, *supra* note 571 at 132.

executive compensation cannot always be effectively constraint by the use of compensation committees and external compensation consultants. In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,⁵⁹³ despite the presence of a compensation committee consisting of three outside directors and the hiring of a compensation consultant, the design of the executive compensation agreement was heavily dominated by the executive concerned, Mr. Berg, who was also the chairman of the board of directors. Being an inside director, Mr. Berg had not only influenced the composition of the board of directors as well as the compensation committee, but he had also exercised strong influence over the external compensation consultant. Two of the members of the compensation committee had been selected as directors by Mr. Berg in his capacity as chairman of the board.⁵⁹⁴ One of these outside directors had in fact never been director of a company before. The third member of the committee who was the only outside director had joined the board earlier than Mr. Berg.⁵⁹⁵ However, this independent director was not present at the committee's meeting concerned with Mr. Berg's compensation package, which is reported to have lasted not more than seven minutes before the package was affirmed. In addition, Mr. Berg had caused the lawyer previously retained exclusively by him to draft the compensation agreement and, subsequently, to retain an external compensation consultant as requested by the committee. In court, the consultant claimed that the lawyer had refused to provide important information necessary for the conduction of the benchmark survey.⁵⁹⁶

Both the establishment of a compensation committee consisting only of outside directors as well as the use of an external compensation expert resulted to be ineffective measures to prevent the influence of the executive over his own compensation. In its judgment, the court held that "[t]here was little that was independent about the process" of establishing the executive's compensation package.⁵⁹⁷ The conduct of the inside director amounted to self-dealing rather than to arm's length negotiations with the board.⁵⁹⁸

In conclusion, the existing intimate ties between top executives and the directors of the corporation impose inherent potential for conflicts of interests on the parties involved in the

⁵⁹³ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁵⁹⁴ *Ibid.* at para. 89-90.

⁵⁹⁵ *Ibid.* at para. 104.

⁵⁹⁶ *Ibid.* at para.102.

⁵⁹⁷ *Ibid.* at para. 118.

⁵⁹⁸ As a legal conclusion, the court held that by acting in such a self-interested manner, the director had breached the fiduciary duty he owed to the corporation, see *ibid.* at para. 123 and para. 185. The issue of fiduciary duties and possible shareholder remedies will be discussed *infra* at II. and III.

compensation setting process.⁵⁹⁹ Especially inside directors have extensive powers of influence over their own compensation.⁶⁰⁰ Executives have a direct financial interest in the outcome of the negotiations. Outside directors, on the other hand, have little at stake financially other than the potential of being ousted from the board. The compensation they agree to pay to the executive is not their own money. Thus, rather than negotiating earnestly on behalf of the shareholders, they are likely to rely on external studies that might have been influenced by the executive or even on proposals for compensation made directly by the executive himself. Directors may even be induced to set executive compensation higher than the average to attract a better grade of executives. This situation will inevitably lead to a race to the top rendering the negotiations between the board and the executive far from at arm's length negotiations for a compensation that optimally minimizes the agency costs arising within the corporation.

4. Impact on Executive Severance Packages and "golden parachute" provisions

The issue of managerial behaviour and potential influence over the bargaining process regarding executive compensation has several impacts on executive severance packages and "golden parachute" provisions.

As a first implication, the executive may exercise his powers as to whether or not he will be entitled to a severance payment upon termination or in the event of a takeover. I have already stated that the boards of directors have become more likely to fire executives who are performing poorly,⁶⁰¹ and that the average tenure of C.E.O.s has decreased from 7 years to about five years during the last twenty years.⁶⁰² Executives, as a measure to insure themselves against financial loss arising from unemployment, have already responded to that new tendency by negotiating executive service contracts which already contain provisions that guarantee high severance packages even if their performance should turn out to have failed.⁶⁰³ The same can be said for "golden parachute" provisions. Due to the increased number of hostile takeover bids over the past years, executives more frequently include "golden parachute" provision in their executive service contracts as a safeguard for their managerial positions in the event of a change in control.

⁵⁹⁹ See also Yablon, *supra* note 554 at 271-272.

⁶⁰⁰ Aimed at minimizing the potential for self-dealing and the capture of other board members by an inside director exercising control, one reform proposal has been that the C.E.O. and other executives be prohibited from serving as chairman of the board of directors or even as a director in general, see, for example, McMenamin, *supra* note 575 at 143; Crystal, *supra*, note 589 at 245, with a discussion of Jay Lorsch's suggestion that C.E.O.s not be permitted to serve on boards at all. This model actually exists in Germany and will be discussed in detail *infra* at Chapter 4, III. 2.

⁶⁰¹ *Supra* note 103.

⁶⁰² *Supra* note 104.

⁶⁰³ *Supra* note 105.

And even if the original contract neither provides for a general severance provision nor for a “golden parachute” provision, executives might still have the possibility to exercise their influence over the boards in order to receive those payments by way of a “golden handshake” at the time the triggering event occurs.

Secondly, as for the structure and level of the severance package, I have already mentioned that the severance package will primarily be linked to the structure and level of the executive’s compensation package insofar as outstanding compensation will be paid. Thus, if the executive has already used his influence over the process of setting his compensation to the extent that he is highly compensated, that influence will indirectly be reflected in the amount of severance he receives upon termination or takeover of the corporation. However, the executive might still be induced to use his bargaining powers to reward himself with even more than he would be entitled to in terms of damages for wrongful dismissal.

Accordingly, managerial power and influence are currently too strong for market forces alone to reduce managerial inefficiencies by creating incentives that somewhat align the managers’ and the shareholders’ interests.⁶⁰⁴ Especially as long as inside directorships are still legally permissible and remain the rule in Canada and the U.S., the present regime governing contracts between the executive and the corporation, represented by the directors, calls for effective legal constraints in order to prevent inside directors from self-dealing and guarantee negotiations that amount to arm’s length negotiations. In the following Part, I will examine the existing legal mechanisms in Canadian law that impose restrictions on managerial self-dealing decisions and serve to control any deviation from the at arm’s length bargaining model between executives and directors with regard to the different kinds of severance agreements.

II. Legal Constraints

The problem of agency costs is the result of the incentives for executives (and directors) to act in their own interests to maximize personal profits. One way of reaching that goal is the design of lucrative severance or “golden parachute” provisions as part of the executive compensation agreement or by way of a “golden handshake”, the negotiations of which are likely to be influenced by the executive’s behaviour. The law responds to the problems of managerial self-dealing and all sorts of other influence over the bargaining process through a variety of

⁶⁰⁴ See also Rehnert, *supra* note 387 at 1160.

corporate governance mechanisms.

It is a fundamental principle of Canadian corporate law that directors and officers owe a fiduciary duty of loyalty and a duty of care to their corporation and its body of shareholders. Their primary duty, therefore, is to always act honestly and in good faith with a view to the best interest of the corporation and to exercise the care, diligence and skill that a reasonable prudent person would bring to the task in comparable circumstances. With regard to self-dealing transactions of corporate insiders with their corporation, Canadian federal and provincial corporate law statutes have introduced mandatory rules of disclosure of conflicts of interests for transparency purposes. Additionally, direct shareholder participation rights have been established in order to constrain managerial misbehaviour. Finally, special takeover legislation is concerned with “golden parachute” provisions and even tax legislation to a certain extent provides for means to control executive severance agreements.

1. The Fiduciary Duty (Duty of Loyalty)

Canadian corporate law imposes only few absolute restrictions on managerial behaviour. Fiduciary obligations of directors and officers are the most significant limitations on the wide discretions for corporate decision-making.⁶⁰⁵

a) The Concept of the Fiduciary Duty in Corporate Law

At common law, a fiduciary relationship exists where one party agrees to act on behalf of or in the interests of another person and, as such, is in a position to affect the interests of that other person in a legal or practical sense.⁶⁰⁶ As such, fiduciary relationships are marked by vulnerability in that the fiduciary can abuse the power or discretion given him to the detriment of the beneficiary.⁶⁰⁷ Put more simply, a fiduciary relationship exists where one person is in a

⁶⁰⁵ Although corporate law originally contained a large number of absolute restraints on managerial behaviour, most of those restraints have now been repealed either by statute or by judicial interpretation. As a result, the board of directors has gained more discretion, with fiduciary obligations being the only significant guarantor of the integrity of the directors' actions. For more detail on that development which originated in the U.S., see J. Robert Brown, Jr., “*Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*” (2003) 54 Hastings L. J. 641 at 644.

⁶⁰⁶ *Frame v. Smith*, [1987] 2 S.C.R. 99, 42 D.L.R. (4th) 81 (S.C.C.). Generally for the directors, see Hansell, *supra* 199 at 9-2; Stikeman, Elliott, *supra* note 134 at § 10.22.

⁶⁰⁷ *Hodgkinson v. Simms* (1994), 117 D.L.R. (4th) 161 (S.C.C.) at 168. *Lac Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 S.C.R. 574 (S.C.C.) at 646 states that “[...] fiduciary duties [...] arise from relationships marked by discretionary power and trust, such as loyalty and “the avoidance of a conflict of duty and interest and a duty not to profit at the expense of the beneficiary”.

position of “trust” vis-à-vis another. In the corporate context, both directors and officers are agents of the shareholders and, accordingly, a fiduciary relationship exists.

As an implication of the diverging interests caused by the separation of ownership and control of the corporation, the common law early established the principle that, as a fiduciary, a director⁶⁰⁸ has an obligation to act “honestly and in good faith with a view to the best interests of the corporation and to avoid conflicts of interest”.⁶⁰⁹ In the meantime, this obligation has been incorporated into most Canadian corporate law statutes as the “fiduciary duty” of directors and officers.⁶¹⁰ For the purpose of distinction from the duty of care, the fiduciary duty is also commonly referred to as the “duty of loyalty”.⁶¹¹

The fiduciary duty is a general standard of behaviour imposed on directors and officers in relation to their dealings with and on behalf of the corporation aimed at abstaining from self-interested behaviour.⁶¹² Directors and officers must serve the corporation selflessly, honestly and loyally.⁶¹³ They are required to respect the trust and confidence that have been reposed to them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation, they must avoid conflicts of self-interest with the corporation.⁶¹⁴ From a law and

⁶⁰⁸ The fiduciary duty also applies to the officer of the corporation. This principle was recognized by *Canadian Aero Service Ltd. v. O'Malley*, *supra* note 194.

⁶⁰⁹ See, for example, *Lac Minerals Ltd. v. International Corona Resources Ltd.*, *supra* note 607; *Hodgkinson v. Simms*, *supra* note 607.

For the common law concept of fiduciary duty see, for example, *K.L.B. v. British Columbia*, [2003] 2 S.C.R. 403, 230 D.L.R. (4th) 513 (S.C.C.): “Fiduciary duties arise in a number of different contexts, including express trusts, relationships marked by discretionary power and trust, and the special responsibilities of the Crown in dealing with aboriginal interests [...]”.

⁶¹⁰ See, for example, Section 122(1) CBCA: “Every director and officer of a corporation in exercising his or her powers and discharging his or her duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation [...]”

Provincial corporate law statutes are similar, see; for example, Section 134(1)(a) of the Ontario Business Corporations Act, R.S.O. 1990, c. B-16, as amended, (referred to hereinafter as “OBCA”); Section 142(1)(a) of the British Columbia Business Corporations Act, S.B.C. 2002 c.57, as amended (hereinafter referred to as “BCBCA”). Jacob S. Ziegel, Ronald J. Daniels, Jeffrey G. MacIntosh, and David L. Johnsten, *Cases and Materials on Partnerships and Canadian Business Corporations* (3th ed., Scarborough: Carswell Thomson Professional Publishers, 1994) at 5331 state “This simple admonition is where the statutory authority for the imposition of fiduciary duties resides.”

⁶¹¹ *Peoples Department Stores Inc. (Trustee of) v. Wise* (2004), 244 D.L.R. (4th) 564, 49 B.L.R. (3d) 165, 2004 SCC 68 (S.C.C.), affirming *Peoples Department Stores Inc. (Trustee of) v. Wise* (2003), 224 D.L.R. (4th) 509 (Que. C.A.) at para. 32. See also Hansell, *supra* note 199 at 9-1.

⁶¹² VanDutser, *supra* note 185 at 270. To the same effect for the U.S., see Brown, *supra* note 605 at 692; D. Gordon Smith, “The Critical Resource Theory of Fiduciary Duty” (2002) 55 Vand. L. Rev. 1399 at 1459.

⁶¹³ Kevin P. McGuinness, *The Law and Practice of Canadian Business Corporations* (Toronto: Butterworths, 1999) at 715.

⁶¹⁴ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 35.

economics perspective, the fiduciary duty is a necessary means to counteract the incentives for directors and officers to benefit themselves personally at the expense of the corporation.⁶¹⁵ In its literal meaning, the duty to act “honestly” prohibits directors and officers from acting fraudulently in relation to the corporation.⁶¹⁶ The requirement to act “in good faith” has been held to relate to self-dealing as well, being violated when the purpose of the proceeding is to benefit oneself personally or some individual shareholder or some group of shareholders at the expense of to the detriment of the shareholders as a whole.⁶¹⁷ Accordingly, whenever exercising their powers, directors and officers are bound to act “in the best interests of the corporation” and must not intend to deprive the corporation of assets for their personal gain.⁶¹⁸

The fiduciary duty of loyalty of directors and officers is owed to the corporation rather than to the shareholders directly.⁶¹⁹ In *Peoples Department Stores Inc. v. Wise*, the Supreme Court of Canada most recently clarified that the best interests of the corporation cannot be read simply as the best interests of the shareholders.⁶²⁰ Thus, defining the best interests of the corporation may cause problems in each specific case. From an economic perspective, the “best interests of the corporation” means the maximization of the value of the corporation.⁶²¹ Canadian courts have, therefore, interpreted the best interests of the corporation primarily as maximization of corporate

⁶¹⁵ See, for example, Frank H. Easterbrook and Daniel R. Fischel, “Corporate Control Transactions” (1982) 81 Yale L. Rev. 689 at 690.

In *Canadian Aero Service Ltd. v. O'Malley*, *supra* note 194 at 609-10, the court decided that directors and officers may even have to account to the corporation for profits they make that do not come at the corporation's expense. A compelling argument for making directors accountable for profits made as a result of their position, though not at the corporation's expense, is presented by Jason Brock, “The Propriety of Profitmaking: Fiduciary Duty and Unjust Enrichment” (2000) 58 U. T. Fac. L. Rev. 185 at 204-205.

⁶¹⁶ Typical cases are those involving some kind of self-dealing or self-interest, see, for example, *Boyle v. Rothschild* (1907), 10 O.W.R. 696 (Ont. H.C.).

⁶¹⁷ *The Sun Trust Co. v. Bégin* (1937), S.C.R. 305 (S.C.C.) at 309.

⁶¹⁸ VanDutser, *supra* note 185 at 271.

⁶¹⁹ *Algonquin Mercantile Corp. v. Cockwell* (1997), 43 B.L.R. (2d) 50 (Ont. Ct. (Gen. Div.)). See also *Colborne Capital Corp. v. 542775 Alberta Ltd.* (1999), 69 Alta. L.R. (3d) 265 (Alta. C.A.); *Malcolm v. Transtech Holding Ltd.* (2001), 12 B.L.R. (3d) 66 (B.C.C.A.); *2475813 Nova Scotia Ltd. v. Rodgers* (2001), 13 B.L.R. (3d) 1 (N.S.C.A.); *Hovsepian v. Westfair Foods Ltd.* (2001) 17 B.L.R. (3d) 291 (Alta. Q.B.); *Imperial Oil Ltd. v. Westlake Fuel Ltd.* (2001), 16 B.L.R. (3d) 1 (Man. C.A.); *G & E Vending Ltd. v. 700748 Alberta Ltd.* (2002), 30 B.L.R. (3d) 216 (Alta. Q.B.).

⁶²⁰ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 42.

⁶²¹ See Edward M. Iacobucci, “Directors' Duties in Insolvency: Clarifying What Is at Stake” (2004) 39 Can. Bus. L. J. 398 at 400-401.

profits in the interests of all of the shareholders, i.e. maximum shareholder wealth.⁶²² Thus, the law tends to disregard the interests of other stakeholders and to treat the interests of the corporation as coextensive with the interests of shareholders in most cases.⁶²³ However, case law submits that, besides the shareholders' interest in maximum shareholder value, various other factors may be relevant in determining what is in the best interest of the corporation.⁶²⁴ For example, no corporation will maximize share value if it completely disregards the interests of its employees, customers, creditors and other stakeholders.⁶²⁵ Thus, depending on all the circumstances of the given case, the directors and officers in order to comply with their fiduciary duty to act in the best interest of the corporation, may be obliged to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and even the environment.⁶²⁶ On the other hand, the fiduciary duty prohibits that the interests of a certain group of stakeholders is favoured over the prevailing general interests of the corporation to

⁶²² See, for example, *Palmer v. Carling O'Keefe Breweries of Canada Ltd.*, [1989] 41 B.L.R. 128, D.L.R. (4th) 128 (Ont. Div. Ct.); *820099 Ontario Inc. v. Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 123 (Ont. Ct. (Gen.Div.)); *PWA Corporation v. Gemini Group Automated Distribution Systems* (1993), 101 D.L.R. (4th) 15 (Ont. Ct. (Gen. Div.)); *Calmont Leasing Ltd. v. Kredl*, [1995] 8 W.W.R. 179 (Alta. C.A.), additional reasons [1995] 10 W.W.R. 574 (Alta. C.A.); *ASI Holdings Inc., Re* (1996), 28 B.L.R. (2d) 74 (Nfld. S.C.). See also *Howard Smith v. Ampol Petroleum Ltd.*, [1974] 1 All. E.R. 1126 (P.C.). For the concept in general, see Janis Sarra and Ronald B. Davis, *Director and Officer Liability in Corporate Insolvency* (Toronto & Vancouver: Butterworths, 2002) at 13.

⁶²³ In particular, although creditors are one group of stakeholders with the remarkable interest that the corporation be a profitable business, the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611, recently held that the fiduciary duty to act in the corporation's best interests does not include the interests of creditors. Whereas some cases previously had suggested that the directors' fiduciary duty might require them to act in the interests of the creditors especially where the corporation is "in the vicinity of insolvency" (see, for example, *369413 Alberta Ltd. v. Pocklington* (2000), 194 D.L.R. (4th) 109 (Alta. C.A.); *Canbook Distribution Corp. v. Borins* (1999), 41 O.R. (3d) 565 (Ont. S.C.J.)), the court in *Peoples Department Stores Inc. (Trustee of) v. Wise* held that no such duty existed as the creditors were sufficiently protected by the duty of care and the oppression remedy. For a general overview of the fiduciary duties of directors and officers with respect to insolvency, see Sarra and Davis, *supra* note 622.

⁶²⁴ *Parke v. Daily News Ltd.*, [1962] Ch. 927; *Teck Corp. v. Millar* (1972), 33 D.L.R. (3d) 288 (B.C.S.C.); *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254, 37 D.L.R. (4th) 193 (Ont. Div. Ct.); *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611.

⁶²⁵ VanDutser, *supra* note 185 at 272.

⁶²⁶ See *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at 42.

The interests of different stakeholders may well be consistent with each other if the corporation is profitable and well capitalized. In contrast, the interests are likely to divert if the corporation faces insolvency. Whereas shareholders might be willing to accept a greater deal of risk by management with a view to shareholder value, especially creditors might prefer that relatively safe decisions are being made so as to maximize the value of their claims against the remaining assets of the corporation. For a discussion of the shifting interests and incentives of shareholders and creditors, see Wayne D. Gray, "Peoples v. Wise and Dylex: Identifying Stakeholder Interests Upon or Near Corporate Insolvency – Stasis or Pragmatism?" (2003) 39 Can. Bus. L. J. 242 at 257; Edward M. Iacobucci and Kevin E. Davis, "Reconciling Derivative Claims and the Oppression Remedy" (2000) 12 Sup. Ct. Rev. (2d) 87 at 114.

maximize shareholder value.⁶²⁷

Accordingly, the fiduciary duty of directors and officers to their corporation requires them not to put their personal interests ahead of the best interests of the corporation. Corporate self-dealing transactions present the most potential for conflicts of interests likely to result in a breach of fiduciary duty.⁶²⁸ Those transactions involve contracts or transactions concluded between the directors and officers of a corporation, either directly or through their interests in another entity, and the corporation itself.⁶²⁹ A frequent example for self-dealing transactions are executive compensation agreements including severance or “golden parachute” provisions or “golden handshake” agreements for executives who are also directors of the corporation and, therefore, negotiating the respective agreements partly or completely with themselves.⁶³⁰ In addition, even where the executive is not an inside director of the corporation, there might still be a substantial conflict of interest if the executive is in a position to influence the outcome of the negotiations. In his capacity as an executive of the corporation, the executive is obliged to act in the best interests of the corporation. With respect to the agency problem, the best interests of the corporation are to pay as little a severance or any other kind of compensation as possible to the executive in order to keep shareholder value at a maximum. As an individual, on the other hand, the executive has an incentive to negotiate the maximum severance possible and exercise his powers in that direction.

At common law, due to the inevitable conflict of interests for the insiders involved, self-dealing transactions were originally prohibited without any consideration of the merits of a particular deal. In *Aberdeen Railway Co. v. Blaikie Bros.*,⁶³¹ the rigid standard regarding corporate self-dealing was described as

“[...] a rule of universal application that no one [...] shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those he is bound to protect. So strictly is the principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.”

⁶²⁷ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 47.

⁶²⁸ Jody Langan, “Wealth Effects and Agency Conflict in Division Management Buyouts” (1996) 54 U.T. Fac. L. Rev. 193 at 227.

⁶²⁹ A. Douglas Harris, Ian B. Lee, Ronald J. Daniels, Jeffrey G. MacIntosh, Edward M. Iacobucci, Poonam Puri, and J. Ziegel, *Cases, Materials and Notes on Partnerships and Canadian Business Corporations* (4th ed., Toronto: Thomson Carswell, 2004) at 376.

⁶³⁰ See, for example, the facts in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁶³¹ *Aberdeen Railway Co. v. Blaikie Bros.* (1854), [1843-60] All E.R. Rep. 249 (H.L.).

The rationale for that strict rule was that the courts had difficulties in assessing when a personal interest in a transaction was significant enough to affect the person's behaviour.⁶³² Under this rule, even transactions in which only the director's or officer's interest possibly conflicted with the fiduciary duty were prohibited.

Despite the conflict of interest inherent in self-dealing transactions, Canadian jurisprudence subsequently moved away from the categorical prohibition to a more flexible rule that those contracts were voidable at the discretion of the company considering the procedural and substantive fairness of each transaction.⁶³³ Although courts no longer strictly prohibited self-dealing transactions, the standard of fairness to be reached was still very high. Given that Delaware jurisprudence on corporate law tended to be very influential with Canadian courts, reference was made to the applicable test under Delaware law with respect to the standard of fairness.⁶³⁴ In *Weinberger v. UOP, Inc.*,⁶³⁵ for example, the Delaware Supreme Court stated the following:

*"When directors of a Delaware corporation are on both sides of the transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."*⁶³⁶

The fairness under the duty of loyalty in Delaware focused directly on the self-dealing process itself, not on any lack of effort or bad business judgment by the directors.⁶³⁷ According to that, the inside party to the contract had the burden to ensure that a deal was fair to the

⁶³² See VanDutser, *supra* note 185 at 274.

⁶³³ See, for example, *Gray v. New Augarita Porcupine Mines Ltd.*, [1952] 3 D.L.R. 1 (P.C.); *Ferguson v. Wallbridge*, [1935] 3 D.L.R. 66 (P.C.); *Wade v. Kendrick* (1905), 37 S.C.R. 32 (S.C.C.) at 53; *Gray v. Yellowknife Gold Mines Ltd.*, [1948] 1 D.L.R. 74 (Ont. C.A.); *Canada (Attorney General) v. Granell* (1956), 17 D.L.R. (2d) 141 (Ont. H.C.).

⁶³⁴ Langhan, *supra* note 628 at 228. Even after the incorporation of the standard of fairness into Canadian corporate statutes, some courts still refer to the law of Delaware when determining the fairness of a self-dealing contract, see, for example, *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 195 considering the judgment of the Delaware Supreme Court in *Weinberger v. UOP, Inc.*, *infra* note 635.

⁶³⁵ *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. S.C., 1983).

⁶³⁶ *Ibid.* at 710.

⁶³⁷ See *ibid.*: "[Fairness] derives solely from self-appropriative acts by which management seeks to take for itself property or potential that would otherwise belong to the corporation or its stockholders." See also *Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del. S.C., 2002) at 265: "Like any other interested transaction, directorial self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation."; *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. S.C., 2001) at 89: "When shareholders challenge actions by a board of directors, generally one of three standards of judicial review is applied: the traditional business judgment rule, an intermediate standard of enhanced judicial scrutiny, or the entire fairness analysis."

corporation as a whole, the price generally being the preponderant consideration.⁶³⁸

However, in recognition that in some cases the only way for the corporation to benefit from a transaction is through a contract with an insider,⁶³⁹ recent Canadian corporate law statutes now explicitly permit certain kinds of corporate insider transactions between executives or directors and the corporation if certain requirements are being met.⁶⁴⁰ By way of negative legislative wording, Section 120 CBCA presumes the invalidity of a contract or transaction between a director or officer and the corporation unless approval of the directors is obtained, disclosure requirements are met and the contract was reasonable and fair to the company at the time it was approved. While approval of the board of directors appears easy for an insider to obtain, the validity of the self-dealing contract will depend on the compliance with the requirements for disclosure and fairness of the contract.

b) Mandatory Disclosure of Conflict of Interests

As a separate aspect of the general fiduciary duty of directors and officers, the law imposes the duty of disclosure of self-interested transactions. As a requirement for the validity of the contract, the law provides that a director or executive shall disclose to the corporation the nature and extent of any interest he has in a material contract with the corporation. Pursuant to s. 120(1) CBCA, for example, the director or executive is obliged to disclose to the corporation his material interest in the contract by giving written notice to the corporation of the nature and extent of his interest.

The duty to disclose is an absolute one, because, without full disclosure, any investigation into whether the beneficiary would have acted in the same manner is impossible.⁶⁴¹ Although there is no precise formula for how much detail must be provided to the corporation, the information must be sufficiently detailed as to the costs incurred by the company and the profits for the corporate insider.⁶⁴² Besides that, depending on the circumstances of the specific case, the director's duty to disclose his material interest in a contract with the corporation may also include the duty to deliver all kind of information to the board of directors that must be regarded

⁶³⁸ See also Langan, *supra* note 628 at 228.

⁶³⁹ VanDutser, *supra* note 185 at 275.

⁶⁴⁰ See, for example, Section 120 CBCA; Section 132 OBCA; Section 151 BCBCA.

⁶⁴¹ McGuiness, *supra* note 613 at 754; *Crighton v. Roman*, [1960] S.C.R. 858 (S.C.C.) at 869.

⁶⁴² See, for example, *Gray v. New Augarita Porcupine Mines Ltd.*, *supra* note 633 at 14: "The amount of detail required must depend in each case upon the nature of the contract or arrangement proposed and the context in which it arises. It can rarely be enough for a director to say, 'I must remind you that I am interested' and to leave it at that [...]" See also *Wedge v. McNeill* (1981), 33 Nfld. & P.E.I.R. 272 (P.E.I.S.C.).

to be material to their judgment.⁶⁴³ In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, the court held that it was material to the judgment of the merely uninformed board to know about previous concerns, about the lack of objective research, benchmarking and analysis as well as about changes made with respect to the executive compensation agreement to be approved by the board.⁶⁴⁴

According to s. 120(7) CBCA, the insider contract must be approved by the board of directors or, eventually, by the shareholders. As a general rule, the law does not allow the insider to vote on any contract in which he has a material interest.⁶⁴⁵ The insider, however, may be present at the board's meeting and, if he is also a director of the company, may even be counted for the quorum. Regardless of that, s. 120(5) CBCA exceptionally establishes that the interested inside director is permitted to vote on contracts relating to his remuneration as a director, officer or employee of the corporation. Although the law expressly refers only to remuneration and indemnification, severance payments and any other monetary benefits also need to be included into this exceptional rule.

Finally, both the CBCA⁶⁴⁶ and provincial corporate law statutes⁶⁴⁷ provide that neither a contractual provision, nor the articles, the by-laws or a shareholder resolution can release the insider from his duties to disclose his self-interest in a transaction and from liability for a breach thereof. If the statutory requirements of disclosure are not met properly, the conflict of interests directly results in a breach of a fiduciary duty.⁶⁴⁸

Disclosure of a director's self-interest, however, is but the first step to approach the issue of corporate self-dealing. Disclosure does not relieve the director of his duty to act honestly and in good faith with a view to the best interests of the corporation.⁶⁴⁹ Once the insider has complied with the technical requirements for disclosure to the corporation, he is not free to exercise his influences and bargaining powers as he pleases.⁶⁵⁰ To the contrary, bound by the duty of loyalty, the insider still remains obliged to place the interests of the corporation ahead of his own

⁶⁴³ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁶⁴⁴ *Ibid.* at para. 116: "Measured against this standard, [the director's] conduct falls well short of what was required of him. [...] It is no answer to the duty to disclose to say the directors could have discovered this for themselves."

⁶⁴⁵ See, for example, Section 120(5) CBCA.

⁶⁴⁶ Section 122(3) CBCA.

⁶⁴⁷ For example, Section 134(3) OBCA.

⁶⁴⁸ Remedies for shareholders in this case of breach of fiduciary duty will be discussed *infra* at III.

⁶⁴⁹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 117.

⁶⁵⁰ VanDutser, *supra* note 185 at 277.

interests.⁶⁵¹ In the self-dealing context, according to the statutory provisions such as Section 120(7.1)(c) CBCA, this requires that the contract be “reasonable and fair” to the corporation at the time it is approved by the board of directors.

c) The “Reasonableness and Fairness” Test

Section 120 of the CBCA presumes the invalidity of a contract or transaction between a director or officer and the corporation unless approval of the directors is obtained, the disclosure requirements are met and the contract was “reasonable and fair” to the corporation when it was approved. It is obvious that there will be conflicting views on the meaning to be ascribed to the words “reasonable and fair to the corporation”.

Before the law evolved in Canada with respect to executive compensation that was “reasonable and fair” to the corporation, early case law in the U.S. developed the so-called “waste test”.⁶⁵² The “waste test” stands for the principle that corporations are not allowed to waste their assets or spend substantial amounts that are unrelated to a reasonable management of the affairs of the corporation.⁶⁵³ On this basis, the courts held that the directors were not liable for breach of their fiduciary duty unless the compensation bore no reasonable relation whatsoever to the benefit which the compensation might expect from the executive’s accomplishments or unless the compensation was so excessive as to constitute a waste of corporate assets.⁶⁵⁴ A self-dealing or any other compensation transaction was regarded to be a waste of corporate assets where “no person of ordinary business judgment would deem the benefit worth what the corporation paid”.⁶⁵⁵ In *Rogers v. Hill*,⁶⁵⁶ the U.S. Supreme Court focused on the size of the compensation rather than on the process used to arrive at the compensation

⁶⁵¹ *Levy-Russell Ltd. v. Tecmotiv Ltd.* (1994), 13 B.L.R. (2d) 1 (Ont. Ct. (Gen. Div.)). For typical conflict of interest issues see also *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177, 44 B.L.R. (2d) 115 (Ont. C.A.) and *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755 (Ont. Ct. (Gen. Div.)).

⁶⁵² *Rogers v. Hill*, 289 U.S. 582 (1933); *Beard v. Elster*, 160 A.2d 731 (Del. S.C., 1960); *Saxe v. Brady*, 184 A.2d 602 (Del. Ch., 1962); *Michelson v. Duncan*, *supra* note 277; *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch., 1997).

⁶⁵³ *Ibid.* For a good overview of the development of the “waste test” under U.S. corporate law, see Lori B. Marino, “Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy” (1999) 147 U. Pa. L. Rev. 1205.

⁶⁵⁴ See *Lewis v. Vogelstein*, *supra* note 652 at 336: “If [...] there is any substantial consideration received by the corporation, and if there is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude ex post that the transaction was unreasonably risky.”; *Saxe v. Brady*, *supra* note 652 at 610.

⁶⁵⁵ *Saxe v. Brady*, *supra* note 652 at 610.

⁶⁵⁶ *Rogers v. Hill*, *supra* note 652.

agreement and held that the generous executive compensation package was valid at the time it was adopted.⁶⁵⁷ However, the court also stated:

*"[The principle of freedom of contract] cannot be used to justify payments of sums as salaries so large in substance and effect to amount to spoliation or waste of corporate property".*⁶⁵⁸

The U.S. "waste test" intends to set a high standard for the challenge of executive compensation packages determined by American boards of directors.⁶⁵⁹ However, in practice the "waste test" almost has no effect because of the development of the "business judgment rule".⁶⁶⁰ In *Aronson v. Lewis*, the Supreme Court of Delaware turned down the allegations that the executive compensation agreement including a "golden parachute" provision amounted to a waste of corporate assets by invoking the "business judgment rule" in terms of that

*"[i]t is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. [...] Absent an abuse of discretion, that judgment will be respected by the courts."*⁶⁶¹

However, some U.S. cases regarding the allegation of excessive compensation were successful on the grounds that the directors had breached their fiduciary duty by failing to establish fairness to the corporation as the salary did not bear a reasonable relation to the executive's ability and services rendered.⁶⁶² In these cases, the reasons for the unfairness of the contract varied too intensely in each particular case as to establish a reliable test.

In Canada, there have been several cases dealing with the reasonableness of executive compensation agreements and fees for inside directors.⁶⁶³ The main focus of these cases, like in the U.S., also was whether the compensation bear a reasonable relation to the services rendered

⁶⁵⁷ The compensation scheme for the C.E.O. of American Tobacco Company in *Rogers v. Hill* had been ratified by shareholders 20 years earlier. It amounted to more than US\$ 1 million in 1930, see *ibid*.

⁶⁵⁸ *Ibid*. at 591. The case was settled before the court could determinate whether the executive compensation in question represented a waste of corporate assets.

⁶⁵⁹ Iacobucci with Trebilcock, *supra* note 89 at 34.

⁶⁶⁰ See, for example, *Aronson v. Lewis*, 473 A.2d 805 (Del. S.C., 1984); *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Circ., 1981). See also Stikeman, Elliott, *supra* note 134 at § 20.153.

Technically, the "business judgment rule" relates to the "duty of care" rather than to the "fiduciary duty of loyalty". It will be discussed in more detail *infra* at 2. c).

⁶⁶¹ *Aronson v. Lewis*, *supra* note 660 at 812. See also *Unocal Corp. v. Mesa Petroleum Co.*, *supra* note 54, regarding the decision to take certain defensive measures against a takeover bid.

⁶⁶² *Lynch v. Patterson*, 701 P.2d 1126 (Wyo. S.C., 1985); *Crosby v. Beam*, 548 N.E.2d 217 (Ohio S.C., 1989); *Owensby & Kritikos, Inc. v. C.I.R.*, 819 F.2d 1315 (5th Circ., 1987); *Rutter v. C.I.R.*, 853 F.2d 1267 (5th Circ., 1988).

⁶⁶³ See, for example, *Nolan v. Parsons*, [1942] O.R. 358, 3 D.L.R. 190 (Ont. C.A.); *National Building Maintenance Ltd. v. Dove*, [1972] 5 W.W.R. 410 (B.C.C.A.); *Diligenti v. RWMD Operations Kelowna Ltd.* (1976), 1 B.C.L.R. 36 (B.C.S.C.).

by the corporate insider for the corporation. In the case of *Stech v. Davies*,⁶⁶⁴ a director who had decided unilaterally to increase his compensation and grant himself special management fees without reasonable relation to the services performed for the corporation was held to have acted unfairly to the corporation. In a similar case,⁶⁶⁵ the directors were found to have acted unfairly when granting themselves certain fees that had no reasonable business basis.⁶⁶⁶ However, there are only few Canadian cases on the issue whether a self-dealing contract of an insider can be justified as being “reasonable and fair” to the corporation under corporate legislation or whether there has been abuse of power by an inside-director trying to enrich himself at the expense of the corporation and the shareholders. The following recent cases deserve special consideration in more detail.⁶⁶⁷

(1) *Cannaday v. McPherson*

In the case of *Cannaday v. McPherson*,⁶⁶⁸ the courts had to consider whether a compensation agreement for a self-interested director was “reasonable and fair” to the corporation. The agreement provided a golden parachute of ten years’ salary and benefits to the director, amounting in all to about \$ 750,000, upon his discharge from a \$ 60,000 per annum position as president of the corporation. In the original trial, the director, *Mr. Cannaday*, asserted that the agreement was reasonable and fair because, by entering into it, the company secured his services which could not have been obtained anywhere at the level of remuneration the company was able to pay.⁶⁶⁹ However, the trial judge noted that the agreement was entirely one sided as it referred only to services and funds provided by the director in the past, but did not commit *Mr.*

⁶⁶⁴ *Stech v. Davies* (1987), 53 Alta. L.R. (2d) 373 (Alta. Q.B.).

⁶⁶⁵ *Re Abraham and Inter Wide Investments Ltd.* (1985), 51 O.R. (2d) 460 (Ont. H.C.J.). See also *Wright v. Donald S. Montgomery Holdings Ltd.* (1989), 39 B.L.R. (2d) 266 (Ont. Ct. (Gen.Div.)); *Radtke v. Machel* (2000), 98 A.W.C.S. (3d) 1198 (Ont. S.C.J.). On the other hand, see *G & E Vending Ltd. v. 700748 Alberta Ltd.*, *supra* note 619.

⁶⁶⁶ See also *Gibbons v. Medical Carriers Ltd.* (2001), 158 Man. R. (2d) 259 (Man. Q.B.), additional reasons at (2001), 161 Man. R. (2d) 198 (Man. Q.B.); *Ludlow v. McMillan*, [1995] 6 W.W.R. 761, 19 B.L.R. (2d) 102, 6 B.C.L.R. (3d) 163 (B.C.S.C.); *Calmont Leasing Ltd. v. Kredl*, *supra* note 622; *Beechwood Cemetery Co. v. Graham* (1996), 64 A.C.W.S. (3d) 80 (Ont. Ct. (Gen.Div.)), affirmed (1998), 41 B.L.R. (2d) 171 (Ont. C.A.).

⁶⁶⁷ In another recent case, bonuses worth more than CDN\$ 27,284,000 for the inside director and certain members of his family were found to be excessive in relation to the services performed. The excess of reasonable comparable compensation was held to be a breach of the director’s fiduciary duty, see *Waxman v. Waxman* (2002), 25 B.L.R. (3d) 1 (Ont. S.C.J.).

⁶⁶⁸ *Cannaday v. McPherson* (1995), 25 B.L.R. (2d) 75 (B.C.S.C.), reversed at (1998), 44 B.C.L.R. (3d) 195 (B.C.C.A.), affirmed *sub nom. Cannaday v. Sun Peaks Resort Corp.*, 1998 CarswellBC 1323 (B.C.S.C.).

⁶⁶⁹ *Ibid.* at para 13.

Cannaday to do anything to the benefit of the company in the future.⁶⁷⁰ In the absence of Canadian authority for a test regarding the notion of “reasonable and fair to the corporation”, the trial judge referred to the general “fairness test” as developed in U.S. jurisprudence.⁶⁷¹ That test, in essence, considers “whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain”,⁶⁷² and “whether “under all the circumstances the transaction would have recommended itself to an independent board of directors that was acting in good faith and had the best interests of the corporation in mind”.⁶⁷³ With respect to that test, the trial judge in *Cannaday v. McPherson* concluded that the compensation agreement including the “golden parachute” provision was in no way fair and reasonable, because it did not have

*“[...] the earmarks of an arm’s length transaction and it cannot be said that it would have recommended itself to an independent board of directors acting in the best interest of the [corporation].”*⁶⁷⁴

On appeal, however, it was decided that the trial judge in considering the question of “fairness and reasonableness” should have had regard to the factual background and the surrounding circumstances to the contract, such as the amount of the directors salary, the term he had served for the company and the fact that the purchaser of the company had known the “golden parachute” agreement.⁶⁷⁵ The case was sent back for new trial. In the new trial, the Supreme Court of British Columbia held that *Mr. Cannaday* had breached his fiduciary duties by entering into an agreement for his own personal benefit only and not in the corporation’s best interests.⁶⁷⁶ The court confirmed the trial judge’s view of the contract to be “completely one-sided” and “not reasonable and fair” to the company, as the director’s efforts did not deserve any special remuneration.⁶⁷⁷

⁶⁷⁰ *Ibid.*: “[The agreement] was a wholly one-sided agreement. [The company] got virtually nothing.”

⁶⁷¹ *Ibid.* at para 12, referring to *Remillard Brick Co. v. Remillard-Dandini Co.*, 241 P. 2d 66 (Cal. C.A., 1952) at 182.

⁶⁷² *Pepper v. Litton*, 308 U.S. 295 (1939) at 306-307.

⁶⁷³ *Summa Corp. v. Trans World Airlines, Inc.* 540 A.2d 218 (Del. S.C., 1976) at 224-225.

⁶⁷⁴ *Cannaday v. McPherson*, *supra* note 668 at para. 15. As a result of that conclusion, the director was held to have breached his fiduciary duty and the company was awarded damages.

⁶⁷⁵ *Cannaday v. McPherson* (1998), 44 B.C.L.R. (3d) 195 (B.C.C.A.) at para 27.

⁶⁷⁶ *Cannaday v. Sun Peaks Resort Corp.*, 1998 CarswellBC 1323 (B.C.S.C.).

⁶⁷⁷ *Ibid.* at paras. 29 and 44. See also *ibid.* at para 40: “[T]he services performed by [the director] in relation to the operation of [the company] were no more than one would expect the president of a corporation to carry out.”

(2) *Rooney v. Cree Lake Resources Corp.*

In *Rooney v. Cree Lake Resources Corp.*,⁶⁷⁸ the court came to a conclusion similar to that in *Cannaday v. McPherson*.⁶⁷⁹ The court refused to give effect to a “golden parachute” provision in a contract that would have triggered the payment of unearned compensation in a lump sum equal to over 70 per cent of the corporation’s assets although there was no reasonable expectation of income to support the payment by the corporation. The court found that this case was essentially different from *Cannaday v. McPherson*,⁶⁸⁰ and, therefore, in the absence of other Canadian case law, also referred directly to the general “fairness test” as established by U.S. case law in similar cases.⁶⁸¹ In addition to the application of the U.S. “fairness test”, the court also applied what is commonly regarded as the “improper purpose test” as developed in *Teck Corp. v. Millar*.⁶⁸² According to that test, as a general rule, there must be reasonable grounds for the directors’ belief, failing of which an inference will be drawn that they were motivated by some other, and improper, purpose.⁶⁸³ Thus, directors who act for an improper purpose such as their own entrenchment act in breach of their fiduciary duty.⁶⁸⁴ Adopting both the “fairness test” as well as the “improper purpose test”, the court in *Rooney v. Cree Lake Resources Corp.* found:

*In determining whether a particular contract is reasonable and fair to the corporation, one must examine all the surrounding circumstances including the purpose of the agreement and its possible ramifications for the corporation. It need not be either fair or reasonable to the director. It is his fiduciary duty to the corporation which requires it to be fair and reasonable to the corporation.*⁶⁸⁵

Since the “golden parachute” provision was held capable to prevent dissatisfied shareholders from exercising their right to effect a legitimate termination of an allegedly incompetent executive, the court concluded that the particular provision was neither reasonable nor fair to the corporation.⁶⁸⁶

⁶⁷⁸ *Rooney v. Cree Lake Resources Corp.* (1998), 40 C.C.E.L. (2d) 96 (Ont. Ct. (Gen. Div.)).

⁶⁷⁹ *Cannaday v. McPherson*, *supra* note 668, as affirmed *sub nom. Cannaday v. Sun Peaks Resort Corp.*, *supra* note 676.

⁶⁸⁰ See *Rooney v. Cree Lake Resources Corp.*, *supra* note 678 at para. 46.

⁶⁸¹ *Ibid.* at para. 47. For the U.S. test, see *supra* notes 671 through 673.

⁶⁸² *Teck Corp. v. Millar*, *supra* note 624.

⁶⁸³ *Ibid.* at para. 113. See also *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, *supra* note 622.

⁶⁸⁴ *Ibid.* See also *347883 Alberta Ltd. v. Producers Pipelines Inc.* (1991), 3 B.L.R. (2d) 237, 80 D.L.R. (4th) 359 (Sask. C.A.), adopting the “improper purpose test” as set out by *Teck Corp. v. Millar*.

⁶⁸⁵ *Rooney v. Cree Lake Resources Corp.*, *supra* note 678 at para. 53.

⁶⁸⁶ *Ibid.* at para. 58.

(3) *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*

Finally, the issue of what is “fair and reasonable to the corporation” has most recently been dealt with instructively by the Ontario Superior Court of Justice in its “ground-breaking decision”⁶⁸⁷ in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*⁶⁸⁸ In that case, the executive’s compensation agreement included \$420,000 in annual salary, a signing bonus of 25 million shares plus stock options to acquire one million more shares, a market capitalization bonus, several executive employee benefits and perquisites as well as a severance package of \$27 million in case of a change of control (“golden parachute”).⁶⁸⁹ Although the board had initially refused to approve the generous compensation package proposed by the director, Mr. Steven Berg, himself, a reconstituted compensation committee eventually approved the terms of the agreement. Almost all of the directors who were initially opposed to the agreement had resigned prior to its acceptance, including the chairman of the compensation committee. New directors that had been proposed by Mr. Berg but were not informed of the previously constituted committee’s resistance concerning the agreement replaced the former committee. When his employment contract was prematurely terminated, Mr. Berg claimed that he was entitled to the severance package under the agreement because his contract had been unanimously approved by the board of directors on the advice of an external compensation consultant and, therefore, the court could not revisit the director’s business decision.⁶⁹⁰

When exploring the meaning of the words “reasonable and fair to the corporation”, the court followed the principles for the test set out for Canada in *Cannaday v. McPherson*⁶⁹¹ and *Rooney v. Cree Lake Resources Corp.*⁶⁹² Accordingly, the court turned to determine both the fairness of the self-dealing process and the reasonableness of its result while considering all the background information relevant to the specific case.⁶⁹³ In order to determine the fairness of the transaction, the court additionally applied the concept of fairness as developed under U.S.

⁶⁸⁷ See Paul Waldie, “Repap ruling seen as weapon for shareholders” *Globeandmail.com* (June 22, 2002) <<http://www.globeandmail.com>> (last visited on December 15, 2004).

⁶⁸⁸ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁶⁸⁹ In court, Marty Whitman, the principal of Third Avenue Funds, Repap’s largest shareholder, testified that “[i]t was quite a package”, see *ibid.* at para. 55.

⁶⁹⁰ *Ibid.* at para. 112.

⁶⁹¹ *Supra* note 668.

⁶⁹² *Supra* note 678.

⁶⁹³ The court stated: “I do not see how one could determine if the contract was reasonable and fair to the corporation when it was approved without considering the circumstances against which it was approved.”, see *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 191

corporate law, consisting of the two separate aspects of fair dealing and fair price.⁶⁹⁴ As for the first aspect of fair dealing, the court noted that the issue embraces questions of when a transaction was timed, how it was initiated, structured, negotiated, disclosed to directors and how the directors' approval was obtained.⁶⁹⁵

On that basis, the court not only found the compensation agreement to be clearly unreasonable in light of the poor financial situation of the corporation and the questionable services of the director,⁶⁹⁶ but also that there was a lack of procedural fairness, considering

*"the inadequate or, more accurately, non-existent arm's length negotiations, a lack of material information in the possession of the Board and undue haste, including a cursorily-prepared "reasonableness" opinion supporting the Agreement."*⁶⁹⁷

The director had not disclosed all relevant information to the board respecting the contract itself and the report provided by the external compensation expert. In addition, the compensation consultant had not been given full information for the preparation of the report. Furthermore, the compensation committee had not properly considered the agreement nor had it been informed about its context. Finally, the court considered as further evidence that the contract was not fair and reasonable to the corporation and that the director viewed the contract as a liability for the company that could be useful to him as a negotiating tool when the company was sold or merged.

(4) Conclusion

The discretionary powers of directors regarding compensation agreements in general and, in particular, severance provisions, are limited by the fiduciary duty of loyalty. Directors and officers are required by the law to act honestly and in good faith in the best interests of the corporation. Any action taken other than in the best interests of the corporation is action taken

⁶⁹⁴ *Ibid.* at para. 195, referring to *Weinberger v. UOP, Inc.*, *supra* note 635. See also *Lewis v. Vogelstein*, *supra* note 652 at 333, observing that directors dealing with themselves "constitute self-dealing that would ordinarily require that the directors prove that the grants involved were, in the circumstances, entirely fair to the corporation". Thus, the test under U.S. law is commonly referred to as the "entire-fairness test"

⁶⁹⁵ *Ibid.* In *Weinberger v. UOP, Inc.*, *supra* note 635 at 711, the U.S. court held that the transaction did not meet the requirements for fair dealing, because there were inadequate arm's length negotiations, a lack of material information in the possession of the Board and undue haste, including a cursorily prepared fairness opinion supporting the transaction in question.

⁶⁹⁶ See *ibid.* at para 197: "[The agreement] burdened the company with extraordinarily large and unearned cash payments, with the potential to create a financially perilous situation for it."

⁶⁹⁷ See *ibid.* at para. 196.

for illegitimate business purpose.⁶⁹⁸

Self-dealing transactions of corporate insiders create a potential for conflict of interest between the best interests of the corporation and the insiders personal interest in benefits. The law does not prohibit such transactions in general. However, self-dealing transactions must be disclosed, approved and, most importantly, reasonable and fair to the corporation. With respect to executive compensation agreements including severance provisions, a small series of Canadian cases indicates that the burden of showing such reasonableness and fairness rests with corporate executives and directors who negotiate their own compensation or severance packages. Several factors need to be included into the determination of whether a transaction is fair and reasonable to the corporation. Among those factors are, for example, the executive's qualification, the nature and the scope of his employment, the size of the corporation's business, the elements of the compensation or severance package, and the profitability or general financial situation of the business. Especially the recent case of *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*⁶⁹⁹ has shown that any kind of improper conduct or influence over the process of reaching the agreement or over the amount agreed upon can result in a breach of fiduciary duty that can effectively be claimed by shareholders.⁷⁰⁰

d) The "Proper Purpose Test" for "Golden Parachutes"

Like any general decision regarding compensation or severance, the decision to provide the executive with a "golden parachute" must not constitute a breach of the fiduciary duty of loyalty. Despite the incorporation of the notion to act "in the best interests of the corporation", in order to determine whether the directors had breached their fiduciary duty some Canadian courts followed English case law and applied what was called the "proper purpose test".⁷⁰¹ Although it is clear that any action for the sole purpose of self-enrichment is not in the best interests of the corporation, the purpose is not always a reliable test to determine a breach of the fiduciary duty.

⁶⁹⁸ See Hansell, *supra* note 199 at 9-48; Stikeman, Elliott, *supra* note 134 at § 20.167.

⁶⁹⁹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁷⁰⁰ For possible shareholder remedies in the case of a breach of the fiduciary duty, see *infra* at III.

⁷⁰¹ Among those early English cases were *Punt v. Symons & Co.*, [1903] 2 Ch. 506 (Eng. Ch. Div.); *Piercy v. S. Mills & Co., Ltd.*, [1920] 1 Ch. 77 (Eng. Ch. Div.); *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254 (Eng. Ch. Div.); *Bamford v. Bamford*, [1970] Ch. 212 (Eng. C.A.). Canadian cases are, for example, *Madden v. Dimond* (1906), 12 B.C.R. 80 (B.C.C.A.); *Bonisteel v. Collis Leather Co.* (1919), 45 O.L.R. 195 (Ont. H.C.); *Smith v. Hanson Tire & Supply Co.* (1927), 21 Sask. L.R. 621 (Sask. C.A.); *Legion Oils Ltd. v. Barron* (1956), 2 D.L.R. (2d) 505 (Alta. T.D.); *Exco Corp. Ltd. v. Nova Scotia Savings & Loan Co.*, [1987], 35 B.L.R. 149, 78 N.S.R. (2d) 91 (N.S.C.A.); *347883 Alberta Ltd. v. Producers Pipelines Inc.*, *supra* note 684.

Especially “golden parachute” provisions have been challenged on the grounds that they were only entered into for the purpose of self-enrichment. I will now briefly discuss why “golden parachutes”, regardless of the primary purpose of the executive, may well be “in the best interests of the corporation”.

(1) The “Proper Purpose Test”

The “proper purpose test”⁷⁰² requires the directors and executives to exercise the powers conferred on them for a proper business purpose. If they exercise their powers for any other purpose, their action will result in a breach of the fiduciary duty.⁷⁰³ The existing case law implies that the “proper purpose test” has primarily, but not exclusively, been applied in situations dealing with the issuance of shares to effect a change in control of the corporation. The leading authority establishing the “proper purpose test” is the English case of *Hogg v. Cramphorn*,⁷⁰⁴ where it was held that the directors may not issue shares for the improper purpose to retain control of the corporation. Although the court found that the board of directors had believed to be acting in the best interests of the corporation, it argued that the delegation of powers to the directors did not permit them to exercise those powers

*“[...] in circumstances which put the directors in a fiduciary situation when exercising those powers, in such a way as to interfere with the exercise by the majority of its constitutional rights”.*⁷⁰⁵

Because the primary purpose of the issuance of shares had been “to ensure control of the company by the directors and those whom they could confidently regard as their supporters”, the directors were held to have acted for improper purposes and, thus, in excess of their powers. According to the “proper purpose test”, if the directors act for improper purpose, they will be in breach of their fiduciary duty even if they intended to act in the best interests of the corporation. Under this test, directors have the burden to prove that they acted for a proper business purpose within the scope of their powers.⁷⁰⁶

The “proper purpose test”, however, has frequently been criticized. Especially since the

⁷⁰² The test has been referred to alternatively as “collateral purpose test”, “abuse of power test”, or “proper purpose doctrine”, see Hansell, *supra* note 199 at 9-27.

⁷⁰³ *Supra* note 701.

⁷⁰⁴ *Hogg v. Cramphorn Ltd.*, *supra* note 701.

⁷⁰⁵ *Ibid.*

⁷⁰⁶ For Canada, see, for example, *Exco Corp. Ltd. v. Nova Scotia Savings & Loan Co.*, *supra* note 701; 347883 *Alberta Ltd. v. Producers Pipelines Inc.*, *supra* note 684.

incorporation of the fiduciary duty of loyalty into all Canadian corporate law statutes, commentators have claimed that the test no longer applies in Canada. They argue that the statutory requirement that directors and officers must exercise their powers “honestly and in good faith, with a view to the best interests of the corporation” makes no reference to the purpose for which the power has been provided.⁷⁰⁷ Therefore, the exercise of the powers of directors and officers should only be constrained by their fiduciary duty to act in the best interests of the corporation and, accordingly, they may exercise their powers for any purpose they consider appropriate.⁷⁰⁸ It has also been argued that the “proper purpose test” cannot be analyzed as an aspect of the fiduciary duty owed to the corporation, because it is nothing more than a limitation on the scope of the powers given to directors and officers.⁷⁰⁹ Consequently, the “proper purpose test” was rejected expressly in favour of the principle to act in the best interests of the corporation by the Canadian decision in *Teck Corporation Ltd. v. Millar*.⁷¹⁰ In this case, as in *Hogg v. Cramphorn*,⁷¹¹ the court was asked to consider whether it was appropriate for the board of directors to issue shares in a situation that changed the balance of control of the corporation. The court held that the directors have the right to consider the interests of the company and to exercise their powers accordingly.⁷¹² The court stated that the directors abuse their powers only if they act in their own interests rather than in the interests of the corporation:

*“The court’s jurisdiction to intervene is founded on the theory that if the directors’ purpose is not to serve the interests of the company, but to serve their own interest or that of their friends or of a particular group of shareholders, they can be said to have abused their power. The impropriety lies in the directors’ purpose. If their purpose is not to serve the company’s best interests, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose, it does not depend upon the nature of any shareholders’ rights that may be affected by the exercise of the directors’ powers.”*⁷¹³

With this, the court turned the onus to show proper purpose away from the directors. Accordingly, improper purpose can only be a relevant issue if the person challenging the directors’ actions can prove it. With regard to the determination of proper purpose, the court

⁷⁰⁷ See, for example, Frank Iacobucci, “The Exercise of Directors’ Powers: The Battle of Afton Mines” (1973) 11 (3) Osgoode Hall L. J. 353 at note 35.

⁷⁰⁸ See Hansell, *supra* note 199 at 9-28.

⁷⁰⁹ Welling, *supra* note 193 at 311.

⁷¹⁰ *Teck Corp. v. Millar*, *supra* note 624. Even earlier, in *Spooner v. Spooner Oils Ltd.*, [1936] 2 D.L.R. 634, the proper purpose test had also been rejected by a Canadian court.

⁷¹¹ *Hogg v. Cramphorn Ltd.*, *supra* note 701.

⁷¹² *Teck Corp. v. Millar*, *supra* note 624 at 410, citing *Smith & Fawcett Ltd., Re.* [1942] 1 Ch. 304 (Eng. C.A.).

⁷¹³ *Ibid.* at 410-411.

proposed as a general rule that

*"[t]he directors must act in good faith. Then there must be reasonable grounds for their belief. If they [...] believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose."*⁷¹⁴

Despite the reasoning in *Teck Corporation Ltd. v. Millar* and its subsequent applications,⁷¹⁵ the law remains unsettled with regard to whether or not the "proper purpose test" should still be applied.⁷¹⁶ It is remarkable to note that the court in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,⁷¹⁷ in contrast to the decision in *Rooney v. Cree Lake Resources Corp.*,⁷¹⁸ did not consider at all, although also referring to *Teck Corporation Ltd. v. Millar*, the purposes of the self-dealing director to reward himself with lucrative benefits. Instead, the court only asked whether the compensation agreement was in the best interests of the corporation, considering the conduct and influence of the director. Although no express statement is made by the court, I infer from the reasons in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* that the court might have regarded the proper purpose test not to be the applicable law in Canada as a supplementary test concerning a breach of the fiduciary duty of directors and officers.

In fact, the "proper purpose test" causes problems as it is based on a merely subjective view, whereas the statutory standards to act in the best interests of the corporation are rather objective. The decision in *Teck Corporation Ltd. v. Millar*⁷¹⁹ suggests that so long as a director's primary motive is in the best interests of the company, his actions are not necessarily improper because the director also benefits from the matter. Furthermore, as shows the following example of "golden parachute" provisions, even if the directors abuse their powers and primarily act in their own interest or use their power for an unauthorized purpose, their actions may still result to be in the best interests of the corporation.

(2) "Golden Parachute" Provisions

I have shown earlier that "golden parachute" provisions, from a contractual law

⁷¹⁴ *Ibid.* at 414.

⁷¹⁵ *First City Financial Corp. v. Genstar Corp.* (1981), 33 O.R. (2d) 631 (Ont. H.C.J.); *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*, *supra* note 624. See also the reference to *Teck Corp. v. Millar* in *Rooney v. Cree Lake Resources Corp.*, *supra* note 678.

⁷¹⁶ Hansell, *supra* note 199 at 9-48.

⁷¹⁷ *Supra* note 389.

⁷¹⁸ *Supra* note 678.

⁷¹⁹ *Supra* note 682

perspective, can be supported by sufficient consideration and, therefore, can be valid and enforceable.⁷²⁰ As far as corporate law is concerned, however, the decision of the directors to provide an executive with a “golden parachute” must not result in a breach of the fiduciary duty.

With regard to the purpose, defensive actions against hostile takeover attempts, in general, have been criticized as serving improper business purposes only. The common allegation has been that those defensive tactics, and “golden parachutes” in particular, were improperly taken to thwart a potential takeover of the corporation in the directors’ and officers’ sole personal interest to retain their positions.⁷²¹ Based on the “proper purpose test”, such defensive measures have therefore been held to be illegitimate decision in breach of the directors’ and executives’ fiduciary duty. In *347883 Alberta Ltd. v. Producers Pipelines Inc.*,⁷²² for example, the directors adopted a “poison pill” strategy to prevent the takeover of their corporation.⁷²³ However, the defensive tactics taken by the directors effectively deprived the shareholders of any chance to sell their shares on the market, leading to a claim against the corporation by minority shareholders. In the circumstances, given that the defence against the takeover had failed, the court found that the directors had acted only for the improper purpose of remaining in control of the corporation.⁷²⁴

To have regard to the primary purpose of a defensive measure only can be vulnerable when the takeover in fact fails and that result turns out to be in the best interests of the corporation. In *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.*,⁷²⁵ the allegation also was that the directors who had reacted to an unsolicited takeover bid acted only in the improper

⁷²⁰ Even single-triggered “golden parachutes” can be supported by sufficient consideration, see *supra* Chapter 2, I. 2. b) (2).

⁷²¹ In *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 651 at para 45, the court recognized that a “potential conflict of interest arises because as director of a target company, the senior executive has a duty to act in the best interests of the shareholders, but as a member of senior management the executive retains an interest in continued employment.” The court then at para. 49 referred to *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 651 at para. 75, where Blair J. commented that a “golden parachute” did not eliminate the potential for conflict of interest with respect to continued employment.

⁷²² *347883 Alberta Ltd. v. Producers Pipelines Inc.*, *supra* note 684.

⁷²³ The term “poison pill” refers to various methods used by target companies to make a takeover prohibitively expensive without the co-operation of the target company’s management. “Golden parachute” provisions are just one of several possible “poison pills”. In *347883 Alberta Ltd. v. Producers Pipelines Inc.*, *supra* note 684, instead of providing management with “golden parachutes”, the directors adopted a so-called “shareholders’ rights plan” requiring the unanimous consent of the board prior to an offer to shareholders to buy back the shares from shareholders.

⁷²⁴ *347883 Alberta Ltd. v. Producers Pipelines Inc.*, *supra* note 684 at 402: “[T]he onus will be on [the directors] to show that their acts were [...] directed to the benefit of the corporation and its shareholders as a whole, and not for an improper purpose such as entrenchment of the directors.”

⁷²⁵ *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*, *supra* note 624.

purpose to entrench their positions. However, here the takeover failed due to the defensive measure taken by the directors who had successfully caused the company to buy back its shares. This step had been recommended by independent professional advisors to maximize shareholder value. Upon that evidence, the court held that the directors' primary objective was to ensure a maximum of shareholder value for all the shareholders. It did not matter that the directors benefited by maintaining their positions within the corporation when they clearly acted in the best interests of the corporation.⁷²⁶

The decision of the Privy Council in *Taupo Totara Timber Co. Ltd. v. Rowe*⁷²⁷ explicitly deals with a "golden parachute". Here, the change in control clause provided for the executive to receive an amount equal to five times his annual salary, plus benefits, should a corporate change occur. It provided that the executive could trigger this provision within 12 months after the corporate change. For the court, Lord Wilberforce noted:

*"The view that inclusion of a provision giving protection in the event of a takeover was in the interests of the company, was clearly one that reasonable and honest directors might take. In its absence, the staff might be likely to go elsewhere. In the case of the respondent, ..., an agreement in substantially similar form had been entered into in 1969 and there could be nothing suspicious, or open to criticism, in replacing that agreement in 1971 when he became a managing director. ..., there is explicit power in the articles to appoint a managing director on such terms as the directors, acting of ourse bona fide, think fit."*⁷²⁸

In addition, in the recent Canadian case of *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*⁷²⁹, the court referred to the issue of proper purpose and expressly stated that "golden parachutes" also have a number of legitimate business purposes. Considering the potential result in substantial financial exposure for the company, the court concluded that "golden parachutes", however, must always be in the best interests of the corporation.⁷³⁰ This statement indicates that "golden parachutes" do not in general constitute a breach of fiduciary duty, but must be "fair and reasonable to the corporation" considering the circumstances in the particular case.⁷³¹

The line of cases indicate that even if "golden parachutes" and other defensive tactics appear to be agreed upon primarily for personal purposes of the directors and executives, they

⁷²⁶ *Ibid.*

⁷²⁷ *Taupo Totara Timber Co. Ltd. v. Rowe*, *supra* note 295.

⁷²⁸ *Ibid.* at 128.

⁷²⁹ *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.* (2002), 57 O.R. (3d) 775 (Ont. S.C.J.).

⁷³⁰ *Ibid.*

⁷³¹ See the following discussion *infra*.

may still be in the best interests of the company. Considering also the statutory fiduciary duty of loyalty not referring to the purpose of any act by directors and officers, the “proper purpose test” should not be applied by Canadian courts. The test should only be whether or not a “golden parachute” was in the best interests of the corporation, regardless of any primary purpose directors and officers might have had.

Despite the existence of few affirming case law mentioned above,⁷³² there has in the past been substantial debate on the issue whether or not “golden parachutes” are in the best interest of the corporation. Directors and executives of corporations that are likely to be the target of a takeover face a potential conflict of interest between their own interests, those of individual groups of shareholders and those of the corporation.⁷³³ According to their fiduciary duty to act in the best interests of the corporation, they must, in a first step, decide whether or not the takeover would result to be in the best interests of the corporation.⁷³⁴ Once the decision not to oppose a takeover is made, the fiduciary duty obliges them to negotiate for the best price available in order to maximize shareholder value.⁷³⁵ On the other hand, directors and officers of a target corporation face the risk of being replaced by the new owners of the corporation. In their own interest, they long for some kind of security or severance in case they are ousted. “Golden parachutes” have been used to approach this potential conflict of interest.

Without a doubt, “golden parachute” provisions or agreements provide substantial financial benefits to an executive upon a change in control of the company.⁷³⁶ They provide the executive with the financial security necessary to survive the turbulent period that surrounds the takeover attempt. Advocates of “golden parachutes”, however, argue that the corporation is also significantly benefited by such agreements and, therefore, they are in the best interests of the

⁷³² See *Taupo Totara Timber Co. Ltd. v. Rowe*, *supra* note 295; *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*, *supra* note 729; *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*, *supra* note 624. To the contrary, see *Rooney v. Cree Lake Resources Corp.*, *supra* note 678; *Cannaday v. McPherson*, *supra* note 668; *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁷³³ See *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 651 at paras. 34 and 45; *Brant Investments Ltd. v. KeepRite Inc.* (1987), 60 O.R. (2d) 737 (Ont. H.C.), affirmed (1991), 3 O.R. (3d) 289 (Ont. C.A.) at 301.

⁷³⁴ *Ibid.*

⁷³⁵ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 54 U.S.L.W. 2483, 66 A.L.R. 4th 157 (Del. S.C., 1985) at 182. The case established the principle that the fiduciary duty shifts from protecting or maintaining the corporate enterprise to the obligation to sell at the best price once the reasonable decision has been made that the takeover has become inevitable. Although Canadian jurisprudence has not adopted the obligation to pursue an auction as established in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, it has accepted the shift in the obligation of the board of directors as to seek the best value reasonably available to shareholders in the circumstances, see *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 651 at para. 62.

⁷³⁶ See also Echlin and Thomlinson, *supra* note 109 at 73.

corporation.⁷³⁷ The proponents assert that “golden parachutes” not only ensure the continuity of top management during periods of uncertainty, as executives are less likely to resign in favour of more secure employment.⁷³⁸ More importantly, a “golden parachute” is viewed to offer a way for the directors to ensure that the executive will manage the company in a conscientious way, even in the event of a change in control, by guaranteeing that the executive will be well rewarded no matter what happens.⁷³⁹ It is also argued that a properly designed golden parachute will make its beneficiary indifferent between remaining in control of his corporation and supporting a takeover that is likely to result in his discharge.⁷⁴⁰ This state of indifference will, in theory, enable the executive to perform his fiduciary duties with less distraction and free him to seek the best outcome for the shareholders.⁷⁴¹ The executive negotiating on behalf of the target corporation is believed to be best able to represent the needs of the company and maximize the return to the shareholders if he is unconcerned as to the ultimate effect of the change of control on his position within the company. This financial security permits the executive to consider, examine and advise on a controversial takeover bid in a dispassionate and objective manner in the best interests of the corporation and with no distracting or compromising concern about his own personal well-being in terms of remaining on the management. Thus, “golden parachutes” allow the board of directors to rely on the executive’s advice without concern for the executive’s objectivity or personal interest.⁷⁴²

Opponents of “golden parachutes”, on the other hand, contend that there is no reason for a corporation to pay a ransom to ensure exclusive loyalty that ought to have been guaranteed by the executive by reason of his employment contract. Executives should not receive additional compensation for a pre-existing duty to be loyal and to act at all times in the best interest of the business and the shareholders. Moreover, executives who will be well compensated despite the outcome of a change of control may favour takeovers that are not in the shareholder’s best interest, as the thought of a lucrative exit may be more appealing than remaining with the company.⁷⁴³

⁷³⁷ See, for example, Noonan, *supra* note 53 at 3.

⁷³⁸ *Ibid.*

⁷³⁹ Echlin and Thomlinson, *supra* note 109 at 73.

⁷⁴⁰ Bress, *supra* note 166 at 959.

⁷⁴¹ *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*, *supra* note 729.

⁷⁴² See Noonan, *supra* note 53 at 3.

⁷⁴³ See Echlin and Thomlinson, *supra* note 109 at 73.

Those arguments are quite compelling. However, although the executive in theory is at any time bound by his fiduciary duty to act in the best interests of the corporation, the potential conflicts of interests in takeover situations, especially the executive facing termination, should not be neglected. In practice, the “golden parachute” provision may in these cases well serve as an incentive for the executive to act partially only in his own best interests in order to save his employment. In addition, if the “golden parachute” is double-triggered, its function as a severance provision cannot be regarded to be against the best interests of the corporation. If the executive is terminated or resigns “for good reason” as a result of the takeover and prior to the contractual end of his term, he would be entitled to damages for wrongful dismissal. In this respect, a double-triggered “golden parachute” prevents the corporation from being sued by the executive for breach of contract. On the other hand, a single-triggered “golden parachute” which is not contingent to the termination of the executive cannot be justified on these grounds. Neither does it preserve the corporation from litigation for wrongful dismissal nor does it serve as an incentive to serve independently with a view to the best interests of the corporation. An executive who will receive a payment only in the event that there is a change in control is not likely to oppose the takeover, even if a takeover results in not being in the best interests of the corporation. Under the security and independence notion, a single-triggered “golden parachute”, therefore, cannot be regarded to be in the best interest of the corporation.

As part of the initial compensation package in terms of a change in control clause, “golden parachutes” can also be regarded as necessary in order to facilitate the recruitment of good executives who otherwise would not consider the position sufficiently attractive.⁷⁴⁴ Without these types of financial arrangements protecting executives from the risk of termination without cause in case of hostile takeovers, businesses which are the target of takeovers would have difficulties in recruiting key executives.⁷⁴⁵ Further, some proponents of “golden parachutes” claim that they are a defence mechanism to hostile takeover bids. In essence, it is believed that an unwanted acquiring company will be discouraged by the costs it will have to incur in the event the attempt becomes reality and the successor wishes to eliminate existing management.⁷⁴⁶ However, in the absence of reliable empirical evidence, this argument needs to remain

⁷⁴⁴ *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*, *supra* note 729. See also Wilson and Taylor, *supra* note 167 at 45; Echlin and Thomlinson, *supra* note 109 at 73. For the U.S., see *Freeman v. Barrow*, (1976) 427 F. Supp. 1129 (S.D.N.Y.).

⁷⁴⁵ See Stikeman, Elliott, *supra* note 134 at § 20.149.

⁷⁴⁶ Wilson and Taylor, *supra* note 167 at 45. Hanrahan, *supra* note 173 at 824

hypothetical in general as the effectiveness of the “golden parachute” as such a defensive measure strongly depends on the relation between the additional compensation that will have to be awarded to the executive and the total costs of the transaction. Assuming, for example, total transaction costs for a major takeover of more than \$ 500 million and “golden parachute” provision of an aggregate amount of not more than \$ 5 million, it appears unlikely for the takeover attempt to fail simply because of additional costs of 1 per cent of the total transaction costs. Although the costs to be incurred might be a factor to be considered by the potential acquiror, especially if the relation is higher than 1 per cent as in the example, I conclude that it is generally unlikely that the parachute standing alone would discourage a hostile takeover.

The defence measure argument is also vulnerable with respect to the fiduciary duty to act in the best interests of the corporation. If a “golden parachute” provision is entered into the original compensation agreement, it is uncertain whether there will be a takeover bid at all. The general strategy to avoid a takeover might not be in the best interests of the corporation. At the time the “golden parachute” is agreed, the financial situation of the corporation may be accurate. However, in the course of the business there may evolve financial distress to an extent that a takeover by a financially stronger corporation may appear to be the only solution that, with regard to shareholder wealth, is in the best interests of the corporation. To put it another way, it is impossible to declare a “golden parachute” provision as a general defence measure to be in the best interest of the corporation. However, once the corporation becomes a target for a hostile takeover, according to the circumstances of the particular case the directors may find that a defence measure may be in the interests of the corporation. In this context, even a single-triggered “golden parachute” may result to be in the best interests of the corporation if it effectively serves the purpose to avoid the takeover.

Finally, opponents also found their criticism on the excessive nature of the monetary clause, alleging that it promotes “corporate waste” and overcompensates executives. This aspect, however, needs to be distinguished from the issue that “golden parachutes” can generally be in the best interests of the corporation. The exact amount of the payment may, of course, not be in the best interest of the corporation. However, this concern rather relates to the notion that a “golden parachute” provision, in order to be regarded in the best interests of the corporation, needs to be “fair and reasonable to the corporation”.⁷⁴⁷

⁷⁴⁷ See the following discussion *infra*.

In conclusion, the decision to provide executives with “golden parachutes” cannot generally be regarded as a breach of the fiduciary duty of loyalty. Although its main intention is to serve the executive, a “golden parachute” provision may as well be in the best interests of the corporation. In *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*,⁷⁴⁸ the court confirmed that “golden parachutes” are a protective mechanism for both the corporation and the executive considering as legitimate business purposes that they serve to retain executives and ensure their loyalty to the corporation in a time of uncertainty and offer financial security to the executive in the event of termination, either voluntary or not. Thus, the general decision whether to provide the executive with a “golden parachute” can well be in the best interests of the corporation, but depends strongly on the circumstances of each particular case. Considering, for example, the potential financial exposure for the company, the fiduciary duty of loyalty not only requires that the decision itself be in the best interests of the corporation, but also requires that the structure and amount of the “golden parachute” be in the best interests of the corporation. Accordingly, “golden parachutes” must be “fair and reasonable” to the corporation.

Early U.S. cases generally justified “golden parachutes” as being in the best interests of the corporation if they represented reasonable damages with respect to all circumstances of the specific case.⁷⁴⁹ On these grounds, the U.S. court in *Buckhorn Inc. v. Ropak Corp.*⁷⁵⁰ upheld a “golden parachute” as reasonable in relation to the threat of a takeover.⁷⁵¹ In another U.S. case, the “golden parachute” for the president of a wholly-owned subsidiary was upheld on the basis of freedom of contract without even considering its reasonableness.⁷⁵² Following cases, however, clarified that the test regarding “golden parachutes” should be whether they could be justified as being “fair and reasonable” to the corporation and whether they would have been recommended themselves to an independent board of directors that was acting in the best interests of the corporation.⁷⁵³

Canadian jurisprudence has subsequently adopted the U.S. test as to whether executive

⁷⁴⁸ *Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.*, *supra* note 729.

⁷⁴⁹ See, for example, *Koenings v. Joseph Schlitz Brewing Co.*, *supra* note 54.

⁷⁵⁰ *Buckhorn Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio, 1987), affirmed 815 F.2d 76 (6th Circ., 1987).

⁷⁵¹ However, the court found that the vesting of stock options and the granting of new stock options were unreasonable actions taken to entrench management and, therefore, could not be justified as reasonable business purpose, see *ibid.* at 232.

⁷⁵² *Royal Crown Companies Inc. v. McMahon*, 359 S.E. 2d 379 (Ga. C.A., 1987).

⁷⁵³ *Supra* notes 671 through 673.

compensation and similar agreements are “reasonable and fair” to the corporation.⁷⁵⁴ By virtue of that case law, the test for “golden parachutes” also needs to be whether or not in all the circumstances the transaction carried the earmarks of an arm’s length bargain, whether the negotiation process was fair, and whether an independent board of directors acting in good faith with a view to the best interests of the corporation would have recommended the “golden parachute”.⁷⁵⁵ All factors relevant in the specific case must be taken into consideration when determining the reasonableness and fairness of the “golden parachute” to the corporation.⁷⁵⁶

Accordingly, a “golden parachute” provision not always, but in certain situations can be inappropriate and not in the best interests of the corporation.⁷⁵⁷ In *Rooney v. Cree Lake Resources Corp.*, considering the particular circumstances, the court found that the only reason to enter into the agreement was to discourage the board from terminating the contract prematurely since the payment of the “golden parachute” would have been disastrous for the company as it represented 70% of its assets.⁷⁵⁸ The agreement had the extent that it potentially prevented the company from terminating the contract in order to financially survive. When aggrieved shareholders claimed a breach of fiduciary duty, the agreement was found to be not fair and reasonable to the corporation and, therefore, not to be enforceable. In light of the financial situation and the substantial influence of the inside director over the negotiation process, the “golden parachute” agreement in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*⁷⁵⁹ was also held to be unfair and unreasonable to the corporation, constituting a breach of fiduciary duty. In another recent Canadian case,⁷⁶⁰ the inside director of the corporation had entered into an agreement providing him the full amount of his remuneration for the whole term of the contract if he was ever terminated. Considering the precarious financial situation of the company at the time the agreement was signed, the court in *Mondoux v. 9041-6868 Québec inc.* held that the “golden parachute” was excessive and unenforceable. It concluded that the director, facing a clear conflict of interests, breached his fiduciary duty to act

⁷⁵⁴ See *supra* at c).

⁷⁵⁵ *Cannaday v. McPherson*, *supra* note 668 and *Rooney v. Cree Lake Resources Corp.*, *supra* note 678 explicitly dealt with “golden parachute” agreements, whereas *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389, applied the test for executive compensation agreements in general.

⁷⁵⁶ For a list of potential factors to be taken into consideration, see *supra* at c).

⁷⁵⁷ See also *Wilson and Taylor*, *supra* note 167 at 46.

⁷⁵⁸ *Rooney v. Cree Lake Resources Corp.*, *supra* note 678 at para. 57.

⁷⁵⁹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁷⁶⁰ *Mondoux v. 9041-6868 Québec inc.*, [2003] R.J.Q. 2596, R.J.D.T. 1545 (Que. S.C.).

with diligence, honesty and loyalty in the best interests of the corporation.

e) Conclusion

Directors and officers owe a fiduciary duty of loyalty to the corporation. They must at any time act honestly, in good faith and with a view to the best interests of the corporation. As fiduciaries, directors and officers cannot permit their private interests to conflict with the best interests of the corporation, except with the knowledge and consent of the company and provided that a self-interested transaction is fair and reasonable to the corporation.

Recent Canadian cases illustrate that self-interested behaviour of corporate insiders to the detriment of the corporation can be effectively challenged by aggrieved shareholders. Compensation and severance agreements as well as “golden parachutes” that result from self-dealing can be regarded as a breach of the fiduciary duty of loyalty. However, there is no general rule as to when such transaction is or is not in the best interests of the corporation. The test will be whether the agreement was fair and reasonable to the corporation under the circumstance of each particular case. Substantial criteria will be the effect of the agreement to the financial situation of the corporation and special factors in the person of the beneficiary.

2. The Duty of Care

The decision to provide executives with severance packages or “golden parachutes”, be it either in the initial executive service contract or by way of a “golden handshake” agreement, is a general business decision by the board of directors.

The directors are obliged by the fiduciary duty to exercise their powers honestly and in good faith with a view to the best interests of the corporation. As fiduciaries, the law of trusts demands that the directors serve with skill and diligence. In addition, the law of negligence recognizes that directors, by virtue of their positions, have such a close relationship to the corporation that their carelessness could foreseeably harm the corporation.⁷⁶¹ Accordingly, directors are obliged to make their business decisions with a certain standard of care. Initially, the standard of care was defined at common law. Since the 1970s, federal and provincial corporate law statutes have incorporated a statutory “duty of care”. Generally speaking, the duty of care imposes a legal

⁷⁶¹ *Kamloops v. Nielsen*, [1984] 2 S.C.R. 2 (S.C.C.); *B.D.C. Ltd. v. Hofstrand Farms Ltd.*, [1986] 1 S.C.R. 228 (S.C.C.); *C.N.R. Norsk Pacific Steamship Co.* (1992), 91 D.L.R. (4th) 289 (S.C.C.); *Hercules Managements Ltd. v. Ernst & Young* (1997), 146 D.L.R. (4th) 577 (S.C.C.).

obligation upon directors and officers to be diligent in supervising and managing the corporation's affairs.⁷⁶² As a result, each director, regardless of him being involved in self-dealing or not, is obliged to exercise reasonable care when making business decisions such as providing the executive with severance packages or "golden parachutes".⁷⁶³

a) The Standard of Care at Common Law

The existence of the duty of care for directors and officers is a long-standing principle of the common law.⁷⁶⁴ The applicable standard of care, however, has been the subject of judicial consideration since the late nineteenth century. In the leading English case of *Re: City Equitable Fire Insurance Company Ltd.*,⁷⁶⁵ the court commented on the directors' standard of care as follows:

*"In discharging the duties of his position thus ascertained a director must, of course, act honestly; but he must also exercise some degree of both skill and diligence [...] as would amount to the reasonable care which an ordinary man might be expected to take, in the circumstances, on his own behalf[, b]ut he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience."*⁷⁶⁶

The court also held that directors are not liable for errors in their business judgment, as their primary function is to use their own particular skills in advocating corporate risk-taking.⁷⁶⁷ Notwithstanding the court's notion of "reasonable care", the decision is generally referred to as illustrating a subjective standard of care imposed on the directors by the common law.⁷⁶⁸ A director was only required to perform his duties in the manner expected of a person of his knowledge, skills and experience. No high objective standard was expected of him and the courts

⁷⁶² *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 32.

⁷⁶³ The recent decision in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 has shown that especially when there is improper influence of a self-interested director over the decision-making process regarding executive compensation, the other directors have to exercise their business judgment with reasonable care. For more details, see *infra* at b) and c).

⁷⁶⁴ See *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 59.

⁷⁶⁵ *Re City Equitable Fire Insurance Company Ltd.*, [1925] 1 Ch. 407, [1924] All. E.R. Rep. 485 (Eng. C.A.). Among the earliest English cases were also *Dovey v. Corey*, [1901] A.C. 477 (Eng. H.C.) and *In re Brazilian Rubber Plantations and Estates, Ltd.*, [1911] 1 Ch. 425 (C.A.).

⁷⁶⁶ *Re City Equitable Fire Insurance Company Ltd.*, *supra* note 765 at 427-428.

⁷⁶⁷ *Ibid.* at 428.

⁷⁶⁸ See, for example, *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 59; VanDutser, *supra* note 185 at 299; Hansell, *supra* note 199 at 9-64; Mike Mangan, *Directors' Liability in Canada* (North Vancouver: STP Specialty Technical Publishers, Loose-Leaf) at 1-37; McCarthy Tétrault (firm), ed., *Directors' and Officers' Duties and Liabilities in Canada* (Toronto and Vancouver: Butterworths, 1997) at 15; Paul L. Davies, *Gowers and Davies' Principles of Modern Company Law* (7th ed., London: Sweet & Maxwell, 2003) at 433.

were not to question his business judgment reasonably exercised.⁷⁶⁹ In addition, the rule in *Foss v. Harbottle*⁷⁷⁰ created a procedural barrier giving the right to sue the directors in these circumstances solely to the company, not to the shareholders.⁷⁷¹ As a result, under the subjective standard of care, at common law directors generally were not exposed to a high risk of being held liable for failing to meet the standards of care.⁷⁷²

b) The Statutory Duty of Care

Consequently, the subjective standard of care as imposed by common law was considered to be too low and, therefore, supplemented by numerous corporate law statutes.⁷⁷³ Most of the Canadian statutes today require directors and officers in exercising their powers and discharging their duties to “exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.”⁷⁷⁴

The statutory provisions generally set a benchmark against which the conduct of directors and officers will be assessed.⁷⁷⁵ In deciding whether a director or officer has met the level of care required by the statutory standard, the courts will make inquiry as to what a reasonably prudent person would have done if he had been director or officer of the corporation in question.⁷⁷⁶ By measuring every individual’s performance against that which one might expect from a reasonable person, the statutory law applies a rather objective standard of care regardless of the

⁷⁶⁹ Stikeman, Elliott, *supra* note 134 at § 20.36.

⁷⁷⁰ *Foss v. Harbottle*, [1843] 2 Hare 461, 67 E.R. 189 (Ch. D.).

⁷⁷¹ At common law, *Foss v. Harbottle* established the fundamental principle of corporate law that a company and its shareholders are distinct entities and only the company can sue for a wrong done to it, see, for example, the recent reference in *Pasnak v. Chura* (2003), 35 B.L.R. (3d) 71, 2003 BCSC 782 (B.C.S.C.) at para. 50. However, corporate law statutes have replaced the rule in *Foss v. Harbottle* by introducing the derivative action, permitting shareholders to sue in the company’s name to remedy an injury to the corporation caused by the directors or executives. The derivative action will be discussed *infra* at III. 3.

⁷⁷² Not surprisingly, VanDutzer, *supra* note 185 at 299, states that “the honest and diligent, but incompetent director had nothing to fear”.

McGuiness, *supra* note 613 at 776 concludes: “Given the history of case law in this area, and the prevailing standards of competence displayed in commerce generally, it is quite clear that directors were not expected at common law to have any particular business skill or judgment.”

⁷⁷³ See, for example, the criticism in *Dixon v. Deacon Morgan McEuen Easson* (1989), 41 B.C.C.R. (2d) 180 (B.C.S.C.).

⁷⁷⁴ This wording is borrowed from Section 122(1)(b) CBCA. See also Section 134(1)(b) OBCA. To the same extent, see Section 142(1)(b) BCBCA. Provisions in other provincial corporate law statutes are also very similar.

⁷⁷⁵ Sarra and Davis, *supra* note 622 at 32.

⁷⁷⁶ McCarthy Tétrault, *supra* note 768 at 16.

individual's particular knowledge and experience.⁷⁷⁷

The statutory duty of care imposes a minimum standard of competence. Directors as well as officers must have at least a rudimentary understanding of the business.⁷⁷⁸ A reasonably prudent person occupying the position of a director or officer of the corporation would generally be expected to pay careful attention to, and be concerned with, the affairs and needs of the corporation. With particular reference to directors, the statutory duty of care requires that directors bring their knowledge, experience, and best judgment to bear on issues of concern to the corporation.⁷⁷⁹ Directors must be kept informed of the policies, business and affairs of the corporation. Moreover, they should not rely blindly on other persons, be they experienced executives or well-known directors.⁷⁸⁰

However, the content of the statutory duty of care, like the fiduciary duty, is highly dependent on the facts of the particular case. The reference to a person "in comparable circumstances" suggests that the statutory duty retains a kind of subjective element.⁷⁸¹ Regardless of whether the standard be called objective or objective-subjective, the statutory standard requires rather than only permits consideration of all of the relevant factors that may have surrounded the decision-making process of the board of directors.⁷⁸² These factors include, among others, the nature of the information available to the director, the time constraints under which the decision was made, the importance of the decision, the availability of feasible alternative decisions.⁷⁸³ However, directors and officers must diligently apply whatever skills and experience they possess. Thus, the standard of care will vary depending on the person's position in relation to whatever is the conduct alleged to constitute a breach of the duty of care. If

⁷⁷⁷ See *ibid.* at 15; VanDutzer, *supra* note 185 at 298; For a discussion of the merits of the object standard, see also Davies, *supra* note 768 at 434-437.

⁷⁷⁸ For the parallel provision in U.S. statutory corporate law, see *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J.S.C., 1981).

⁷⁷⁹ McCarthy Tétrault, *supra* note 768 at 16.

⁷⁸⁰ See, for example, *Banks, Re* (2003), 34 B.L.R. (ed) 292 (Ont. Sec. Com.), where the chairman of the board and C.E.O. was held to have breached his duty of care by unreasonably relying on the management and other directors. See also 484887 *Alberta Inc. v. Faraci* (2002), 27 B.L.R. (3d) 110, 4 Alta. L.R. (4th) 154 (Alta. Q.B.). Another very important decision in this subject is *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁷⁸¹ VanDutzer, *supra* note 185 at 300-301. By contrast, the court in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 62 believed that "[t]his is not the introduction of subjective element relating to competence of the director, but rather the introduction of a contextual element into the statutory standard of care]" and, therefore, prefers to describe it as an objective standard.

⁷⁸² *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra*, note 611 at para. 63. See also VanDutzer, *supra* note 185 at 298.

⁷⁸³ Mangan, *supra* note 768 at 1-38.

a person has significant knowledge or experience, it will result in a higher standard of care.⁷⁸⁴ For example, serving on a board committee will constitute different comparable circumstances and may require more care of the director on the basis that he has special knowledge, better expertise or greater access to relevant information.⁷⁸⁵

In summary, directors who wish to meet the statutory standard of care need to be attentive, active and informed. They will have to ascertain their duties and seek to acquire sufficient knowledge concerning the corporation's business and affairs in order to comply with the statutory duty of care.⁷⁸⁶ Whereas at common law corporations tended to set their own standard of care at a level even lower than required by case law,⁷⁸⁷ corporate statute law establishes that no provision in a contract, the articles, the by-laws, or a resolution relieves a director or officer from the statutory duty of care or from liability for breaching it.⁷⁸⁸

c) The Business Judgment Rule

The emergence of a stricter statutory standard of care obliges the corporations to improve the quality of business decisions made by the board of directors and the management. However, despite the movement from the sole subjective standard of care at common law to the more objective one under statute law, an allegation of a breach of the duty of care in practice is still faced with the obstacle commonly referred to as the "business judgment rule" that protects directors and officers from liability for decisions made without fraud or self-dealing.⁷⁸⁹

U.S. courts were the first to recognize the risk inherent in business decisions taken by

⁷⁸⁴ *Soper v. Canada*, [1998] 1 F.C. 124, 149 D.L.R. (4th) 297 (F.C.A.): "directors who are also managers must meet a higher standard of care." See also *Re Standard Trustco Ltd.* (1992), 6 B.L.R. (2d) 241 (Ont. Sec. Com.). This case has been criticized as raising the standard of care for directors and officers too much, see Jeffrey G. MacIntosh, "Standard Trustco Case signals Expansion of the 'Public Interest' Powers of Securities Regulators" (1993) 1 Corp. Financing 38.

⁷⁸⁵ *Re Standard Trustco Ltd.*, *supra* note 784 at 290. See also the example in VanDutser, *supra* note 185 at 301, referring to a director who is member of an audit committee.

⁷⁸⁶ See also McCarthy Tétrault, *supra* note 768 at 16.

⁷⁸⁷ See, for example, *Re City Equitable Fire Insurance Company Ltd.*, *supra* note 765, where the by-laws of the corporation provided that the directors were liable only for their "wilful neglect or default".

⁷⁸⁸ See Section 122(3) CBCA.

⁷⁸⁹ See *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct., 1944), holding that "the 'business judgment rule', however, yields to the rule of undivided loyalty. This great rule of law is designed to avoid the possibility of fraud and to avoid the temptation of self-interest".

directors and management of the corporation.⁷⁹⁰ Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. The courts believed that judicial deference to board decisions was necessary to encourage boards to take risks and exercise their best judgment.⁷⁹¹ They realized that risk-taking and sound judgment might be impaired, if boards feared their decisions might be second-guessed by the courts, which normally have the benefit of hindsight but only limited business experience.⁷⁹² The courts conceded that directors and officers generally have better business expertise,⁷⁹³ and evinced reluctance to interfere with business decisions as long as they did not involve fraud or self-dealing and were made on an informed basis and in what the directors and executives honestly believed to be in the best interests of the corporation.⁷⁹⁴ Therefore,⁷⁹⁵ the courts applied the “business judgment rule” to give

*“great deference to the substance of the directors’ decision[.] [Courts] will not invalidate the decision, will not examine its reasonableness, and will not substitute [their] views for those of the board if the latter’s decision can be attributed to any rational business purpose”.*⁷⁹⁶

⁷⁹⁰ Among the best known cases are *Aronson v. Lewis*, *supra* note 660; *Smith v. Van Gorkom*, 488 A.2d 858 (Del. S.C., 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, *supra* note 735; *Hanson Trust plc v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. N.Y. 1986); *Re First Boston, Inc., Shareholders Litigation*, [1990] Fed. Sec. L. Rep. 322 (Del. S.C., 1990); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. S.C., 1994).

See also earlier cases such as *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. S.C., 1919) at 684; *Davis v. Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 142 A. 654 (Del. Ch., 1928); *Heller v. Boylan*, 29 N.Y.S.2d 653 at 667, affirmed on rehearing, 29 N.Y.S.2d 702 (Sup. Ct. 1941), affirmed, 263 A.D. 815, 32 N.Y.S.2d 131 (1941), rehearing denied, 263 A.D. 852, 32 N.Y.S.2d 1011 (1942); *Bayer v. Beran*, *supra* note 789; *Shlensky v. Wrigley*, 9, Ill. App. 2d 173 (1968) at 181, 237 N.E.2d 776 at 780; *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. S.C., 1971) at 720; *Panter v. Marshall Field & Co.*, *supra* note 660 at 293; *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982) at 1282.

More recent U.S. cases are, for example, *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, (Del. Ch., 2002); *Re Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch., 2003).

⁷⁹¹ *Johnsen*, *supra* note 171 at 912.

⁷⁹² *Shlensky v. Wrigley*, *supra* note 790 at 781.

⁷⁹³ See, for example, *Dodge v. Ford Motor Co.*, *supra* note 790: The Michigan Supreme Court famously invoked the business judgment rule in refusing to enjoin Henry Ford’s plans to expand production, noting that “we are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company”. As justification for its decision, the court modestly observed that “[J]udges are not business experts.” See also *Mills v. Esmark, Inc.*, *supra* note 790.

⁷⁹⁴ *Smith v. Van Gorkom*, *supra* note 790.

⁷⁹⁵ According to Marleen A. O’Connor, “*The Enron Board: The Perils of Groupthink*” (2003) 71 U. Cin. L. Rev. 1233 at 1247, social psychology also lends support to the business judgment rule because external review of group decision-making would harm the interpersonal relationships among board members that are necessary for boards to function. This threat to cohesiveness is believed by O’Connor to also offer a rationale as to why corporate law does not distinguish among directors for liability purposes.

⁷⁹⁶ See *Paramount Communications, Inc. v. QVC Network, Inc.*, *supra* note 790 at 45 note 17, quoting *Unocal Corp. v. Mesa Petroleum Co.*, *supra* note 54 at 949.

The “business judgment rule” under the traditional U.S. model establishes a legal presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.⁷⁹⁷ Regarding executive compensation agreements and “golden parachute” provisions, the “business judgment rule” poses that the courts defer to the board of directors' good faith decisions.⁷⁹⁸ When deciding whether a board has acted in good faith in determining executive compensation, the courts typically require that the compensation bear a reasonable relationship to the services performed by the executive.⁷⁹⁹ If those services are wholly unrelated to the compensation given, the board's decision is likely to be invalidated as corporate waste. In addition, however, it is also required that the process for making the decision be reasonable in the circumstances of the particular case.⁸⁰⁰ Accordingly, the decision-maker must have made reasonable efforts to ensure that he had the information and advice necessary to make a reasonable decision.⁸⁰¹ If self-dealing is involved, the presumption of the “business judgment rule” is rebutted and the burden of proof shifts to the corporate insider who then must show that the contract was “reasonable and fair to the corporation” with respect to his fiduciary duty of loyalty.⁸⁰²

Although the approach taken by Canadian courts was similar to the American procedure,⁸⁰³

⁷⁹⁷ *Aronson v. Lewis*, *supra* note 660 at 812: “the business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”; *Heller v. Boylan*, *supra* note 790 at 667: “[The] courts are hesitant to interfere with business decisions made by a corporate board unless there is evidence of fraud, bad faith, or overreaching”; *Mills v. Esmark, Inc.*, *supra* note 790 at 1282 note 3: “The business judgment rule is a rule of judicial restraint born of the recognition that directors are, in most cases, more qualified to make business decisions than are judges.” Its basic premise is that, absent some evidence of wrongdoing, the business decisions made by a board of directors should not be fodder for in-depth ex post legal scrutiny, see *Sinclair Oil Corp. v. Levien*, *supra* note 790 at 720; *Shlensky v. Wrigley*, *supra* note 790 at 781.

⁷⁹⁸ *Johnsen*, *supra* note 171 at 923.

⁷⁹⁹ See *supra* at 1. c).

⁸⁰⁰ *Smith v. Van Gorkom*, *supra* note 790. For Canada, with regards to the fairness of the decision-making process, see *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁸⁰¹ *Smith v. Van Gorkom*, *supra* note 790.

⁸⁰² *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch., 1986) at 111. At U.S. law, the “reasonableness and fairness test” is also called the “entire fairness principle”, see *Weinberger v. UOP, Inc.*, *supra* note 635 at 711 and accompanying text to notes 634 through 638. See also *Lewis v. Vogelstein*, *supra* note 652 at 333, observing that directors dealing with themselves “constitute self-dealing that would ordinarily require that the directors prove that the grants involved were, in the circumstances, entirely fair to the corporation”.

⁸⁰³ See, for example, *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733; *Benson v. Third Canadian General Investment Trust Ltd.* (1993), 14. O.R. (3d) 493 (Ont. Ct. (Gen. Div.)); *Re R. J. Jowsey Mining Co.* (1969), 6 D.L.R. (3d) 97 (Ont. C.A.).

the business judgment rule was not officially adopted in Canada until the late 1990s.⁸⁰⁴ In its 1991 decision, the court in *Brant Investments Ltd. v. KeepRite Inc.* confirmed the U.S. position without expressly referring to the “business judgment rule” when stating that

*“[...] [T]he trial judge is required to consider the nature of the impugned acts and the method in which they were carried out. That does not mean that the trial judge should substitute his own subject for that of managers, directors or a committee [...]. He is dealing with the matter at a different time and place, it is unlikely that he will have the background knowledge and expertise of the individuals involved [...] and it is unlikely that he would have any knowledge of the specialized market in which the corporation operated. In short, he does not know enough to make the business decision required. That does not mean that he is not well equipped to make an objective assessment of the very factors [...].”*⁸⁰⁵

The court also approved the remarks of the trial judge that

*“[b]usiness decisions, honestly made, should not be subject to microscopic examination. There should be no interference simply because a decision is unpopular with the minority.”*⁸⁰⁶

The position in Canada also was that the duty of care required that business decisions, which were likely to affect shareholder wealth, needed to be made on an informed and reasonable basis. The court in *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* expressed this rule as follows:

“[Directors and officers] must make a decision and exercise their judgment in an informed and independent fashion, after reasonable analysis of the situation and acting on a rational basis with reasonable grounds for believing that their actions will promote and maximize shareholder value. [...]” “The directors’ actions are not to be judged against the perfect vision of hindsight, and should be measured against the facts as they existed at the time the impugned decision was made. In addition, the court should be reluctant to substitute its own opinion for that of the directors where the business decision was made in reasonable and informed reliance on the advice of financial and legal advisors appropriately retained and consulted in the circumstances.”⁸⁰⁷

Subsequently, in *Maple Leaf Foods Inc. v. Schneider Corp.*, the court finally recognized the American business judgment rule in effect also in Canada by stating:

“The law as it has evolved in Ontario and Delaware has the common requirements that the

⁸⁰⁴ Among the first cases were *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 651; *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 651. Most recently, the Canadian Supreme Court of Justice in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 64, confirmed that Canada has adopted the name of the “business judgment rule” for “a rule of deference to business decisions”; see also text following text *infra*.

⁸⁰⁵ *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733 at 320.

⁸⁰⁶ *Ibid.*

⁸⁰⁷ *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 651 at para. 43. See also *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, *supra* note 622, at 176; *Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.*, *supra* note 624.

court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a reasonable decision not a perfect decision. Provided that the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. [...] This formulation of deference to the decision of the board is known as the 'business judgment rule'."⁸⁰⁸

The Supreme Court of Canada in its decision *Peoples Department Stores Inc. (Trustee of) v. Wise*⁸⁰⁹ has recently confirmed the effectiveness of the "business judgment rule" in Canada.⁸¹⁰ The court explicitly adopted the U.S. view that directors and officers usually have business expertise that the courts do not possess, and that many business decisions, although unsuccessful in result, can be regarded as reasonable business decisions at the time they were made. The court noted that

*"[b]usiness decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available ex post facto."*⁸¹¹

Accordingly, the "business judgment rule" as effective in Canada modifies the way a court investigates a claim that a director or officer has breached his duty of care. Directors and officers will not be held to be in breach of the duty of care if they act prudently and on reasonably informed basis.⁸¹² Instead of requiring that directors and officers make perfect decisions, the "business judgment rule" requires that the decision and the conduct be reasonable in light of all the circumstances about which the director or officer knew or ought to have known. As long as the business decision is within the range of reasonableness, the "business judgment rule"

⁸⁰⁸ *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 651 at para. 36. In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 152, the court stated that "[t]his approach recognizes the autonomy and integrity of the corporation and the expertise of its directors and officers. They are in the advantageous position of investigating and considering first-hand the circumstances that come before it and are in a far better position than a court to understand the affairs of the corporation and to guide its operation." For differences of the rule between Canada and the U.S., see John Sullivan, "Business Judgment Cases Differ In Ontario, Delaware" *The Lawyers Weekly* (August 22, 2003).

⁸⁰⁹ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611. See also *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

⁸¹⁰ The business judgment rule is also partially reflected in Section 123(5) CBCA. This provision excludes from liability a director who relies in good faith on financial statements represented by an officer or the corporation's auditor as fairly reflecting the financial condition of the corporation, or on a report by a professional whose profession lends credibility to his or her statements. However, the statutory provision only requires good faith reliance rather than the more stringent reasonable and informed reliance on financial and other advisors, see Martha O'Brien, "The Director's Duty of Care in Tax and Corporate Law" (2003) 36 U.B.C. L. Rev. 673 at 677.

⁸¹¹ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 64.

⁸¹² See, for example, *ibid.* at para. 67 with reference to the statutory duty of care under Section 122(1)(b) CBCA.

establishes that the courts ought not to intervene, even though subsequent events may cast doubt on the decision. However, directors and officers are only protected to the extent that their actions actually evidence their business judgment.⁸¹³ Although the courts are ill-suited to second-guess a business decision, they certainly can determine whether directors or officers brought an appropriate degree of prudence and diligence to their decisions.⁸¹⁴ The courts are entitled to consider the content of the decision and the extent of the information on which the decision was based and to measure this against the facts as they existed at the time the decision was made.⁸¹⁵ Thus, although business decisions are not generally subject to “microscopic examination”,⁸¹⁶ they can well be subject to examination.⁸¹⁷

In summary, where an alleged breach of the duty of care relates to business decisions rather than failing to detect and address wrongdoing, the courts do not second-guess the directors’ or officers’ business decisions.⁸¹⁸ As a rule, the courts will refrain from interfering in corporate matters if directors and officers make a reasonable decision in good faith, after properly investigating the matter, and provided that the decision is not oppressive or unfair to parties who have a legitimate interest.⁸¹⁹ However, the courts give directors the benefit of the “business judgment rule” only when there is an absence of self-dealing.⁸²⁰ In cases of conflict-of-interest transactions, the interested fiduciary has the burden of proving that the transaction is “fair and reasonable to the corporation”, which means that the terms are similar to those obtained in an arm's-length deal.⁸²¹ In the absence of self-dealing, fraud, or conflict of interest, directors and officers are presumed to have acted properly in making a business decision if they acted on an informed basis, in good faith and in an honest belief that the actions taken were in the best

⁸¹³ In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para 153, the court expressed this limitation on the assumption that “the principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at their decisions”. Remarkably, the wording by the Delaware Chancery Court in the recent U.S. case *Re Walt Disney Company Derivative Litigation*, *supra* note 790 was similar: “[O]ur corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational directorial obligation to act honestly and in good faith to advance corporate interests”.

⁸¹⁴ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 389 at para. 67.

⁸¹⁵ *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 651 at 10.

⁸¹⁶ *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733 at 320.

⁸¹⁷ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para 153.

⁸¹⁸ VanDutser, *supra* note 185 at 303.

⁸¹⁹ Mangan, *supra* note 768 at 1-42

⁸²⁰ O'Connor, *supra* note 795 at 1248; Bainbridge, *supra* note 478 at 108.

⁸²¹ Given that directors pursuing conflict of interest transactions may rely on the mutual trust of fellow board members to approve deals that favour the director, social psychology also supports the need for courts to scrutinize those business decisions for reasonableness and fairness, see O'Connor, *supra* note 795 at 1248.

interests of the corporation.⁸²² This presumption, however, can be rebutted, in which case the directors and officers must prove the reasonableness and fairness of their business decision and the process involved.⁸²³

d) Severance Agreements and “Golden Parachutes”

As far as severance agreements and “golden parachutes” are concerned, the decision to provide the executive with this kind of compensatory benefit is a business decision made by the board of directors at its exclusive discretion.⁸²⁴ As such, the decision is generally protected from judicial scrutiny for an alleged breach of the duty of care by the “business judgment rule”.⁸²⁵ The courts will presume that the board of directors has exercised reasonable business judgment unless exceptional circumstances exist. Thus, in the absence of fraud, bad faith, or self-dealing, the courts will refrain from interfering with the exercise of business judgment by the board of directors.

However, as set out above, directors are only protected to the extent that they exercised an appropriate degree of prudence and diligence and acted on an informed basis. If a decision is made on an uninformed basis where more information was available to the directors, the decision-making process will be held to be unreasonable. In the recent *UPM-Kymmene Corp. v. UPM Kymmene Miramichi Inc.* case,⁸²⁶ the involvement of a compensation committee was held not to relieve the directors of their independent obligation to make an informed decision on a reasonable basis. Although the court had already confirmed a breach of the fiduciary duty of the self-interested chairman who had exercised undue influence over the decision-making process, it also found a breach of the duty of care of the independent, non-self-dealing directors. The evidence revealed that the decision-making process leading to the approval of the employment contract including a lucrative compensation package as well as a “golden parachute” provision for the chairman of the board of directors fell short of the exercise of prudent judgment in the interests of the shareholders that is expected from the directors. Upon a short presentation of an

⁸²² VanDutzer, *supra* note 185 at 303.

⁸²³ With regard to an executive compensation agreement made by the board of directors, the presumption was rebutted successfully by shareholders in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389; see the following text *infra* at d).

⁸²⁴ Johnson, *supra* note 54 at 47.

⁸²⁵ For executive compensation agreements in general, see Lin, *supra* note 546 at 905. For “golden parachutes” in particular, see Bress, *supra* note 166 at 955; Wolk, *supra* note 176 at 128; Johnsen, *supra* note 171 at 912.

⁸²⁶ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

external compensation expert that had been retained indirectly by the chairman, the board of directors approved without prior discussion the generous employment contract for a person they did not even know. In addition, the compensation expert as well as the compensation committee⁸²⁷ had been given insufficient information by the chairman. The court concluded that the board of directors could have learned about the inappropriateness of the compensation package with a minimum of effort. Its decision to approve the contract was held to be neither an informed nor a reasoned one and, therefore, the court refused to apply the “business judgment rule” to protect the decision from judicial intervention. The court stated:

*“The business judgment rule cannot apply where the Board of Directors acts on the advice of a director’s committee that makes an uninformed recommendation.”*⁸²⁸

With the decision in *UPM-Kymmene Corp. v. UPM Kymmene Miramichi Inc.*, the likelihood of a successful challenge of an executive severance package, a “golden parachute” provision or any other kind of lucrative benefits for the executive on the grounds of a breach of duty of care has substantially increased. While the courts will not substitute their own judgments for that of the directors’ (and officers’), especially the allegation that the board of directors acted on an uninformed basis will cause the courts to refrain from the general application of the “business judgment rule”. Instead, they will scrutinize closely the decision-making process in order to determine whether the business judgment of the directors was exercised honestly, with diligence, in the corporation’s best interests and on the basis of all material information reasonably available for the directors.

However, in order to rebut the presumption that the board of directors has exercised a reasonable business decision, the law requires a minimum of evidence that the directors acted on an uninformed basis or otherwise refrained from exercising prudent and reasonable business judgment. In practice, the prospect of a successful allegation of breach of the statutory duty of care will mainly depend on the availability of respective evidence in each particular case.

3. Disclosure Requirements Under Securities Legislation

Corporations, shares of which are publicly traded on the stock exchange, are subject to

⁸²⁷ The compensation committee consisted of three outside directors, two of which had been selected by the chairman himself and were inexperienced as they had never been on a compensation committee before.

⁸²⁸ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 155, citing *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 651 at 10.

securities laws.⁸²⁹ Historically, securities law was aimed at increasing the efficiency of the capital market and protection of investors from unfair, improper or even fraudulent corporate practices.⁸³⁰ However, concerns about public confidence in the capital markets have caused securities regulators to also address corporate governance issues. In the early 1990s, in an attempt to foster transparency, both American and Canadian securities regulators demanded as part of the continuous disclosure system increased disclosure of executive compensation.⁸³¹ Over the past decade, developments in securities law have enhanced the ability of shareholders to monitor director's decisions about executive compensation.⁸³² Certain disclosure requirements have raised the consciousness about the issue of executive compensation including severance packages and "golden parachute" provisions.⁸³³ Regulations in both the U.S. and Canada have shifted to a detailed disclosure that requires issuing corporations to provide tables breaking down the composition of executive pay, charts comparing the financial performance of the firm with similarly situated firms, and a textual explanation of the firm's compensation policy.⁸³⁴ In this section, I will present the relevant regulation for disclosure under Canadian securities law and discuss the implications for the decision-making process regarding executive compensation in

⁸²⁹ Technically speaking, the shares traded like this are called "securities", and the stock exchange is referred to as the "securities market".

⁸³⁰ Mary Condon, Anita Anand, Janis Sarra, *Securities Law in Canada: Cases and Commentary* (Toronto: Emond Montgomery Publications Ltd., 2005) at 349 and 425.

⁸³¹ Iacobucci, *supra* note 482 at 497.

In contrast to Canada, The U.S. has had extensive mandatory disclosure of executive compensation in terms of the Securities Exchange Act since 1934. For a discussion of the effects, see George J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934" (1973) 63 (1) American Economic Review 132. However, the U.S. Securities and Exchange Commission expanded the requirements for disclosure in October 1992, facilitating shareholder communication about corporate voting matters and giving shareholders unambiguous disclosure about the compensation of their top executives, see Salky, *supra* note 55 at 809. For an overview of the U.S. reforms in 1992, see Marlo A. Bakris, "Executive Compensation Disclosure: The SEC's Newest Weapon in Its Arsenal against Executive Compensation Abuses" (1993) 71(1) University of Detroit Mercy Law Review 105.

Most recently on July 30, 2002, the U.S. enacted the Sarbanes-Oxley Act (H.R. 3763). The Act was an instant response to the Enron scandal in the U.S. and is designed to restore confidence in U.S. capital markets rather than to focus especially on executive compensation. For an outline of the Act, see David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation* (3rd ed., Markham: LexisNexis Butterworths, 2003) at 452. For an evaluation of the Act, see Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (September 25, 2004). NYU, Law and Econ. Research Paper 04-032; Yale Law and Econ. Research Paper 297; Yale ICF Working Paper 04-37; ECGI - Finance Working Paper 52/2004, available online at <<http://ssrn.com/abstract=596101>> (last accessed on March 22, 2005).

⁸³² Iacobucci with Trebilcock, *supra* note 89 at 35.

⁸³³ Stikeman, Elliott, *supra* note 134 at § 20.167.

⁸³⁴ By referring explicitly to change in control agreements, the securities law disclosure requirements introduced in 1993 in Ontario for reporting corporations respecting executive compensation specifically include the disclosure of "golden parachutes". See *infra* at a).

general and severance packages and “golden parachutes” in particular.

a) Introduction to the Disclosure Rules under Canadian Securities Legislation

Unlike the U.S., Canada has no federal securities regulation or federal securities regulator comparable to the U.S. Securities and Exchange Commission.⁸³⁵ Canadian securities law falls largely under the jurisdiction of the provinces.⁸³⁶ The legislative framework described here is mainly securities law of the province of Ontario, as almost all large public corporations in Canada are listed on the Toronto Stock Exchange^{837 838}

Rules regarding the disclosure of executive compensation of issuing corporations were first introduced in Ontario in 1985.⁸³⁹ The disclosure requirements were contained in the old Form 41 of the regulation under the former Ontario Securities Act.⁸⁴⁰ The rules simply provided for disclosure of the aggregate compensation of all members of the executive body without a definition of who was to be included in that group.⁸⁴¹ Based on comparison with several foreign disclosure requirements, critics therefore instantly argued that more detailed disclosure of executive compensation on an individual rather than on a group basis was needed for greater governance transparency.⁸⁴² Thus, on October 13, 1993, Ontario adopted disclosure rules similar to those of the S.E.C.⁸⁴³ by introducing Ontario Securities Regulation 1015 of the Revised Regulations of Ontario 1990 under the Ontario Securities Act, together with the new Form 40 for

⁸³⁵ The U.S. Securities and Exchange Commission is hereinafter referred to as “S.E.C.”.

⁸³⁶ Each of the ten provinces and three territories has own securities legislation, consisting of securities acts, rules, regulations, National Policies (“NPs”), National Instruments (“NIs”), and Multilateral Instruments (“MIs”), Local Policy Statements (“LPs”) as well as administrative and judicial decisions. For more detail regarding the legislative framework, see Johnston and Doyle Rockwell, *supra* note 831 at 9. Recently, the lack of national securities legislation has been lamented. For an excellent synthesis of the issue, see *ibid* at Chapters 16 and 17.

⁸³⁷ The Toronto Stock Exchange will hereinafter be referred to as “TSX”.

⁸³⁸ In the 1990s, approximately 90 per cent of the 300 largest public corporations in Canada were listed on the TSX, see Xianming Zhou, *Essays on Executive Compensation and Managerial Incentives* (Doctoral Thesis, University of Toronto, 1997) at 57. See also Iacobucci with Trebilcock, *supra* note 89 at 33 note 15. Ontario, therefore, is Canada’s largest securities province, see Johnston and Doyle Rockwell, *supra* note 831 at 25 note 1. However, note that the present disclosure requirements as set out in National Instrument 51-102 Continuous Disclosure have been adopted by all Canadian provinces and territories, see *infra* at b).

⁸³⁹ Robert A. Donaldson and Veronica Tham, “*Disclosure of Executive Compensation*” in *Executive Compensation Disclosure* (Toronto: Insight Press, 1994) at 1.

⁸⁴⁰ Ontario Securities Act, R.S.O. 1980, c. 466, as amended.

⁸⁴¹ See, for example, Zhou, *supra* note 838 at 26.

⁸⁴² Donaldson and Tham, *supra* note 839 at 5.

⁸⁴³ The new Canadian disclosure rules are not identical to the U.S. requirements of the S.E.C. because they evolved independently. However, both jurisdictions provide for approximately the same level of mandatory disclosure, see Alarie, *supra* note 96 at 60 and note 66. For an overview of the U.S. requirements for disclosure of executive compensation, see Cheffins, *supra* note 97 at 534.

disclosure of executive compensation, as a supplement to Part XVIII of the Ontario Securities Act.⁸⁴⁴

The new disclosure rules under Form 40 required publicly trading corporations to disclose executive compensation of senior management in the form of a report by the board of directors or the compensation committee, if any. The rules intended to increase the transparency of the board of directors' decision-making process by giving security holders information on individual salaries and other compensation paid by the issuer to certain executives.⁸⁴⁵ Pursuant to the new rules, detailed disclosure of all compensation on a three-year comparative basis was required for the C.E.O. regardless of the amount of the compensation and each of the next four highest paid executive officers of the issuing corporation who were compensated with a minimum of CDN\$ 100,000 each. A fundamental change in relation to the old rules was the new requirement that compensation be disclosed in a variety of tables rather than in a potentially confusing narrative.⁸⁴⁶ Form 40 required the issuing corporation to disclose all executive compensation by way of a "Summary Compensation Table", a "Long-Term Incentive Plan Awards Table", an "Options and Stock Appreciation Rights Table",⁸⁴⁷ a "Pension Plan Table"⁸⁴⁸ as well as the disclosure of executive service contracts and respective termination and change in control agreements together with the amounts paid thereof.⁸⁴⁹ "All compensation" was extensively defined as "all plan and non-plan compensation awarded to, earned by, or paid to, each [officer or director] for services rendered by that individual in all capacities to the issuer [...] or otherwise in connection with office or employment [...]".⁸⁵⁰ In particular, if exceeding the amount of CDN\$ 50,000, perquisites and all other personal benefits of the executives needed to be disclosed.⁸⁵¹

⁸⁴⁴ Ontario Securities Act, R.S.O. 1990, c. S.5 (hereinafter referred to as "OSA"), OSA Regulation, R.R.O. Reg 1015, Form 40, as amended by O.Reg. 638/93, s. 7 (hereinafter referred to as "O.Reg. 1015, Form 40" or "Form 40"). The new rules for disclosure contained in Form 40 became effective on October 31, 1993. Due to recent changes to the continuous disclosure regime, Form 40 has recently been revoked by O.Reg. 56/04, s. 14(4) with effect as of March 10, 2004, see *infra* at b).

⁸⁴⁵ Edward J. Waitzer, "Holding Our Heads High" in Iacobucci with Trebilcock, *supra* note 89 at 136; Johnston and Doyle Rockwell, *supra* note 831 at 115.

⁸⁴⁶ Iacobucci with Trebilcock, *supra* note 89 at 35 note 16.

⁸⁴⁷ The issuer was also required to disclose details of the repricing of any options in the past year and any other repricing over the past ten years and to give reasons for these decisions.

⁸⁴⁸ O. Reg. 1015, Form 40, *supra* note 844, Items II. – VI.

⁸⁴⁹ *Ibid.*, Item VII. See also Item II.6(a)(ii).

⁸⁵⁰ *Ibid.*, Item I.7.

⁸⁵¹ *Ibid.*, Item II.4(a).

In addition, Form 40 also required the issuer to establish a compensation committee to evaluate the appropriateness of the compensation awarded.⁸⁵² The committee had to provide a yearly report detailing its policies for compensation, including "the specific relationship of corporate performance to executive compensation".⁸⁵³ To aid the assessment of the propriety of the composition of the compensation committee, the issuer was compelled to outline personal conflicts such as interlocks present in the committee or any other relationship of directors to the corporation.⁸⁵⁴ Finally, the issuing corporation had to provide graphs plotting the shareholders' return alongside the returns to a comparable market or industry index.⁸⁵⁵ Aside from these technical requirements, the issuer was also required to outline the compensation philosophy of the corporation, including a discussion of pay-performance linkages.⁸⁵⁶

The information under the new disclosure rules was said to make directors more accountable for their decisions in setting executive compensation.⁸⁵⁷ Their stated purpose was to improve governance of the establishment of executive compensation and governance of the corporation generally because of the motivating effects of intelligently designed compensation arrangements.⁸⁵⁸ The new disclosure rules were designed to aid shareholders in determining whether directors and officers of the issuer competently represent their interests, and allow them to make informed decisions on matters respecting executive pay levels.⁸⁵⁹ In fact, the new regulation was believed to „enhance the incentives of both directors and institutional shareholders to review and control executive compensation arrangements. Under the sunlight of heightened disclosure, compensation committees will be encouraged to devise compensation arrangements that meet shareholder expectations“. ⁸⁶⁰ *Peter Dey*, the former chair of the Ontario Securities Commission, praised the new disclosure requirements in 1993, stating:

"Good corporate governance relies on an informed and active investor community. In some respects, this legislation recognizes their legitimate need for information that enables them to

⁸⁵² Johnston and Doyle Rockwell, *supra* note 831 at 115.

⁸⁵³ O. Reg. 1015, Form 40, *supra* note 844, Item IX.2(b).

⁸⁵⁴ Iacobucci with Trebilcock, *supra* note 89 at 35.

⁸⁵⁵ O. Reg. 1015, Form 40, *supra*, note 844, Item X.1.

⁸⁵⁶ *Ibid.*, Item IX.2.

⁸⁵⁷ See Joseph Groia and Emma Kenley, "New Liability Issues for Directors and Officers" in *Executive Compensation Disclosure*, *supra* note 839 at 4.

⁸⁵⁸ Iacobucci, *supra* note 482 at 497.

⁸⁵⁹ Groia and Kenley, *supra* note 857 at 4.

⁸⁶⁰ Ronald J. Daniels, "Executive Compensation: Perhaps Company Managers Aren't Paid Enough ..." (Spring 1994) *Can. Investment Rev.* 41 at 44.

relate management's performance to the performance of the company."⁸⁶¹

b) The New National Instrument 51-102 On Continuous Disclosure

Although the Ontario reforms of 1993 were believed to provide increased disclosure of executive compensation including severance and "golden parachute" agreements and, thus, to have brought Ontario Securities law in line with the revisions adopted by the S.E.C. for the U.S. in 1992,⁸⁶² the Canadian Securities Administrators⁸⁶³ recently recognized that the quality of executive compensation reports varied among the different companies. Concerned especially with the narrative discussion of the corporations' approach to executive discussion, the C.S.A. launched a review of the compliance with the executive compensation requirements in 2002.⁸⁶⁴ The results of the C.S.A. review concluded that 95 per cent of the companies reviewed discussed executive compensation in very general terms, without explaining specifically how compensation was determined or how it related to the companies' performance.⁸⁶⁵ The report by the C.S.A. indicated that Canadian companies still needed to improve their executive compensation disclosure practices and more stringent rules might need to be promulgated.⁸⁶⁶

Based on the findings of its review, the C.S.A. developed a set of continuous disclosure requirements for reporting issuers, other than investment funds, which was published on December 19, 2003 as "National Instrument 51-102 *Continuous Disclosure Obligations*" ("NI

⁸⁶¹ As quoted in Karen Howlett, "Shareholders gain advocate at OSC" *The Globe and Mail* (October 18, 1993) at B1. The Ontario Securities Commission will be referred to hereinafter as "O.S.C.".

⁸⁶² Iacobucci with Trebilcock, *supra* note 89 at 36.

⁸⁶³ The Canadian Securities Administrators is a forum for and council of the 13 securities regulators of Canada's provinces and territories whose objectives are to improve, coordinate and harmonize regulation of the Canadian capital markets. The Canadian Securities Administrators will be referred to hereinafter as "C.S.A.".

⁸⁶⁴ See C.S.A. Press Release "Securities Regulators Loo at How Companies Report Executive Compensation" (May 15, 2002), available online at <http://www.osc.gov.on.ca/About/NewsReleases/2002/nr_20020515_csa-exec-comp.jsp> (last visited on January 29, 2005).

⁸⁶⁵ See C.S.A. Press Release "Regulators Require Companies To Improve Executive Compensation Disclosure" (November 5, 2002), available online at <http://www.csa-acvm.ca/html_CSA/news/exec_comp1105.htm> (last visited on January 29, 2005). As an example for the boilerplate language used by company reports, the press release quotes: "The Board of Directors is of the view that the Executive Compensation Plan is appropriate for the Company in that it provides an adequate level of motivation for the executive officers." See also the C.S.A. Staff Notice 51-304 "Report on Staff's Review of Executive Compensation Disclosure", available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20021104_51-304.pdf> (last visited on January 30, 2005).

⁸⁶⁶ *Ibid.*, quoting Doug Hyndman, Chair of C.S.A.: "The compensation committee reports need improvement by the vast majority of companies [...] examined."

Another review of compliance with the disclosure requirements pursued by the Report on Business ("RoB") in 2003 confirmed that many large Canadian companies "are breaching the Ontario Securities Act by failing to disclose to shareholders the details of their executive compensation policies", see Janet McFarland, "Firms Break Pay Disclosure Rules" *Globeandmail.com* (September 23, 2003), available online at <<http://www.theglobeandmail.com/series/boardgames2k3/news/five.html>> (last visited on January 29, 2005).

51-102”) together with Forms 51-102F1, 51-102F2, 51-102F3, 51-102F4, 51-102F5 and 51-102F6 (“the Forms”) as well as Companion Policy 51-102CP *Continuous Disclosure Obligations* (“NI 51-102CP”).⁸⁶⁷ The improved continuous disclosure system is aimed at more transparency, efficient access to information and intended to harmonize the continuous disclosure obligations of reporting issuers in Canada.⁸⁶⁸ Canada’s securities regulators implemented NI 51-102, the Forms and the Companion Policy 51-102CP with effect as of March 30, 2004.⁸⁶⁹ Generally, NI 51-102 applies to every reporting issuer in Canada and has replaced all pre-existing local legislation regarding continuous disclosure obligations.⁸⁷⁰ It is intended to eliminate the problem of companies having to meet different disclosure requirements in multiple jurisdictions in which they report, and shall form a basis for implementing an integrated disclosure system.⁸⁷¹ The continuous disclosure requirements addressed by NI 51-102 include financial statements, annual

⁸⁶⁷ NI 51-102 was published as a “Rule” together with the Forms and NI 51-102CP as well as certain amendments to other National Instruments in a Supplement to the Ontario Securities Commission Bulletin on December 19, 2003, (2003) 26 OSCB (Supp. 3). The published document is available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040402_51-102-cont-disc-ob.pdf>. (last visited on January 29, 2005).

The most important changes introduced by NI 51-102 are summarized by the C.S.A. in its brochure “*Canada’s Continuous Disclosure Rules Are Changing*”, available at the website of the Ontario Securities Commission <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040220_51-102_csa-brochure.pdf> (last visited on January 30, 2005).

⁸⁶⁸ See C.S.A. Press Release “*Securities Regulators Release New National Disclosure Rule*” (December 19, 2003), available at <http://www.csa-acvm.ca/html_CSA/news/continuous_disclosure_33.htm> (last visited on January 30, 2005); “Securities regulators have taken another significant step toward a uniform legislative and regulatory framework for Canadian public companies with today’s advance notice of a new national rule for continuous disclosure.” For a discussion of the underlying rationale, see Condon, Anand, and Sarra, *supra* note 830 at Chapter 6, Continuous Disclosure, 347-390.

⁸⁶⁹ NI 51-102, the Forms and NI 51-102CP were approved in Ontario on February 16, 2004 by the Minister of Finance pursuant to Section 143.3(3) of the Securities Act (Ontario), see Notice of Ministerial Approval, (February 16, 2004) available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040326_51-102-not-min-app-ni.jsp> (last visited on January 30, 2005). After approval, NI 51-102 including the Forms and NI 51-102CP was published in the Ontario Securities Commission Bulletin on April 2, 2004, (2004) 27 OSCB 3439, available at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040402_51-102-cont-disc-ob.pdf> (last visited on February 2, 2005).

For implementation in the province of British Columbia, see Instrument 51-801 *Implementing National Instrument 51-102 Continuous Disclosure Obligations* of March 30, 2004, available online at <<http://www.bsc.bc.ca/policy.asp?id=1076>> (last visited on January 30, 2005). The changes relating to proxy and executive compensation disclosure are in force since June 1, 2004.

⁸⁷⁰ As for Ontario securities legislation, the cumulative effect of NI 51-102 and its implementing rule (OSC Rule 51-801 *Implementing National Instrument 51-102 Continuous Disclosure Obligations*, April 2, 2004, available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20040402_51-801-imp-ni-51-102.jsp> (last visited on March 21, 2005)) is that NI 51-102 supersedes the requirements applicable to reporting issuers, other than investment funds, found in Parts XVIII and XIX (other than sections 76 and 87) of the OSA, see Borden Ladner Gervais LLP (firm), Paul G. Findlay, ed., *Securities Law And Practice* (3rd ed., Toronto: Thomson Carswell, 2004, Loose-leaf) at § 18.0, 18-2.

⁸⁷¹ See C.S.A. Press Release (December 19, 2003); *supra* note 867.

information forms, management's discussion and analysis ("MD&A"), material change reports, business acquisition reports and statements of executive compensation.

The requirements for disclosure of executive compensation are set out specifically in Form 51-102F6 *Statement of Executive Compensation* of NI 51-102.⁸⁷² A completed Form 51-102F6 has to be included in Form 51-102F5 *Information Circular*.⁸⁷³ Form 51-102F5 *Information Circular* establishes the mandatory information to be provided to security holders whenever an Information Circular under NI 51-102, Part 9 has to be sent out to security holders by the company or management. Thus, prior to every meeting of security holders the executive compensation must be disclosed as part of the information circular. The introduction of Form 51-102F6 for the disclosure of executive compensation has replaced the former Form 40,⁸⁷⁴ which, as an implication, has recently been revoked.⁸⁷⁵

Form 51-102F6 provides a general framework for disclosure on many different types of executive compensation. Disclosure is required of all compensation earned by certain executive officers and directors in connection with office or employment by issuing Canadian corporations.⁸⁷⁶ According to Form 51-102F6, Item 1, 1.3, now disclosure of the compensation of the C.E.O., the Chief Financial Officer ("C.F.O.") and each of the corporation's three most highly paid other executive officers whose total salary and bonus exceed CDN\$ 150,000 is mandatory.⁸⁷⁷ The Form requires the disclosure of certain severance and "golden parachute" provisions. In particular, as part of the "Summary Compensation Table" required by Item 2 of Form 51-102F6, the amount paid, payable or accrued to the applicable executives for the resignation, retirement or other termination of the employment or for a change in control of the

⁸⁷² Hereinafter referred to as "Form 51-102F6".

Recently, on January 14, 2005, the C.S.A. also issued guidance on the disclosure of retirement benefits that goes beyond the disclosures required under the new securities legislation, see C.S.A. Press Release "*Canada's Securities Regulators Issue Guidance on Retirement Benefits Disclosure*" (January 14, 2005), available online at <http://www.csa-acvm.ca/html_CSA/news/05_02guidance_retirement_benefits_dis.htm> (last visited on January 30, 2005). See also C.S.A. Staff Notice 51-314, available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20050114_51-314_retirebenefitsdisc.jsp> (last visited January 30, 2005).

⁸⁷³ See Form 51-102F5 *Information Circular*, Item 8.

⁸⁷⁴ O.Reg. 1015, Form 40, *supra* note 844.

⁸⁷⁵ See O.Reg. 56/04 of March 10, 2004, published in the Ontario Gazette on March 27, 2004.

⁸⁷⁶ See Form 51-102F6, *supra* note 872, Item 1, 1.1.

⁸⁷⁷ The changes have also affected the existing exemption from certain aspects of executive compensation disclosure for "small business issuers" with revenues less than CDN\$ 25 million. This exemption has been deleted and replaced with an exemption for "venture" issuers who are defined as issuers which are not listed on the Toronto Stock Exchange or other market or exchange, see Form 51-102F6, Item 13.

company or one of its subsidiaries or for a change in the responsibilities following such a change in control must be disclosed. Besides that, Item 7, 7.1 of Form 51-102F6 requires the description of the terms and conditions, including dollar amounts, of any executive employment contract between the company or its subsidiaries in existence at the end of the most recently completed financial year and any compensatory plan, contract or arrangement, where an executive is entitled to receive more than CDN\$ 100,000 from the issuer or its subsidiaries, including periodic payments or instalments, in the event of the resignation, retirement or any other termination of the executive's employment with the company and its subsidiaries, a change of control of the company or any of its subsidiaries, or a change in the executive's responsibilities following a change in control. Form 51-102F6, Item 8, 8.1 also requires the identification of any members of the compensation committee, or in its absence of the board of directors, as well as the disclosure of any employment relationship any of these members might have with the corporation. Further, a separate "Report on Executive Compensation" is required that describes the policies of the compensation committee or other board committee performing equivalent functions during the most recently completed financial year for determining the compensation of executive officers.⁸⁷⁸

c) Implications of Mandatory Disclosure

Transparency and disclosure are key factors in shareholder protection and a hallmark of the securities regime.⁸⁷⁹ Mandatory disclosure has a corporate governance role as it can be used as a monitoring tool in the oversight of corporate performance.⁸⁸⁰ However, the disclosure obligations have had an ambiguous impact on the overall level of executive compensation, with both constraining and inflationary elements.⁸⁸¹

One fundamental aspect of corporate law and corporate governance is the shareholder's right to determine on an informed basis whether to keep his capital invested in the corporation or to divest it.⁸⁸² *Berle* and *Means* were the first to argue that government regulation can improve corporate governance as shareholders may benefit from the information provided by public

⁸⁷⁸ See Form 51-102F6, Item 9, 9.1: "Boilerplate language should be avoided".

⁸⁷⁹ Janis Sarra, "The Corporation as Symphony: Are Shareholders First Violin or Second Fiddle?" (2003) 36 U.B.C. L. Rev. 403 at 426.

⁸⁸⁰ Condon, Anand, and Sarra, *supra* note 830 at 348.

⁸⁸¹ Alarie, *supra* note 96 at 61.

⁸⁸² Faith Stevelman Kahn, "Transparency and Accountability – Rethinking Corporate Fiduciary Law's Relevance to Corporate Disclosure" (2000) 34 Georgia Law Review 505 at 517.

disclosure that they could not afford to obtain individually.⁸⁸³ They argued that in the absence of regulatory intervention, shareholders might not have the means to monitor executives effectively due to the high cost to obtain necessary information and that disclosure requirements would reduce shareholders' costs to monitor and control executive compensation.⁸⁸⁴ The disclosure rules under securities law are therefore regarded as an attempt to facilitate the disclosure of complex compensation and severance packages by mandating a standardized and highly digestible format for investors seeking information about the compensation of the corporate executives.⁸⁸⁵

Commentators have further argued that mandatory compensation disclosure improves corporate governance by permitting shareholders to enjoin the board of directors to reward executives in ways that are consistent with shareholder value creation.⁸⁸⁶ The mandated compensation disclosure including an explanation of the firm's pay philosophy and comparisons with the performance of similarly situated firms is held to provide a governance mechanism that enables shareholders to exert pressure on the board, if necessary.⁸⁸⁷ In the absence of mandated disclosure of compensation, it is argued, the ability of executives to structure the compensation contracts according to their personal preference in contrast to the best interests of the corporation would be enhanced.⁸⁸⁸ Thus, mandatory disclosure is believed to serve making shareholders – especially institutional shareholders – aware of abuses perpetuated against the corporation by influential executives and, given the presence of inside directors, the board of directors itself.⁸⁸⁹

However, clearer and more transparent disclosure is useful only if the additional information engenders the kind of shareholder activity that is intended. To the extent that shareholder apathy is rational, due to the collective action problem inherent in widespread

⁸⁸³ Berle and Means, *supra* note 476 at 48.

⁸⁸⁴ *Ibid.* See also Iacobucci with Trebilcock, *supra* note 89 at 44.

⁸⁸⁵ Alarie, *supra* note 96 at 60.

⁸⁸⁶ See James A. Brickley, Ronald C. Lease and Clifford W. Smith, Jr., "Corporate Voting: Evidence from Charter Amendment Proposals" (1994) 1 *Journal of Corporate Finance* 5.

⁸⁸⁷ Richard J. Zeckhauser and John Pound, "Are Large Shareholders Effective Monitors? An Investigation of Share Ownership and Corporate Performance" in R. Glenn Hubbard, ed., *Asymmetric Information, Corporate Finance, and Investment* (Chicago: University of Chicago Press, 1990) at 149-180.

⁸⁸⁸ See Jane Craighead, Michel Magnan, Linda Thorne, "The Impact of Mandated Disclosure on Performance-based CEO Compensation" (2004) 21 (2) *Contemporary Accounting Research* at 11, available online at <<http://www.caaa.ca/publications/car/bi/car21-2/5x.shtml>> (last accessed on March 20, 2005). Jensen and Meckling, *supra* note 481 at 25 posed that executives prefer compensation contracts that minimize firm specific risk and maximize their personal wealth.

⁸⁸⁹ See Alarie, *supra* note 96 at 60.

ownership,⁸⁹⁰ the most likely response will be for aggrieved shareholders with small ownership to sell their shares.⁸⁹¹ Each shareholder is considered to be rationally apathetic because the private costs of monitoring executive compensation are borne completely by the individual monitoring shareholder, whereas the benefits are only partially realized by him.⁸⁹² Thus, prior to mandatory disclosure, it may have been very difficult, if not impossible, for a shareholder to obtain information about the composition of executive compensation packages. With information from the corporation now available under the disclosure requirements, the aggrieved shareholder might decide to exercise his right to "exit" by selling his shares.

Other potential responses such as the exercise of "voice" are only likely to be engaged by institutional shareholders who might find the exercise of voice worth the necessity, time and energy.⁸⁹³ Although disclosure does not affect the private benefits received by each individual shareholder, it has significant effects on the private costs of monitoring compensation as the cost of obtaining information decreases substantially with disclosure.⁸⁹⁴ With the cost of monitoring the propriety of executive compensation or severance packages reduced through mandatory disclosure, particularly institutional shareholders may face sufficient incentives to exercise some monitoring control over executive compensation agreements by way of "voice" instead of "exit", notwithstanding collective action problems.⁸⁹⁵ On the other hand, in the absence of mandatory disclosure of information about the essence of compensation and severance packages, institutional shareholders would have nothing to "voice" concern about.⁸⁹⁶

Mandatory disclosure, however, also has the potential to cause reverse results. The first concern refers to the cost of disclosure. Although the monitoring costs for shareholders are likely

⁸⁹⁰ For a more detailed analysis of the collective action problem, see Mancur Olson, *The Logic of Collective Action* (Cambridge: Harvard University Press, 1971).

⁸⁹¹ Alarie, *supra* note 96 at 60. The sale of shares by investors if they are dissatisfied with the overall governance and direction of the corporation is called "exit" of shareholders, whereas the exercise of security holder rights through the proxy process is referred to as "voice", see Condon, Anand, and Sarra, *supra* note 830 at 393.

⁸⁹² Iacobucci, *supra* note 482 at 497: "[A]ll shareholders benefit, not just the monitor".

⁸⁹³ Due to the complicated proxy solicitation process, the exercise of voice is being criticized as too stringent, resulting in a reduction of the effectiveness of the oversight process, see Canada, Senate, *Report of the Senate Standing Committee on Banking, Trade, and Commerce on Corporate Governance* (Ottawa: Public Works and Government Services, 1996), quoted partly by Condon, Anand and Sarra, *supra* note 830 at 393-394. For recent changes to a broader, informal shareholder communication, see Stuart Morrow, "Proxy Contests and Shareholder Meetings" (2003) 36 U.B.C. L. Rev. 483; Sarra, *supra* note 879 at 424.

⁸⁹⁴ Iacobucci, *supra* note 482 at 498.

⁸⁹⁵ *Ibid.* See also Iacobucci with Trebilcock, *supra* note 89 at 43.

⁸⁹⁶ Alarie, *supra* note 96 at 61, points out that initiatives taken by institutional shareholders are likely to include lobbying boards to reduce executive compensation.

to be reduced by the required disclosure of certain documents, the disclosure creates additional costs of compliance for the corporation. Critics, therefore, have argued that the disclosure requirements under securities regulation yield either no benefits or benefits insufficient to justify the costs for compliance.⁸⁹⁷ With respect to the cost of compiling the required compensation tables and charts under U.S. securities law,⁸⁹⁸ *Ragsdale* has summarized the cost issue convincingly as follows:

"[I]t is important to ask the question: disclosure at what cost? And, it appears that one thing is certain about the new [SEC] regulations – that is that companies will incur increased costs in compliance."⁸⁹⁹

In this regard, in practice shareholders are facing even another obstacle. Even though disclosure rules reduce the cost of monitoring executive compensation to a certain extent, they do not contribute to reducing the cost of activities designed to alter compensation and severance packages.⁹⁰⁰

Secondly, critics also argue that the disclosure of individual pay packages for executives may incite an even more inflationary executive compensation environment. It is argued that most boards of directors in receipt of comparable market data are likely to be inclined to compensate their executives at a level that is at least slightly above the average for the industry or the comparable market, provided that the company has performed well, measured with regards to the share price.⁹⁰¹ The boards are believed to do so in order to maintain a positive relationship between the directors and the C.E.O. and to demonstrate the board's confidence in the management team.⁹⁰² And even where the boards not automatically increase the level of executive compensation, there is still a risk that corporate executives will lobby their boards to increase their compensation.⁹⁰³ As corporate executives become aware of the compensation of their fellow outside colleagues, disclosure provides them with ammunition with which to

⁸⁹⁷ MacIntosh, "Executive Compensation: The Importance of Context", *supra* note 499 at 112. According to the theory of implicit regulation established by Jensen and Murphy, *supra* note 528 at 227, the disclosure regulation creates even "negative benefits".

⁸⁹⁸ The requirements in Canada, particularly in Ontario, are now similar to those of U.S. securities law, see *supra* note 843.

⁸⁹⁹ Michael E. Ragsdale, "Executive Compensation: Will the New SEC Disclosure Rules Control 'Excessive' Pay at the Top?" (1993) 61 (3) U.M.K.C. L. Rev. 537 at 569.

⁹⁰⁰ Iacobucci with Trebilcock, *supra* note 89 at 44.

⁹⁰¹ Iacobucci, *supra* note 482 at 503; Alarie, *supra* note 96 at 61.

⁹⁰² Alarie, *supra* note 96 at 61.

⁹⁰³ MacIntosh, "Executive Compensation: The Importance of Context", *supra* note 499 at 112. MacIntosh refers to this behaviour as a "keeping up with the Joneses" mentality.

negotiate compensation increases.⁹⁰⁴ Consequently, if all corporations seek to pay their executives at this above-average level, there will be an observable and pronounced “ratcheting-up” effect over time.⁹⁰⁵ Mandatory disclosure, thus, may indeed result in an increase in executive compensation and severance packages.

Finally, the disclosure of the compensation elements also affects the issue of privacy of the concerned executive. It is obvious that the required disclosure of executive compensation or severance packages “tend[s] to invade privacy”.⁹⁰⁶

In practice, however, there is evidence that the introduction of mandatory disclosure requirements by the O.S.C. in 1993 and its developments have had impact on the behaviour of executives and directors involved in the compensation-setting process. Although the C.E.O. still gives recommendations for the structure and level of executive compensation to the board of directors or the compensation committee, the decision-making dynamics have changed.⁹⁰⁷ The recommendations by the C.E.O. are no longer automatically approved by the compensation committee or the board. Recommendations to increase base pay are now usually backed up by market data, and base pay is being de-emphasized in favour of an annual bonus and other long-term incentives. In other words, the potential upside in the “at risk” portion of pay is being promoted in the belief that compensation committees and, ultimately, the shareholders will be less likely to resist such adjustments.⁹⁰⁸ Since the new rules came into force, compensation committee members are very sensitive to shareholders’ questions about executive compensation at annual meetings. This attitude serves as a counterweight to outrageous compensation demands by executives in widely held corporations.⁹⁰⁹

On balance, the disclosure requirements for executive compensation imposed by securities law lower the monitoring costs for shareholders and, therefore, encourage shareholder activism,

⁹⁰⁴ Fisch, *supra* note 494 at 762, for the potential effect under U.S. securities regulation.

⁹⁰⁵ See Stabile, *supra* note 571 at 131-132.

⁹⁰⁶ Disclosure of the elements of the executive’s compensation also “tend[s] to invade [the] privacy” of the executive concerned, see Marian Stinson, “Executive Pay Disclosure Wins Diverse Friends”, *The Globe and Mail* (October 16, 1993) at B1, quoting the C.E.O. of Stelco Corp. Stinson even goes so far as to worry that disclosure of executive compensation will increase dangers of kidnapping. However, there has been no evidence as to mandatory disclosure of executive compensation being the reason for a kidnapping of an executive.

⁹⁰⁷ Martin F. Harts, “Does Canada Have a Problem with Executive Compensation” in Iacobucci with Trebilcock, *supra* note 89 59 at 60.

⁹⁰⁸ *Ibid.* at 61.

⁹⁰⁹ *Ibid.*

in particular of institutional investors.⁹¹⁰ The openness that the new disclosure rules have brought to the process of setting executive compensation contracts will serve to better protect the interests of shareholders than they have been in the past.⁹¹¹

4. Corporate Governance Guidelines

In addition to securities regulation, disclosure requirements for corporations have been addressed by corporate governance guidelines for a decade in Canada. Originally, the existing corporate governance guidelines had been issued by the TSX. Most recently, in an attempt at harmonizing corporate governance guidelines throughout Canada, Canadian securities regulators in 2004 proposed certain changes to the existing requirements, including disclosure of executive compensation and severance packages.

a) TSX Guidelines for Effective Corporate Governance

In 1995, the TSX adopted Guidelines for Effective Corporate Governance for issuing corporations listed on the TSX.⁹¹² According to Section 473 of the TSX Manual, every corporation incorporated under federal or provincial Canadian jurisdiction that is listed at the TSX must disclose on an annual basis its approach to corporate governance in a “Statement of Corporate Governance Practices” as part of the company’s annual report or information circular. Each listed corporation is required to describe the company’s system of corporate governance with reference to the 14 best practice corporate governance guidelines set out in Section 474 of the TSX Manual and to disclose whether the governance practices align with the best practices recommended by the TSX Guidelines. Whereas the corporate governance guidelines established by the TSX as a self-regulating organization are voluntary, there is an obligation for the issuing corporation to disclose whether or not it complies with the guidelines.⁹¹³

⁹¹⁰ Iacobucci, *supra* note 482 at 501.

⁹¹¹ See also Harts, *supra* note 907 at 61.

For a discussion of the potential implications of non-compliance with the disclosure rules regarding executive compensation and possible remedies for shareholders, see *infra* at III. 2.

⁹¹² The TSX’s Guidelines for Effective Corporate Governance (hereinafter referred to as the “TSX Guidelines”) are drawn from the report entitled “Where Were the Directors”, which was issued in December 1994 by the Toronto Stock Exchange Committee on Corporate Governance in Canada (The “Dey Report”), see Part IV, M. CORPORATE GOVERNANCE, Section 472 of the TSX Company Manual (hereinafter referred to as the “TSX Manual”, available online at <<http://www.tsx.com/en/pdf/CompanyManual.pdf>> (last accessed on March 23, 2005)). The Guidelines are available online at <<http://www.tsx.ca/en/pdf/CorpGovCurrentRequirements.pdf>> (last accessed on March 14, 2005).

⁹¹³ See Section 473 of the TSX Manual. See also Condon, Anand, and Sarra, *supra* note 830 at 425.

Whereas the existing TSX Guidelines recommend that a board committee should review the adequacy and form of the compensation of directors and ensure that compensation realistically reflects the responsibilities and risk involved in being an effective director,⁹¹⁴ they do not establish the disclosure or rules regarding the compensation of the corporation's executives. However, the TSX Guidelines propose that both the nominating committee as well as the compensation committee be composed of independent outside directors.⁹¹⁵

Clearly, the existing TSX Guidelines are aimed at providing more independence of the boards of directors and preventing self-dealing transactions and general conflicts of interests. However, given the voluntary nature of the TSX Guidelines in general as well as the lack of any requirement regarding composition or disclosure of executive compensation, they cannot be regarded as an effective restriction on the composition of compensation and severance packages for corporate executives or the bargaining process between executives and the board of directors or a specific committee, respectively. Thus, especially in light of recent corporate scandals in the U.S. and Canada, the regulation of corporate governance disclosure has been the subject of debate in Canada in recent years, leading to proposals for changes in 2004.⁹¹⁶

b) Proposed Changes to Corporate Governance Guidelines

As a result of the recent corporate scandals and the enactment of the U.S. Sarbanes-Oxley Act, the Canadian securities regulators reviewed the existing regulation for corporate governance in Canada between 2002 and 2004. The review led to two separate proposals for increased corporate governance disclosure requirements in Canada aimed at greater transparency for the

⁹¹⁴ Section 474, Guideline (8) of the TSX Manual.

⁹¹⁵ Section 474, Guideline (9) of the TSX Manual explicitly recommends a majority of "unrelated" directors. An "unrelated" director in this sense means "a director who is independent of the management of the corporation and free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation [...]", see Section 474, Guideline (2) of the TSX Manual.

⁹¹⁶ Prior to the 2004 proposals by the C.S.A., *infra* at b), there had already been several recommendations for amendments of the TSX Guidelines. In November 2001, the Report of The Joint Committee on Corporate Governance in Canada (The "Saucier Report") recommended certain amendments to the TSX Guidelines that were approved by the Board of Directors of the TSX on March 26, 2002. After the enactment of the Sarbanes Oxley Act, the TSX itself also released further proposals for amendments for comment in 2003, see Hansell, *What Directors Need to Know: Corporate Governance*, *supra* note 552 at 181.

market place.⁹¹⁷ In an effort to harmonize those differing regulatory approaches for Canada and align them with the existing corporate governance rules in the U.S., on October 29, 2004, the CSA proposed for comment National Instrument 58-101 *Disclosure of Corporate Governance Practices*, Form 58-101F1 *Corporate Governance Disclosure* and Form 58-101F2 *Corporate Governance Disclosure (Venture Issuers)*⁹¹⁸ and National Policy 58-201 *Corporate Governance Guidelines*^{919, 920} Although the official comment period expired on December 13, 2004, both, the Disclosure Instrument as well as the Best Practices Policy, have yet to be officially adopted and incorporated into the respective provincial and territorial securities laws.⁹²¹

Prior to the publication for comment of the Policy and the Instrument, the Board of Directors of the TSX on September 28, 2004 with the expectation of the Policy and the Instrument to become effective approved an amendment of the existing TSX Guidelines.⁹²² In order to avoid confusion in the marketplace and duplication of effort of TSX issuers and investors, TSX amended the TSX Guidelines by replacing Sections 472 through 475 of the TSX Manual with a new Section 472 requiring each listed corporation subject to the Instrument to disclose its corporate governance practices in accordance with National Instrument 58-101

⁹¹⁷ On January 16, 2004, the securities regulators of Alberta, Saskatchewan, Manitoba, Ontario, New Brunswick, Nova Scotia, Prince Edward Island, Newfoundland and Labrador, the Yukon Territory, the Northwest Territories and Nunavut published for comment proposed Multilateral Policy 58-201 Effective Corporate Governance and proposed Multilateral Instrument 58-101 Disclosure of Corporate Governance Practices. On April 23, 2004, the securities regulators of British Columbia, Alberta and Québec published for comment proposed Multilateral Instrument 51-104 Disclosure of Corporate Governance Practices.

⁹¹⁸ Hereinafter referred to entirely as "Disclosure Instrument". The text of the National Instrument 58-101 Disclosure of Corporate Governance Practices including Form 58-101F1 Corporate Governance Disclosure ("Form 58-101F1") and Form 58-101F2 Corporate Governance Disclosure (Venture Issuers) ("Form 58-101F2") is available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20041029_58-101_disc-corp-gov-practices.jsp> (last accessed on February 2, 2005).

⁹¹⁹ Hereinafter referred to as "Best Practices Policy". The text of the Best Practices Policy is available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20041029_58-201_corp-gov-guidelines.jsp> (last accessed on February 2, 2005).

⁹²⁰ See C.S.A. Notice – Request for Comment – Proposed National Policy 58-201 Corporate Governance Guidelines and Proposed National Instrument 58-101 Disclosure of Corporate Governance Practices, Form 58-101F1 and Form 58-101F2 of October 29, 2004, (2004) 27 OSCB 8825, available online at <http://www.tsx.ca/en/pdf/RequestForComments_Oct29-04.pdf> (last accessed on February 2, 2005).

⁹²¹ The C.S.A. anticipates the implementation of the Disclosure Instrument and the Best Practices Policy in the first half of the year 2005 to the extent that they will apply to information circulars or annual information forms which are filed following financial years ending on or after June 30, 2005, see C.S.A. Staff Notice 58-302 (January 21, 2005), available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/csa_20050121_58-302_not-imp-corp-gov-pol.jsp> (last accessed on February 3, 2005).

⁹²² See TSX Request for Comment – Corporate Governance Policy – Proposed New Disclosure Requirement, published October 29, 2004, (2004) 27 OSCB 8944, available online at <http://www.tsc.ca/en/pdf/TSXRuleReview_Oct29-04.pdf> (last accessed on February 2, 2005).

Disclosure of Corporate Governance Practices or any replacement of the Instrument.⁹²³ The proposed new Section 472 of the TSX Manual also provides for new implications for non-compliance. Under the new proposals, enforcement of any violation of the corporate governance requirements are expected to be enforced more effectively since the failure to provide the required information will constitute a breach of securities law, giving leave to enforcement proceedings and sanctions.⁹²⁴

The new corporate governance practices as proposed are based on the final corporate governance rules implemented by the New York Stock Exchange after the enactment of the Sarbanes Oxley Act.⁹²⁵ Unlike the U.S. rules that are mandatory listing standards, the Canadian proposal still is voluntary, with a mandatory disclosure requirement only for the description of how the corporation meets the objectives of the guideline if differing from the corporate governance standards as suggested by the new guidelines. Thus, the focus now is on a statement of the company's individual corporate governance practices rather than on the sole explanation why the company does not comply with a particular guideline. However, compliance with the new disclosure requirements under the Disclosure Instrument will be a condition for listing on the TSX.⁹²⁶

(1) NI 58-101 Disclosure of Corporate Governance

Firstly, the proposed National Instrument 58-101 *Disclosure of Corporate Governance Practices* establishes mandatory disclosure requirements regarding the corporate governance practices the issuer has adopted.⁹²⁷ Disclosure will be generally in reference to the corporate governance guidelines contained in the Best Practices Policy. The disclosing issuer hereby has two options to comply with his obligations under the Disclosure Instrument in terms of either describing the compliance with the Best Practices Policy guidelines or explaining how the

⁹²³ The proposed changes to Sections 472 through 475 by the new Section 472 of the TSX Manual are contained in TSX Request for Comment – Corporate Governance Policy – Proposed New Disclosure Requirement, *supra* note 922 at 8945.

⁹²⁴ The proposed Section 472 of the TSX Manual, as amended, *supra* note 923, reads: “Listed Issuers who evidence a blatant and consistent disregard of TSX’s disclosure requirements will be referred to the Ontario Securities Commission and may be subject to other legal proceedings.”

⁹²⁵ Condon, Anand, and Sarra, *supra* note 830 at 425.

⁹²⁶ See proposed Section 472 of the TSX Manual, *supra* note 923.

⁹²⁷ See Disclosure Instrument, *supra* note 918, Part II, Sections 2.1 and 2.2.

objectives of the guidelines are otherwise achieved.⁹²⁸ In addition, the Disclosure Instrument requires every issuer who has adopted a written code of corporate governance to file a copy of that code on the System for Electronic Document Analysis and Retrieval⁹²⁹ no later than the date on which the issuer's next financial statements must be filed.⁹³⁰

Pursuant to Section 2.1 of the Disclosure Instrument, disclosure is required either as part of the management information circular of each proxy solicitation process for the purpose of election of directors or as a part of the annual information form required by National Instrument 51-102 *Continuous Disclosure Obligations*.⁹³¹ Such disclosure has to be made in accordance with Form 58-101F1.⁹³² With respect to the potential conflicts of interest and self-dealing, Item 1 of Form 58-101F1 requires the disclosure of whether the board consists of a majority of independent directors and whether the chairman of the board is an independent director. The corporation is also obliged to identify both independent and non-independent directors. Furthermore, according to Item 6 disclosure must be made regarding the existence or non-existence of an independent nominating committee. Item 5 (b) requires a description of the steps taken by the board of directors to ensure directors exercise of independent judgment considering transactions and agreements in respect of which a director or executive officer has a material interest. As far as the compensation for directors and officers is concerned, Item 7 requires disclosure of the process of determination of the compensation for the company's directors and officers. The company is required to state whether it has a compensation committee and, if so, whether or not it is composed entirely of independent directors. If the board does not have a compensation committee composed entirely of independent directors, the steps taken by the board to ensure an objective process for determining the compensation must be disclosed, too.

(2) NP 58-201 Corporate Governance Guidelines

Secondly, the proposed National Policy 58-201 *Corporate Governance Guidelines*

⁹²⁸ See TSX Request for Comment – Corporate Governance Policy – Proposed New Disclosure Requirement, *supra* note 922.

⁹²⁹ See National Instrument 13-101 System for Electronic Document Analysis and Retrieval (SEDAR), as amended, available online at <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/trn_part1_index.jsp> (last accessed on March 23, 2005).

⁹³⁰ See Disclosure Instrument, *supra* note 918, Part II, Section 2.3.

⁹³¹ NI 51-102, *supra* note 867.

⁹³² *Supra* note 918. In recognition of the existence of smaller issuers with less formal procedures in effect, with Form 58-101F2 the Disclosure Instrument provides for reduced disclosure requirements for those “venture issuers”, see Disclosure Instrument, *supra* note 918, Part II, Section 2.2.

explicitly provides guidance on corporate governance practices that have been formulated to achieve balance between providing protection to investors and fostering fair and efficient capital markets and confidence in capital markets; to be sensitive to the realities of the greater numbers of small companies and controlled companies in the Canadian corporate landscape; to take into account the impact of corporate governance developments in the U.S. and around the world; and to recognize that corporate governance is evolving.⁹³³ In this context, the corporate governance guidelines established by the Best Practices Policy are neither mandatory nor intended to be descriptive, but rather to encourage issuers to consider the guidelines in developing their own corporate governance practices.⁹³⁴ In particular, issuers are not required to disclose their corporate governance practices in comparison to the guidelines.⁹³⁵

Technically, the Best Practices Policy in Part 3 contains 18 specific corporate governance guidelines. With respect to the self-dealing and compensation issues, the following corporate governance practices are suggested to be considered for the corporation's own corporate governance practices. Primarily, a corporation is encouraged to ensure that its board of directors be composed of at least a majority of independent directors and be chaired by an independent director (guidelines 3.1 and 3.2).⁹³⁶ Besides that, the board of directors should also appoint a nomination committee consisting entirely of independent directors (guideline 3.10). Pursuant to guideline 3.15, the board of directors is asked to appoint an independent compensation committee that, according to guideline 3.16, should be responsible for (a) reviewing and approving corporate goals and objectives relevant to C.E.O. compensation, evaluating the C.E.O.'s performance in light of those goals and objectives, and determining the C.E.O.'s compensation level based on this evaluation; for (b) making recommendations to the board with respect to non-C.E.O. officer and director compensation, incentive-compensation plans and equity-based plans; and for (c) reviewing executive compensation disclosure before the issuer publicly discloses this information.

⁹³³ See Best Practice Policy, *supra* note 919, Part 1, Section 1.1.

⁹³⁴ *Ibid.*

⁹³⁵ Simon Romano and Andrew Grossman, "Corporate Governance Disclosure in Canada: A National Approach... Finally" (2004) 8 (7) Wall Street Lawyer 11 at 12.

⁹³⁶ Where an independent chairman is considered to not be "appropriate", an independent "lead director" should be appointed, see Best Practice Policy, *supra* note 919, Part 3, Guideline 3.2.

c) Estimated Implications for the Future

Although the new requirements for corporate governance practices as proposed by the Disclosure Instrument and the Best Practices Policy have not yet been effectively adopted, they are expected to come into effect as early as in the first half of the year 2005.⁹³⁷ Thus far, the compliance with the existing TSX Guidelines is not mandatory, but the disclosure of whether or not the issuing corporation adheres to the guidelines is a condition for the listing at the TSX.

At this time, it remains rather uncertain whether the proposed amendments by securities regulation will result in any measurable change in corporate governance. Again, compliance with the proposed new corporate governance guidelines, in essence, will be voluntary. Despite the fact that corporations are to disclose whether or not they comply with the guidelines as suggested, non-adherence to the proposed guidelines will not cause sanctions under securities law. As long as the issuer complies with the proposed disclosure requirements, he will remain listed at the TSX as under the present regime. Only the issuer's failure to comply with the enhanced disclosure obligations under the Disclosure Instrument will constitute a breach of securities law. It is expected that the TSX will legally proceed against the issuer with the potential of a de-listing or other sanctions under securities law.⁹³⁸

According to securities law, the only remedy exercisable by shareholders is shareholder exit by way of sale of shares. Canadian corporate law, by contrast, does not yet provide for explicit remedies in case of non-compliance with corporate governance disclosure requirements or practices. Given the mandatory requirements for disclosure, a breach of the disclosure obligation might be deemed a breach of the directors' duties of loyalty and care in terms of the obligation to comply with the applicable laws. In light of the voluntary nature of the corporate governance guidelines of the proposed Best Practices Policy, however, it is especially questionable whether a major departure from the guidelines might, to the same extent, form the basis of a legal action against directors under the applicable corporate law statutes.⁹³⁹ Both a claim for breach of the directors' duties of loyalty and care as well as an action for oppressive conduct towards shareholders are not likely to succeed as the breach does not concern mandatory law and, therefore, might not be considered as a relevant breach of law for legal proceedings.

⁹³⁷ *Supra* note 921.

⁹³⁸ Condon, Anand, and Sarra, *supra* note 830 at 431. For a broader discussion of the implications resulting from a breach of securities law and potential shareholder remedies, see *infra* at III.

⁹³⁹ *Ibid.*

Thus, the failure to comply with the disclosure requirement will not suffice unless that failure also damages the corporation or shareholder interests in a substantial way.

5. Tax Deductibility Restrictions

Canadian tax law provides for several provisions with respect to executive compensation in general and severance payments in particular. In the following, I will explain the existing restrictions on the deductibility of corporate business expenses imposed by income tax rules and evaluate whether they serve as an efficient constraint on the design of executive severance packages. In this context, I will also refer to the latest reforming legislative steps taken at U.S. tax law in order to increase the efficacy of tax deductibility constraints with respect to executive compensation and “golden parachutes”.

a) Limited Deductibility of Executive Severance Packages

Any payments made to a terminated employee as a consequence of the loss of employment are included in computing the taxable income as a „Retiring Allowance“ under Section 56(1)(a)(ii) of the Canadian Income Tax Act.⁹⁴⁰ A retiring allowance as defined by Section 248(1)(b) ITA also includes any judicial award of damages for wrongful dismissal and any ancillary award of aggravated or punitive damages.⁹⁴¹ Thus, for the purpose of taxation, any kind of severance package received by the corporate executive as compensation for the termination of the executive service contract, including payments caused by a double-triggered “golden parachute” provision, constitutes taxable income in terms of retiring allowance.⁹⁴² Single-triggered “golden parachutes”, by contrast, are not retiring allowances in the meaning of the ITA, as they are not contingent to the termination of the employment. Regardless of their exclusion from retiring allowance, such payments constitute regular income from employment pursuant to Section 5(1) ITA.

For the corporation, on the other hand, all such severance payments, either paid as a lump-sum or as continued compensation, are deductible from business income as a corporate

⁹⁴⁰ Canadian Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), as amended, hereinafter referred to as “ITA”.

⁹⁴¹ *Nowegijick v. Canada* (1983), 144 D.L.R. (3d) 193 (S.C.C.).

⁹⁴² With respect to the taxation procedure of this kind of income, Sections 153(1)(c) and 227(8.4) ITA require the employer to withhold the tax on retiring allowance payments. Failure to do so may result in the employer being subject to interest charges and penalties.

expense.⁹⁴³ Under Canadian tax law, however, the tax deduction is subject to an overall test of reasonability. Section 67 ITA provides that “no deduction shall be made in respect of an outlay or expense in respect with of which any amount is otherwise deductible under [The Income Tax Act], except to the extent that the outlay or expense was reasonable in the circumstances”. In other words, the corporation would not be allowed to deduct as corporate business expense a compensation or severance package that is regarded to be unreasonable in the specific case.⁹⁴⁴

The problem this provision is facing when considered as a constraint on executive severance packages is apparent. The reference to the reasonable standard brings us back to the business judgment rule.⁹⁴⁵ Since the determination of executive compensation and severance packages is a general business decision taken by the board of directors at its own discretion at the given time, the temptation might exist to assess the same business decision differently *ex post* on the basis of all information available, although the decision might have been reasonable under the particular, and possibly limited circumstances from an *ex ante* perspective. In light of this risk of business decisions to turn out differently at a later point of time,⁹⁴⁶ the corporate law duty of care only requires an amount of care a reasonable business person would take under the same circumstances.⁹⁴⁷ Therefore, in the corporate context, Canadian courts have adopted the business judgment rule from U.S. corporate law with its general implication that the courts should be reluctant to second-guess the business-judgment of the board of directors, as not a perfect decision, but only a reasonable decision is required of them.⁹⁴⁸ Consequently, Canadian case law has also adopted the business judgment rule in the tax context when the tax courts have to determine the reasonableness of executive compensation as a condition for deduction as business expenses in accordance with Section 67 ITA. In *Gabco Limited v. Minister of National Revenue*,⁹⁴⁹ the Exchequer Court stated that

“[i]t is not a question of the Minister or this Court substituting its judgment for what is a reasonable amount to pay, but rather a case of the Minister or the Court coming to the

⁹⁴³ See, for example, Wilson and Taylor, *supra* note 167 at 230.

⁹⁴⁴ A similar provision exists in U.S. tax law. Pursuant to § 162(a)(1) of the Internal Revenue Code (26 U.S.C., hereinafter referred to as “IRC”), the deductibility is only given for “a reasonable allowance [...] for personal services actually rendered”.

⁹⁴⁵ *Supra* at 2. c).

⁹⁴⁶ This risk has been referred to commonly in the legal literature as “hindsight bias”.

⁹⁴⁷ See, for example, Section 122(1)(b) CBCA.

⁹⁴⁸ *Supra* at 2. c). Most recently, see especially *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611.

⁹⁴⁹ *Gabco Ltd. v. Minister of National Revenue*, [1968] C.T.C. 313 (Ex.), 2 Ex. C.R. 511 (Ex. Ct.).

conclusion that no reasonable business man would have contracted to pay such an amount having only the business consideration of the appellant in mind".⁹⁵⁰

This statement by the court was made in the context of a private Canadian corporation. *Alarie* has convincingly pointed out that it would be difficult to uphold such an absolute reasoning in the context of a public corporation where the contractual arrangements between the corporation and its executives regarding compensation matters were taken by a compensation committee consisting mainly or entirely of independent directors who are also business persons.⁹⁵¹ In a different case,⁹⁵² the court actually denied the deduction of the full amount of the management salaries paid to the spouse and children of the executive and reduced the deductible payments to a reasonable amount.⁹⁵³ In this case, however, the court reviewed the substantive merit of the salaries paid mainly because of the family relationships involved.⁹⁵⁴

In general, Canadian tax courts have adopted the business judgment approach to Section 67 ITA and are reluctant to second-guess the business judgment of the directors as long as payments appear to have been motivated by business purposes.⁹⁵⁵ Thus, by imposing the same standard of reasonableness as corporate law, Canadian income tax law is likely to serve as a constraint on contractual severance arrangement between the corporation and its executives only to the same extent as does the corporate law duty of care. The effectiveness of both corporate and tax law provisions referring to a reasonable amount varies from case to case, given the difficulties in determining what constitutes a reasonable compensation or severance package.

b) Tax Deductibility Caps under United States Tax Legislation

The reasonable expense rule as a regulatory measure to restrict the deductibility of executive compensation and severance packages exists in both Canada and the U.S.⁹⁵⁶ The U.S.

⁹⁵⁰ *Ibid.* at 522.

⁹⁵¹ *Alarie*, *supra* note 96 at 63. *Alarie* also states, unfortunately without reference to empirical evidence, that the judicial practice applies the reasonable compensation rule almost exclusively to closely-held corporations instead of also to widely-held public corporations.

⁹⁵² *Maduke Foods Ltd. v. Canada*, [1989], 2 C.T.C. 284 (F.C.T.D.).

⁹⁵³ In this case, however, the court reviewed the substantive merit of the salaries paid mainly because of the familiarly relationships involved.

⁹⁵⁴ Other cases where Canadian tax courts applied the reasonable expense rule, but not in the context of executive compensation, are, for example, *Bonin v. R.*, [2000] 2 C.T.C. 2011 (T.C.C.); *Tarantino v. R.*, [2000] 1 C.T.C. 3039 (T.C.C.); *Mohammed v. R.*, [1997] 3 C.T.C. 321 (F.C.A.); *Monga v. Canada*, [1997] 1 C.T.C. 2529 (T.C.C.); *Graves v. Canada*, [1990] 1 C.T.C. 357 (F.C.T.D.); *MSS Inc. v. R.*, [1989] 2 C.T.C. 30 (F.C.A.); *Compagnie Idéal Body Inc. v. Canada*, [1989] 2 C.T.C. 187 (F.C.T.D.).

⁹⁵⁵ *Alarie*, *supra* note 96 at 63.

⁹⁵⁶ For the U.S. tax provision, see *supra* note 944.

tax legislators have approached the ineffectiveness of the provision caused by the business judgment rule by introducing two different tax deductibility caps for payments made to corporate executives. Canadian tax legislation, however, has not yet taken similar action.

(1) § 162(m) Internal Revenue Code regarding executive compensation

As an attempt at more effective restriction of executive compensation, the U.S. have chosen to set absolute legal limits for the deductibility of executive compensation as business expenses rather than to rely on the reasonable expense rule under § 162(1)(a) IRA.⁹⁵⁷ In response to the public outcry over what was considered to be “excessive” executive compensation in the early 1990s, U.S. Congress enacted § 162(m) IRA as a measure to reduce such compensation.⁹⁵⁸

As a general rule, § 162(m) IRA limits the deductibility of executive compensation payments per year.⁹⁵⁹ The rule applies to publicly-held U.S. corporations and prevents them from deducting as ordinary and necessary trade or business expense amounts in excess of US\$ 1 million that are paid to the C.E.O. or any employee who is among the four highest compensated employees other than the C.E.O.⁹⁶⁰ Thus, any private corporation or any corporation that is not registered for trading on a public U.S. stock exchange is exempt from the rule. Besides that, § 162(m)(4)(C) IRA provides that the restriction as to the deductibility does not apply to those parts of the compensation package that are solely performance-based if three further requirements are met. First, the goals of the performance must have been determined priorily by a compensation committee which was comprised of at least two outside directors. Secondly, the material terms of the compensation agreement must have been approved by a separate shareholder vote and, finally, the compensation committee must have certified that the

⁹⁵⁷ The U.S. approach is referred to as a “limited regulatory approach”, see Fisch, *supra* note 494 at 761.

⁹⁵⁸ Omnibus Budget Reconciliation Act of 1993 (S.1134), U.S. Tax Rep. (RIA) No. 26 (June 24, 1993), at 69.

The Committee Report states: “Recently the amount of compensation received by corporate executives has been the subject of scrutiny and criticism. The committee believes that excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to \$ 1 million per year.”, see Committee on Ways and Means, “*Revenues Report to Accompany Recommendations from the Committee on Ways and Means*” (1993) H.R. Rep. No. 103-111 at 646, reprinted in 1993 U.S.C.C.A.N. 378 at 877.

⁹⁵⁹ § 162(m)(1) IRC reads: “In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$ 1,000,000.”

For a good overview of the new U.S. provision including its requirements and exceptions, see Salky, *supra* note 55 at 815-823.

⁹⁶⁰ The term “publicly-held corporation” is defined in § 162(m)(2) IRC. For a definition of the “covered employee”, see § 162(m)(3) IRC.

performance goals were met if it wishes to pay out performance-based compensation in excess of US\$ 1 million. In addition, according to § 162(m)(4)(F) IRA, the US\$ 1 million limitation is reduced by the amount of any excess “golden parachute” payment that is not deductible by the corporation pursuant to § 280G IRA.⁹⁶¹

The introduction of § 162(m) IRA has received differing resonance. Some commentators praise the new provision to be the most promising avenue for curbing excessive executive compensation as it serves to add teeth to the requirement that executive compensation be reasonable with respect to § 162(a)(1) IRA.⁹⁶² In light of the limitation of deductibility to non-performance-based compensation, the new rule is held to be a suitable mechanism for the corporation and its directors to act in the best interest of the shareholders by allowing the corporation to deduct compensation in excess of US\$ 1 million that is performance-based and has been approved by shareholders.⁹⁶³ Also, the rule is believed to encourage corporations to a more frequent and increased use of performance-based compensation instead of fixed remuneration.⁹⁶⁴

On the other hand, however, studies after the enactment of § 162(m) IRA have shown no evidence that the restriction to tax deductibility resulted in a net reduction of executive compensation.⁹⁶⁵ By contrast, the rule in fact had the effect of causing an increased use of performance-based elements such as stock-options as part of the overall compensation package in lieu of fixed salaries exceeding US\$ 1 million.⁹⁶⁶ Alternatively, many companies even increased the fixed salary to the US\$ 1 million gap established by the provision.⁹⁶⁷ Thus, the U.S. provision has been characterized as being “a good example of the shortcomings of regulatory approaches to corporate governance”.⁹⁶⁸

(2) § 280G Internal Revenue Code regarding “golden parachutes”

In response to the increased use of “golden parachutes” in the corporate environment in the

⁹⁶¹ For a discussion of § 280G IRC, see *infra* at (2).

⁹⁶² Alarie, *supra* note 96 at 66 with several proposals for the case of an adoption of the rule to Canadian tax law.

⁹⁶³ James R. Repetti, “*The Misuse of Tax Incentives to Align Management-Shareholder Interests*”(1997) 19 Cardozo L. Rev. 697 at 708

⁹⁶⁴ Alarie, *supra* note 96 at 66.

⁹⁶⁵ See Brian J. Hall and Jeffrey B. Liebman, “*The Taxation of Executive Compensation*” in *Tax Policy and the Economy, Vol 14* (Cambridge: MIT Press, 2000) at 1; Perry and Zenner, *supra* note 89.

⁹⁶⁶ Hall and Liebman, *supra* note 965 at 42; Repetti, *supra* note 963 at 709.

⁹⁶⁷ See John A. Byrne, “*That’s Some Pay Cap, Bill*” Business Week (April 25, 1994) at 57.

⁹⁶⁸ Fisch, *supra* note 494 at 761.

early 1980s, the U.S. in 1984 enacted a tax provision that specifically deals with the deductibility of payments in terms of "golden parachutes".⁹⁶⁹ Although no U.S. provision prohibited a corporation from including a "golden parachute" provision in the executive service contract or the particular compensation agreement, § 280G IRA was introduced to discourage corporations from using "golden parachutes" as a means of providing executives with "excessive" compensation.⁹⁷⁰ § 280G IRA denies deductions to corporations for the payment of any "excess parachute payments" made to "disqualified individuals".⁹⁷¹ In addition to that, § 4999 IRA, which was also introduced in 1984, imposes a non-deductible 20% excise tax on the recipient of any excess parachute payments. Given that restrictive effect for tax purposes on behalf of the taxpayer, the legislative approach is regarded as a "tax penalty".⁹⁷²

§ 280(b) IRA is a complex rule that contains a variety of specific terms that are defined by the rule itself. According to § 280G(b) IRA, a "parachute payment" in the meaning of the provision is any payment to a "disqualified individual"⁹⁷³ in the nature of compensation, if such payment is contingent on a change in control of the corporation and the aggregate present value of all such payments equals or exceeds three times the individual's "base amount".⁹⁷⁴ The base amount is the average annual taxable compensation paid by the corporation to the executive for the five taxable years (or shorter period of service) preceding the taxable year in which the

⁹⁶⁹ § 280G Internal Revenue Code, added as part of the Deficit Reduction Act of July 18, 1984, Pub. L. No. 98-369, Div. A, Title I, § 67(a), 98 Stat. 585.

For a good overview of the introduced provision and its effects on "golden parachute" provisions, see Johnson, *supra* note 54; Wolk, *supra* note 176.

⁹⁷⁰ The U.S. Senate Finance Committee stated its views as follows: "The committee [...] is concerned that in many instances golden parachute contracts do little but assist an entrenched management team to remain in control. They also may provide corporate funds to subsidize officers or other highly compensated individuals. The committee is unwilling to permit the tax law to be used as a subsidy in such situations. In fact, the committee believes that a tax penalty should be enacted in those situations.", see Senate Comm. on Finance, 98th Cong., "Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Comm. on Mar. 21, 1984" at 195 (Comm. Print 1984).

⁹⁷¹ The general rule established by § 280G(a) IRC reads: "No deduction shall be allowed under this chapter for any excess parachute payment."

⁹⁷² Wolk, *supra* note 176 at 126; Ocker and Schick, *supra* note 221 at 48; Bress, *supra* note 176 at 986; Harrison Campbell, *supra* note 171 at 282.

⁹⁷³ A "disqualified individual" is "any individual who is an employee or independent contractor of a corporation and who is an officer, shareholder, or highly compensated individual" (i.e., any individual who is or would be if the individual were an employee one of the highest paid 1% of employees of the corporation, but not to exceed the highest paid 250 employees of the corporation), see § 280G(c) IRC. In the following, I will only refer to officers in terms of executives as defined *supra* at Chapter 1, IV.

⁹⁷⁴ By referring to "any kind of compensation", the legal definition of "golden parachute" given by § 280G IRC also includes severance payments or accelerated vesting of stock options in connection with a change in control and, therefore, does not differ essentially from the definition of "golden parachute" as developed earlier in this thesis, *supra* at Chapter 1, III.

change in control occurs.⁹⁷⁵ An “excess parachute payment” is defined by § 280G(b)(1) IRC as “any parachute payment in excess of the portion of the base amount allocated to such payment”. The “portion of the base amount allocated” to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of the parachute payment, and the denominator of which is the aggregate present value of all such payments.⁹⁷⁶

Thus, according to § 280G IRA, an excess parachute payment results if the aggregate payments received by the executive that are contingent on a change in control equal or exceed three times the executive’s base amount of compensation.⁹⁷⁷ Under these circumstances, the executive is subject to a 20 per cent non-deductible excise tax on the excess over the base amount and the corporation is denied a tax deduction in terms of business expenses for the same amount.⁹⁷⁸ To the contrary extent, any amount less than three times the executive’s base amount is generally referred to as the “golden parachute’s safe harbour” under § 280G IRC.⁹⁷⁹ Moreover, a major implication of the establishment of that absolute limit is that, by virtue of the law, a “golden parachute” cannot be regarded as “unreasonable compensation” in terms of § 162(m) IRC as long as the benefits thereof do not exceed the limit.⁹⁸⁰ Accordingly, by relying on the limits imposed by tax law, U.S. courts have drawn the conclusion for corporate law not to pursue any judicial scrutiny when the amount of a “golden parachute” is within the limits of § 280G IRC.⁹⁸¹

There are basically three ways for a corporation and the executive to influence the design of a “golden parachute” in order to avoid the tax penalties under the rule. As a first alternative, in the event that the “golden parachute” will be regarded as excessive under § 280G IRC, the corporation can provide the executive with an additional gross-up payment in order to put the executive into the same position after taxes as he would have been without the liability for excise

⁹⁷⁵ See § 280G(b)(3)(A), (d)(2) IRC.

⁹⁷⁶ See § 280G(b)(3)(B) IRC.

⁹⁷⁷ In *Gaillard v. Natomas Co.*, *supra* note 54, which was one of the first cases dealing with § 280G IRC, the court found the three hundred percent rule to be of considerable probative value, noting that any amount beyond that figure would constitute an excessive payment.

⁹⁷⁸ See § 280G(a), § 4999 IRC.

⁹⁷⁹ See, for example, Michael S. Sirkin and Lawrence K. Cagney, *Executive Compensation* (New York: Law Journal Seminars Press, Loose-leaf, 1999) at § 9.01[4][a].

⁹⁸⁰ See *Stikeman, Elliott*, *supra* note 134 at § 11.89.

⁹⁸¹ *Buckhorn Inc. v. Ropak Corp.*, *supra* note 750; *Worth v. Huntington Bancshares, Inc.*, *supra* note 54; See also *Gaillard v. Natomas Co.*, *supra* note 977, *e contrario*.

tax.⁹⁸² Secondly, the corporation can choose to reduce the executive's golden parachute payments to an amount less than three times the base amount.⁹⁸³ Thirdly, the corporation can grant the executive a tax restoration payment to the extent that, after the payment of the income tax and the excise tax on the additional payment, the executive has sufficient after-tax funds to pay the excise tax on the original parachute payments.⁹⁸⁴ Finally, if a change in control is contemplated for some future year, the corporation can attempt to avoid the tax penalties of § 280G IRC by increasing the executive's base amount in the years prior to the change in control. This goal could be accomplished, for example, through an acceleration of the payment of bonuses or other incentive awards and the early exercise of stock options or vesting of restricted stock.⁹⁸⁵

§ 280G IRC, however, also contains various exceptions to its application. Excluded from the reach of the provision are reasonable compensation for services rendered either prior to or following the change in control.⁹⁸⁶ If the executive can show that a payment is reasonable compensation for past or future services, that payment will first reduce the portion of the executive's base amount allocated to that payment and the balance will be exempt from treatment as an excess parachute payment. Furthermore, § 280G(b)(5)(A)(i) IRC establishes that certain payments made by private corporations that have received shareholder approval are also exempt from the deductibility limitations under the rule.⁹⁸⁷ In order to satisfy the shareholder approval requirements, the payment must be approved by 75 per cent of the voting power of the corporation prior to the change in control.

In conclusion, the introduction of § 280G IRC has resulted in being of limited effect. To some extent, it has proven to be counterproductive with respect to its goal to limit executive compensation in general. The establishment of an absolute limit for "golden parachutes" has been considered by U.S. corporations to be a permission to increase the payments up to exactly the legal limit, as those payments are regarded to be reasonable in the meaning of the law. There

⁹⁸² Sirkin and Cagney, *supra* note 979 at § 9.05[3]. A gross-up will result in the corporation paying not only the excise tax on behalf of the executive, but also the income and further excise tax on the additional gross-up payments.

⁹⁸³ Ocker and Schick, *supra* note 221 at 48. This alternative is commonly referred to as "cutback". In fact, any cutback to a maximum of 2.99 times the base amount will be harmless with respect to the safe harbour.

⁹⁸⁴ In the 1990s, this alternative was the favored approach for approximately 50 per cent of corporations to reach the safe harbor, see *ibid.* The tax-restoration provided by the corporation would not be deductible as business expenses.

⁹⁸⁵ *Ibid.*

⁹⁸⁶ § 280G(b)(4)(A) and (B) IRC.

⁹⁸⁷ This exception was introduced for private corporations as an amendment in 1986. Congress declined, however, to provide an exception for publicly traded corporations, see Repetti, *supra* note 963 at 704.

is also evidence that many corporations have added a "gross up" to the compensation paid to executives to take account of the excise tax imposed by section § 280G IRC.⁹⁸⁸ Alternatively, corporations have invented the technique of tax restoration in order for the executive to avoid additional taxation. Thus, instead of eliminating or minimizing golden parachutes, the effect of the legislative tax restrictions imposed by § 280G IRC has turned out to make "golden parachute" payments more expensive to the corporations. Therefore, the introduction of tax penalties by U.S. tax legislation cannot be considered as a meaningful constraint on executive compensation.

6. Criminal Law

By far the most serious legal implications for self-dealing corporate directors and executives would follow from criminal law, as a criminal offence could result in severe fines or even imprisonment. So far, there has not been a single case in Canada or in the U.S. where criminal charges for illegal self-dealing were brought against corporate managers by aggrieved shareholders. Given the different civil law remedies available for the corporation and aggrieved shareholders to set aside a severance or golden parachute agreement or to claim for reimbursement of excessive amounts, it is also not likely that criminal charges will be made in the first place.

However, as experienced in the recent German example in the Mannesmann case, there are a series of criminal offences that could be subject to criminal accusation against executives and directors in the case of alleged excessive self-dealing. In Germany, the principle accusation against the executives and directors in the Mannesmann case was that the severance payments paid out to Esser and other corporate executives and directors were considered to be excessive and not based on any valid legal grounds and, therefore, constituted a criminal breach of trust. Although the criminal charges failed in practice due to the lack of sufficient proof of criminal intent of the individuals involved, the criminal charges and the proceedings had been taken very seriously and the result could possibly have been different in the event of more substantive proof of the actions and negotiations involved. Canadian criminal law, too, imposes a series of similar criminal offences that might, at least theoretically, be subject to criminal charges in the context of managerial self-dealing of corporate executives. In the following, I will briefly present the

⁹⁸⁸ See Susan J. Stabile, "Is there a Role for Tax Law in Policing Executive Compensation" (1998) 72 St. John's L. Rev. 81 at 93.

different criminal acts contained in the Criminal Code and assess their relevance, although it will not be possible to make final statements as to their actual application in practice. Additionally, even if one of the criminal offences were applicable in a specific case, the outcome of the criminal proceedings would, of course, depend to a large degree on the availability of proof.

Directors and officers of the corporation are expected not to tread into the realm of the criminal law. With regards to the process of entering into executive severance agreements and "golden parachute" provisions, the following criminal offences of the Canadian Criminal Code could be of relevance for criminal implications of the actions involved as they might also apply to self-interested behaviour of corporate insiders who act in their own personal interests in terms of diverting assets to themselves by way of executive compensation and severance arrangements that result to be excessive. In this context, those corporate insiders are not acting as the "alter ego" of the corporation, i.e. as their "directing mind".⁹⁸⁹ Therefore, the issue of corporate liability for criminal offences does not arise, but rather the personal criminal liability of the corporate insider.⁹⁹⁰

a) Misappropriation of Money held under Direction, S. 332 CCC

A self-dealing transaction of an inside director who diverts corporate assets to himself could possibly constitute a fraudulent violation of the fiduciary duty. Under Section 332 of the Canadian Criminal Code,⁹⁹¹ it is an offence to misappropriate money held under direction. Accordingly, a corporate insider who receives benefits in terms of money or valuable security that originally belonged to the corporation commits theft if his proceeds are fraudulently obtained and contrary to the direction received, applied for an unauthorized purpose, or paid to a third person not entitled to benefit from them.⁹⁹²

The crucial issue for criminal charges would be whether the corporate insider is holding the corporate assets under direction of a beneficiary, i.e. the shareholders of the corporation. Section

⁹⁸⁹ *Canadian Dredge & Dock Co. v. R.*, [1985] 1 S.C.R. 662 (S.C.C.).

⁹⁹⁰ In *Canadian Dredge & Dock Co. v. R.*, *supra* note 989 at paras. 38 et seq., the Supreme Court of Canada extensively analysed the corporate criminal liability in Canadian Law. Based on the facts that a corporation cannot think or show a state of mind, the corporation was traditionally considered under common law not to be liable for criminal offences. The Supreme Court approached the problem by applying the "identification theory" to the extent that the corporation is liable under criminal law for offences committed by persons who, as the corporation's directing mind, have expressed, implied or de facto decision-making control over corporate activity.

⁹⁹¹ Criminal Code of Canada, R.S.C. 1985, c. C-46, as amended, hereinafter referred to as "CCC".

⁹⁹² *R. v. Skalbania* (1997), 120 C.C.C. (3d) 217 (S.C.C.).

332 CCC does not particularize the nature of the agreement or the meaning of the term "direction". The Supreme Court of Canada held that Section 332 CCC does not specifically relate to any particular kind of contract.⁹⁹³ Thus, the direction need not be particularly explicit.⁹⁹⁴ On the other hand, expectations of shareholders standing alone are not directions within the meaning of Section 332 CCC.⁹⁹⁵ However, if the recipient knows the specific expectations, they can be tantamount to a direction.⁹⁹⁶ Thus, whether there is a direction that the corporate assets can be used for a particular purpose by the corporate insider will have to be inferred from the surrounding circumstances.

Obviously, given the fiduciary duty imposed by corporate law on directors and executives to act in the best interests of the corporation, one could argue that those insiders act with the actual knowledge of the expectation of the corporation's shareholders to obey by the law and not to divert assets that primarily belong to the corporation, i.e. to the shareholders. On the basis of the case law cited, this would constitute a direction in terms of Section 332 CCC given by the shareholders to the corporate managers to pay out as compensation and severance only the amount that is reasonable and does not constitute a breach of the fiduciary duty. However, as noted earlier, the breach of the fiduciary duty representing a breach of the direction alone does not suffice to constitute a criminal offence pursuant to Section 332 CCC, as fraudulent intention also is a prerequisite for any criminal act of this kind. Especially given the existence of the business judgment rule, the sole excess of an amount that is considered reasonable by the shareholders does not amount to a criminal offence unless there is proof of criminal intention to benefit from the self-dealing to the detriment of the corporation and its shareholders.

b) Criminal Breach of Trust, S. 336 CCC

Section 336 CCC establishes the offence of a criminal breach of trust by trustees for the fraudulent conversion of the object of trust to an unauthorized use in contravention of the trust. Contrary to the requirement of direction under Section 332 CCC, which does not necessarily need to be expressed, there must be an express trust under Section 336 CCC, otherwise the offence could only be theft.⁹⁹⁷ Provided that directors and executives can be regarded as trustees

⁹⁹³ *R. v. Légaré* (1977), 36 C.C.C. (2d) 463 (S.C.C.).

⁹⁹⁴ *R. v. Lowden* (1982), 68 C.C.C. (2d) 531 (S.C.C.).

⁹⁹⁵ *Ibid.*

⁹⁹⁶ *Ibid.*

⁹⁹⁷ *R. v. Rosen* (1985), 16 C.C.C. (3d) 481 (S.C.C.).

for the shareholders with respect to the corporation's assets, a diversion of corporate assets to themselves in terms of excessive compensation or severance payments could be held a criminal breach of trust pursuant to Section 336 CCC.

The issue of whether directors and officers are trustees of the shareholders has been subject to extensive debate. Early case law characterized directors as "trustees for the shareholders, [who] are answerable to their cestuis que trust for the due employment of the funds entrusted to them".⁹⁹⁸ Also, in the case of *Exchange Banking Co., Re*⁹⁹⁹ the court held that directors

"[...] are trustees of the money which may be collected by subscription, and of all the property that may be acquired; they have the direction and management of the property, and at the same time they have incurred direct obligation to the persons who have so entrusted them with their money. [...] That the relationship of trustee and cestui que trust subsists between the directors of joint stock companies and the shareholders, I do not entertain the slightest doubt."

In another case, however, it was found that in the performance of their duties, directors only stand in a fiduciary relationship to the corporation.¹⁰⁰⁰ As an analogy of what the duties of directors are, the court found the comparison with trustees "wholly misleading".¹⁰⁰¹ In the same sense, the court in *Regal (Hastings) Ltd. v. Gulliver*¹⁰⁰² ruled that

*"[d]irectors of a limited company are the creatures of statute and occupy a position peculiar to themselves. In some respects they resemble trustees, in others they do not. In some respects they resemble agents, in others they do not. In some respects they resemble managing partners, in others they do not".*¹⁰⁰³

The comparison of corporate directors to trustees has originally been applied to prevent directors from claiming remuneration for their services. As one case summarized the relationships between the corporation, its shareholders and the directors,

"[...] the corporation is controlled by ... the directors, and ... those are the persons who in fact control the corporation and decide what shall be done. It is plain that those persons are as much in a fiduciary position as trustees in regard to any acts which are done respecting the corporation and its property. It is quite plain that it would be entirely illegal if they were

⁹⁹⁸ *Land Credit Co. of Ireland v. Lord Fermoy* (1869), L.R. 8 Eq. 7 (U.K.) at 11. See also *Keech v. Sandford* (1726), 25 E.R. 223 (Eng. Ch. Div.). This trust case not directly dealt with directors, but has had significant implication for directors, as it confirmed a breach of trust with respect to corporate opportunities.

⁹⁹⁹ *Exchange Banking Co., Re* (1882), 21 Ch. 519 (Eng. C.A.) at 525.

¹⁰⁰⁰ *Re City Equitable Fire Insurance Company Ltd.*, *supra* note 765. See also *Imperial Hydropathic Hotel Co., Blackpool v. Hampson*, [1883] 23 Ch. 1 (Eng. C.A.); *Alexandra Palace Co., Re*, [1881] 21 Ch. D. 149 (Eng. Ch. Div.) at 163.

¹⁰⁰¹ *Re City Equitable Fire Insurance Company Ltd.*, *supra* note 765.

¹⁰⁰² *Regal (Hastings) Ltd. v. Gulliver*, [1942] 1 All. E.R. 378 (U.K. H.L.).

¹⁰⁰³ *Ibid.*

simply to put the property, or the proceeds of the property of the corporation, into their pockets and make use of it for their own individual purposes or for their purposes as a whole, and not for the purposes of the charitable trust for which the property is held."¹⁰⁰⁴

As for Canada, the Supreme Court of Canada in an early decision¹⁰⁰⁵ left the question open but pointed into that direction by stating that

*"[...] it seems [...] likely to stifle any suggestion that a mere director is intended to share in the benefit of the provision. [...] [H]owever the case stands as to a director, who has in hand money or property of the company, and who is thus, in a qualified sense, a trustee [...]"*¹⁰⁰⁶

Finally, in *Angus v. R. Angus Alberta Ltd.*,¹⁰⁰⁷ the Alberta Court of Appeal held that the directors were trustees, as they

*"[...] owe a duty to the shareholders to act according to the law and according to the provisions of the memorandum and articles of association. Misapplication of company funds in breach of that duty in furtherance of an ultra vires scheme is treated as a breach of fiduciary duty. The directors are trustees of the money misapplied and their liability for breach of that trust is the same as that of any other trustee. They must recoup the loss or compensate the company for it, with interest."*¹⁰⁰⁸

By contrast, in the Quebec case of *Giroux v. Marchildon*,¹⁰⁰⁹ however, it was held that a director was not a trustee of the corporation for the purposes of the criminal code since

*"[...] the fact that he may be entrusted in his said quality (as an agent, scil.) with the cash or securities or other assets of the company does not make him a trustee in respect of such money, security or assets, within the meaning of the criminal code. Theft by an agent of the property of his principal does not become theft by a trustee merely because the agent was entrusted as agent with the property which he stole."*¹⁰¹⁰

In sum, criminal liability under Section 336 to a large extent will depend on the trial court's findings whether the corporate insider concerned was indeed considered a trustee, be it by law or upon an express trust present in the specific case. In the German Mannesmann case, in comparison, the issue of whether the directors were trustees of the corporate assets for the shareholder was also highly controversial, but finally was confirmed by the court.¹⁰¹¹ Thus, once

¹⁰⁰⁴ *French Protestant Hospital, Re*, [1951] 1 Ch. 567 (Eng. Ch. Div.) at 570.

¹⁰⁰⁵ *Cape Breton Cold Storage Co. v. Rowlings*, [1929] S.C.R. 505 (S.C.C.) at 508-509.

¹⁰⁰⁶ *Ibid.*

¹⁰⁰⁷ *Angus v. R. Angus Alberta Ltd.* (1988), 39 B.L.R. (Alta. C.A.), reconsideration refused (1988), 62 Alta. L.R. (2d) 33 (Alta. C.A.), additional reasons (1988), 63 Alta. L.R. (2d) 33 (Alta. C.A.) at 15.

¹⁰⁰⁸ *Giroux v. Marchildon*, [1926] 2 D.L.R. 900 (Que. K.B.) at 906.

¹⁰⁰⁹ *Angus v. R. Angus Alberta Ltd.*, *supra* note 1007.

¹⁰¹⁰ *Giroux v. Marchildon*, *supra* note 1007.

¹⁰¹¹ *Ibid.* at 906.

¹⁰¹¹ The court then turned to the essential aspect of the presence of criminal intention to breach that trust, which was rejected due to the lack of sufficient proof.

such a charge is brought to a Canadian court for the first time, it is likely that the court will have to clarify on the issue of a trust relationship between the corporate insiders and the shareholders. But even if a Canadian court should characterize directors and executives as trustees of the corporation's assets, the accused will not be guilty of a criminal breach of trust unless there is also sufficient proof of their criminal intention to breach the trust with the intention of self-enrichment. The availability of proof of that criminal intention will, in practice, be a hurdle that hardly can be challenged by the shareholders as they will not have detailed insight into the decision-making process and relevant knowledge of the parties' real intentions.

c) Fraud, Section 380 CCC

Finally, the self-dealing behaviour of a corporate insider could possibly represent the offence of criminal fraud in accordance with Section 380 CCC. Fraud encompasses a wide range of dishonest commercial dealings. Section 380 CCC provides that everyone who, by deceit, falsehood or other fraudulent means defrauds any person of any property, money or valuable security is guilty of an indictable offence.

In the criminal law meaning, fraud is deliberate dishonest economic deprivation or risk of deprivation.¹⁰¹² Thus, the requirements of both dishonesty and deprivation must be met, which will be the case if a person is dishonestly deprived of something which is his or something to which he is or would be or might be entitled to had the fraud not been perpetrated.¹⁰¹³ In the corporate context, a conviction for fraud requires that the shareholders be deprived dishonestly of assets that they would be required to receive instead of them being diverted to the corporate insiders.

Dishonesty connotes an "underhanded design which has the effect of, or engenders the risk, of depriving others what is theirs".¹⁰¹⁴ Dishonest conduct is that which ordinary, decent people would feel discreditable and at variance with straightforward or honourable dealings.¹⁰¹⁵ It cannot be said that in every case where the facts determine that the conduct falls below the

¹⁰¹² *R. v. Olan* (1978), 41 C.C.C. (2d) 145 (S.C.C.); *R. v. Thérault* (1993), 79 C.C.C. (3d) 449 (S.C.C.); *R. v. Zlatić* (1993), 79 C.C.C. (3d) 466 (S.C.C.). See also the classic definition of fraud in *London & Globe Finance Corp. Ltd. (Re)*, [1903] 1 Ch. 728 at 732: "To defraud is to deprive by deceit: it is by deceit to induce a man to act to his injury. More tersely it may be put, that to deceive is by falsehood to induce a state of mind; to defraud is by deceit to induce a course of action", amended by *Scott v. Metropolitan Police Commissioner* (1974), 17 C.C.C. (2d) 355 (H.L.).

¹⁰¹³ *Scott v. Metropolitan Police Commissioner*, *supra* note 1012 at 839.

¹⁰¹⁴ *R. v. Zlatić*, *supra* note 1012.

¹⁰¹⁵ *Ibid.*

highest standard of straightforward or honourable dealings that finding alone would be sufficient to make out a case of fraud or conspiracy to defraud. That imposes too high a standard against which to measure criminality.¹⁰¹⁶ Rather, there must also be the wrongful use of something in which another person has an interest in such a manner that a reasonable decent person would consider it to be unscrupulous.¹⁰¹⁷ Thus, not every misrepresentation constitutes fraud. Criminal dishonesty extends further. As stated in *R. v. Mugford*,¹⁰¹⁸ what must be assessed is whether it can objectively be said that the person had been cheated out of money.¹⁰¹⁹

Whether certain conduct falls within these parameters and amounts to fraud is determined upon an objective assessment of the facts. Where the allegation is that fraud was committed by deceit or falsehood, it needs to be decided whether the situation was represented to be a certain character when in reality it was not.¹⁰²⁰ Where it is alleged that the offence was committed by other fraudulent means, the existence of such means is determined by what reasonable people consider to be dishonest dealings.¹⁰²¹ On the other hand, it is not necessary that the perpetrator personally consider the means to be dishonest in order that there be a conviction for fraud.¹⁰²² It need only be established that the acts were knowingly undertaken with the awareness that the deprivation or risk thereof could follow as a likely consequence.¹⁰²³

With regards to the corporate decision-making in relation to executive severance agreements or “golden parachute” provisions that can be regarded as a diversion of corporate assets, those decisions cannot be considered criminal fraud in the alternatives of deceit or falsehood towards the shareholders. Where directors and executives are negotiating or where an inside director contracts with himself on behalf of the corporation, shareholders will generally not be a bargaining party or the addressees of statements made by the directors and executives. Notwithstanding the existence of the fiduciary obligations arising from corporate law, actions by the corporate insiders as a use of their bargaining power cannot be regarded as dishonest dealings in terms of deceit or falsehood towards the shareholders who are not involved in the decision-

¹⁰¹⁶ *R. v. Doren* (1982), 66 C.C.C. (2d) 448 (S.C.C.) at 452.

¹⁰¹⁷ *R. v. Zlatic* (1993), *supra* note 1012.

¹⁰¹⁸ *R. v. Mugford* (1990), 58 C.C.C. (3d) 172 (Nfld. C.A.).

¹⁰¹⁹ *Ibid.*

¹⁰²⁰ *R. v. Théroux* (1993), *supra* note 1012 at 457.

¹⁰²¹ *Ibid.*

¹⁰²² *R. v. Gatley* (1992), 74 C.C.C. (3d) 468 (B.C.C.A.); *R. v. Long* (1990), 61 C.C.C. (3d) 156 (B.C.C.A.).

¹⁰²³ *Ibid.* The subjective belief that the conduct is not dishonest does not afford a defence, see *R. v. Lafrance* (1974), 13 C.C.C. (2d) 289 (S.C.C.); *R. v. Lemire*, [1965] S.C.R. 174 (S.C.C.); *R. v. Olan*, *supra* note 1012.

making process. The alternatives of deceit and falsehood require as a *conditio sine qua non* that a third party be the object of the deceptive or false behaviour or statements. Thus, where directors and executives act together to the detriment of the shareholders, be it intentional or not, the act could constitute a breach of the fiduciary duty, but it could only result in criminal fraud if the behaviour includes dishonesty in terms of deceit or falsehood towards the shareholders, which will not be the case.

However, in the corporate context, the proof of deceit or falsehood towards shareholders is not essential to support a conviction under s. 380(1) CCC.¹⁰²⁴ The diversion of corporate assets can be fraudulent even though the shareholders have not been defrauded by deceit or falsehood. As the corporation is a distinct entity from its shareholders,¹⁰²⁵ it can for itself be defrauded in the alternative of "other fraudulent means" by its directors, executives or others who are in control even in the absence of deceit.¹⁰²⁶ The words "others fraudulent means" in Section 380(1) CCC include means which are not in the nature of a falsehood or a deceit; they encompass all other means which can properly be stigmatized as dishonest.¹⁰²⁷ A dishonesty of any kind is sufficient.¹⁰²⁸ The element of deprivation is satisfied on proof of detriment, prejudice or risk of prejudice to the economic interests of the victim, and it is not even essential that there be actual economic loss as the outcome of the fraud.¹⁰²⁹ Accordingly, the directors of a corporation could commit fraud by knowingly using its assets in a manner detrimental to the best interests of the corporation.¹⁰³⁰ Also, the use of the assets of the corporation for personal purposes rather than *bona fide* for the benefit of the corporation can constitute dishonesty in a case of alleged fraud by directors of a corporation.¹⁰³¹ For example, the courts have held that if all the directors of a corporation jointly use the corporation's funds to purchase an asset which they knew to be worthless as part of a scheme to divert those funds to their own use they would be guilty of

¹⁰²⁴ *R. v. Olan*, *supra* note 1012.

¹⁰²⁵ The principle of the corporation being a separate legal entity was established for the Commonwealth jurisdiction in the groundbreaking case of *Salomon v. Salomon & Co. Ltd.*, [1897] A.C. 22 (H.L.).

¹⁰²⁶ *R. v. Lemire*, *supra* note 1023; *R. v. Olan*, *supra* note 1012; *R. v. Shaw* (1983), 4 C.C.C. (2d) 348 (N.B.C.A.). See also *Cosman v. Viacom Entertainment Canada Inc.*, 2002 CarswellOnt 1569 (Ont. S.C.).

¹⁰²⁷ *Cox v. R.*, *Paton v. R.*, [1963] S.C.R. 500, 40 C.R. 52, 2 C.C.C. 148 (S.C.C.).

¹⁰²⁸ *Scott v. Metropolitan Police Commissioner*, *supra* note 1012.

¹⁰²⁹ *R. v. Ruhland* (1998), 123 C.C.C. (3d) 262 (Ont. C.A.); *R. v. Olan*, *supra* note 1012 at para. 13.

¹⁰³⁰ *R. v. Sinclair*, [1975] A.C. 819 (H.L.).

¹⁰³¹ *Cox v. R.*, *Paton v. R.*, *supra* note 1027; *R. v. Olan*, *supra* note 1012 at para. 12; *R. v. Zlatic*, *supra* note 1012; *R. v. Geddes* (1979), 52 C.C.C. (2d) 230 (Man C.A.); *R. v. Gaetz*, [1993] 3 S.C.R. 645 (S.C.C.); *R. v. Currie* (1984), 5 O.A.C. 280 (S.C.C.); *R. v. Black* (1983), 5 C.C.C. (3d) 313 (Ont. C.A.).

defrauding the company of those funds, even though the company would not have been deceived, but defrauded “other fraudulent means” of the directors.¹⁰³² Additionally, in the earlier English case of *R. v. Sinclair*,¹⁰³³ the defendants were charged with conspiring to cheat and defraud a company, its shareholders and creditors by fraudulently using its assets for purposes other than those of the company and by fraudulently concealing such use.

As a result, a corporate executive or director using the corporation’s funds for unwise business purposes only does not commit fraud.¹⁰³⁴ Such unwise business purpose can also be an executive compensation or severance agreement that is regarded as excessive in terms of unreasonable by third parties in the absence of any indication of fraudulent intent. On the other hand, however, following the existing line of cases, the diversion of corporate assets for exclusively private purposes of the corporate insider, even in terms of executive compensation or severance payments, could be fraud if the corporation suffered deprivation as a result. The dishonesty lies in the wrongful or unauthorized use of the assets in which the corporation – and indirectly the shareholders as well – has a substantial interest, and reasonable decent persons would consider the behaviour or the dealing as dishonest and unscrupulous. The limit of when innocent conduct becomes criminal action is not always evident, particularly when financial pressure is involved or several distinctive interests are at stake. As in the cases of misappropriation of money held under direction and criminal breach of trust, the decisive question and dividing element in each case will generally be the criminal intent of the accused. Thus, in practice a conviction for fraudulent diversion of corporate assets does not appear completely unlikely, but depends largely on whether fraudulent intent can be established as proof of a criminal act.¹⁰³⁵ Even if certain dealings or transactions appear to be somewhat dishonest to the corporation and its shareholders, allegations of criminal fraud against corporate insiders might be turned down due to the lack of proof of fraudulent intention in most cases.

7. Conclusion

In this part, I have presented a series of legal constraints Canadian law imposes on executive severance agreements and “golden parachute” provisions. Most of the restrictions

¹⁰³² *R. v. Olan*, *supra* note 1012.

¹⁰³³ *R. v. Sinclair*, *supra* note 1030.

¹⁰³⁴ To the same extent, see also *R. v. Olan*, *supra* note 1012; *R. v. Zlatic*, *supra* note 1012.

¹⁰³⁵ For an example for the distinction line, see *R. v. Milec* (1997), 110 C.C.C. (3d) 439 (Ont. C.A.).

analysed refer to the decision-making process in relation with those arrangements, mainly focusing on the behaviour of the involved corporate insiders such as executives and directors in order to prevent managerial self-dealing.

First, as a matter of Canadian corporate law, directors and executives are bound by their statutory fiduciary duty to always act in the best interest of the corporation, avoiding any prevalence of self-interest over the best interests of the corporation and its shareholders. If a corporate insider is involved in a self-dealing transaction, he is required to disclose his self-interest to the corporation. The transaction will only be deemed valid if it results to be an at arm's length decision that is fair and reasonable towards the corporation. The duty of care established by corporate law statutes, on the other hand, imposes an obligation on all parties involved in the decision-making process to act with reasonable diligence and care as well as upon reasonable information when exercising their powers to conclude the agreement. If necessary in the particular circumstances of each case, the executives and directors are obliged to pursue further inquiries before making their respective decisions. Especially the recent Canadian case *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*¹⁰³⁶ proves that the board of directors as a whole is responsible that a decision is made upon an informed basis and cannot rely blindly on statements of outside experts or the inside directors directly concerned with the matter.

Secondly, Canadian securities law attempts to address the issue of reasonable and fair executive arrangements by substantial disclosure requirements, enabling minority shareholders and other stakeholders to obtain essential information for potential proceedings against the decisions. Under the proposed modifications to the recent disclosure regime, the board will be required to not only disclose the general executive compensation agreements on an annual basis, but also all severance and "golden handshake" provisions contained therein or separately arranged for.

Canadian tax law adopts the standard of reasonableness from corporate law and, therefore, indirectly imposes a barrier for executive severance agreements that need to be taken into account for tax deductibility purposes. However, any attempts to set an explicit cap on executive severance agreements and "golden parachute" provisions by establishing a limit for tax deductibility as practiced in the U.S. corporate law system has not been adopted by Canadian

¹⁰³⁶ *Supra* note 389.

legislation.

Finally, although there has not been a single case of conviction, executives and directors should also consider the severe legal implications that might follow from fraudulent behaviour under Canadian criminal law. Provided there is sufficient proof of criminal intention with respect to the breach of their legal obligations towards the corporation and its stakeholders, corporate insiders might possibly even be held liable for criminal acts.

III. Shareholder Rights and Remedies

The foregoing Part has developed several different legal constraints on contractual arrangements between executives and the board of directors, acting on behalf of the corporation. With regards to executive severance agreements and “golden parachute” provisions, those restrictions can serve as general limitations on the structure or amounts of those arrangements, as only reasonable and fair agreements are permissible. Moreover, the law provides for different mechanisms that focus on self-dealing of corporate insiders and the diversion of corporate assets to the detriment of the corporation and its stakeholders. In this context, both the executive as well as the directors are bound by certain legal obligations for self-dealing transactions to be regarded as legally permissible and valid.

Notwithstanding the existence of those legal obligations to limit executive agreements and, especially, constrain self-interested managerial behaviour, in order for the shareholders to effectively exercise their oversight of the board and the management and express their concerns of non-compliance with the imposed legal duties and requirements, the law also needs to provide for some mechanisms for the efficient exercise of their protected rights and establish legal remedies against those corporate insiders in breach of the law. Accordingly, in the following Part of this Chapter, I will assess the means Canadian law provides for shareholders to challenge executive severance and “golden parachute” agreements that are believed to be in breach of the law.

The two main legal grounds on which aggrieved shareholders may assert a claim for relief under Canadian corporate law are the derivative action and the oppression remedy. Before I turn to those remedies in detail, I will briefly address further existing shareholder rights as a device for control of managerial misbehaviour with special attention to shareholder approval, and then explain the implications of non-compliance with the new requirements for disclosure set out by securities law.

1. Shareholder Approval

Shareholders have certain personal rights against the corporation. These rights include the right to attend the annual shareholder meetings and the right to receive financial statements of the corporation prior to that meeting. Canadian corporate law also permits shareholders direct participation in some corporate decisions through shareholder proposals¹⁰³⁷ and votes.¹⁰³⁸ A breach of these rights will allow a shareholder to bring a personal action claim against the corporation.¹⁰³⁹

Canadian corporate law imposes several restrictions on the authority of directors in terms of the requirement for shareholder approval. For example, the shareholders must approve certain “fundamental changes” of or in respect to the corporation.¹⁰⁴⁰ Shareholders are also empowered to vote for the directors of the corporation.¹⁰⁴¹ If the shareholders are dissatisfied with the performance of the directors, one way of participation is the power to replace the board of directors and, indirectly through this vote, also replace management of the corporation.¹⁰⁴² However, the efficacy of this right is limited in practice with respect to widely-held corporations where typically only few shareholders will actually attend the shareholder meeting requisitioned for the purpose of the removal of directors and given the process of voting by proxy.¹⁰⁴³ Further limits arise from the existing threshold shareholding required by the law to nominate directors,

¹⁰³⁷ See, for example, Section 137 CBCA; Section 99 OBCA.

¹⁰³⁸ Voting rights, however, might be restricted to certain classes of shares only, depending on the corporation's articles.

¹⁰³⁹ Michael J. Iacovelli and Gil A. Lan, *Counselling Corporations and Advising Businesses* (Toronto and Vancouver: Butterworths, 2000) at 226. For the three different types of personal shareholder action available at common law, see Davies, *supra* note 768 at 453 through 458.

¹⁰⁴⁰ “Fundamental changes” include, inter alia, amalgamation (Section 183 CBCA; Section 176 OBCA; Section 172 BCBCA), sale of all or substantially all the assets of the corporation (Sections 189(3)-(8) CBCA; Sections 184(3)-(8) OBCA; Sections 301(1)(b) BCBCA), continuance of the business in another jurisdiction (Section 188 CBCA; Section 181 OBCA; Section 308(2)), and changes to the corporation's articles of incorporation (Section 173 CBCA; Section 168 OBCA; Section 259(1) BCBCA).

¹⁰⁴¹ See Section 106(3) CBCA; Section 119(4) OBCA; Section 122(1) BCBCA.

¹⁰⁴² See Section 109(1) CBCA, Section 122(1) OBCA; Section 128(3) BCBCA.

¹⁰⁴³ Another obstacle to the effectiveness of this step is the collective action problem, commonly also referred to as “rational shareholder apathy” in a widely-held corporation, see Robert Clark, “Vote Buying and Corporate Law” (1979) 29 Case West L. Rev. 776. Given that the benefits of such action are distributed among all shareholders, each shareholder has an incentive to let someone else proceed, which is likely to result in refraining from participation at the vote. For a more detailed discussion, see Raymond Crête, *The Proxy System in Canadian Companies: A Critical Analysis* (Montréal: Wilson & Lafleur-Martell Ltée., 1986); Frank H. Easterbrook and Daniel R. Fischel, “Voting in Corporate Law” (1983) 26 J. Law & Econ. 395.

and the obligation to circulate the nomination in a management proxy circular.¹⁰⁴⁴

There are, however, only few statutory requirements for shareholder approval of transactions other than "fundamental change" or appointment and removal of shareholders.¹⁰⁴⁵ The process of setting the compensation for the corporation's executives, in particular, is the sole authority of the directors.¹⁰⁴⁶ Shareholders may impose restrictions on this authority such as the requirement for shareholder approval only through the articles, by-laws or a unanimous shareholder agreement.¹⁰⁴⁷ Otherwise, direct shareholder participation for the determination of executive compensation is not possible.¹⁰⁴⁸

Although there have been proposals for reform in this regard based on the latest developments in the U.S., no regulatory steps have so far been taken to increase shareholder voice and participation with respect to the design of executive compensation and severance agreements.¹⁰⁴⁹ As for the U.S., the SEC changed its policy of disallowing shareholder proposals regarding executive compensation in 1993.¹⁰⁵⁰ Shareholders are now entitled to vote in their own proxy materials on at least advisory, non-binding shareholder proposals regarding executive compensation.¹⁰⁵¹ Canada has not followed the general U.S. approach for executive compensation. In Canada, the only exception where shareholder approval is possible with regards to the executive compensation is for security-based parts of the executive compensation

¹⁰⁴⁴ Section 137(4) CBCA, for example, requires a threshold shareholding of five per cent of the shares in the aggregate for shareholders who intend to propose nominations for the election of directors. For the management proxy circular, see Section 137(2) CBCA.

¹⁰⁴⁵ At common law, there appears to be a growing trend to require shareholders approval or ratification by a majority of the minority of shareholders, see, for example, *Wedge v. McNeil* (1981), 126 D.L.R. (3d) 596 (P.E.I.S.C.), reversed on evidentiary grounds (1982), 142 D.L.R. (3d) 133 (P.E.I.C.A.); *Re Norhtwest Forest Products Ltd.*, [1975] 4 W.W.R. 724 (B.C.S.C.); *Clemens v. Clemens Bros. Ltd.*, [1976] 2 All. E.R. 268 (Ch. D.).

¹⁰⁴⁶ See, for example, Section 125 CBCA, Section 137 OCBA.

¹⁰⁴⁷ *Ibid.*

¹⁰⁴⁸ *Iacobucci with Trebilcock*, *supra* note 89 at 35.

¹⁰⁴⁹ In a recent Canadian case, however, a minority shareholder of the National Bank of Canada was allowed to put various corporate governance proposals to a shareholder vote that, eventually, resulted to be unsuccessful. The proposal included a rule that would have capped executive pay at a maximum of twenty times the average employee pay, see *Michaud v. Banque Nationale du Canada*, [1997] R.J.Q. 547 (Que. S.C.).

¹⁰⁵⁰ For a discussion of the new proposal rules, see Ragsdale, *supra* note 899 at 551.

¹⁰⁵¹ An overview of the rules is provided by Kevin G. Salwen, "The People's Proxy: Shareholder Proposals on Pay Must be Aired, SEC to tell 10 firms" *Wall Street Journal* (February 13, 1992) at A1.

package, such as stock option plans.¹⁰⁵² Shareholder approval is, in fact, a crucial and highly controversial issue when the shareholders ratify an act of the board of directors or of an individual director that constitutes a breach of the fiduciary duty or any other kind of the law. From a scholarly perspective, it is rather questionable if, in particular, a self-interested contract or any similar kind of self-dealing transaction objectively contrary to the law should be subject to legitimation through shareholder approval.¹⁰⁵³

Consequently, shareholders under the present regime have few direct rights to exercise with regards to the bargaining process of executive compensation and severance agreements between the executive and the board of directors. On the other hand, the recent developments in securities law have increased shareholders' rights to detailed information and, thus, their ability to monitor the board of directors' decisions with respect to compensation and severance agreements. The new disclosure requirements have been described in detail at some earlier point.¹⁰⁵⁴ In the following, I will assess the implications that might result from a breach of compliance with the Disclosure obligations under Canadian securities law.

2. Non-Compliance with Disclosure Obligations

The new disclosure obligations set out by NI 51-102¹⁰⁵⁵ supersede the respective Parts XVIII and XIX of the OSA.¹⁰⁵⁶ Disclosure of executive compensation by way of Form NI 51-106F6 is required as part of the information circular under Section 9 of NI 51-102 in connection with Form 51-102F5. Reporting issuers, therefore, have to comply with the provisions of NI 51-102 rather than with the requirements of Section 86 OSA.¹⁰⁵⁷

Given the supremacy of NI 51-102 over provincial and territorial securities law, the failure to comply with the requirements of NI 51-102 to provide adequate disclosure, i.e., in particular, the failure to disclose the details of executive compensation as part of the information circular

¹⁰⁵² In fact, the TSX now requires a disinterested shareholder approval for all security-based compensation arrangements of listed issuers, see TSX Venture Exchange Corporate Finance Manual - Policy 4.4, Section 2.10. (as of December 2, 2004), available online at <<http://www.tsx.com/en/pdf/Policy4-4.pdf>> (last accessed on March 21, 2005).

¹⁰⁵³ This specific problem will not be discussed in more detail in this thesis.

¹⁰⁵⁴ *Supra* at II- 3.

¹⁰⁵⁵ *Supra* note 867.

¹⁰⁵⁶ See *supra* note 870.

¹⁰⁵⁷ See Companion Policy 51-801CP to OSC Rule 51-801, *supra* note 870, Section 1.2.

under Section 9 of NI 51-102, constitutes a breach of securities law.¹⁰⁵⁸ According to Section 122(1)(c) OSA, the breach of securities law is deemed to constitute an offence, eventually causing liability to a fine of not more than CDN\$ 5 million or to imprisonment for a term of not more than five years less a day, or both.¹⁰⁵⁹ In addition, pursuant to Section 122(1)(b) OSA any misrepresentation of statements made in the information circular also constitutes an offence.

Generally, another potential consequence of violating securities legislation is statutory civil liability under Part XXIII (Sections 130 to 134) OSA.¹⁰⁶⁰ However, the statutory civil liability only applies to misrepresentations according to prospectus, offering memorandum, directors' circular in connection with takeover bids and material facts or changes amounting to inside information. So far, there is no statutory civil liability for misrepresentations in continuous disclosure documents.¹⁰⁶¹ Although there have been reform proposals as to the introduction of statutory civil liability in the area of continuous disclosure for several decades, such liability has not yet been implemented.¹⁰⁶²

As long as no statutory civil liability exists, however, shareholders have remedies under the common law.¹⁰⁶³ Where the issuer engages in fraud, investors can pursue the traditional common law causes of an action under tort law for fraudulent misrepresentation.¹⁰⁶⁴ The problem with this

¹⁰⁵⁸ See, for example, *Borden Ladner Gervais LLP, Findley*, *supra* note 870 at §19.3.9 at 19-24.

¹⁰⁵⁹ However, in *Pacifica Papers Inc. v. Johnstone* (2001), 92 B.C.L.R. (3d) 158, 15 B.L.R. (3d) 249 (B.C.S.C.), affirmed (2001) 93 B.C.L.R. (3d) 20, 19 B.L.R. (3d) 62 (B.C.C.A.), the British Columbia Supreme Court held that the failure to provide an information circular will not necessarily result in the invalidity of votes taken at a general meeting.

¹⁰⁶⁰ For a general overview, see Johnston and Doyle Rockwell, *supra* note 831 at Chapter 11 (at 221).

¹⁰⁶¹ Except to the extent that continuous disclosure documents are incorporated in prospectus documents.

¹⁰⁶² For an overview of the history of reform proposals starting as early as 1979, see Johnston and Doyle Rockwell, *supra* note 831 at 228; Jeffrey G. MacIntosh, *Securities Law* (Toronto: Irwing Law, Inc., 2002) at 282.

¹⁰⁶³ Section 130(10) OSA explicitly provides that "[t]he right of action for rescission or damages conferred by this section is in addition to and without derogation from any other right that the purchaser may have at common law". This principle has recently been confirmed in *Kerr v. Danier Leather Inc.* (2004), 46 B.L.R. (3d) 167, 23 C.C.L.T. (3d) 77 (Ont. S.C.J.).

¹⁰⁶⁴ Important case law regarding fraudulent misrepresentation includes, among others, *Edgington v. Fitzmaurice* (1885), 29 Ch. D. 459 (C.A.); *Bradford Third Equitable Benefit Building Society v. Borders*, [1941] 2 All. E.R. 205 (H.L.); *Peek v. Gurney* (1873) L.R. 377; *Pigott v. Nesbitt, Thomson & Co. Ltd.*, [1941] S.C.R. 520, 4 D.L.R. 353 (S.C.C.); *Ames v. Investo-Plan Ltd.*, [1973] 5 W.W.R. 451 (B.C.C.A.); *Re Coal Economising Gas Co.* (1875) 1 Ch. D. 182 (C.A.); see also *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389; *Kerr v. Danier Leather Inc.*, *supra* note 1063.

For negligent misrepresentation see, for example, *Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.*, [1963] 2 All. E.R. 575 (H.L.); *Myers v. Thompson* (1965), [1967] 2 O.R. 335 (Co. Ct.); *Mutual Life and Citizens Assurance Co. Ltd. v. Evatt* (1970), 44 A.L.J.R. 478 (P.C.); *J. Nunes Diamonds Ltd. v. Dominion Electric Protection Co.*, [1972] S.C.R. 769 (S.C.C.); *Farish National Trust Co.*, [1975] 3 W.W.R. 499 (B.C.S.C.).

remedy is that actual fraud is notoriously difficult to prove in practice.¹⁰⁶⁵ Further, the shareholder must prove reliance on the representation, which has also seen to be difficult to prove.¹⁰⁶⁶ Besides tort law, contractual remedies under common law also are not very promising as there is no direct contract between the investor and the misrepresenting issuer.¹⁰⁶⁷

Finally, apart from the civil liability imposed by Sections 130 to 134 OSA, a breach of securities legislation can, under certain circumstances, constitute a criminal offence under the Canadian Criminal Code. Prosecution under the Criminal Code is the most severe sanction in the securities regime and will be undertaken where the accused's conduct has been flagrant or persistent or clearly indicates malice.¹⁰⁶⁸ The Criminal Code provides for specific sanctions in the context of false disclosure or fraudulent misrepresentation. Section 380(1) CCC deals with the offence of defrauding the public or a person of property by deceit, falsehood or other fraudulent means. Section 380(2) CCC establishes an offence to affect by deceit, falsehood or other fraudulent means the public market price of securities. Pursuant to Section 382 CCC, it is an offence in terms of fraudulent misrepresentation of stock exchange transactions, where the same party acts on both sides of the transaction in order to fraudulently affect the security's price.¹⁰⁶⁹ Section 400 CCC, in particular, addresses the issue of a false prospectus. The alleged offender must have the intention to induce persons to become shareholders, deceive or defraud members, shareholders or creditors, of a company, or induce any person to entrust something to a company or enter into any security for a company's benefit.¹⁰⁷⁰

As a result, shareholders have only restricted remedies to claim for breaches of the new disclosure requirements. Although any non-compliance constitutes a breach of securities law, as

¹⁰⁶⁵ MacIntosh, *supra* note 1062 at 279.

¹⁰⁶⁶ Johnston and Rockwell, *supra* note 831 at 227. The U.S. have approached that problem by introducing the "fraud of the market" theory. In the leading U.S. case *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) at 241 the U.S. Supreme Court adopted the explanation of the theory as set out in *Peil v. Speiser*, 806 F.2d 1154 (3d Cir, 1986) at 1160: "The fraud on the market theory is based on the hypothesis that [...] the price of a company's stock is determined by the available material information regarding the company and its business [...] Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. [...]". The theory, however, has not been accepted by Canadian jurisprudence, see *Carom v. Bre-X Minerals Ltd.* (1998), 41 O.R. (3d) 780 (Ont. Ct. (Gen. Div.)).

¹⁰⁶⁷ See Joan C. Smart and Patricia L. Olasker, "Disclosure Standards in Canada" (1996) 19 O.S.C.B. 221 at 256.

¹⁰⁶⁸ Johnston and Doyle Rockwell, *supra* note 831 at 273.

¹⁰⁶⁹ This offence is also referred to commonly as "wash trading".

¹⁰⁷⁰ Note that the Ontario Securities Act has recently been amended by the Statutes of Ontario, 2002, chapter 22, section 182, by adding Section 126.1 "Fraud and Market Manipulation". The new provision, which has not yet been proclaimed in force (as of April 3, 2005), stipulates that no person or company shall engage or participate in any act relating to securities that perpetrates a fraud. However, the new provision does not disregard the general provisions regarding fraud contained in the CCC.

long as fraud cannot be proven, there is no direct remedy for shareholders to challenge or even to set aside an executive severance agreement by way of securities law. Despite the fact that the new obligations to disclose issues of executive compensation might cause more consciousness upon the board of directors and upon the concerned executives, the securities law disclosure obligations do not provide an effective means for direct shareholder activism in terms of avoidance or rectification of “excessive” severance agreements and “golden parachute” provisions.

3. Derivative Action

Another means of controlling the conduct of corporate insiders is the private enforcement of rights by way of shareholder action. The most practicable way for an aggrieved shareholder who claims a breach of his rights by directors or officers would be a personal action against the acting person.¹⁰⁷¹ The major limitation on a personal action for shareholders to enforce the rights attached to the ownership of a share in the corporation, however, is that most important legal constraints on directors and officers such as the fiduciary duty of loyalty and the duty of care are owed primarily to the corporation rather than directly to the shareholders.¹⁰⁷² As a result, breaches of these duties cannot be the basis of a personal action by shareholders.¹⁰⁷³

a) The Common Law Rule in *Foss v. Harbottle*

At common law, thus, the general rule was that individual shareholders have no cause of action for wrongs done to the corporation. In the leading case of *Foss v. Harbottle*,¹⁰⁷⁴ the court developed the fundamental principle that a corporation and its shareholders are distinct entities and, therefore, only the corporation as the injured party could proceed with legal action against its directors and officers.¹⁰⁷⁵ The rationale for the rule was that legitimate control of a solvent corporation is vested in its boards of directors, the board is elected by the shareholders, and the

¹⁰⁷¹ For shareholders' personal action for breach of personal rights, see *supra* at 1039.

¹⁰⁷² See *supra* at II. 1.a).

¹⁰⁷³ See VanDutzer, *supra* note 185 at 320.

¹⁰⁷⁴ *Foss v. Harbottle*, *supra* note 770. The court held that the shareholders could not maintain the action for fraud against five directors and two other persons because the voting shareholders could approve the impugned acts, and ratification by a majority of shareholders would be a complete answer to the allegation of harm done to the company.

¹⁰⁷⁵ *Ibid.* The principle has recently been referred to by *Pasnak v. Chura*, *supra* note 770 at para. 50.

courts should not interfere with the “democratic” will of a voluntary association.¹⁰⁷⁶ Exceptions to the rule were granted for wrongs that are beyond the authority of majority shareholder approval in terms of acts that are ultra vires the company, transactions that require approval by a special majority, acts which amount to fraud on the minority shareholders, and where the individual wrongdoers hold voting control of the company.¹⁰⁷⁷

Under the rule in *Foss v. Harbottle*, the prospect of a legal claim to be pursued by the corporation against its directors or officers appeared to be highly limited in practice.¹⁰⁷⁸ In many cases, the same people who allegedly breached their duties, i.e. directors and officers, were the same people who had to decide whether or not to cause the corporation to sue. With a view to their own reputation and position within the corporation, directors and officers were likely to have a different view of whether their action or conduct constituted a breach of duty.¹⁰⁷⁹ In addition, it was often impossible to draw a clear distinction between an injury to the shareholder and one solely to the corporation. As the holder of the residual claim to the assets of the corporation, the shareholders’ interests can be substantially affected by any injury to the corporation in terms of a diminution in the value of the shares.¹⁰⁸⁰ The inefficiencies of shareholder remedies at common law led to legislative reforms resulting in the introduction of the derivative action as a shareholder remedy under Canadian statutory corporate law.

b) Scope of the Statutory Derivative Action

As a legislative response to the perceived failure of the common law to adequately protect the interests of shareholders from misconduct of corporate management, in the 1970s Canadian federal¹⁰⁸¹ and most of the provincial¹⁰⁸² legislation enacted the statutory derivative action.¹⁰⁸³

¹⁰⁷⁶ *Ibid.* The rule was slightly extended by the decisions in *Mozley v. Aston* (1847), 1 Ph. 790; *MacDougall v. Gardiner* (1875) 1 Ch. Div. 13; *North-West Transportation Co. Ltd. v. Beatty* (1887), 12 App. Cas. 589 (P.C.).

¹⁰⁷⁷ These exceptions to the rule in *Foss v. Harbottle* have been replaced by the statutory derivative action, see *Re Goldstream Resources Ltd.* (1986), 2 B.C.L.R. (2d) 244 (B.C.S.C.). For an extensive recapitulation of the rule and its exceptions, see Stanley M. Beck, “The Shareholders’ Derivative Action” (1974) 52 Can. Bar Rev. 159 at 164. For a discussion of the derivative action, see *infra* at b).

¹⁰⁷⁸ For a detailed presentation of the experienced limits imposed by the rule in *Foss v. Harbottle*, see William Kaplan and Bruce Elwood, “The Derivative Action: A Shareholder’s ‘Bleak House’?” (2003) 36 U.B.C. Law Rev. 443 at 445.

¹⁰⁷⁹ Clearly, this dilemma still exists in today’s corporate environment, but no longer is as crucial as it was before the introduction of both the derivative action and the oppression remedy.

¹⁰⁸⁰ See VanDutser, *supra* note 185 at 861.

¹⁰⁸¹ See Section 239 CBCA.

¹⁰⁸² See, for example, Section 245 OBCA; Section 232 BCBCA.

The restrictive conditions arising from *Foss v. Harbottle* have been replaced. The statutory derivative action allows shareholders and other stakeholders to bring an action on behalf of the corporation in order to enforce rights belonging to the corporation.

The derivative action under the statutory regime serves two purposes.¹⁰⁸⁴ First, it ensures that shareholders can recover property belonging to the corporation or enforce rights to which the corporation is entitled where management or the directors refuse to take appropriate action.¹⁰⁸⁵ As such, the remedy seeks to provide some level of deterrence against abuses of managerial or directorial powers, given the possibility that shareholders can sue in the event that the directors and management refuse to proceed.¹⁰⁸⁶ Secondly, the derivative action intends to promote managerial responsibility and accountability by providing as a means of shareholder activism the right to bring an action against directors and officers who allegedly have breached their duties owed to the corporation.¹⁰⁸⁷ Thus, the statutory derivative action provides shareholders and other stakeholders with a substantive recourse to protect the interests of the corporation if the directors or officers damage the corporation and, not surprisingly, do not take action against themselves. Accordingly, a variety of corporate wrongs have already been the subject of derivative actions. Leave has been granted to permit derivative actions to pursue, *inter alia*, breaches of fiduciary duties by directors¹⁰⁸⁸ as well as self-dealing behaviour on the part of directors.¹⁰⁸⁹

Due to its representative character as a remedy on behalf of the corporation, the derivative action is subject to certain statutory requirements. Section 239(1) CBCA provides that a complainant who seeks to bring a derivative action in the name and on behalf of the corporation for the purpose of prosecuting the action on behalf of the corporation, must apply to the court for a leave to bring such action. Before leave will be granted by the court, notice of the potential claim must be given to the corporation at least fourteen days prior to the application for leave.¹⁰⁹⁰

¹⁰⁸³ See Robert W. V. Dickerson, John L Howard, and Leon Getz, *Proposals for a New Business Corporations Law for Canada: Commentary*, vol. 1 (Ottawa: Information Canada, 1971) at para 482: "[An attempt to] abrogate the notorious rule in *Foss v. Harbottle* [...]".

¹⁰⁸⁴ *Richardson Greenshields of Canada Ltd. v. Kalmacoff* (1995), 18 B.L.R. (2d) 197, 123 D.L.R. (4th) 628 (Ont. C.A.) at 584 citing M. A. Maloney, "Whiter the Statutory Derivative Action?" (1986) 64 Can. Bar Rev. 309.

¹⁰⁸⁵ *Ibid.*

¹⁰⁸⁶ Kaplan and Elwood, *supra* note 1078 at 455.

¹⁰⁸⁷ *Richardson Greenshields of Canada Ltd. v. Kalmacoff*, *supra* note 1084.

¹⁰⁸⁸ *Appotive v. Computrex Centres Ltd.* (1981), 16 B.L.R. 133 (B.C.S.C.).

¹⁰⁸⁹ *Armstrong v. Arbour*, [1994] B.C.J. No. 2562 (QL) (B.C.S.C.).

¹⁰⁹⁰ Section 239(2)(a) CBCA.

The court then must be satisfied that the directors will not take appropriate action.

Furthermore, pursuant to Section 239(1)(b) and (c) CBCA, leave to bring the action requires satisfaction of the court that the complainant is acting in good faith and that the action itself is in the best interests of the corporation. The requirement to act in good faith will be considered to having been met as long as no bad faith is shown.¹⁰⁹¹ The concept of good faith relates to the intention of the complainant in bringing the action for the benefit of the corporation rather than for some other, personal purpose.¹⁰⁹² In each case, the court needs to determine whether the complainant's interests in pursuing the derivative action are consistent with the interests of the corporation.¹⁰⁹³ Self-interest of the complainant, thus, does not constitute bad faith if the personal interest coincides with the corporation's interests.¹⁰⁹⁴ The requirement for the derivative action to appear to be in the best interests of the corporation is regarded as a low threshold, given that especially minority shareholders often are not in a position to obtain substantive information or evidence to establish their case.¹⁰⁹⁵ However, some consideration of the merits of the case and the corporation's decision not to pursue the action are required.¹⁰⁹⁶ In this context, the courts have developed the notion that the action appears to be in the best interests of the corporation if there exists an "arguable" case with "a reasonable prospect of success".¹⁰⁹⁷ On that basis, leave to bring the derivative action will not be granted only if it appears that the action is bound to be unsuccessful.¹⁰⁹⁸

Finally, Section 242(1) CBCA provides that neither leave to bring the derivative action nor the proceedings as such can be dismissed on the grounds that the alleged breach of right or duty

¹⁰⁹¹ VanDutzer, *supra* note 185 at 324.

¹⁰⁹² *Tremblett v. S.C.B. Fisheries Ltd.* (1993), 116 Nfld. & P.E.I.R. 139, 363 A.P.R. 139 (Nfld. S.C.).

¹⁰⁹³ *Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.* (1995), 13 B.L.R. (3d) 300 (B.C.S.C.).

¹⁰⁹⁴ *Richardson Greenshields of Canada Ltd. v. Kalmacoff*, *supra* note 1084; *Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.*, *supra* note 1093 at para 34: "Anything that benefits a company will indirectly benefit its shareholders by increasing the share value and it is hard to imagine a situation where a shareholder will not have a self-interest in wanting the company to prosecute an action which is in its interests to prosecute."

¹⁰⁹⁵ VanDutzer, *supra* note 185 at 324.

¹⁰⁹⁶ McCarthy Tétrault, *supra* note 768 at 74.

¹⁰⁹⁷ *Bellman v. Western Approaches Ltd.* (1981), 130 D.L.R. (3d) 193 (B.C.C.A.) at 201; *Intercontinental Precious Metals Inc. v. Cooke* (1993), 10 B.L.R. (2d) 203 (B.C.S.C.) at 221; *Marc-Jay Investments Inc. v. Levy* (1974), 50 D.L.R. (3d) 45 (Ont. H.C.) at 47; *First Edmonton Place Ltd. v. 315888 Alberta Ltd.* (1988), 60 Alta. L.R. (2d) 122 (Alta. Q.B.) at 158; *Richardson Greenshields of Canada Ltd. v. Kalmacoff*, *supra* note 1084. Initially, the "arguable case test" and the "reasonable prospect test" had been applied on an alternative basis by the courts. In *Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.*, *supra* note 1093 at para. 39, the court finally clarified the discussion to the extent that "there is no difference between those two tests".

¹⁰⁹⁸ *Marc-Jay Investments Inc. v. Levy*, *supra* note 1097 at 47.

has been or possibly may be approved by shareholders.¹⁰⁹⁹ Evidence of approval by shareholders, however, must be taken into account by the court for its final order to be made under the derivative action.

As for the remedies sought under the derivative action, the court is granted broad powers to make any order it thinks fit including orders concerning the conduct of the action and orders for the payment for the complainant's legal fees by the corporation.¹¹⁰⁰ The enumeration included in Section 240 CBCA is not intended to be limited and, therefore, the remedy granted in each single case will depend on the particular circumstances of that case.

c) Derivative Action against Executive Severance Agreements

The derivative action has only been used on few occasions in Canada.¹¹⁰¹ One reason is that derivative actions are often directed at wrongdoing on the part of the management or the directors of the corporation.¹¹⁰² For the shareholders, it is often difficult to uncover any misuse of control or any other misbehaviour of those in control of the corporation. However, with respect to shareholders who seek to challenge executive compensation or severance agreements, the derivative action appears to be a remedy with the potential to effectively challenge the agreement and, therefore, in light of its availability, to constrain the behaviour and conduct of directors and executives involved in the negotiation process.

In most cases, the damages or relief are awarded to the corporation. In the context of excessive executive compensation, the goal of aggrieved shareholders can be two-fold. Firstly, if the agreement has not been executed, shareholders might wish to set aside the contract in order to prevent the corporation from being liable for the respective amount that indirectly affects shareholder value, too. Secondly, once the severance amounts have been paid out to the executive, shareholders might want to proceed with an action for repayment on behalf of the corporation. In any case, the potential success of the derivative action brought on behalf of the corporation by an aggrieved shareholder merely depends on the information available as evidence of a breach of the fiduciary duty by the parties involved in the bargaining process. This,

¹⁰⁹⁹ Section 242(1) CBCA, therefore, is an explicit elimination of the rule in *Foss v. Harbottle*, *supra* note 770.

¹¹⁰⁰ Section 240 CBCA.

¹¹⁰¹ Kaplan and Elwood, *supra* note 1078 at 468, have discovered only three derivative actions of significant size within the corporate jurisdiction of British Columbia: *Intercontinental Precious Metals Inc. v. Cooke*, *supra* note 1097, *Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.*, *supra* note 1093, and *Discovery Enterprises Inc. v. Ebco Industries Ltd.* (1999), 70 B.C.L.R. (3d) 299, 50 B.L.R. (2d) 207 (B.C.C.A.).

¹¹⁰² McCarthy Tétrault, *supra* note 768 at 75.

clearly, will be a question of facts in each individual case.

However, the experience gained from recent derivative action cases suggests that the derivative action, in practice, does not provide an efficient means for enforcing standards of corporate conduct or resolving intra-corporate, self-dealing issues. Its insufficiency derives from several procedural difficulties that are caused in part by the nature of the derivative action in which a real protagonist of the litigation is not a party to the contract, while the party for whose benefit the action is brought is participating against its will as expressed by the reluctance of the directors to proceed action against themselves on behalf of the corporation.¹¹⁰³ Provided that a minority shareholder brings the derivative action without access to essential information, and assuming that the corporation is opposed to the proceeding, it will in fact be difficult for the minority shareholder to prepare the action with a view to successful litigation.¹¹⁰⁴

4. The Oppression Remedy

Another legal remedy for shareholders provided by corporate statute law is the oppression remedy. It has famously been described as “the broadest, most comprehensive and most open-ended shareholder remedy in the common law world [...] unprecedented in its scope”.¹¹⁰⁵ The oppression remedy represents an emerging standard of behaviour that not only complements the duties imposed on corporate management, but also rivals the fiduciary duty as the operative measure against which all management activities must be measured.¹¹⁰⁶

a) Scope of the Oppression Remedy

The oppression remedy was first introduced in Canada in 1960 in the former British Columbia Companies Act.¹¹⁰⁷ It has been adopted by the CBCA upon its enactment in 1975 and

¹¹⁰³ Procedural difficulties were encountered, for example, in *Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.*, *supra* note 1093 and in *Discovery Enterprises Inc. v. Ebco Industries Ltd.* (1997), 40 B.C.L.R. (3d) 43, 35 B.L.R. (2d) 111 (B.C.S.C.).

¹¹⁰⁴ See Kaplan and Elwood, *supra* note 1078 at 471.

¹¹⁰⁵ Stanley M. Beck, “Minority Shareholders’ Rights in the 1980’s” in *Corporate Law in the 80s*, Special Lectures of the Law Society of Upper Canada (Don Mills, Ont.; Richard De Boo, 1982) 311 at 312. This statement has been cited in *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, *supra* note 622 at 179; *Deluce Holdings Inc. v. Air Canada* (1992), 12 O.R. (3d) 131 (Ont. Ct. (Gen. Div.)) at 150, and most recently in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 48. To the similar effect, see also *Waxman v. Waxman*, *supra* note 667, and *Welling*, *supra* note 193 at 563.

¹¹⁰⁶ VanDutzer, *supra* note 185 at 319.

¹¹⁰⁷ British Columbia Companies Act, R.S.B.C. 1960, c. 67, Section 185. It was interpreted narrowly until it was amended to add, among other things, “unfair prejudice” as a ground for relief in 1973 (S.B.C. 1973, c.18).

been part of the Canadian federal and provincial corporate law landscape ever since.¹¹⁰⁸ The introduction of the oppression remedy has fundamentally changed the type of conduct by a corporation and its directors and officers that gives rise to a claim by affected stakeholders.¹¹⁰⁹ The oppression remedy has imposed an obligation of fairness on both the corporation and its directors and officers.¹¹¹⁰ If the required standard of fairness is not complied with, the oppression remedy represents a “statutory lifting of the corporate veil”.¹¹¹¹

The oppression remedy is designed to fairly protect the interests and reasonable expectations of shareholders and other corporate stakeholders in the context of corporate conduct and decision-making, although the acts complained of may be entirely lawful.¹¹¹² With the oppression remedy, the law provides a broad range of relief in respect to corporate conduct in terms of an act or omission “that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any” stakeholder specified by the law.¹¹¹³ In addition, pursuant to Section 241(1)(b) and (c) CBCA, the oppression remedy also applies to the manner in which the corporation’s business and affairs are conducted and to the manner in which the powers of the directors are exercised.¹¹¹⁴

Statute law does not provide a definition of what constitutes “oppressive” and “unfairly prejudicial”. The meaning of “oppressive” was defined by case law as a conduct “that is burdensome, harsh and wrongful” or “which lack[s] probity and fair dealing in the affairs of a company to the prejudice of some portion of its members”.¹¹¹⁵ Despite the general adoption of this definition for Canadian law,¹¹¹⁶ it remained uncertain whether or not bad faith was required

¹¹⁰⁸ Section 241 CBCA. For provincial legislation, see, for example, Section 248 OBCA; S. 227(2) BCBCA. For a detailed discussion of the oppression remedy, see Dennis H. Peterson, *Shareholder Remedies in Canada* (Toronto: Butterworths, Loose-leaf); and Jeffrey G. MacIntosh, “The Oppression Remedy: Personal or Derivative” (1991) 70 Can. Bar Rev. 29.

¹¹⁰⁹ VanDutser, *supra* note 185 at 327.

¹¹¹⁰ *Westfair Foods Ltd. v. Watt* (1990), 73 Alta. L.R. (2d) 326 (Alta. Q.B.), affirmed 79 Alta. L.R. (2d) 363 (Alta. C.A.), leave to appeal to S.C.C. refused [1992] 1 W.W.R. xv; *Keho Holdings Ltd. v. Noble* (1987), 38 D.L.R. (4th) 368 (Alta. C.A.); *Elder v. Elder & Watson Ltd.*, [1952] C.S. 49 (Que.).

¹¹¹¹ Sarra and Davis, *supra* note 622 at 34.

¹¹¹² See *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at 199.

¹¹¹³ Section 241(2)(a) CBCA.

¹¹¹⁴ See, for example, *Lyall v. 147250 Canada Ltd.* (1993), 84 B.C.L.R. (2d) 234, 106 D.L.R. (4th) 304 (B.C.C.A.).

¹¹¹⁵ *Scottish Co-operative Wholesale Society Ltd. v. Meyer*, [1958] 3 All. E.R. 66 (H.L.), [1959] A.C. 324 at 342.

¹¹¹⁶ The definition was confirmed by many Canadian cases including, for example, *Bank of Montreal v. Dome Petroleum Ltd.* (1987), 54 Alta L.R. (2d) 289 (Alta. Q.B.); *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733; *Mahoney v. Taylor*, [1996] B.C.J. No 1479 (B.C.S.C.) at para. 21.

for oppressive conduct.¹¹¹⁷ Based on merely ambiguous findings in *Safarik v. Ocean Fisheries Ltd.*,¹¹¹⁸ the British Columbia Supreme Court in *Mahoney v. Taylor*¹¹¹⁹ concluded that if the corporation or its directors act without legal authority, the act or conduct can be considered oppressive even if there was no *mala fides*. A legally authorized act, however, can only be oppressive if bad faith was also present.¹¹²⁰ The case law shows that even a decision that objectively is in the best interests of the corporation may be oppressive to the interest of certain groups.¹¹²¹

“Unfairly prejudicial” has been found to mean that the conduct is “unjustly or inequitably detrimental to the complainants’ interests”.¹¹²² This alternative of the oppression remedy is intended to protect a wider range of rights than those under the oppressive conduct aspect of the remedy.¹¹²³ Therefore, the standards which delineate conduct that is “unfairly prejudicial” are less rigorous than those which constitute “oppressive” conduct. A finding of malice or bad faith is not required, but would nevertheless be probative.¹¹²⁴ Whereas the focus with regard to “oppression” is on the character of the conduct complained of, the focus as to “unfairly prejudicial” is on the effect of the impugned conduct on the part of the injured shareholder. The fairness obligation needs to be assessed specifically to the actual context.¹¹²⁵ Accordingly, the legal rights and reasonable expectations of the applicant for relief from oppression and the extent

¹¹¹⁷ Bad faith was deemed not required in *Low v. Ascot Jockey Club* (1986), 1 B.C.L.R. (2d) 123 (B.C.S.C.). To the contrary, see *Nystad v. Harcrest Apt. Ltd.* (1986), 3 B.C.L.R. (2d) 39 (B.C.S.C.).

On the issue of bad faith with regards to the oppression remedy in general, see Jeffrey G. MacIntosh, “Bad Faith and the Oppression Remedy: Uneasy Marriage or Amicable Divorce?” (1990) 69 Can. Bar Rev. 276

¹¹¹⁸ *Safarik v. Ocean Fisheries Ltd.* (1995), 12 B.C.L.R. (3d) 342 (B.C.C.A.). In this case, the British Columbia Court of Appeal per Madam Justice Southin at 372 rejected the ruling of the trial judge that “neither bad faith nor improper motive is [...] necessary [...], and all that must be shown [...] is that the majority has not dealt fairly and honestly with the minority”.

¹¹¹⁹ *Mahoney v. Taylor*, *supra* note 1116.

¹¹²⁰ *Ibid.* at para. 24.

¹¹²¹ Further cases are, for example, *Act Enterprises Ltd. v. Cliger Construction Ltd.* (2001), A.C.W.S. (3d) 409 (B.C.S.C.); *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733; *Paley v. Leduc* (2002), 118 A.C.W.S. (3d) 355 (B.C.S.C.); *Gordon Graves Holding Ltd. v. Care Corp. of Canada* (1998), 38 B.L.R. (2d) 56 (Ont. Ct. (Gen.Div.)); *Krela v. OrthoSoft Inc.*, 2001 CarswellQue 1823 (Que. S.C.).

¹¹²² *Diligenti v. RWMD Operations Kelowna Ltd.*, *supra* note 663, where the court based this first attempt to define the meaning of the term on the explanation found in Shorter’s Oxford English Dictionary.

¹¹²³ *Deluce Holdings Inc. v. Air Canada*, *supra* note 1105; *Safarik v. Ocean Fisheries Ltd.*, *supra* note 1118; *Paley v. Leduc*, *supra* note 1121.

¹¹²⁴ *Brant Investments Ltd. v. KeepRite Inc.*, *supra* note 733; *Bially v. Churchill Electric* (1993), 78 B.C.L.R. (2d) 305 (B.C.S.C.); *Mahoney v. Taylor*, *supra* note 1116.

¹¹²⁵ *Westfair Foods Ltd. v. Watt*, *supra* note 1110; *First Edmonton Place Ltd. v. 315888 Alberta Ltd.*, *supra* note 1097; *Re Ferguson and Imax Systems Corp.* (1983), 150 D.L.R. (3d) 718 (Ont. C.A.); *Re Brake*, [1996] N.J. No. 126 (Nfld. S.C.); *American Reserve Energy Corp. v. McDorman* (1998), 48 B.L.R. (2d) 167 (Nfld. T.D.).

to which they have been affected have to be considered in every single case.¹¹²⁶ Compliance of directors and officers with their respective fiduciary duties, for example, is part of the reasonable expectations of the shareholders as complainants under the oppression remedy.¹¹²⁷

In sum, several stakeholders such as minority shareholders, directors and officers, as well as creditors,¹¹²⁸ have the right to contest fraudulent, bad faith and illegal actions of officers and directors and actions, which are “oppressive” or “unfair” in the sense that they are contrary to the reasonable expectations of these stakeholders. Poor corporate management or bad business decisions, on the other hand, will not necessarily give rise to a recourse under the oppression remedy unless it is coupled with some definable harm to the corporation or the interest of the shareholder.¹¹²⁹

The oppression remedy has been used in a variety of different matters for virtually all forms of corporate conduct, not only as a remedy to protect the interests of minority shareholders as intended, but also those of minority groups and majority shareholders. When compared with the nature of the derivative action, however, it appears that the oppression remedy primarily applies to conduct that is “oppressive” or “unfair” to individual stakeholders rather than to the corporation itself.¹¹³⁰ In *Furry Creek Timber Corp. v. Laad Ventures Ltd.*,¹¹³¹ the court clarified that the derivative action and the oppression remedy are not exclusive. The court held that a breach of the fiduciary duty to act in the best interests of the corporation, which is owed to the corporation, does not only give a shareholder the right to pursue a derivative action on behalf of the corporation. Provided that the complaining shareholder has been affected by the breach in a manner different from or in addition to the indirect effect on the value of all shareholders’ shares, he is entitled to pursue the oppression remedy, too.¹¹³² Accordingly, proceedings under the oppression remedy require at least some kind of personal loss, damage or harm distinct from the

¹¹²⁶ *Westfair Foods Ltd. v. Watt*, *supra* note 1110.

¹¹²⁷ See, for example, *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

¹¹²⁸ Most recently, in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 611 at para. 50, the Supreme Court of Canada has confirmed that creditors for the purpose to pursue an oppression remedy can have the status of “complainant” under Section 238 CBCA.

¹¹²⁹ See *Stikeman, Elliott*, *supra* note 134 at § 13.126.

¹¹³⁰ The relationship and interaction between derivative and oppression proceedings has, therefore, been the subject of debate, see, for example, MacIntosh, “*The Oppression Remedy: Personal or Derivative?*”, *supra* note 1108 at 46.

¹¹³¹ *Furry Creek Timber Corp. v. Laad Ventures Ltd.* (1992), 75 B.C.L.R. (2d) 246 (B.C.S.C.).

¹¹³² *Ibid.*

damage suffered by the corporation.¹¹³³ Wherever the complainant cannot show any personal loss or damage other than a decrease of his share value in the corporation, the claim will have to be pursued as a company claim by way of the derivative action. On the other hand, in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,¹¹³⁴ the Ontario Court of Appeal most recently clarified that the oppression remedy cannot be limited to the extent that it is only available as a remedy for shareholders that do not have the majority voting control and, therefore, are unable to either cause the corporation to sue or sue in the name of the corporation under the derivative action. As a result, the oppression remedy is available to rectify the conduct by directors that amounts to self-dealing at the expense of the corporation or other shareholders if personal injury is suffered by the individual shareholder.¹¹³⁵

One of the most innovative features of the oppression remedy is the unlimited flexibility granted to the court to fashion remedies.¹¹³⁶ Pursuant to Section 241(2) CBCA, the court is generally empowered to make any order “to rectify the matters complained of”. The oppression remedy gives the court considerable discretion in the type of final or interim order it can make including orders against directors personally.¹¹³⁷ Thus, there are a variety of orders that can be made, including compensatory orders or an order to vary or set aside a contract to which a corporation is a party.¹¹³⁸ The orders are to be tailored to remedy the type of unfairness or oppression in the particular context, but should not exceed the purpose to rectify the oppression to the effect of punishment of the oppressor or unnecessary interference with the affairs of the

¹¹³³ See also *Pasnak v. Chura*, *supra* note 771 at paras. 97-99.

¹¹³⁴ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, [2004] 183 O.A.C. 310, 42 B.L.R. (3d) 34 (Ont. C.A.) at para. 3, citing Peterson, *supra* note 1108, at 2.36.

¹¹³⁵ *C.I. Covington Fund Inc. v. White* (2000), 10 C.P.R. (4th) 49 (Ont. S.C.J.) at paras. 21, 40, 41, 43, affirmed (2001), 15 C.P.R. (4th) 144 (Ont. Div. Ct.). See also *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para. 201.

¹¹³⁶ See, for example, *Bury v. Bell Gouinlock Ltd.* (1984), 48 O.R. (2d) 57, 12 D.L.R. (4th) 451 (Ont. H.C.J.); *Loveridge Holdings Ltd. v. King-Pin Ltd.* (1991), 5 B.L.R. (2d) 195 (Ont. Ct. (Gen. Div.)); *820099 Ontario Inc. v. Harold E. Ballard Ltd.*, *supra* note 622 at 181; *Such v. RW-LB Holdings Ltd.* (1993), 11 B.L.R. (2d) 122 (Alta. Q.B.); *Themadel Foundation v. Third Canadian Investment Trust Ltd.* (1995), 23 O.R. (3d) 7 (Ont. Ct. (Gen. Div.)).

¹¹³⁷ See Section 241(3) CBCA.

¹¹³⁸ For the reasonableness of the remedy to set aside a contract, see, for example, *Sparling v. Javelin International Ltee*, [1986] R.J.Q. 1073 (Que. S.C.).

corporation.¹¹³⁹

b) Oppression Remedy against Executive Severance Agreements

In order to challenge executive severance agreements or “golden parachute” provisions, aggrieved shareholders should consider to bring an oppression remedy under the respective corporate law statute, since the oppression remedy is a possible means to rectify the conduct of directors who engage in self-dealing at the expense of the corporation or its shareholders.¹¹⁴⁰

The effectiveness of the remedy has even increased since the recent decision in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,¹¹⁴¹ where it was decided that the oppression remedy was available to set aside a self-interested executive compensation contract that was the result of a breach of the fiduciary duty as it imposed enormous liability on the corporation without any corresponding benefits to the shareholders. Although the business judgment rule recognizes the autonomy and integrity of a corporation and the expertise of its directors and officers and, therefore, will often protect the directors from challenges to their substantive business decisions, the courts are not precluded from considering the merits of a transaction and the process by which it was carried out in order to determine whether the specific conduct constituted oppression.¹¹⁴²

5. Application to Set Aside the Contract, Section 120(8) CBCA

In addition to the derivative action and the oppression remedy, aggrieved shareholders have the right to apply to a court to set aside a self-dealing contract. Section 120(8) CBCA grants the court the power to set aside, upon application, a contract or transaction that does not comply with the requirements for the validity of a self-interested contract as set out in Section 120(1)-(7) CBCA. Thus, if a self-dealing inside director has failed to disclose his self-interest or if the contract does not meet the requirement to be reasonable and fair to the corporation, it can be set aside.

The remedy under Section 120(8) CBCA has recently been granted in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,¹¹⁴³ where the court not only set aside the compensation

¹¹³⁹ *Sparling v. Royal Trustco Ltd.* (1984), 6 D.L.R. (4th) 682 (Ont. C.A.), affirmed [1986] 2 S.C.R. 537 (S.C.C.); *Nanef v. Con-Crete Holdings Ltd.* (1995), 23 O.R. (3d) 481; *820099 Ontario Inc. v. Harold E. Ballard*, *supra* note 622 at 197: “The court should not interfere with the affairs of a corporation lightly. I think that where relief is justified to correct an oppressive type of situation, the surgery should be done with a scalpel, and not a battle axe.”

¹¹⁴⁰ See *supra* note 1135.

¹¹⁴¹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

¹¹⁴² *Corporación Americana de Equipamientos Urbanos S.L. v. Olifas Marketing Group Inc.* (2003), 38 B.L.R. (3d) 156 (Ont. H.C.J.); *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389 at para 152-153.

¹¹⁴³ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

agreement based on the oppression remedy under Section 241(3)(h) CBCA, but also based on Section 120(8) CBCA, since the inside director failed to disclose his material interest and certain inside knowledge to the board of directors, leading to a contract that fell far short from being reasonable and fair to the corporation.

6. Conclusion

Aggrieved shareholders have several possibilities to exercise their rights in the event that corporate executives or directors allegedly breached their obligations when providing the executive with severance or “golden parachute” packages.

Besides the different shareholder voting and participation rights established by corporate law, there are mainly two ways to proceed with legal action against the board or the management. Depending on the particular circumstances and the timing in each case, shareholders can pursue different remedies, such as a claim that the respective executive agreement or contractual provision be set aside by the court, that the compensation be reimbursed totally or in part by the receiving executive or any other remedy they might think fits the particularities of their case. In practice, case law has shown that the effectiveness of a derivative action is substantially limited due to the high procedural pre-requisites that need to be met by the shareholder as claimant. By contrast, the statutory oppression remedy seems to be a suitable means for shareholders either to pursue claims on behalf of the corporation or individual shareholders’ rights directly against the directors and officers of the corporation.

However, as far as an alleged breach of the duty of care is concerned, the business judgment rule has proven to be a powerful obstacle to judicial proceedings, as Canadian courts like their U.S. counterparts are reluctant to second-guess management’s decisions unless there is proof of some kind of managerial self-dealing or unlawful intentions of the parties involved in the decision-making process.

IV. Chapter Summary

In sum, Canadian law does not explicitly impose special limits on the structure or amounts of executive severance agreements or “golden parachute provisions”. Instead, as I have shown in this Chapter, the current law establishes certain legal duties and obligations on the parties involved in the decision-making process of such executive contracts. Generally speaking, an executive severance agreement or “golden parachute” provision must be the result of a fair and reasonable bargaining process that is in the best interests of the corporation and, indirectly, of the

shareholders.

However, I have also argued that the present legal regime for the conclusion of executive contracts to some extent encourages managerial self-dealing and, therefore, creates a potential for conflicts of interests, given the theoretical possibility and actual presence of inside directors who in dual capacity also serve as an executive of the corporation. Those inside directors can exercise their discretionary powers either by contracting directly with themselves or by using substantial influence over the rest of the board of directors. Thus, one form of diversion of corporate assets to self-interested insiders can be the conclusion of unreasonable, i.e. excessive executive severance or “golden parachute” packages, either as a provision of the original executive service contract or as a subsequent “golden handshake” agreement at the time of termination, which is not in the best interests of the corporation.

Although the Canadian capital structure is essentially different from that in the U.S., consisting to a high degree of corporations that are not widely-held, there will, however, always be a separation of ownership and control of some sort where at least some minority shareholders have invested equity capital into the corporation. Therefore, these minority shareholder together with all controlling shareholders are faced with agency costs incurred by the corporation to control the management of the corporation. So long as the directors and executives of the corporation together own less than 100 per cent of the corporation, the agency costs are borne indirectly and in proportion by the minority shareholders in terms of decreasing revenues as investors into the corporation.

From a theoretical corporate governance perspective, executive compensation packages in general and, consequently, severance and “golden parachute” arrangements as well, are regarded by proponents of the optimal contract approach as a means to reduce the arising agency costs.¹¹⁴⁴ On the basis of my findings, however, such executive compensation agreements rather are likely to cause even more agency costs, as proposed by supporters of the managerial power approach.¹¹⁴⁵ Given the possibility of diversion and self-enrichment through those agreements to the sole personal benefit of the executive due to the exercise of influence of managing inside directors, executive severance and “golden parachute” arrangements cannot always be regarded as optimal devices to minimize agency costs.

In this context, Canadian law appears to imply in essence the managerial power approach

¹¹⁴⁴ See *supra* at I. 2. a).

¹¹⁴⁵ See *supra* at I. 2. b).

as it relies not only on the relevant market forces set out in the optimal contract theory as sufficient constraints to avoid excessive, self-dealing agreements, but also addresses the issue of managerial self-dealing by imposing as constraints the specific legal duties and obligations reviewed in Part II and establishing certain shareholder rights and remedies as pointed out in Part III of this Chapter.

Thus, the legal regime as describes can be characterized as a model of corporate governance that combines elements of both the optimal contract and the managerial power approach. The law basically leaves it to the board and the executive as the contracting parties to enter into an agreement they think perfectly aligns the interests of both the corporation and the individual executive. In accordance with the basic principle of freedom of contract, both parties in the decision-making process have wide discretion to come to an agreement. The law also acknowledges that fundamental principle by establishing the business judgment rule as a limit to judicial review of the agreement representing a business judgment of the board on behalf of the corporation. Under the optimal contract theory, the attitude that courts will not substitute their business judgment and perception of fairness for that of the directors is not even necessary as the contract is regarded to be the result of arm's length negotiation, effectively reducing the agency costs. For the managerial power approach, on the other hand, the business judgment rule is damaging to the extent that only limited judicial control or review of the transaction can be achieved.¹¹⁴⁶ However, the law appears to recognize some deficiencies inherent in the optimal contract model that aims at imposing effective constraints only by way of economic market forces instead of establishing explicit legal rules. Canadian legislation has established certain legal restrictions such as the fiduciary duty, the duty of care, disclosure requirements as well as corporate governance guidelines, tax provisions and even criminal provisions that supplement market mechanisms that aim to constrain managerial misbehaviour and self-dealing of corporate executives and, therefore, serve as limits as to the structure and the amount of executive severance agreements and "golden parachute" provisions, as well as to executive compensation arrangements in general.

However, by not imposing a strict limit on the structure or the amount of such executive contracts, the law balances the predominant principle of freedom of contract with the justified interests of the corporation not to be deprived of its assets for the personal enrichment of

¹¹⁴⁶ See also Alarie, *supra* note 96 at 63.

corporate managers, indirectly resulting in detrimental effects for the shareholder with a view to shareholder value and wealth. The law to a certain extent acknowledges the power of market forces to serve as constraints on the bargaining parties. On the other hand, on the basis of the present regime, shareholders in Canada are not without a remedy if they believe their rights have been injured by self-dealing corporate insiders breaching their respective obligations under corporate or supplementary law. I will assess the effectiveness of the present regime and discuss potential modifications in the following Chapter.

CHAPTER 4

ASSESSMENT OF THE EFFECTIVENESS OF THE LEGAL REGIME

In this Chapter, I will assess the effectiveness of the present Canadian regime to limit executive severance agreements and “golden parachute” provisions. Based on a comparative study of the German legal systems, influenced to some extent by legislation of the European Union, with the Canadian legal system, I will discuss whether or not certain changes should be implemented in Canada. The reference to the German regime will also allow me to comment on the outcome and implications of the Mannesmann case, which I have presented in the introductory part of this thesis.

However, before undertaking the evaluation of the current system and the contemplation of additional legislative initiative in order to improve the existing system, it is essential to have a general theoretical understanding of what causes the problems that will need to be addressed by legislative intervention and a theory about how possible changes and modifications will affect the present situation and the different interests involved. Thus, in order to impose legal restrictions on the behaviour of corporations or the corporate management and the board of directors, my assessment will have to start with a certain theory of the corporation that explains why particular changes and policies will work. In general, there is the choice between sole economic mechanisms to control the relevant markets or legislative control of managerial behaviour such as, for example, the duties of loyalty and care.

I. Managerial Behaviour and Corporate Law Theory

Irrespective of the particular goals to which the corporation is devoted, there is an incentive for corporate managers to deviate from those corporate goals in an effort to maximize their own personal welfare. As we have seen so far, Canadian corporate law in conjunction with a variety of other regulatory instruments can serve to limit the scope for such opportunism by imposing certain constraints on managerial behaviour.

In order to assess the effectiveness and, more importantly, the necessity for improvements of the governing law by initiating new regulations, there is a need for an articulated theory of the factors that impact on the behaviour of corporate directors, managers, and the corporate culture as a whole. On the grounds of such corporate law theory, I will be able to assess whether or not

the current system as such is sufficiently effective in addressing the conflicts of interests and potential for managerial self-dealing involved in the bargaining process regarding executive severance agreements and “golden parachute” provisions, if changes or modifications of the regime are both necessary as well as permissible.

1. *Berle and Means’ Conception of the Corporation as a Management Power Structure*

The concern over opportunistic behaviour of corporate insiders has been in the centre of corporate legal theory scholarship ever since the early work of *Berle and Means* on the subject of corporate governance in 1932.¹¹⁴⁷ The classical economic corporate law model had long been that profit-maximizing individuals both own the means of production and make all decisions related to production and consumption.¹¹⁴⁸ Market competition had been regarded as to effectively control producers, constrain the incompetent and legitimize private economic power.¹¹⁴⁹ But the increase of corporate mass production on a large capital base did not fit into the perceived classical model of the corporation.¹¹⁵⁰

Accordingly, as already noted earlier in this thesis, *Berle and Means* conceived of the corporation rather as a management power structure.¹¹⁵¹ They observed a considerable scope for broad managerial discretion and powers in large publicly-held American corporations, caused by the high degree of separation of ownership and control.¹¹⁵² The big corporations of the twentieth century, thus, were regarded to have split the classical entrepreneurial function between salaried executives at the top of the corporate hierarchy and anonymous equity participants who held only small stakes of the corporation.¹¹⁵³ According to *Berle and Means*, the extent of the dispersion of share ownership diminished the incentives of individual shareholders to assume the responsibility and bear the costs for controlling the affairs of the corporation, especially monitoring its directors and executives. *Berle and Means* argued that management, in the

¹¹⁴⁷ *Berle and Means*, *supra* note 476.

¹¹⁴⁸ See William W. Bratton, “*The Economic Theory of the Firm: Critical Perspectives from History*” (1989) 41 *Stan. L. Rev.* 1471 at 1486.

¹¹⁴⁹ See *Berle and Means*, *supra* note 476 at 9; William W. Bratton, “*Berle and Means Reconsidered at the Century’s Turn*” (2001) 26 *J. Corp. L.* 737 at 754.

¹¹⁵⁰ See Bratton, “*Berle and Means Reconsidered at the Century’s Turn*”, *supra* note 1149 at 754.

¹¹⁵¹ See *supra* note 476.

¹¹⁵² *Berle and Means*, *supra* note 476 at 2-5 and 84-89.

¹¹⁵³ *Ibid.* at 9, 78-85, 308.

absence of a controlling owner, had the *de facto* power to confiscate part of the corporation's wealth.¹¹⁵⁴ In essence, the high degree of dispersed stock ownership transformed shareholders into passive principals of the corporation they owned. Based on these findings, shareholders were believed to be unable to exercise control over the corporation, which instead was exercised by management that, if any, only held minor ownership interest in the capital of the corporation. Due to lack of direct interest in the capital of the corporation, management was likely not to have the intention to pursue the affairs of the corporation in a manner that would generate a maximum of shareholder wealth.

The legacy of the notion of separation of ownership and control in the modern North American corporation, therefore, was to submerge the motive of generating profits as the perceived primary cause for corporate action. Ever since the perceptions of *Berle* and *Means*, the conception of corporate North America was a large aggregation of capital being directed by managers who were virtually unaccountable to any constituency but themselves. According to *Berle* and *Means*, that combination of dispersed capitalization and management by salaried executives did not fit within the classical economic model, as they believed corporate law not to be able to constrain management's powers of confiscation.¹¹⁵⁵ Rather, they asserted that corporate property should no longer be deemed private property.¹¹⁵⁶ Based on that assertion, they called for governmental intervention as to the control of corporate activity instead of reliance on constraints imposed by self-regulation.¹¹⁵⁷ *Berle* and *Means* developed and presented a trust model of corporate fiduciary duty as a constraint of the problem of management self-dealing, as they believed that contracts between executives and the corporation would not be sufficient to control the emerging agency problems.¹¹⁵⁸ On the basis of their contentions, management's powers should be exercisable only for the rateable benefit of all shareholders of the corporation.¹¹⁵⁹ They intended to leave it to the judiciary to intervene into the corporate realm by way of defining the actual contours of the fiduciary obligation and by enforcement of the limitations imposed by the fiduciary obligations.¹¹⁶⁰

¹¹⁵⁴ *Ibid.* at 219.

¹¹⁵⁵ See Bratton, "*Berle and Means Reconsidered at the Century's Turn*", *supra* note 1149 at 758.

¹¹⁵⁶ *Berle* and *Means*, *supra* note 476 at 219.

¹¹⁵⁷ *Ibid.* at 4, 131.

¹¹⁵⁸ *Ibid.* at 119-252.

¹¹⁵⁹ *Ibid.* at 220.

¹¹⁶⁰ *Ibid.* at 197 and 295.

The trust model, however, revealed its shortcomings and inefficiencies. In widely-dispersed corporations, collective action problems and the extreme expense and difficulty of litigation left shareholders virtually helpless.¹¹⁶¹ The trust model turned out to be a model where the shareholder's right lay in the expectation of fair dealing rather than in the ability to enforce a series of supposed legal claims.¹¹⁶² Consequently, *Berle and Means'* trust model never came to be adopted in corporate law.

However, ever since their early work showing agency problems primarily arising from the separation of ownership and control of a publicly-held corporation, shareholder value maximization has become and still remains one of the leading principles for corporate governance.¹¹⁶³ In fact, *Berle and Means* appear to be the original expositors of corporate law's leading incentive problems.¹¹⁶⁴ Under current corporate law statutes, the majority of corporate decisions are assigned to the board of directors, who frequently use their powers to delegate the exercise of that competence to the executive management. Consequently, shareholders that do not hold a controlling majority of the shares have essentially little power to initiate corporate action and are entitled to approve or disapprove only a small amount of the board's or management's decisions. A perfect incentive model would align the separate interests of both management and the corporation and its shareholders, reducing agency costs to a minimum.¹¹⁶⁵ Any movements for corporate governance to be considered will have to take that theoretical background of the separation of ownership and control and agency costs arising from it into account.¹¹⁶⁶

¹¹⁶¹ The same also applies to minority shareholders of closely-held corporations in Canada, who are unable to voice their concerns against the majority shareholder who is in control of the corporation.

¹¹⁶² Berle and Means, *supra* note 476 at 242-243.

¹¹⁶³ Bratton, "*Berle and Means Reconsidered at the Century's Turn*", *supra* note 1149 at 756 and 769. Also, Berle and Means' presentation of the separation of ownership and control remains corporate law's principal source of unsolved problems and, thus, is a keystone in corporate legal theory and leading policy analysis of corporate governance, see *ibid.* at 750-751 and 754.

¹¹⁶⁴ *Ibid.* at 758-759: Berle and Means were the first to suggest that high executive compensation alone does not provide optimal motivation in the absence of stock ownership. With that conclusion, they also fit perfectly into the contemporary managerial power approach that intends to establish an improved compensation theme that concentrates more on incentives and compensation for performance, see, for example, Bebchuk *et al.*, *supra* note 92.

¹¹⁶⁵ In their work, Berle and Means explicitly referred to a perfect incentive model that would replicate the motivations of the sole proprietor of classical economics, see Berle and Means, *supra* note 476 at 9, 308.

¹¹⁶⁶ See also Stephen M. Bainbridge, "*The Board of Directors as Nexus*" (2002) 99 Iowa L. Rev. 1 at 3: "The chief criteria for any model of the corporation must be the model's ability to predict the separation of ownership and control, the formal institutional governance structures following from that separation, and the legal rules responsive to their separation."

2. The Corporation as a Nexus of Contracts

The concept of corporate law submitted by *Berle* and *Means* remained practically unchallenged for more than four decades, until the new law and economics movement emerged with a contractual conception in the 1980s and 1990s.¹¹⁶⁷ That so-called nexus of contracts theory has become the dominant model of the corporation in legal scholarship.¹¹⁶⁸ To some extent, that theory is based on the original findings of *Berle* and *Means*, while on the other hand it contradicts it, pointing out certain other conflicts inherent in the modern corporation.

At the core of the law and economics analysis of the corporation is the conception of the corporation as a nexus of implicit and explicit contractual relationships among the corporation's economic actors, such as contracts between the shareholders as investors and management,¹¹⁶⁹ contracts among investors, as well as contracts between "the corporation" and its employees, creditors, suppliers and consumers.¹¹⁷⁰ The arrangements among all these actors depend on contracts and positive law rather than on corporate law or the status of the corporation as an entity.¹¹⁷¹ Thus, the corporation is viewed not as an individual, but – notwithstanding its recognition as a separate legal entity¹¹⁷² – rather as a legal fiction which serves as a focus for a complex process in which the conflicting objectives of the individuals are brought into

¹¹⁶⁷ Among the most notable works of that movement are Armen Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization" (1972) 62 Am. Econ. Rev. 777; Jensen and Meckling, *supra* note 481; Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control" (1983) 26 J. Law and Econ. 301; Frank H. Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991).

Ronald H. Coase, "The Nature of the Firm" (1937) 4 *Economica* 386, is believed to have been the earliest proponent of the theory that firm operations could be described contractually, see Bainbridge, "The Board of Directors as Nexus", *supra* note 1166 at 9. However, his model had no influence until after 1970, see Bratton, "Berle and Means Reconsidered at the Century's Turn" a note 116. See also Ronald H. Coase, "The Nature of the Firm: Meaning" (1988) 4 J. L. Econ. & Org. 19 at 23.

¹¹⁶⁸ See, for example, Bainbridge, "The Board of Directors as Nexus", *supra* note 1166 at 9.

¹¹⁶⁹ Technically, shareholders contract with management "through" the corporation, see Victor Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract" (1985) 85 Colum. L. Rev. 1403 at 1403.

¹¹⁷⁰ Jensen and Meckling, *supra* note 481 at 310; Fama and Jensen, *supra* note 1167 at 302; Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract" in Lucian A. Bebchuk, ed., *Corporate Law and Economic Analysis* (Cambridge, New York, Port Chester, Melbourne, Sydney: Cambridge University Press, 1990) 182 at 183.

¹¹⁷¹ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 12. However, the term contract is not limited to a relationship constituting a legal contract. Instead, contractarians by using the term contract refer generally to long-term relationships between the involved economic actors, see Bainbridge, "The Board of Directors as Nexus", *supra* note 1166 at 10; Oliver E. Williamson, "Corporate Governance" (1984) 93 Yale L. J. 1197.

¹¹⁷² For a detailed discussion of the implications of the nexus of contracts theory on the corporation as a separate legal entity on the grounds of *Salomon v. Salomon & Co. Ltd.*, *supra* note 1025, see William W. Bratton, "The 'Nexus of Contracts' Corporation: A Critical Appraisal" (1989) 74 Cornell L. Rev. 407 at 423-426.

equilibrium within a framework of contractual relations.¹¹⁷³ Corporations are regarded not to differ from ordinary market contracting between any two people, as a dissatisfied party can always terminate its dealing with the corporation.¹¹⁷⁴ On those assumptions, contractarians claim that management is in fact a continuous process of negotiating successive contracts.¹¹⁷⁵

Under the nexus of contracts model, the separation of ownership and control is not of great importance as it was for *Berle* and *Means*, since the corporation represents a series of contracts aligning inputs to produce outputs such as goods and services.¹¹⁷⁶ Like employees providing labour and creditors providing debt capital for the corporation, equity capital initially provided by the shareholders, which had been in the main focus of *Berle* and *Means*,¹¹⁷⁷ is also regarded as simply another main input governed by a specific contract, which by itself is subject to corporate law and, therefore, no specific regulatory solution is held to be necessary only for such a contract.¹¹⁷⁸

Implicit in these contractual relationships, however, is the delegation of functional authority over corporate affairs from principals to agents. Directors and officers of the corporation are treated as the agents of the shareholders as equity investors.¹¹⁷⁹ The delegation of authority entails the danger of the agents misusing their conferred powers to pursue their own goals at the expense of the goals favoured by the shareholders as principals. In accordance with the assertions by *Berle* and *Means*, this conflict is of high importance if authority is delegated from capably interested shareholders to directors and officers of the corporation who do not have any stake in the corporation. Accordingly, as for the Canadian capital structure of mostly non-widely held corporations, there is practically no broad scope for such agency conflicts to arise as ownership and control are mainly concentrated in one and the same person or entity.¹¹⁸⁰ If the controlling managing shareholder engages in diversion of corporate assets to his own

¹¹⁷³ Jensen and Meckling, *supra* note 481 at 310.

¹¹⁷⁴ Alchian and Demsetz, *supra* note 1167 at 777.

¹¹⁷⁵ *Ibid.* at 794.

¹¹⁷⁶ Bratton, "The 'Nexus of Contracts' Corporation: A Critical Appraisal", *supra* note 1172 at 420. Generally, see Easterbrook and Fischel, "The Corporate Contract", *supra* note 1170; Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 12; Brudney, "Corporate Governance, Agency Costs, and the Rhetoric of Contract" *supra* note 1169; Eisenberg, *supra* note 524 at 1461.

¹¹⁷⁷ Berle and Means, *supra* note 476 at 420.

¹¹⁷⁸ See Bratton, "Berle and Means Reconsidered at the Century's Turn", *supra* note 1149 at 755.

¹¹⁷⁹ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 91; Jensen and Meckling, *supra* note 481 at 312-319.

¹¹⁸⁰ For closely-held corporations generally, see Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 228 and 232-233.

personal benefits, he will also have to bear the related costs of such behaviour in the form of a decrease of the profits he is entitled to as a shareholder of the corporation. Thus, when ownership and control are attributed to the same person, the potential for agency conflicts is minimized because the costs of the opportunistic behaviour are reflected back onto the party engaging in such behaviour.¹¹⁸¹

However, the situation is different as soon as minority shareholders are involved that do not have any kind of control of the corporation, but according to their degree of shareholdings are considered owners of the corporation. Any amount diverted by management negatively affects – to the respective proportion of investment – the return of all shareholders in terms of dividends, thus again creating agency costs. Even more, an increasing amount of outside shareholders will proportionally reduce the personal loss the controlling shareholder will suffer from diversion exercised by him. This relationship is likely to create incentives for him to increase the amounts of corporate assets he diverts in his role as a manager, since his proportion of loss in shareholder value will be less than it would be were he the only shareholder of the corporation that is controlled by him. As a result, the greater the outside ownership, the greater the incentive of the majority shareholder in control of the corporation to engage in opportunistic behaviour. Regarding this point, the proponents of the law and economics approach of the corporation agree that the problem of separation of ownership and control as described by *Berle and Means* indeed gives rise to the mentioned agency problems.¹¹⁸²

Thus, the implications arising from the principal-agent-relationship within the corporation, that is primarily the agency costs incurred by shareholders, are also in the centre of the focus of the proponents of the nexus of contracts approach. More precisely, from that law and economics perspective, the purpose of corporate law is to achieve the cost-effective reduction of agency costs.¹¹⁸³ Supporters of the nexus of contracts theory, therefore, favour fiduciary obligations of the directors and officers to maximize shareholder wealth.¹¹⁸⁴ Shareholders retain a privileged

¹¹⁸¹ Harris *et al.*, *supra* note 629 at 209.

¹¹⁸² *Ibid.* at 210. See also Jensen and Meckling, *supra* note 481 at 6; Bratton, “*Berle and Means Reconsidered at the Century’s Turn*”, *supra* note 1149 at 755.

¹¹⁸³ At this point, the different corporate governance approaches to executive compensation come into play. Whereas the optimal contract approach regards executive compensation as a necessary means in order to optimally reduce the agency costs to a minimum, the managerial power approach questions the likelihood of optimal executive contracts, given the deficiencies of market constraints and the broad discretion and power of executives to exercise influence over their own compensation, see *supra* at Chapter 3, I. 2.

¹¹⁸⁴ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 91.

position among the corporation's various constituencies, because their contract with the corporation has ownership-like features, including the right to vote and the fiduciary obligations imposed on directors and officers.¹¹⁸⁵ Besides that, the contractarian model regards free market competition as an efficient means to solve the problem of separation of ownership and control by forcing corporations to minimize agency costs.¹¹⁸⁶ Economic markets such as the market for management, the market for corporate control, the product market, as well as the capital market serve as an incentive to keep the agency costs as low as possible whereas no additional regulation is necessary.¹¹⁸⁷ Management, therefore, is not regarded to be as powerful as described by *Berle and Means*. If management fails to operate the corporation at a minimum of agency costs, market forces are believed to reply accordingly. For example, the market for corporate control might reply with a hostile takeover offer, terminating the executive as a result thereof. A firm with high agency costs may also fail in the product market. Or, most likely, the executive himself will be removed as an implication by the management labour market. Thus, the incentives of management are believed to be focused on a long-run productive success for the corporation and its enterprise.¹¹⁸⁸

In contrast to the model presented by *Berle and Means*, economic theorists that favour the nexus of contracts model of the corporation share confidence that shareholders, even those of widely-held corporations, are capable to anticipate and control the arising agency conflicts.¹¹⁸⁹ Based on the contractual conception of the corporation, it does not make sense for a party to enter into a contract that is designed to be to the disadvantage of that party. Contractarians claim that the agency problem will be controlled to the extent that any additional capital spent with the intention to control managerial behaviour or even induce a certain kind of managerial conduct is exactly equivalent to the benefit thereby generated. In their estimation that the corporation will be structured as to minimize the agency costs, investors who chose the corporate framework to pursue their investment can rely on the fiduciary duty of directors and officers and several market mechanisms that serve to discourage management from self-dealing. Assuming that only those contracts survive which efficiently reduce agency costs, there is no reason for the legislative body to further intervene in order to protect investing shareholders.

¹¹⁸⁵ Bainbridge, "The Board of Directors as Nexus", *supra* note 1166 at 6.

¹¹⁸⁶ See Bratton, "Berle and Means Reconsidered at the Century's Turn", *supra* note 1149 at 755.

¹¹⁸⁷ Bratton, "The 'Nexus of Contracts' Corporation: A Critical Appraisal", *supra* note 1172 at 417-418.

¹¹⁸⁸ *Ibid.*

¹¹⁸⁹ Harris *et al.*, *supra* note 629 at 210.

Under the nexus of contracts theory of the corporation, all corporate actors are rational, economic actors driven by their divergent self-interests and seeking to maximize values for themselves.¹¹⁹⁰ They resourcefully conceptualize and predict future courses of action effectively. The corporation, therefore, appears to be the product of their contracting behaviour. This theoretical approach successfully challenged *Berle and Means'* assertion that the corporation be regarded as public property, as the corporate property rather is private property resulting from a nexus of privately concluded contracts.¹¹⁹¹ On those grounds, the movement against government intervention in the corporate realm has its merits.

3. The Role of Corporate Law

In any contract, parties have an economic incentive to adopt value-maximizing rules.¹¹⁹² If corporations are simply considered a nexus of contracts between those parties, negotiations could be based entirely on contract law without a special need for corporate law rules.

However, corporate law as a body of law distinct from contract law serves two vital roles on the foundation of the model of the corporation as a nexus of contracts. First, many of the markets that are believed to cause the equilibrium between the different objectives of the contracting parties only work successfully because of the law.¹¹⁹³ Certain market rules as well as shareholder voting rules are a matter of corporate law. Capital markets depend on the rules that corporate law establishes for determining how investors realize returns. It is corporate law that establishes many of the rights associated with share ownership that in turn makes shares valuable.

Secondly, under the contractarian model, corporate law is viewed as a set of terms available off-the-rack so that participants in corporate ventures can save the costs of individual contracting.¹¹⁹⁴ Thus, as a "standard form contract" reducing the costs otherwise incurred for individual contracting, corporate law provides a series of complicated legal rules that almost every participant of the corporate venture will want to adopt, but that would be hard to include

¹¹⁹⁰ Michael C. Jensen, "Organization Theory and Methodology" (1983) 50 Acct. Rev. 319 at 324; Fama, *supra* note 478 at 289.

¹¹⁹¹ See William W. Bratton, "The Economic Structure of the Post-Contractual Corporation" (1992) 87 Nw. U. L. Rev. 180 at 186-190.

¹¹⁹² Harris *et al.*, *supra* note 629 at 218.

¹¹⁹³ *Ibid.* at 218.

¹¹⁹⁴ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 34; Easterbrook and Fischel, "The Corporate Contract", *supra* note 1170 at 211.

and specify into any single contract.¹¹⁹⁵ Corporate law – and in particular the fiduciary duty enforced by courts – fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and had the costs of negotiating at arm's length for every contingency been sufficiently low.¹¹⁹⁶ Entrepreneurs can offer investors this standard form contract simply by incorporating, saving additional transaction costs for all the parties involved.

Moreover, the standby-terms established by corporate law grant great discretion to managers and facilitate actual contracts, as they are basically free to every corporation in terms of its individual articles of corporation, enabling the ventures to concentrate on matters that are specific for their undertaking.¹¹⁹⁷ The body of corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all situations, hence the enabling structure of corporate law to adopt individual terms that optimally fit the respective business purposes.¹¹⁹⁸

Accordingly, corporate law supplements but never displaces actual bargains, save in situations of third party interests or effects.¹¹⁹⁹ Corporate law, if uniformly applied, can be seen to maximize the value of the corporate endeavour as a whole because it can facilitate the contracting process by providing a general standard form contract or completing open-ended contracts.¹²⁰⁰ However, there is no reason why corporate law should be used to impose a term that defeats actual bargains or reduce the venturers' joint wealth.¹²⁰¹ Instead, corporate law should adopt its enabling role and give private parties the option to contract around a particular term if they prefer to do so.¹²⁰² Unless there is some kind of market failure that engenders mistrust of private contracting, corporate law should seek to give parties what they want and allow them to do something if they so choose and generally avoid mandatory restrictions on the parties' right to contract on a free basis.¹²⁰³

In conclusion, the corporation is a nexus of explicit and implicit contracts. Some of those

¹¹⁹⁵ Easterbrook and Fischel, "The Corporate Contract, *supra* note 1170 at 194

¹¹⁹⁶ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 15.

¹¹⁹⁷ *Ibid.* at 15 and 34.

¹¹⁹⁸ Easterbrook and Fischel, "The Corporate Contract, *supra* note 1170 at 183.

¹¹⁹⁹ *Ibid.* at 211-212. Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 34.

¹²⁰⁰ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 35.

¹²⁰¹ *Ibid.*; Easterbrook and Fischel, "The Corporate Contract", *supra* note 1170 at 193.

¹²⁰² Harris *et al.*, *supra* note 629 at 219.

¹²⁰³ *Ibid.*

contracts may be negotiated by the parties based on their bargaining powers resulting from the freedom of contract. Others may be a set of standard terms included in the articles of the corporation, which are dictated and accordingly accepted by all shareholders. Further terms may be implied by the courts or corporate legislation in an attempt to supply the terms that would have been negotiated had the corporate actors addressed the problem explicitly.¹²⁰⁴

The executive severance agreement or a “golden parachute” provision to the benefit of a corporate executive is only one of many contracts inherent in the corporate venture. On the basis of the corporate law theory that the corporation is a nexus of contracts, the evaluation of the present legal regime in Canada dealing with this kind of contracts must acknowledge to a high degree the character of the agreement as an individual contract between the corporation and its executive governed by the contract law principle of freedom of contract. However, as the interests of third parties such as the shareholders are concerned, the arrangement must constitute a product of arm’s length negotiations. In order to guarantee a fair bargaining process, the applied corporate law theory requires that constraints be imposed primarily by economic market forces rather than by mandatory rules. Moreover, legislative intervention should only be contemplated if the economic market forces prove to be insufficient means to align the diverging interests of the executive and the corporation or to avoid managerial self-dealing in the first place.

Given this theoretical understanding of corporate law, I will analyze the effectiveness of both the available market mechanisms and the legal constraints provided by the present Canadian regime with regards to executive severance agreements and “golden parachute” provisions in the following part. In this context, I will resume the discussion of the contrary positions established by the two theoretical approaches to governance in the area of executive compensation, the optimal contract theory and the managerial power approach.

II. Analysis of the Effectiveness of the Canadian Regime

Based on the theoretical background of the corporate law theory of the corporation as a nexus of contracts, I now turn to assess the effectiveness of the legal constraints for executive severance agreements and “golden parachute” provisions provided by the present regime. In light of the existing principal-agent-relationship as the origin for the arising agency problems and

¹²⁰⁴ Easterbrook and Fischel, “*The Corporate Contract*”, *supra* note 1170 at 193.

agency costs, I have shown earlier that there are two contrary approaches of corporate governance that concentrate specifically on the issue of executive compensation agreements in general. First, the optimal contract theory claims that there are sufficient economic market forces that align the interests of management and shareholders with the result that executive compensation agreements are regarded as an optimal contract to minimize agency costs.¹²⁰⁵ Proponents of the managerial power approach, on the other hand, argue that the existing market mechanisms are unlikely to impose significant restraints on executive compensation.¹²⁰⁶ At this point, I will return to that controversy and discuss whether the economic factors really suffice as efficient constraints on managerial behaviour in order to prevent the diversion of corporate assets by way of excessive executive severance agreements and “golden parachute” provisions. I will argue that the market mechanisms indeed do not impose sufficiently effective constraints especially on management of closely-held corporations as present in the Canadian capital markets. Therefore, the managerial power approach gets it right when claiming that further legal constraints are necessary. In a next step, accordingly, I will assess whether the legal restrictions under the present Canadian system are efficient supplements for ineffective economic factors.

1. Market Mechanisms

Market instruments operate on two levels. Like legal rules, market mechanisms can, by direct intervention, impose significant costs on self-serving management. But market forces also place a second role in furnishing information to the corporation's principals, the shareholders, which may enhance the quality of supervision by those corporate owners. If market signals furnish shareholders with information of managerial diversion, then the shareholders can discipline managers in a variety of ways such as the exercise of voting rights, eventually resulting in the replacement of the board of directors and, subsequently, the team of managing executives.

a) The Capital Market

Firstly, the capital market serves to furnish shareholders with valuable information about the performance and behaviour of the corporate management and, therefore, is believed to play a

¹²⁰⁵ Easterbrook, *supra* note 91 at 540; Daniel R. Fischel, “The Corporate Government Movement”, *supra* note 91 at 1259; Daniel R. Fischel, *supra* note 511 at 916-920; Fama, *supra* note 478 at 289.

¹²⁰⁶ Bebchuk *et al.*, *supra* note 92 at 775.

central role in controlling agency costs.¹²⁰⁷

At the time a shareholder makes his initial investment, capital markets, if perfectly efficient, will ensure that the price that is paid for securities of the corporation fully reflects the magnitude of expected costs generated by agency conflicts. Shareholders will not suffer reductions in their wealth by managerial diversion of corporate assets because the costs were anticipated at the time of the initial investment and were impounded into the price paid for their shares. By incorporating the consequences of managerial misconduct into share prices, capital markets furnish shareholders with a signal of corporate performance. Accordingly, if the price of a corporation's securities increases at a rate that compares favourably with the securities of corporations having similar characteristics, the investor can be reasonably confident that the corporation in which he has invested is being well managed. Conversely, if the share price of the corporation underperforms industry competitors, the spectre of managerial incompetence is raised.

Furthermore, market discipline may also arise from the possibility that the firm will need to return to the market for additional equity capital in order to expand. The prospect of needing to sell additional shares to the public might cause a value-maximizing management team to maintain restraint and develop a reputation as conservative self-competitors.¹²⁰⁸

Empirical tests of market efficiency have found that capital markets are generally efficient with respect to publicly available information such as information disclosed in the financial press and in various other publicly-available documents.¹²⁰⁹ However, the empirical evidence also demonstrates that markets are not efficient with respect to what can be referred to as "insider information" or similar kinds of information not available for the public.¹²¹⁰ Additionally, there are also limits to the extent to which managerial opportunism can be accurately anticipated at the time of the initial investment. Foresight is not perfect, and management may embark on a course of action that was not foreseeable when the shareholder made his initial investment. Indeed, little in the capital market appears to encourage executive management to disclose the extent of, or even to offer a reduction of their discretion with respect to general managerial shirking or the

¹²⁰⁷ See Harris *et al.*, *supra* note 629 at 214.

¹²⁰⁸ Bebchuk *et al.*, *supra* note 92 at 778.

¹²⁰⁹ For the empirical analysis, see generally Eugene E. Fama, "Efficient Capital Markets II" (1991) 46 J. Finance 1575; Jeffrey N. Gordon and Lewis A. Kornhauser, "Efficient Markets, Costly Information, and Securities Research" (1985) 60 N.Y.U. L. Rev. 761.

¹²¹⁰ *Ibid.*

diversion of corporate assets.¹²¹¹ In contrast to the situation regarding closely-held corporations, public investors of widely-held corporations do not have the ability that a sole owner has to separate, assess, and alter management apart from the other components of the enterprise only upon the information available through the operation of the capital market. Thus, the conclusion can be drawn that the systematic asymmetry of information about the range of managerial discretion or the quality of management is not materially narrowed, and certainly not cured, by the existence or operation of the capital market.¹²¹²

Moreover, the shareholders are limited in their power to choose or police the terms on which management operates or holds office if that choice can only be exercised through their decision to buy or sell shares of the corporation. The share price is affected by the systematic risk that affects all market assets, and therefore does not reflect only firm-specific risk. Hence, any decision to buy or sell corporate stock inherits factors that are remote from managerial employment terms, if not at all indifferent to managerial performance.¹²¹³ Additionally, the capital market cannot incorporate in stock prices any adequate estimate and discount of the risks of dilution of the legal rules limiting managerial discretion. Accordingly, the share price determined by the stock market cannot properly reflect shareholder preferences with respect to the appropriate scope of managerial discretion.

Considering only firm-specific factors, a purchase or sale of shares represents a combined decision that is influenced by a series of factors perceived by the shareholder with regards to the corporation's success in the market. The choice to buy or sell represents a complex mixture of satisfactions and dissatisfactions, but does not permit a separate conclusion as to the particular quality of the corporation's management. It always also includes a reflection of certain industry factors, timing issues or even internal matters in the business of the corporation for which the present management cannot be held responsible.

In sum, the capital market to some extent correctly prices the shares of widely-held corporations listed in the stock market. However, that pricing efficiency is not to be confused with pressure on management to operate efficiently or to maximize shareholder wealth in any given corporation. At best, the share market price correctly reflects the existence of managerial

¹²¹¹ See Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", *supra* note 1169 at 1423.

¹²¹² *Ibid.*; Williamson, *supra* note 1171 at 1219.

¹²¹³ Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", *supra* note 1169 at 1423.

discretion and the inherent potential for diversion of corporate assets. However, the impact of the stock markets does not, by its own, force executives to compete in limiting their power to divert assets and generate personal benefits through their role as managers of the corporation.

The foregoing discussion regarding the capital market focuses on widely-held corporations as are the rule in the U.S. In Canada, by contrast, less than one per cent of the securities of all incorporated companies are traded on the Canadian stock market.¹²¹⁴ The majority of corporations are closely-held entities owned and controlled by a single shareholder or only a small group of shareholders. Risk bearing and management in those corporations are not separated at all if no outside minority shareholder exist or, respectively, only to an extent in proportion to the existence of additional outside minority shareholders. If the shares are not publicly traded on the stock market, the capital market, especially in the form of the secondary market such as the stock exchange, cannot have any impact as an economic factor that addresses the problems of agency costs and managerial behaviour.

However, agency problems also exist even in closely-held corporations, although only to a smaller extent. Managers who own all or a large percentage of the outstanding shares of a corporation will have an incentive to perform well and engage less in self-dealing than managers who own only a small percentage or even no stock of the corporation.¹²¹⁵ The relatively small number of shareholders as residual claimants in closely-held corporations facilitates contracting and monitoring to reduce agency problems. The lack of a public capital market for those corporations has profound implications with respect to the minority shareholders who cannot dispose of their shares through the market. Thus, there is the risk that majority shareholders oppress minority shareholders by diverting corporate assets or other kind of self-dealing.¹²¹⁶ Moreover, the absence of a secondary market for closely-held corporations makes valuation of residual claims of shareholders highly uncertain and is likely to create conflicts over dividend policy and other distributions that would not occur to the same extent in widely-held, publicly traded corporations.¹²¹⁷ Finally, the lack of a liquid capital market for shares deprives

¹²¹⁴ Harris *et al.*, *supra* note 629 at 214.

¹²¹⁵ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 229.

¹²¹⁶ In the absence of a capital market for minority shareholders of closely-held corporation, those shareholders need to be protected by different means. As we have seen, corporate law in Canada has addressed that issue by introducing the oppression remedy as a statutory legal remedy available especially for minority shareholders who claim oppression by the majority shareholder or management, see *supra* at Chapter 3, III. 4.

¹²¹⁷ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 230.

uninformed investors of the protection of purchasing at fair market price. Accordingly, since the capital market does not apply for closely-held corporations, effective governance mechanisms with special focus on managerial behaviour within closely-held corporations must be intended to be achieved through different means.

b) The Product Market

A further market mechanism as a potential external constraint on management behaviour is the product market.¹²¹⁸ This is the market in which the corporation's goods or services are offered, sold and bought. Proponents of the law and economics approach to corporate law argue that in a competitive product market, inefficient managerial behaviour produces competitive disadvantages, shrinking profits and business concentration or failure.¹²¹⁹

In general, the impact of the product market can be twofold. First, it can discipline managers indirectly by providing useful information to shareholders about the performance of corporate management.¹²²⁰ The success or failure of a corporation's goods or services on the product market is governed by the price, quality, and service characteristics of the corporation's products and services. If a corporation supplies a product that is superior to competing products, then its profits should increase. To the contrary, if a company's product or service fails to earn recognition of a sufficient range of consumers, then a significant information signal will be transferred not only to the management, but also to the shareholders of the corporation. Dismal product market performance sends a signal to investors about managerial performance, particularly if a corporation is performing poorly while its industry peers are thriving. As a possible reaction, shareholders can threaten to modify the composition of the board of directors or remove it entirely through their voting power if the board refuses to discipline executive management.

Secondly, the product market can also sanction corporate executives directly for inferior performance.¹²²¹ In the worst-case scenario, an egregious failure of the corporation to compete successfully in the product market will result in the bankruptcy of the corporation. Even if the corporation is successfully reorganized and continues to operate after bankruptcy, its management will most likely be replaced by the new board of directors and new executives in

¹²¹⁸ See, for example, Bebchuk *et al.*, *supra* note 92 at 778

¹²¹⁹ Easterbrook, *supra* note 91 at 557.

¹²²⁰ See Harris *et al.*, *supra* note 629 at 215.

¹²²¹ *Ibid.* at 217.

charge of the daily operation of the business.

Although the described effects of the product market may discourage management from acting in ways that decrease the productivity of the corporation, the diversion of corporate assets or benefits to executives has no significant direct impact on the operational efficiency of the company or the success of its products or services in the product market.¹²²² However, the product market may result in having an indirect impact on executive compensation agreements. Any costs incurred by the corporation for executive compensation and other payments must eventually be reflected in the costs of the goods produced or the services provided by the corporation.¹²²³ In the event of excessive executive compensation or a similar kind of diversion of corporate profits, the corporation's products will need to be excessively priced in order to compensate for the losses incurred through managerial self-dealing. This, in turn, will result in a decrease of sales and revenues generated by the corporation. With lower revenues, the corporation will be less profitable, ultimately causing the corporation's share price to drop. In light of the inferior share price and less shareholder value, shareholders are likely to raise their voice and, in extreme cases, cause a proxy fight resulting in the appointment of a new board of directors and the delegation of management power to a new executive team.

All of the above may be true for the potential effect of the product markets in the event of a diversion of corporate assets by way of excessive executive compensation agreements in general. Indeed, increasingly in the last several years, the threat of shareholder discipline has provoked a number of boards in leading North American corporations to initiate the ouster of senior executives.¹²²⁴ In those cases, it is likely that excessive compensation packages caused a failure of the corporation in the product market, as the amount of the compensation appeared to be excessive in relation to the performance of the executive, hence a diversion of corporate assets. The termination of the executive then sends a signal to both shareholders as well as the corporation that managerial self-dealing will have to be constrained in order to prevent such consequences in the future.

However, the same effect of the product market cannot be attributed to excessive executive severance agreements and "golden parachute" provisions. Those payments are exercised at a

¹²²² Bebchuk *et al.*, *supra* note 92 at 778; Eisenberg, *supra* note 524 at 1489

¹²²³ See Alarie, *supra* note 96 at 50.

¹²²⁴ See Harris *et al.*, *supra* note 629 at 216. See also the cases of ousted C.E.O.s of North American corporations cited *supra* at Introduction, II.

time where the executive has already been terminated, be it for poor performance indicated through the product market or, in the case of the “golden parachute”, through the market for corporate control.¹²²⁵ Thus, the design of an excessive severance agreement or “golden parachute” provision, constituting another form of diversion of corporate assets, will not have any implication for the executive concerned as it is already contingent on the executive’s termination. By contrast, in light of the increased threat of premature termination the executives are recently facing, such arrangements appear to be the last opportunity for the executive to benefit from their bargaining positions and influence and successfully divert corporate assets to themselves. Given the direct relation to the occurrence of the executive’s termination, neither the product market nor the market for corporate control will have any impact on the decision to conclude an excessive executive severance agreement or “golden parachute” provision.

Again, the situation is different as far as “golden parachute” provisions are concerned that are only single-triggered. Those provisions are not contingent on a termination of the executive, but simply provide the executive with an additional payment in the event of a change in control of the corporation.¹²²⁶ Irrespective of the questionable permissibility of those payments, they can, in this context, be treated as general executive compensation agreements. The executive remains in service for the corporation with the possibility that, subsequently, the product market may provide the signal that the payment has been excessive, resulting in a failure of the product in its respective market. Here, the executive may indeed face termination despite receiving a premium in terms of the “golden parachute” following the change in control of the corporation.

c) The Managerial Market

The market for top executives, referred to as the managerial market, also is believed to exert powerful impact on managerial behaviour by imposing direct penalties on opportunistic managerial behaviour.¹²²⁷ The managerial market can be described as the market where the services of corporate executives are traded.

According to supporters of the optimal contracting approach, the degree of which C.E.O.s are able to engage in managerial self-dealing to the detriment of the corporation, such as, for example, to exercise control over their own compensation packages, depends on the readily

¹²²⁵ See *infra* at II. 1. d).

¹²²⁶ See *supra* at Chapter 2, I. 2. b) (2).

¹²²⁷ See Harris *et al.*, *supra* note 629 at 216-217.

available market alternatives.¹²²⁸ If such a competitive managerial market existed, a self-dealing executive could and most likely would be replaced by an equally effective executive. Indeed, the threat of having to compete in the managerial market with a possible result in termination might encourage executives to act in the corporation's best interests instead of trying to pursue the private goal of generating personal profits. Provided the existence of an efficient managerial market, an executive who diverts corporate assets will suffer from a reduction in the compensation he may otherwise have received corresponding to the magnitude of the agency costs he is expected to generate for future employers.¹²²⁹ If these costs are fully impounded into an opportunistic executive's expected compensation, then the executive derives no benefit from engaging in that misbehaviour. Any immediate gain from opportunistic behaviour is offset by reductions in the value of the executive's human capital.

The effectiveness of this market mechanism relies on the ability of the market to evaluate the performance of the manager under consideration in isolation from his team. Linking measures of managerial performance such as the market share price to managerial compensation can offer valuable incentives to managers to perform their duties diligently. In practice, however, the effectiveness of the market for executives is limited for another reason. For some executives there is an inside managerial market within the corporation they perform their services for. To the extent that individuals within the company aspire to be promoted and replace top executives above them, they may be motivated to scrutinize closely the performance of senior management in an effort to detect conduct that will invite discipline and, eventually, cause the removal of those executives. The removal of opportunistic executives represents opportunities for the employees formerly below them in the corporate hierarchy. The more generous the promotion or bonus that is correlated with successful "whistle-blowing", the more powerful the incentive to search for managerial opportunism. In practice, most executive positions in fact are filled internally.¹²³⁰ By contrast, for the C.E.O., who is the highest ranked executive of the corporation, internal promotion is impossible.¹²³¹ For him, only external promotion to become the C.E.O. of a larger or better performing corporation is a possibility. However, there are likely to be few other jobs that are both available and more desirable than the current one. Accordingly, the

¹²²⁸ See Alarie, *supra* note 96 at 49.

¹²²⁹ See Harris *et al.*, *supra* note 629 at 216.

¹²³⁰ See C. Edward Fee and Charles J. Hadlock, "Raids, Rewards, and Reputations in the Market for Managerial Talent" (2003) 16 *Review of Financial Studies* 1311 at 1324.

¹²³¹ Bebhuk *et al.*, *supra* note 92 at 776.

overwhelming majority of C.E.O.s are not hired by other corporations, as those companies rather fill the available executive positions by promoting inside junior management or other employees.¹²³²

The theory of an efficient market is faced with further limitations. Shareholders do not hire or even participate in the process of hiring the executives. Instead, it is the board of directors who, as agents for the shareholders, purchase managerial services in terms of corporate executives. That process of selection or hiring managers can be subject to conflicts of interests, especially when one of the directors becomes an executive of the corporation. The inside director then is both, purchasing managerial services as agent on behalf of the shareholders as well as selling managerial services to the corporation as an individual contractor. In this case, there simply is no free managerial market, as the conflict of interest of the inside director makes impossible a market in which shareholders can participate through independent directors as their agents in the selection process.¹²³³ For independent outside directors, the conflicts of interests are less acute. However, their social and economic relationship to managers, their own personal economic incentives as well as possible time constraints infect all efforts to identify them exclusively with shareholders' interests in selecting, retaining, or monitoring management. Indeed, given the existing interlocking ties of directors and executives, directors are likely to identify more closely with management than with shareholders, particularly when it comes to the termination of management.¹²³⁴

Finally, the economic mechanism of the market for corporate executives can be applied as an argument explaining the noticed rise in the use of and the increase in the amounts of executive severance and "golden parachute" packages, either resulting from a contractual provision or subsequently negotiated as a "golden handshake". As mentioned earlier, corporate executives are presently faced with an increased risk of being removed from office and prematurely terminated.¹²³⁵ Once ousted, the former executives are confronted with the potential of unemployment or, at least, a substantial reduction in remuneration, given that there are only a limited number of positions available of C.E.O. or executive in another corporation. Especially those executives that are terminated at a time when they are near the age of retirement are

¹²³² See Eisenberg, *supra* note 524 at 1495.

¹²³³ See Brudney, "Corporate Governance, Agency Costs and the Rhetoric of Contract", *supra* note 1169 at 1421.

¹²³⁴ Brudney, *supra* note 519 at 610-613, 617-619; Williamson, *supra* note 1171 at 1215-16.

¹²³⁵ See *supra* notes 103 and 601 as well as accompanying text.

potentially forced into early retirement, as there are hardly any positions available of the same level and given that other corporations will likely prefer younger personnel. As an implication of that market risk, executives are forced to bargain for some kind of safeguard in the event of premature termination. Severance agreements, especially, are an adequate measure to compensate that risk of future unemployment or loss of earnings. The increase in takeovers also has caused executives to negotiate special "golden parachute" that, in the event the takeover occurs and the executive is terminated as an implication thereof, appear to have the same effect as a general severance agreement that is not contingent to a takeover. As developed in Chapter 2 of this thesis, those arrangements are legally permissible under employment and contract law as far as they compensate the executive for remaining entitlements arising from the executive service contract. However, provided that the executive has sufficient power to influence the board with regards to the bargaining process, executives may be tempted to negotiate for even more than they are actually entitled to according to the law. Thus, the limited market for corporate managers and the limited availability of similar positions can be seen as one reason for the executive to divert corporate assets to himself by way of severance or "golden parachute" arrangements, rather than from refraining from that behaviour.

d) The Market for Corporate Control

Finally, the market for corporate control is believed to be the most powerful safeguard against the diversion of corporate assets and the generation of all other kinds of agency costs, as it helps to align the interests of management and shareholders.¹²³⁶

This market mechanism operates by transferring control of mismanaged corporations to owners more willing or able to discipline self-serving management.¹²³⁷ The transfer of control is affected by the use of a hostile takeover bid. The principal attraction of the hostile takeover bid is that it can operate independently of the consent of the target corporation's management. Once an acquirer has achieved actual or *de facto* control, he can exercise his voting rights conferred by the controlling majority of shares and oust the existing management by electing new directors, who subsequently appoint new executives as managers. The acquirer profits by purchasing shares at a price that reflects significant agency problems, reducing those problems once in

¹²³⁶ This mechanism was first identified by Manne, *supra* note 514. See also Easterbrook, *supra* note 91 at 564-570; For recent critique on the effects of the market of corporate control on executive compensation agreements, see Bebchuk *et al.*, *supra* note 92 at 777; Alarie, *supra* note 96 at 49.

¹²³⁷ See Harris *et al.*, *supra* note 629 at 217.

control, and then realizing the greater value of shares. Therefore, a corporation whose share price decreases becomes more vulnerable to a hostile takeover than its well-performing competitors.

There is considerable empirical evidence that many corporations that are the subject of hostile takeovers are poorly managed companies, and that successful takeovers increase the aggregate value of target corporations.¹²³⁸ Thus, the market for corporate control can be regarded as effective in both discouraging deviations from shareholder wealth maximization before they occur and penalizing such behaviour in the event it actually does occur. The fear of a possible takeover and a consequent threat of loss of employment serve as a powerful countervailing force on management diversion. The most efficient defensive tactic is self-imposed restraint from diversion by diminishing opportunistic behaviour, as the share price of the corporation will rise and attenuate the gains for a potential acquirer contemplating a change in control through a hostile takeover.

If, for example, a corporate executive is compensated excessively, assuming there is a well functioning market for corporate control, market participants will recognize the potential gains associated with the acquisition of control of that corporation and a subsequent replacement of the current management by new executives who will either not demand compensation as high as that of the current management or who will deliver managerial performance sufficiently strong enough to merit the existing rate of executive compensation.¹²³⁹ However, the actual impact of a takeover threat caused by the market for corporate control heavily depends on the overall performance of the corporation and, in particular, on the proportion between the levels of diversion compared to the general market value of the corporation. Accordingly, if the diversion by way of excessive executive compensation amounts to less than one per cent of the market value of the company, it is unlikely to cause a takeover bid.¹²⁴⁰ Although the direct benefit for the executive from an increase in compensation or similar kind of diversion might indeed be large, the costs to the corporation in consideration of its market value will be proportionally low. Thus, the increase of a takeover risk resulting only from a minimal percentage reduction in the company's market value appears to be quite limited.

In sum, the market for corporate control does impose some constraints not only on managerial self-dealing in general, but also on increasing amounts of executive compensation or

¹²³⁸ *Ibid.*

¹²³⁹ See Alarie, *supra* note 96 at 49.

¹²⁴⁰ Bebchuk *et al.*, *supra* note 92 at 777.

similar kinds of remunerations such as executive severance agreements. In closely-held corporations, where the ability of outsiders to acquire shares is restricted, the market for corporate control is of little effect.¹²⁴¹ In widely-held, publicly traded corporations, the market for corporate control appears to be capable of restricting the exercise of bargaining power of tempted executives.¹²⁴² Taking into consideration the proportion of diversion compared to the corporation's value, at some point shareholders might become sufficiently outraged to be willing to support a takeover bid of an outsider. On the other hand, executives who dispose of and exercise considerable bargaining power over their own contracts are likely to foresee the possibility that market participants may recognize any of the corporation's performance inefficiencies or existing problems of diversion and launch a takeover bid in an attempt to replace them. As a consequence, they may arrange for themselves general severance agreements or specific "golden parachute" provisions, or at least achieve those payments by way of a "golden handshake" by the time the takeover occurs and they are terminated.

Also, as has been pointed out earlier, "golden parachute" provisions can be intended to be a defensive measure against a hostile takeover in an attempt to avoid the change in corporate control.¹²⁴³ Clearly, a "golden parachute" arrangement will only result to be an efficient defensive measure if it provides for a level of payment sufficiently large enough to discourage the potential acquirer from incurring the additional costs arising from it. If applied as a defence measure, "golden parachutes" actually ensure that the market for corporate control will not be a persistent and binding constraint on corporate governance unless the gains from a change in control are highly significant.¹²⁴⁴ Thus, in addition to the market for corporate control and the other market factors analyzed above, certain corporate law initiatives are necessary to make those market forces more effective by restricting the use of defensive tactics.¹²⁴⁵

¹²⁴¹ Easterbrook and Fischel, *The Economic Structure of Corporate Law*, *supra* note 1167 at 231. Regardless of that, outsiders always can make offers to acquire shares that are just too generous to refuse, although especially family-owned and controlled corporation are likely to turn down even such a generous offer.

¹²⁴² Alarie, *supra* note 96 at 49.

¹²⁴³ See *supra* at Chapter 3, II. 1. d) (2).

¹²⁴⁴ Alarie, *supra* note 96 at 49.

¹²⁴⁵ See, for example, Frank H. Easterbrook and Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1982) 94 Harv. L. Rev. 1161; John C. Coffee, Jr., "Regulating the Market for Corporate Control, A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 Colum. L. Rev. 1145; Lucien A. Bebchuk, "The Case Against Board Veto on Corporate Takeovers" (2002) 69 U. Chicago L. Rev. 975. The legal constraints provided by corporate law will be assessed next, see *infra* at 2.

e) Conclusion

The foregoing analysis shows that distinct economic market forces alone do not always impose sufficient constraints on the bargaining behaviour of executives with a view to self-dealing and the diversion of corporate assets. Product and managerial markets often suffer from various structural imperfections, the capital market is relevant only for widely-held, publicly traded corporations but not efficient in relation to certain sets of information, and the market for corporate control only operates above certain threshold levels of agency costs.¹²⁴⁶

Although the market mechanisms might, however, impose some constraints and deter management from deviating extremely from optimal contracting arrangements,¹²⁴⁷ they fail to completely eliminate or efficiently reduce agency costs with a successful free economic market solution.¹²⁴⁸ In corporations with dispersed shareholdings, collective action problems substantially impair contractual self-protection by the dispersed equity interest. Here, despite the impacts of the capital market and the market for corporate control, due to the separation of ownership and control agency costs are likely to remain substantially high.¹²⁴⁹ In closely-held corporations the capital market does not apply as a constraint at all and the impact of the market for corporate control is strongly limited. Notwithstanding some potential influence of the product market and the managerial market, minority shareholders are faced with the potential for the controlling majority to engage in contractual self-dealing to the detriment of the minority. A diversion of corporate assets by way of excessive executive compensation agreements or excessive severance or "golden parachute" packages remains possible, given the inability of the market forces to effectively prevent the exercise of managerial power and influence provided by the legal regime in all different kinds of corporations.¹²⁵⁰

As a result, I agree with the proponents of the managerial power approach that economic market factors alone are not a sufficient governance model to prevent managerial self-dealing and, consequently, to effectively reduce the agency costs generated within the corporation.

¹²⁴⁶ See also Harris *et al.*, *supra* note 629 at 219; Bebchuk *et al.*, *supra* note 92 at 779; Bratton, "Berle and Means Reconsidered at the Century's Turn", *supra* note 1149 at 755.

¹²⁴⁷ See Bebchuk *et al.*, *supra* note 92 at 779.

¹²⁴⁸ Bratton, "The Economic Structure of the Post-Contractual Corporation", *supra* note 1191 at 193-197. See also Bratton, "Berle and Means Reconsidered at the Century's Turn", *supra* note 1149 at 755.

¹²⁴⁹ John C. Coffee, Jr., "The Mandatory/Enabling Balance in Corporate Law: An Essay in the Judicial Role" (1989) 89 Colum. L. Rev. 1618 at 1674 note 234 and 1675-1676; Jeffrey N. Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1549 at 1577.

¹²⁵⁰ See also Easterbrook and Fischel, "The Corporate Contract", *supra* note 1170 at 182.

Instead, the deficiencies of the optimal contract model call for legislative intervention by corporate law and supplementary laws in order to protect shareholders as investors of the corporation. In the following section, I will assess the effectiveness of those legal correctives provided by the existing legal system in Canada.

2. Legal Constraints

Recent Canadian corporate law together with supplementary laws addresses the issue of managerial self-dealing and diversion of corporate assets with a series of legal rules. I have presented those relevant legal mechanisms in Chapter 3 of this thesis.¹²⁵¹ As I have shown there, under the present legal regime the conduct of corporate executives concerning the bargaining process and the outcome of all kinds of contracts between the corporation and the executive needs to be evaluated against the legal standards, rights and obligations established by the law. Among the most important possible outcomes of the law are that the contract is set aside, preventing the executive from executing the contemplated agreement or, more likely, that *ex post* costs are imposed onto the executive in terms of a reimbursement of the funds or assets improperly received.

At this point, I will proceed with an assessment of the effectiveness of those restrictions imposed by the law as a supplementary corrective on the grounds of an understanding of the corporation as a nexus of contracts. Since the Canadian corporate capital structure includes both the widely-held corporation with liquid markets for its shares and the closely-held corporation consisting of only one or a small group of controlling shareholders with a thinly-traded market for its shares, the legislation must address all issues that may arise in those two different types of corporations.¹²⁵²

a) Balance between Freedom of Contract and Fiduciary Duty

The general legal conception of executive severance agreements and “golden parachute” provisions under the dominant theory of corporate law is that such arrangements are simply one kind of many private contracts concluded between the executive and the board of directors acting on behalf of the corporation as a separate legal entity consisting of a nexus of different contractual relationships. The corporate law regime does not provide for the shareholders to

¹²⁵¹ See *supra* at Chapter 3, II.

¹²⁵² Davis, *supra* note 504 at 990.

actively participate in the negotiation process. Thus, like any private contract, executive severance agreements as well as “golden parachute” provisions are governed by the basic principle of freedom to contract arising from contract law as the primary legal source for private contracts. Both of the bargaining parties are principally free to negotiate a contract that is favourable to or, at best, optimally aligns the respective interests.

As far as the agreement intends to compensate the executive for loss of employment in terms of termination of his executive service contract, the contract is also governed partly by employment law. Earlier in this thesis, I have argued that employment law entitles the executive to a certain minimum amount of severance payment in the event of premature termination of his contract without due cause. If the executive claims those entitlements in the bargaining process, the board of directors would act contrary to the law if they grant the executive less than he is entitled under employment law. However, as a matter of freedom of contract, the executive of course is free to give up parts or all of his severance entitlements for whatever reason, although this is not likely to occur in practice. On the other hand, according to contract law, the board of directors is basically free in its decision to grant the executive even more than the minimum severance entitlements. The final contents of the agreement simply depends on the bargaining power of the parties in the particular circumstances of each case, as a consequence of the freedom of contract of both parties.

However, in the corporate context, the board’s freedom to contract with executives or all other parties is limited. Under the nexus of contracts theory of corporate law, the directors act as agents for the shareholders who are regarded as the directors’ principals. This principal-agent relationship arises from the investment by the shareholders into the company. The purchase of shares, regarded as the initial investment contract, is simply another private contracts of the nexus of contracts within the corporation. By entering into the investment contract with the corporation as a nexus of contracts, the shareholders as principals grant broad discretion to the board of directors to pursue the enterprise of the corporation. Legally, the shareholders authorize the board to enter into any kind of contract in order to achieve that goal. Under the nexus of contracts theory, shareholders formally are a third party with regards to the contracts concluded by the board of directors. They are not directly involved in the decision-making process of the board concerning executive service contracts. Regardless of that, given their position as principal of the board of directors, the shareholders are indirectly affected by the contracts negotiated by the board of directors. Their primary interest by entering into an investment contract with the corporation is the maximization of shareholder wealth. They contractually agree upon that this

goal be pursued by the corporation, delegating the authority and power for respective decision-making in the board of directors as their agents in the corporate enterprise. Accordingly, the decisions by the board of directors need always take into consideration the board's institutional role as agents for the shareholders.

Corporate law acknowledges this principal-agent-relationship between the shareholders and the board of directors and its implications by imposing the statutory fiduciary duty of loyalty on the directors and all other individuals to whom authority to act on the principals' behalf is granted to. Thus, the basic principle of freedom of contract in the corporate context is restricted by the fiduciary duty of loyalty. However, in an attempt to balance both the freedom of contract and the interests of the shareholders as principals of the corporate enterprise, the law does not attribute unlimited impact to the shareholders' interests to generate maximum shareholder wealth. Instead, the fiduciary duty requires that directors and officers of the corporation act in the best interests of the corporation rather than of the individual shareholders. With that, the law recognizes that there are several other factors that might be of relevance for business decisions in a particular case. In general, however, unless there are those special circumstances, the best interests of the corporation will be identical to the interests of the shareholder to generate a maximum of shareholder value.

With the existence of the fiduciary duty of the directors and executives, shareholders who to a high degree depend on management in order to achieve their investment goals, can reasonably expect management to abstain from self-interested behaviour that would not be in the best interests of the corporation and, indirectly, of the shareholders. Full disclosure of self-dealing transactions as required by the law encourages the parties to the contract toward arm's length negotiations. The requirement for reasonable and fair terms means a comparison with comparable arm's length transactions. Thus, the law tolerates self-dealing so long as freely situated outside parties would conclude the same transaction or contract.

On the other hand, the law does well in referring to the general term of the best interests of the corporation without defining it in more depth. In actual business life, it is not always easy for the involved parties to know or assess what will be in the best interests of the corporation. The law leaves it to the corporation's management to determine the interests of the corporation in any given case as a basis for considerations upon which subsequent business decisions will be made. Generally, neither the shareholders nor a court are specially skilled and can determine what would be necessary with a view to the best interests of the corporation from an *ex ante* perspective. But, clearly, even directors can be wrong in their assessment of the situation and

implications with regard to the business decision to be made. Therefore, the law encourages managers to take the risk inherent in the business decision-making process by applying the business judgment rule to business decisions that lack any kind of self-interest or self-dealing. On the other hand, when managerial self-dealing is involved, the fiduciary obligation restricts the freedom of contract to the extent that the decision must represent a fair and reasonable decision that would also have been made at arm's length negotiations with an outside party.

Conclusively, the fiduciary duty of loyalty as established by most Canadian corporate law statutes appears to be, at least theoretically, a powerful legal device to constrain managerial self-dealing through excessive executive compensation arrangements and, particularly, through excessive executive severance agreements and "golden parachute" provisions. Furthermore, it does not interfere with the freedom of contract as it allows managerial self-dealing to the extent that the deal represents at arm's length negotiations. By this, the law does not deprive the executive of his rights to offer the corporation services as any other outside party or to transact with the corporation as an independent contractor available on the market.

However, the fiduciary duty can only serve as an efficient legal mechanism against the diversion of corporate assets if it is exercisable in practice. In this respect, with the derivative action and the oppression remedy, Canadian law offers shareholders two major ways for legally claiming a breach of the fiduciary duty. Recent case law in Canada has proven that claims of the directors' breach of their fiduciary duty to act with loyalty and in the best interests of the corporation in practice indeed can cause the courts to set aside a contract between the board of directors and a self-interested executive which results in the diversion of corporate assets through excessive compensation.¹²⁵³ On grounds of that development, the fiduciary duty of loyalty appears to be a reliable legal instrument to also constrain managerial influence over executive severance agreements and "golden parachute" provisions.

b) Dependence of the Effectiveness on the Availability of Information

Jeffrey G. MacIntosh has famously stated that "[n]o principal-agent system can be invented that is free of abuse".¹²⁵⁴ This assertion appears to be true. However, faced with the problems of the economic markets to effectively prevent abuse, legislation should at least seriously attempt to

¹²⁵³ See especially *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 389.

¹²⁵⁴ MacIntosh, "Executive Compensation: The Importance of Context", *supra* note 499 at 88. Also, even Berle and Means in their influential early work noted that a controlling party has every incentive to maximize its own returns at the corporation's expense, see Berle and Means, *supra* 476 at 114.

address the issue and minimize the opportunities for abuse such as, in the corporate context, the diversion of corporate assets through managerial self-dealing transactions.

Thus far, I have argued that the corporate law duty of loyalty aims at abolishing the possibilities for such abuse by imposing an express obligation on corporate decision-makers to act in the best interests of the corporation rather than in self-interest. As good as this legal constraint might appear to be in theory, its success as an efficient mechanism in practice depends highly on the detection of potentially abusive actions by corporate management. Once managerial misbehaviour has been detected, a breach of the fiduciary duty can be claimed by shareholders through the derivative action or the oppression remedy, both of which are available for shareholders under Canadian corporate law statutes. Accordingly, the existence of the fiduciary duty of loyalty alone does not achieve its constraining goal if managerial abuse cannot be detected in practice.

Regarding the board's negotiations with executives about severance or "golden parachute" packages, corporate law does not provide for any direct participation of shareholders in the decision-making process. Except for stock option plans, executive compensation agreements are not even contingent to shareholder approval. Instead, shareholders are left outside of the bargaining-process and have no possibility to raise their concern at the time the negotiations take place. The law provides a regime where the shareholders are given possibilities to exercise *ex post* oversight of the board, especially through shareholder voting rights. To some extent, the institution of shareholder voting is a powerful control mechanism. If shareholders are dissatisfied with the board's vigilance in ensuring optimal managerial behaviour or performance, it is within the power of the shareholders to voice their concern or discontent by altering the composition of the board by removing disliked or dependent inside directors. However, the success of this kind of shareholder oversight including a claim for breach of the fiduciary duty depends on the information available for shareholders. One way of obtaining substantial information is the legal obligation for the board and executives to disclose self-dealing arrangements as a pre-requisite for the transaction to be legally valid. Once in receipt of information about a self-dealing contract, the shareholders are able to assess whether or not the deal amounts to at arm's negotiation or rather to unauthorized diversion of assets. However, in daily practice there is no guarantee for shareholders that the parties involved will always duly disclose each self-dealing transaction. Instead, as with every obligation imposed by the law, a perfect system in which each addressee of a legal obligation obeys with his obligations is highly unlikely, especially if the disobedience is expected to generate personal benefits. Under Canadian law, though, the failure

to disclose a self-dealing transaction, such as the unauthorized diversion of corporate assets in general, might have serious implications such as the invalidity of the transaction, charges for civil fraud or even for criminal actions, provided that fraudulent intent can be proven and that the details of the transactions become publicly known in the aftermath of the deal. Thus, the potential for severe legal implications can be regarded as an incentive for the corporate insiders to comply with their corporate law duty to act honestly and refrain from the diversion of corporate assets through self-dealing transactions.

Consequently, the effectiveness of the legal constraints depends on the magnitude and quality of information available for shareholders. The more information available to shareholders, the more rational and effective will be their vote. As far as the exact amount of executive severance agreements or “golden parachute” provisions is concerned as a basis for shareholders to assess the reasonableness of the package, there are now the disclosure requirements for issuing corporations established by securities law and the corporate governance guidelines. Whereas disclosure under securities law is mandatory, the rules of the corporate governance guidelines operate on a voluntary basis. However, the intention of the different provisions is the same. Issuing corporations are induced to disclose executive compensation including severance and “golden parachute” terms in an attempt to achieve more transparency and provide shareholders with the necessary information on which to exercise shareholder rights. Compliance with the disclosure requirements, however, has the potential disadvantage of causing a race to the top as has been outlined earlier. If detailed information about the structure and amount of executive compensation including severance packages is publicly available, competitors are likely to compare and, eventually, increase the amounts of those payments in order to remain attractive as an employer for potential executives. As a result, the amount of compensation and severance payments that will be regarded as reasonable and not excessive in the respective industry is likely to increase, although at the same time the increase cannot necessarily be justified with increased performance of the executive or even a noticeable maximization of shareholder wealth. In this respect, the mandatory nature of the disclosure rules is questionable. However, the practice has shown that corporations have been reluctant in disclosing financial information about executive compensation and severance agreements. If there is no voluntary disclosure, mandatory disclosure appears to be the only form to provide shareholders with the necessary information to individually assess the conformity of compensatory agreements such as severance agreements and “golden parachute” provisions with at arm’s length bargaining. The latest regulatory movements are an effective means to increase

the power of shareholders to effectively exercise their rights and, therefore, serve as a constraint on managerial behaviour with a view to the diversion of assets through excessive severance agreements and “golden parachute” provisions.

Finally, I have also stated that Canadian legislation has not adopted the legislative approach undertaken by U.S. tax regulators to impose an express cap on executive severance agreements and “golden parachute” provisions regarding the deductibility of such payments. Instead, Canadian tax law applies the reasonableness and fairness test established by corporate law. Before I can assess whether the U.S. tax law example should be adopted or any other kind of additional regulatory control is necessary in light of the new disclosure rules, shareholder initiatives and the fiduciary duty under the present Canadian system, I will briefly pursue a comparative study of the German legal regime, as several legislative initiatives have been discussed there in the immediate aftermath after the Mannesmann affair in the year 2000.

III. Comparative Study of the German and European Union Legal Regime

The corporate governance structure of German stock corporations (“Aktiengesellschaft”)¹²⁵⁵ has long been and still remains different from the regime governing Canadian corporations and especially U.S. corporations. However, there have recently been developments towards a more American model of governance including the introduction of several legislative amendments. Before I assess the recent German regime, which is partly influenced by European Union law,¹²⁵⁶ I will briefly explain the main structures of the German stock corporation as a basis for future analysis.¹²⁵⁷

1. The Capital Structure of the German Aktiengesellschaft

Traditionally, the capital structure of the Aktiengesellschaft has been similar to the capital

¹²⁵⁵ The German stock corporation is called “Aktiengesellschaft”. Accordingly, reference will be made to the German stock corporation hereinafter as “Aktiengesellschaft”.

¹²⁵⁶ The European Union will be referred to hereinafter as “E.U.”.

¹²⁵⁷ For a more detailed description of the German Aktiengesellschaft, see Klaus J. Hopt, “*The German Two-Tier Board (Aufsichtsrat): A View on Corporate Governance*” in Klaus J. Hopt and Eddy Wymeersch, eds., *Comparative Corporate Governance. Essays and Materials* (Berlin and New York: Walter de Gruyter, 1997) at 3; Klaus J. Hopt, “*The German Two-Tier Board: Experience, Theories, Reforms*” in Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch, and Stefan Prigge, eds., *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford: Clarendon Press, 1997) at 227, especially at 232; Stefan Prigge, “*A Survey of German Corporate Governance*” in *ibid.* at 943, especially at 972-74. See also Cheffins, *supra* note 97 at 499; Susan-Jacqueline Butler, “*Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*” (2000) 17 *Ariz. J. Int’l & Comp. Law* 555.

structure of typical Canadian corporations, as share ownership in Germany was not widely-dispersed as it is the case in the U.S.¹²⁵⁸ The majority of German stock corporations are family-owned, medium-sized corporations, only a few of which have shares listed on the stock market such as the German stock exchange.¹²⁵⁹ Also, institutional shareholders such as banks and insurance companies play a dominant role in German Aktiengesellschaften.¹²⁶⁰ Those majority shareholders own enough equity capital to exercise substantial influence within the corporation.

However, Germany's corporate capital structure has recently shifted towards a model of more widely-held public corporations. In particular, the success of the so-called "New Economy" at the end of the 20th century has, similar as in the North American market, caused the creation of many "start-up" companies and a substantial increase in the number of initial public offerings in Germany.¹²⁶¹ Also, and as a result of that development, there has been a remarkable rise of hostile takeovers on the German capital market ever since the first successful hostile takeover of Mannesmann by Vodafone in 2000.¹²⁶²

Consequently, although there still remain many closely-held corporations in Germany, the economic factors have become much more important as a mechanism of governance in the past. Additionally, legislative steps in the field of corporate governance have been undertaken that also focus on the widely-held, issuing Aktiengesellschaft rather than only on the closely-held corporation. Next, I will describe the main tools of corporate governance with respect to the issue of managerial behaviour and the potential to divert corporate assets through severance and "golden parachute" provisions.

2. Independence of the Supervisory Board: The German Two-Tier System

The main characteristic of the German model of corporate governance is a two-tier system of management and supervision of the corporation. In the German Aktiengesellschaft the

¹²⁵⁸ For a detailed discussion of the differences of the capital structure between German and U.S. corporations as well as corporations in the United Kingdom (hereinafter referred to as "U.K."), and perceived movements towards a wider dispersion of shareholdings in Germany, see Cheffins, *supra* note 97 at 499.

¹²⁵⁹ Those corporations are also referred to as "Mittelstand enterprises". They account for more than half of Germany's industrial turnover, see *ibid.* at 499 with further reference in note 18.

¹²⁶⁰ Especially German banks exercise significant multiple functions. Aside from their principle role to as a financing institution for the corporation, they own shares in their own right and frequently act as proxies for other shareholders. Additionally, they often serve as financial advisers to their business customers with regard to the stock performance of the Aktiengesellschaft's shares.

¹²⁶¹ Cheffins, *supra* note 97 at 501. Similar to the North American market, many "start-up" companies emerged with the success of the New Economy by the end of the century.

¹²⁶² See *supra* note 20.

responsibilities for managing and for supervising the corporation's business are formally separated. The management of the daily operation of the business is entrusted to the board of executive officers ("Vorstand"),¹²⁶³ whereas the responsibility for supervision of management rests with the distinct supervisory board ("Aufsichtsrat").¹²⁶⁴ The shareholders have no authority to give instructions to the Vorstand. Their only way to participate in the enterprise is through the institution of the shareholders' meeting.¹²⁶⁵ The shareholders' meeting, however, is not entitled to decide issues dealing with management, except in cases where the Vorstand explicitly asks for shareholder approval.¹²⁶⁶ It is neither possible to confer responsibilities of the management to the Aufsichtsrat, since his sole task is the supervision, not the exercise of management of the Aktiengesellschaft.¹²⁶⁷ For certain types of transactions, however, the law provides the possibility to require approval of the Aufsichtsrat in the articles of incorporation.¹²⁶⁸

Subject to special regulation by several laws of co-determination, the Aufsichtsrat is generally appointed by the shareholders through the ordinary meeting of shareholders ("Hauptversammlung").¹²⁶⁹ The Aufsichtsrat appoints and has the power to remove the members of the Vorstand.¹²⁷⁰ Thus, if both the Aufsichtsrat and the Hauptversammlung are dominated by majority shareholders, the real power lays with those two bodies, although, formally, the Vorstand exercises the management of the Aktiengesellschaft.¹²⁷¹

With special respect to severance agreements, it is worthwhile to note that the members of the Vorstand can be appointed for a period not exceeding five years, with a possibility of

¹²⁶³ The executive management board of the German Aktiengesellschaft is called and will also be referred to hereinafter as "Vorstand", see § 76 of the German Stock Corporation Act ("Aktiengesetz") of September 6, 1965, BGBl. I 1965, 1089, as amended, hereinafter referred to as "AktG". For an English Translation of the German Stock Corporation Act, see Hannes Schneider and Martin Heidenhain, *The German Stock Corporation Act 3* (2nd ed., The Hague: Kluwer Law; München: C.H. Beck, 2000).

¹²⁶⁴ The supervisory board of the German Aktiengesellschaft is called and will also be referred to hereinafter as "Aufsichtsrat", see § 111(1) AktG.

¹²⁶⁵ The shareholders' meeting is called and will also be referred to hereinafter as "Hauptversammlung", see § 118(1) AktG.

¹²⁶⁶ See § 119(2) AktG.

¹²⁶⁷ See § 111(4) Sentence 1 AktG.

¹²⁶⁸ See § 111(4) Sentence 2 AktG.

¹²⁶⁹ See § 101 AktG. The ordinary meeting of shareholders is called and will be referred to hereinafter as "Hauptversammlung". The exact composition of the Aufsichtsrat is regulated by §§ 95, 96 AktG in connection with several laws of co-determination. Once a certain threshold is met, the law requires the representation of employees in the Aufsichtsrat.

¹²⁷⁰ See § 84(1) AktG. The Aufsichtsrat is obliged to remove the members of the Vorstand if the shareholders pass a motion of no confidence against the Vorstand, see § 84(3) AktG.

¹²⁷¹ See Butler, *supra* note 1257 at 566.

renewal, each of which also must not exceed a term of five years.¹²⁷² As has also been pointed out earlier with regards to Canadian executives,¹²⁷³ the appointment as member of the Vorstand must be distinguished from the individual executive service contract between the individual and the Aktiengesellschaft, which determines the contractual rights and duties of both parties, especially the executive compensation and, eventually, severance and “golden parachute” provisions.¹²⁷⁴ In Germany, it is a general rule that members of the Vorstand are employed for a fixed-term of five years, representing the maximum period of initial appointment as member of the Vorstand.¹²⁷⁵ Accordingly, if a German executive is removed without due cause by the Aufsichtsrat prior to the end of his five-year appointment period, he will in most cases be contractually entitled to the compensation for the remainder of the fixed term of service.¹²⁷⁶

The most important feature of the German two-tier regime is that the law, in contrast to the Canadian regime, requires that the Aufsichtsrat be comprised only of individuals independent from management.¹²⁷⁷ More precisely speaking, the members of the Aufsichtsrat must not act in any executive capacity for the management of the Aktiengesellschaft. By that, the law not only encourages the independence of the Aufsichtsrat with regards of its functions to monitor and supervise the Vorstand of the Aktiengesellschaft, it also attempts to prevent any conflicts of interests in connection with any kind of contract the executive would have to conclude with the Aufsichtsrat acting on behalf of the Aktiengesellschaft. Given the function of the Aufsichtsrat to set the executive compensation and decide whether or not to remove the members of the Vorstand, there will be no direct possibility for a member of the Vorstand to enter into such an arrangement with himself. However, other self-dealing transactions like general contracts for services still remain possible even under German corporate law, as the Vorstand would enter into those contracts in his dual capacity as representative organ for the Aktiengesellschaft as well as individual contractor.

¹²⁷² See § 84(1) AktG.

¹²⁷³ *Supra* at Chapter 2, I. 1. a).

¹²⁷⁴ The executive service contract represents a “Dienstvertrag” in accordance with § 611(1) of the German Civil Code (“Bürgerliches Gesetzbuch”), of August 18, 1896, RGBL. 1896, 195, as amended.

¹²⁷⁵ *Supra* note 1272.

¹²⁷⁶ Note also that the removal of a German executive from office is not contingent to any due cause or business reason, whereas the separate executive service contract can only be terminated prematurely with cause or upon consent by the executive. The executive will most likely give his consent to early termination only in return for an executive severance package, resulting in a “golden handshake” between the Aktiengesellschaft and the executive.

¹²⁷⁷ See § 105(1) AktG.

When compared to the Canadian system, aside from the merit to effectively prevent managerial self-dealing through executive compensation or severance agreements by the exclusion of executives from serving as a member of the supervisory board, the German two-tier regime has another advantage as it prevents direct interlocks between executives and members of the Aufsichtsrat and, therefore, reduces the potential for the exercise of influence of the executive over the contents of those compensatory agreements. The German Stock Corporations Act disallows membership in the Aufsichtsrat of an Aktiengesellschaft for those individuals that are members of the Vorstand of another Aktiengesellschaft of which the Aufsichtsrat consists of at least one member of the Vorstand of the concerned Aktiengesellschaft.¹²⁷⁸ Thus, no situation is possible in which a German executive can influence members of his Aufsichtsrat to an extent that he, in his function as member of the Aufsichtsrat of a corporation of which the other is a member of the Vorstand, will grant higher compensation or more favourable severance terms in return for the same benefit granted by the other.

Clearly, the two-tier system serves as an effective means to ensure the independence of the supervisory board when exercising its functions or concluding contracts with the executives of the corporation. Therefore, in an attempt to achieve more independent decisions and control by the board of directors, one proposal for reform that should be considered by Canadian legislators is the modification of the existing governance system towards a model that prevents the simultaneous membership of both the board of directors and the management team of a Canadian corporation.¹²⁷⁹ It should be noted, though, that the German two-tier system cannot avoid the kind of influence of executives over contracts regarding their compensation, severance entitlements or other benefits arising from indirect interlocking relationships. By that, I refer to the general possibility of a member of the Vorstand to be a member of the Aufsichtsrat of another Aktiengesellschaft, provided that no direct interlocking relationship exists between both corporation as described before. For example, when the Mannesmann affair occurred the Aufsichtsrat of Mannesmann was chaired by *Dr. Joseph Ackermann*. Not only was he chairman of the Mannesmann Aufsichtsrat, but at the same time he was C.E.O. of Germany's largest financial institution Deutsche Bank AG. As chairman of the Mannesmann Aufsichtsrat,

¹²⁷⁸ See § 100(2) No.3 AktG.

¹²⁷⁹ For the U.S. market, these proposals have in the past already been made, although without success, see *supra* note 600. However, as has been noted earlier, there is now an increased tendency towards the use of independent special committees or independent outside consultants, see *supra* at Chapter 3, I. 3. b) and c).

Ackermann voted for the generous severance payments to be granted to former Mannesmann C.E.O. *Esser*. By approving such unprecedented executive severance package, *Ackermann* like any other C.E.O. in Germany is likely to indirectly benefit from that decision, as it could readily be used as reference for justification by the Aufsichtsrat of Deutsche Bank AG of a similar amount of compensation or severance offered to *Ackermann* in his capacity of C.E.O.

3. Fiduciary Duty of Corporate Insiders

Like the Canadian counterpart, German corporate law also imposes a fiduciary duty upon both members of the Vorstand and members of the Aufsichtsrat. Additionally, and here the German regime once again deviates from the Canadian regime, the law explicitly restricts the level of executive compensation to certain factors in an attempt to guarantee its reasonableness.

a) The Duty to Act in the Interests of the Business

Remarkably, other than one would expect from a civil law system, German statutory law does not contain a provision that explicitly establishes the fiduciary duty of corporate insiders to act in the best interests of the corporation. However, as a matter of case law, the fiduciary duty is also an essential corporate law principle in Germany. The German Federal Constitutional Court¹²⁸⁰ as well as the German Federal Supreme Court of Justice¹²⁸¹ have frequently confirmed that both the Vorstand and the Aufsichtsrat must always act in the interests of the business.¹²⁸² Although the courts have acknowledged that business decisions on behalf of the corporation require some range of discretion, they have imposed the restriction that the decision must not be contrary to the interests of the business.¹²⁸³

Two particularities should be noted. First, the fiduciary duty as imposed under German corporate law, does not require the act to be in the best interest, but rather in the interest of the

¹²⁸⁰ "Bundesverfassungsgericht". The leading decisions are *BVerfGE* 34, 103 at 112 and *BVerfGE* 50, 290 at 374.

¹²⁸¹ "Bundesgerichtshof". The leading decisions are *BGHZ* 36, 296 at 306, 310 and *BGH NJW* 1079, 1823 at 1826.

¹²⁸² See also Kersten von Schenk in Johannes Semler and Kersten von Schenk, eds., *Arbeitshandbuch für Aufsichtsratsmitglieder* (2nd ed., München: C.H. Beck, 2004) at § 7 no. 127; Johannes Semler and Gerald Spindler in Bruno Kropff and Johannes Semler, eds., *Münchener Kommentar zum Aktiengesetz*, vol. 3 (2nd ed., München: C.H. Beck 2004) at no. 84 before § 76; Johannes Semler in *ibid.* at § 111 no. 147; Ralph Wollburg, "Unternehmensinteresse bei Vergütungsentscheidungen. Oder: Verstieß die Zahlung der Mannesmann-Prämien gegen das Unternehmensinteresse der Mannesmann AG" (2004) *Zeitschrift für Wirtschaftsrecht* 646 (ZIP 2004, 646) at 651.

¹²⁸³ *BVerfGE* 34, 103 at 112; *BGHZ* 64, 325 at 329. See also Johannes Semler, *Leitung und Überwachung der Aktiengesellschaft: Die Leitungsaufgabe des Vorstands und die Überwachungsaufgabe des Aufsichtsrats* (2nd ed., Köln: Heymanns, 1996) at no. 50 and 57; Wollburg, *supra* note 1282 at 647. Uwe Hüffer, *Kommentar zum Aktiengesetz* (6th ed., München: C.H. Beck, 2004) at § 76 no.13 f.

business.¹²⁸⁴ Thus, German law grants wider discretion to the corporate decision-makers than does Canadian law. A decision that apparently was in the interest of the corporation will not constitute a breach of the fiduciary duty, even if it serves other interests as well. Secondly, the German version of that legal concept does not refer to the interests of the corporation, but rather to the interests of the business as such. There has been a wide-ranging legal debate among German legal scholarship about whether both interests are identical or distinct. Despite that controversy, the general understanding so far is that the notion of the interests of the business comprises a variety of distinct interests such as the interest of the corporation to remain successful in the economic markets, the interests of the shareholders to generate a maximum of shareholder wealth, the interests of creditors, employees as well as the interests of the public that the Aktiengesellschaft be a good corporate citizen.¹²⁸⁵

In recent years, German courts have shown a tendency to more carefully scrutinize the actions of both the Vorstand and the Aufsichtsrat as to the compliance with their fiduciary duties. Ever since the leading case *ARAG/Garmenbeck*,¹²⁸⁶ there have been an increasing number of judgments that held liable members of the Vorstand or the Aufsichtsrat for breaches of their fiduciary duties. Most recently, although rendered by a criminal court, the decision in the Mannesmann case also included the finding that the Aufsichtsrat had breached its fiduciary duty to act in the interests of the business with respect to the large amount of severance payments granted to the former C.E.O. Esser and other executives.¹²⁸⁷

Accordingly, without going into the particularities of the concept of the German fiduciary duty in more detail, the conclusion can be drawn for purposes of the comparative study that the decision by the Aufsichtsrat to provide the executive with a severance agreement or “golden parachute” must be in the interest of the business. In order to comply with the fiduciary duty, the judgment of the Aufsichtsrat must be two-fold. First, he must assess if an executive severance

¹²⁸⁴ The German Corporate Governance Code, *infra* note 1303, however, has adopted that principle in two different alternatives. In section 4.1.1, the Code similarly requires that the Vorstand acts in the interests of the business. Section 3.7 (2), on the other hand, contains a version slightly different from the general notion evolved from case law. With respect to decisions regarding takeovers, the Code here requires both the Vorstand and the Aufsichtsrat to act in the best interests of the shareholders and the business. The German Corporate Governance Code will be discussed in detail *infra* at 4.

¹²⁸⁵ See Hans-Joachim Mertens in Wolfgang Zöllner, ed., *Kölner Kommentar zum Aktiengesetz*, vol. 2 (2nd ed., Köln: Heymanns, 1996) at § 76 no. 16; Hüffer, *supra* note 1283 at § 76 no. 16f; Wollburg, *supra* note 1282 at 647.

¹²⁸⁶ BGHZ 135, 244 – “ARAG/Garmenbeck”, BGH NJW 1997, 1926, BGH ZIP 1997, 883.

¹²⁸⁷ LG Düsseldorf, NJW 2004, 3275, *supra* note 15.

agreement or “golden parachute” is in the interests of the business. In general, those agreements are in the interests of the business if the executive is legally entitled to compensation for a breach of contract by the corporation in terms of premature termination. With respect to “golden parachute” arrangements, as has been argued earlier, those payments can even serve interests of the business other than just compensate the executive for early termination as a result of a takeover. As a second step, whenever payments or other benefits are granted to the executive, the Aufsichtsrat is obliged to determine *how much* is in the interests of the business. As far as Canadian law is concerned, we have seen that the law generally does not impose any limits on those agreements. Only if a self-dealing corporate insider is involved, Canadian corporate law requires that the agreement be reasonable and fair for it to represent an at arm’s length negotiation. In this context, German law seems to be more restrictive than its Canadian counterpart as it imposes a general test of reasonableness for any kind of executive compensation, which is presented in the following.

b) Statutory Requirement of Reasonableness of Executive Compensation

As a special part of the fiduciary duty to act in the interests of the business, German corporate law generally limits all kinds of executive compensation to a reasonable amount. § 87 (1) AktG provides that the aggregate remuneration of any member of the Vorstand must bear a reasonable relationship to the duties of that particular member and to the financial condition of the Aktiengesellschaft. The aggregate remuneration contains general base salary as well as all other kinds of benefits for the executive.

In practice, that provision results to be of small influence when assessing executive compensation agreements. The law not only refers to the aggregate remuneration, thus making it possible that the unreasonableness of an individual part of the compensation package is compensated by another part of that package that appears to be unreasonably low, rendering the overall compensation reasonable in total. Moreover, the Aufsichtsrat also has a wide discretion, as the reasonableness of the compensation package itself is an undefined term that needs to be determined by the Aufsichtsrat at the time the decision is made. In many corporations, the Aufsichtsrat establishes compensation guidelines on the basis of which the executive compensation is granted. Notwithstanding these limitations, the legal requirement that the compensation be in a reasonable relationship to certain general criteria as well as the compliance with general legal duties of the Vorstand and the Aufsichtsrat are subject to judicial review.

c) Shareholder Remedies

The German regime for judicial review of actions or conduct of the Vorstand and the Aufsichtsrat differs entirely from the range of legal remedies available for shareholders at Canadian law. Based on a different conception of the corporation, German corporate law generally does not provide direct remedies for shareholders.

Like the Canadian corporation, the German Aktiengesellschaft is a separate legal entity.¹²⁸⁸ However, it is not regarded as a nexus of contracts between the shareholders and the management. Instead, the contractual relationships always exist directly with the Aktiengesellschaft as a legal entity.¹²⁸⁹ Accordingly, the members of the Vorstand and the Aufsichtsrat owe their duties only and directly to the Aktiengesellschaft. Only the Aktiengesellschaft as the sole beneficiary of the duties has the right to sue for respective breaches. It is irrelevant under the German doctrinal concept that a breach of duty usually has a negative impact on the value of the shares and, therefore, indirectly affects the shareholders.¹²⁹⁰ Thus, subject to limited exceptions, shareholders have no direct remedy to pursue a claim that belongs to the corporation.

In general, a claim belonging to the Aktiengesellschaft is pursued by the Vorstand on behalf of the corporation, as it constitutes a general business action of the Aktiengesellschaft.¹²⁹¹ That principle applies to claims against outsiders for breach of contract as well as for a breach of duty owed by the Aufsichtsrat or a member thereof. However, if a breach of duty by the Vorstand itself is alleged, in order to prevent conflicts of interests of the Vorstand, the law exceptionally provides an obligation for the Aufsichtsrat to decide whether an action should be brought against the Vorstand and, eventually, to pursue that claim on behalf of the corporation.¹²⁹² If, for any given reason, the Vorstand or the Aufsichtsrat refuse to pursue a claim against the Aufsichtsrat or against the Vorstand, respectively, then, and only then, do the shareholders have a chance to get directly involved. The law provides for two different ways for the shareholders to have the claim be pursued on behalf of the corporation.¹²⁹³ First, in a shareholder meeting, a simple majority of the Hauptversammlung can vote in favour of that an action will be brought. Secondly, a minority

¹²⁸⁸ See § 1(1) AktG.

¹²⁸⁹ See Butler, *supra* note 1257 at 600.

¹²⁹⁰ *Ibid.*

¹²⁹¹ See § 78(1) AktG.

¹²⁹² See § 111 AktG in connection with §§ 78, 112 AktG.

¹²⁹³ See § 147(1) AktG.

of shareholders of 20 per cent of the stated capital of the Aktiengesellschaft can require that the claim be pursued.¹²⁹⁴

Other than that, the possibility of legal proceedings against the Vorstand or the Aufsichtsrat by an individual shareholder or a minority group of shareholders is highly limited. The derivative action, which is called "actio pro socio" at German law, is only available for shareholders in very exceptional cases.¹²⁹⁵ The oppression remedy, which has turned out to be the most effective means for minority shareholders in the Canadian corporate law system, does not even exist under German law. The shortcomings of the German system for means of judicial review against the behaviour and conduct of the Vorstand and the Aufsichtsrat have been illustrated clearly in relation with the Mannesmann affair. Although the exact intentions of the shareholders in bringing criminal allegations against both the Vorstand and the Aufsichtsrat have not been revealed, there were no possibilities to claim compensation for the breaches involved in the decision-making regarding the executive severances packages by way of corporate law proceedings.¹²⁹⁶ As the public became aware of the facts only after the takeover had been successfully performed and the target company had been restructured and renamed, the former Aktiengesellschaft Mannesmann AG no longer existed as the competent entity to pursue legal action against its Vorstand and Aufsichtsrat. Thus, the only remaining way to go after the Vorstand and the Aufsichtsrat were criminal charges against those parties as individuals, breaching obligations recognized by criminal law as well.¹²⁹⁷ In light of this, there have recently been reform proposals for better protection especially of minority shareholders. However, the latest legislative initiative does not contemplate the introduction of shareholder remedies directly against the Vorstand or the Aufsichtsrat, but rather provides for the improvement of shareholder

¹²⁹⁴ This is a simplified description of the procedure required by § 147 AktG. Note that there are a number of complicated legal requirements that must be met in order for the minority shareholders to succeed with their mission. Additionally, the minority shareholders as well as the Hauptversammlung can under certain further requirements have a special representative be appointed, who pursues the claim on behalf of the Aktiengesellschaft.

¹²⁹⁵ See BGHZ 135, 244 – "ARAG/Garmenbeck", *supra* note 1286.

¹²⁹⁶ It should be noted that under German criminal law, there is a limited possibility for the court to hold a party that has been convicted of a criminal action liable for civil damages, too.

¹²⁹⁷ As a condition for a conviction of corporate insiders for criminal breach of trust, as alleged in the Mannesmann case, the court had to previously determine whether there had been breaches of obligations imposed by German civil and corporate law. The Federal Supreme Court of Justice had pointed out earlier as a fundamental principle that there can be no criminal act if the Vorstand and Aufsichtsrat have not seriously breached their duties arising from civil and corporate law, see BGHSt 47, 187 – "SSV Reutlingen".

action against resolutions of the Hauptversammlung.¹²⁹⁸ The proposal mainly focuses on the protection of minority shareholders against resolutions concerning a squeeze out of the minority, since an increased number of such cases has been experienced in the German corporate environment over the past years.

In sum, German corporate law gives little procedural protection especially for minority shareholders to pursue breaches of duties by the Vorstand and the Aufsichtsrat. Instead, the system relies on an independent Aufsichtsrat as an effective means of control and supervision of the Vorstand as the managing organ of the Aktiengesellschaft. The introduction of direct shareholder remedies like the oppression remedy might be an effective step to overcome the shortcomings of the present system with regards to enforcement of managerial obligations.

4. Disclosure

German disclosure requirements with respect to executive compensation and executive severance payments, including “golden parachute” and similar payments, are quite lax compared to the mandatory system of disclosure in North American jurisdictions. Although the German Stock Corporations Act establishes that the aggregate remuneration of each member of the Vorstand be reasonable in relation to the duties of that member and to the financial condition of the Aktiengesellschaft,¹²⁹⁹ German law only requires that the aggregate remuneration of all members of the Vorstand be disclosed in the annual accounts of the corporation.¹³⁰⁰ It also requires the disclosure of the aggregate amount of severance payments paid to former members of the Vorstand.¹³⁰¹ Unlike a Canadian corporation, however, the Aktiengesellschaft is not required to publish any details on the remuneration of each executive or reveal the types of compensation awarded to the Vorstand.

Recently though, the field of disclosure has been subject to reform as part of Germany's

¹²⁹⁸ See “Entwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG)” (January 2004), available online at <<http://www.bundesjustizministerium.de/media/archive/797.pdf>> (last accessed on March 15, 2005). The proposal had originally been scheduled to get into force as of January 1, 2005. Due to substantial criticism by the Federal Council of Germany (“Bundesrat”), however, it has not yet been passed, see press release of the German Ministry of Justice “UMAG – Regierungsentwurf” (March 9, 2005), available online at <http://www.bundesjustizministerium.de/enid/f32ae2a9129eda10b24ee6a8b3329866,0/Gesetzesentwuerfe/Corporate_Governance_jt.html> (last accessed on March 15, 2005).

¹²⁹⁹ See *supra* at 3. b).

¹³⁰⁰ See § 285 no. 9 a) of the German Commercial Code (“Handelsgesetzbuch”) of May 10, 1897, RGBI. 1897, 219, as amended, hereinafter referred to as “HGB”.

¹³⁰¹ See § 285 no. 9 b) HGB.

movements towards the North American models of corporate governance. Especially the Mannesmann affair has revealed the shortcomings of the German regime in this area. As a consequence, the German Ministry of Justice in September 2001 appointed the "Government Commission" to develop a Corporate Governance Code that, *inter alia*, had to include improved requirements for disclosure.¹³⁰² On February 26, 2002, the Commission officially adopted the German Corporate Governance Code, which then came into force on July 26, 2002.¹³⁰³ The new Corporate Governance Code works on a voluntary basis. Its provisions are intended to be guidelines directed to every Aktiengesellschaft that is listed on the German Stock Exchange.¹³⁰⁴ The only mandatory requirement introduced by the Code is the annual explanation of the Aktiengesellschaft as to whether or not or to what extent the corporation complies with the guidelines of the Code.¹³⁰⁵ In Section 4.2.2, the Code recommends that the compensation of members of the Vorstand be determined by the Aufsichtsrat on the basis of an evaluation of the executive's performance. As criteria for the reasonableness of the compensation, the Code explicitly mentions the responsibilities of the Vorstand, his personal performance as well as the economic situation of the corporation in the comparable industry, also considering potential future developments. According to section 4.2.3 of the Code, each individual component of the overall package must be reasonable by itself. The same Section requires that the general principles of executive compensation be made available on the company's web site and be explained in the annual statements. Furthermore, disclosure should be made for the compensation of each individual member of the Vorstand rather than a mere disclosure of the aggregate amount of compensation of the Vorstand as a whole, as provided by mandatory law.

With the introduction of the Corporate Governance Code as a voluntary supplement to German corporate law, German legislators had truly anticipated an increase of information provided by the corporations to the shareholders and the public, especially with regards to executive compensation. However, more than two years after the adoption of the Code, only 70% of the German corporations subject to the recommendations of the Code have in fact

¹³⁰² "Regierungskommission Deutscher Corporate Governance Kodex".

¹³⁰³ "Deutscher Corporate Governance Kodex" of February 26, 2002, as amended, available online at <http://www.corporate-governance-code.de> (last visited on March 23, 2005), referred to hereinafter as "the Code". An English version of the Code is available at <http://www.corporate-governance-code.de/eng/kodex/1.html> (last visited on March 23, 2005).

¹³⁰⁴ In addition, the Code explicitly recommends compliance with its guidelines also for stock corporations that are not listed on the stock exchange, see Section 1, "Präambel" of the Code.

¹³⁰⁵ See § 161 AktG. That obligation is commonly referred to as the duty to "comply or explain".

disclosed detailed information about the compensation of individual members of the Vorstand.¹³⁰⁶ As a result of the perceived ineffectiveness of the voluntary disclosure guidelines established by the Code, the German legislative authorities most recently proposed a legislative initiative for the mandatory, individual disclosure of executive compensation.¹³⁰⁷ The proposal establishes the requirement to disclose in the annual statements of the Aktiengesellschaft the individual components of compensation for each individual member of the Vorstand, the name of which must also be disclosed. Its explicit intention is to increase the rights of shareholders and of the Hauptversammlung by providing substantial and detailed information about the individual executive compensation packages in order for shareholders to assess the reasonableness of the remuneration.¹³⁰⁸ With regards to the existing provision of the Code, the legislators claim that the new legislative proposal is aimed at rendering the Code more effective in that individual aspect rather than replace it.¹³⁰⁹

Whereas the German Corporate Governance Commission favours the legislative approach as proposed, German top executives have immediately reacted with broad opposition against it.¹³¹⁰ *Wendelin Wiedeking*, C.E.O. of Porsche AG, has claimed that the proposed legislation would be equal to the introduction of socialism in the management boards of German corporations.¹³¹¹ Another top C.E.O., *Nikolaus von Bomhard* of Münchener Rückversicherung AG, has criticized the proposed law as problematic from a constitutional law perspective

¹³⁰⁶ See Press Release by the German Ministry of Justice (March 11, 2005) "*Eckpunkte eines Gesetzesentwurfs 'Individualisierte Offenlegung der Gehälter von Vorstandsmitgliedern von Aktiengesellschaften' vorgestellt*", available online at <http://www.bmj.de/enid/ba5a663590480ccc0b6f021398ebe2441,0/Presse/Pressemitteilungen_58.html> (last accessed on March 23, 2005). The survey pursued by the German Ministry of Justice revealed that global players such as DaimlerChrysler AG, BMW AG, BASF AG and Porsche AG declined to reveal the details of the individual compensation of members of the Vorstand, whereas large corporations such as Volkswagen AG, Telekom AG and Deutsche Bank AG complied with the recommendations of the Code, see "*Rot-Grün zwingt Manager zur Veröffentlichung ihres Gehalts*" Spiegel Online, *supra* note 2, (March 11, 2005), available online at <<http://www.spiegel.de/wirtschaft/0,1518,345859,00.html>> (last accessed on March 15, 2005).

¹³⁰⁷ "Gesetzesentwurf für die Individualisierte Offenlegung der Gehälter von Vorstandsmitgliedern von Aktiengesellschaften", see Press Release by the German Ministry of Justice, *supra* note 1306. The German Minister of Justice explicitly stated that, with the mandatory disclosure requirements as proposed, Germany follows the international developments in the U.S. and Canada.

¹³⁰⁸ See Press Release by the German Ministry of Justice (March 11, 2005) "*Individualisierte Offenlegung der Gehälter von Vorstandsmitgliedern von Aktiengesellschaften*", available online at http://www.bmj.bund.de/enid/2411dd0ee54441d73fd29ef7cac1d0fa,0/Corporate_Governance/Individualisierte_Offenlegung_von_Managergehaeltern_s9.html (last visited on March 23, 2005).

¹³⁰⁹ *Ibid.*

¹³¹⁰ See "*Dax Konzerne lehnen Veröffentlichung der Vorstandsgehälter ab*" Spiegel Online, *supra* note 2, (March 13, 2005) <<http://www.spiegel.de/wirtschaft/0,1518,346222,00.html>> (last visited on March 16, 2005).

¹³¹¹ See "*Porsche-Chef hält sein Gehalt weiter geheim*" Spiegel Online, *supra* note 2, (March 12, 2005) <<http://www.spiegel.de/wirtschaft/0,1518,346162,00.html>> (last visited on March 16, 2005).

considering the executives' personality rights.¹³¹² The proposed law is scheduled to come into force by 2006. Until then, it is likely to be in the centre of intense controversy between corporate insiders, shareholders and the public.

In conclusion, the German legal system has adopted the Corporate Governance Code as a means to improve disclosure of information towards shareholders. However, being a voluntary system at present with a considerable number of corporations not complying with all of the recommendations, the German regime results in being less effective than the Canadian regime in providing information on which to assess agreements between the management and the supervisory board.

5. Special Takeover Legislation with Respect to "Golden Parachutes"

As far as "golden parachute" provisions are concerned, German law has recently adopted amendments to special takeover legislation that serve as constraints on those payments. In addition, there exists legislation by the E.U. that deals with the obligations of management in special takeover situations.

a) The New German Takeover Law

In Germany, "golden parachute" payments to executives came to the attention of shareholders and the public in connection with the Mannesmann affair. In general, the different unprecedented issues involved in the takeover deal between Vodafone and Mannesmann led to legislative initiatives in the field of corporate takeovers. In 2001, only one year after the Mannesmann deal had been concluded, Germany introduced special takeover legislation.¹³¹³ Ever since then, the term "golden parachute" is being used by German legal scholarship as a reference to special payments that in view of their amount might serve as a defensive measure against takeovers, regardless of their further characteristic as a general severance provision for

¹³¹² See "*Münchener-Rück-Chef hat Angst vor Kidnappern*" Spiegel-Online, *supra* note 2, (March 15, 2005) <<http://www.spiegel.de/wirtschaft/0,1518,346534,00.html>> (last visited on March 15, 2005). Von Bomhard even fears that members of Vorstand be targets for kidnapping once details of their compensation are individually disclosed.

¹³¹³ "Wertpapiererwerbs- und Übernahmegesetz" of December 20, 2001, BGBI. I 2001, 3822, as amended, available online at <http://bundesrecht.juris.de/bundesrecht/wp_g/> (last accessed on March 15, 2005), hereinafter referred to as "WpÜG".

executives who lose their job as a result of a change in control.¹³¹⁴

The new law does not prohibit “golden parachute” provisions in general. Instead, it imposes a duty of neutrality upon the Vorstand of an Aktiengesellschaft that has become the target of a takeover.¹³¹⁵ According to the law, the duty of neutrality applies at the time the decision of an offeror to make a takeover bid has been published pursuant to the law.¹³¹⁶ In general, from that point of time on, the Vorstand of the target corporation must not take any action that is likely to prevent the success of the takeover.¹³¹⁷ It is essential to note that the law does not refer to the intentions, but rather on the potential implication of the action. Thus, all actions that are likely to have the effect of a defensive measure, including “golden parachute” provisions, constitute a breach of the duty of neutrality.

However, as an exception to the rule, any action that actually serves as a defence measure will not constitute a breach of the duty of neutrality if the Aufsichtsrat of the target corporation has consented to the action.¹³¹⁸ Since the Aufsichtsrat is the competent organ to provide the Vorstand with a “golden parachute” provision, be it in the original executive service contract or by way of a subsequent amendment in light of the takeover bid, the takeover law does not disallow the provision of “golden parachute” payments in any way. However, in accordance with their fiduciary duty, the corporate insiders still have to consider whether the contemplated agreement or provision serves the interests of the business.¹³¹⁹ That might, for example, not be the case if a “golden parachute” payment actually causes the takeover bid not to succeed, although the takeover would have been to the corporation’s benefit, given the circumstances of the specific case.

As a result, the new German law on takeovers does not necessarily constrain the behaviour

¹³¹⁴ See Heribert Hirte, *Kölner Kommentar zum WpÜG* (Köln: Heymanns, 2002) at § 33 no. 59; Klaus J. Hopt, “Verhaltenspflichten des Vorstands der Zielgesellschaft bei feindlichen Übernahmen – Zur aktien- und übernahmerechtlichen Rechtslage in Deutschland und Europa” in *Festschrift für Lutter* (Köln: Otto Schmidt, 2000) 1361 at 1389; Wolfgang Richter in Johannes Semler and Rüdiger Vollhard, eds., *Arbeitshandbuch für Unternehmenübernahmen* (München: C.H. Beck, 2001) at § 52 no. 163; Andreas Schwennicke in Stephan Geibel and Rainer Süßmann, eds., *Wertpapiererwerbs- und Übernahmegesetz. Kommentar* (München: C.H. Beck, 2002) at § 33 no. 34.

¹³¹⁵ § 33(1) Sentence 1 WpÜG.

¹³¹⁶ A similar provision is contained in Section 3.7 of the German Corporate Governance Code, *supra* note 1303.

¹³¹⁷ As an exception to the rule, the Vorstand is not prevented from looking for concurring offers in the market, see § 33(1) Sentence 2 WpÜG.

¹³¹⁸ For a detailed discussion of that exception, see Hartmut Krause, “Prophylaxe gegen feindliche Übernahmeangebote” (2002) *Die Aktiengesellschaft* 133 (AG 2002, 133) at 143.

¹³¹⁹ If the Aktiengesellschaft has agreed to comply with the Corporate Governance Code, the action must even be in the best interests of the shareholders and the business, see Section 3.7 of the Code, *supra* note 1303.

of corporate executives in trying to benefit from their position by entering into generous “golden parachute” agreements. Instead, if the Aufsichtsrat agrees to conclude such an agreement, neither the Vorstand nor the Aufsichtsrat will be in breach of the duty of neutrality, notwithstanding their obligations to comply with other corporate law duties such as the fiduciary duty.

b) The European Takeover Directive

As a Member State of the E.U., Germany’s law is subject to E.U. Law. In general, if E.U. law differs from the law of a Member State, E.U. law overrides that national law to the extent of the inconsistency. Thus, German law has always been analyzed in consideration of, if any, existing E.U. law.

In the field of corporate takeovers, the E.U. had for a long time intended to provide general regulation for the Member States. In July of 2001, after twelve years of negotiations between the European Parliament and the Council, a first proposal for a directive on takeover bids was finally rejected by Parliament.¹³²⁰ Following the rejection of the proposal, the European Commission set up a working group with the task of resolving discrepancies and presenting a new proposal. After another three years of negotiations, on April 21, 2004, the European Parliament and the Council approved the new proposal, which was published on April 30, 2004, and came into effect on May 20, 2004.¹³²¹ As so-called secondary law, the E.U. Takeover Directive does not apply directly as national law in the Member States.¹³²² Instead, each Member State now has to implement it as national legislation by May 20, 2006.¹³²³ Since Germany already has introduced national legislation on the subject of takeover bids,¹³²⁴ it is now obliged to guarantee that the national legislation does not conflict with the standards imposed by the E.U. Takeover Directive. For the purpose of this thesis, I will limit the analysis of the E.U. Takeover Directive to the duties it imposes on the Vorstand and the Aufsichtsrat of a German Aktiengesellschaft that has become the target of a takeover, with special focus on “golden parachute” provisions as potential

¹³²⁰ For a detailed background and the exact reasons for the rejection, see the official summary of legislation on takeover bids provided by the E.U., available online at <<http://europa.eu.int/scadplus/leg/en/lvb/I26012a.htm>> (last visited on March 16, 2005).

¹³²¹ Directive 2004/25/EC of the European Parliament and of the Council of April 21, 2004 on takeover bids, Official Journal L 142, 30/04/2004 P. 0012-0023, available online at <http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32004L0025&model=guichett> (last visited March 16, 2005), hereinafter referred to as “E.U. Takeover Directive”.

¹³²² According to E.U. law, a Directive only has direct legal effect in the exceptional case that a Member State has failed to adopt the Directive through national legislation within the period of time offered for that adoption.

¹³²³ See Article 22 of the E.U. Takeover Directive, *supra* note 1321.

¹³²⁴ WpÜG, *supra* note 1313.

defence tactics.

The E.U. Takeover Directive establishes minimum guidelines for the conduct of takeover bids and seeks to provide an adequate level of protection for all security holders involved in such transactions.¹³²⁵ As a general principle, Article 3, Section 1 (a) of the E.U. Takeover Directive establishes that the board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid. More specifically, Article 9 of the E.U. Takeover Directive sets out the obligations of the board of a company that has become target of a takeover.¹³²⁶ The Member States must ensure that rules are in force requiring that, at the latest, after the announcement of the bid, and until the result of the bid is made public or the bid lapses, the board of the offeree company should not take any action other than seeking alternative bids that may result in the frustration of the offer, unless the board has the prior authorization of the general meeting of the shareholders given for this purpose. Additionally, any decisions taken prior to this period but not yet partly or completely implemented also require shareholder approval if the decision was outside the normal course of business and its implementation may result in the frustration of the takeover bid.

In this context, Article 12 of the E.U. Takeover Directive is of importance. The provision grants the Member States an option to opt out of the provisions of Article 9. This would generally allow corporations to take defensive measures to frustrate the takeover bid without prior shareholder approval even after the bid has been made public. The opt-out provision is likely to increase protectionism across the E.U. and will impede the attempts for the achievement of a uniform takeover regime throughout the E.U. For example, if the United Kingdom required Article 9 to be applied for all U.K.-based companies but Germany did not require the application of Article 9 for its corporations, a U.K. target company would not be allowed to adopt takeover defensive actions without prior approval from its shareholders, whereas a German target corporation would be able to. Although there has not yet been an official statement as to whether Germany will in fact decide to opt out of that provision, it is quite likely that it will do so, taking into consideration the more liberal provisions Germany has recently adopted as national law. § 33 WpÜG, as has been described earlier, only requires the approval of the Aufsichtsrat if the

¹³²⁵ See the preliminary considerations (1) through (9) of the E.U. Takeover Directive, *supra* note 1321.

¹³²⁶ With regards to a two-tier board structure as it exists in Germany, Article 9, Section 6 of the E.U. Takeover Directive, *supra* note 1321, clarifies that in this case the obligations are owed by both the management board such as the Vorstand and the supervisory board in terms of the Aufsichtsrat.

Vorstand wants to take defensive measures against the takeover. Accordingly, at the time the E.U. Takeover Directive must be officially implemented by Germany, German law will not be in breach of European law if Germany opts out of the provisions of Article 9.

Apart from the obligations of the Vorstand and the Aufsichtsrat, the E.U. Takeover Directive in Article 10 contains several requirements for the disclosure of information in relation to the takeover bid. Article 10, Section 1 (k) requires the disclosure of information about any agreements between the company and its board members providing for compensation if they resign or are terminated without cause, i.e. merely because of the takeover. Thus, any “golden parachute” arrangements or similar severance agreements that are contingent on the takeover of the corporation and legally permissible under E.U. or, in the case of an opt-out, under German law, will have to be disclosed in the annual report of the Aktiengesellschaft.

6. Tax Law

Like the Canadian system, German tax law does not establish legal provisions aimed to serve as a cap on executive compensation in general or severance packages and “golden parachutes” in particular either. Based on the findings of this thesis so far, I can only conclude that both Canada and Germany should refrain from imposing explicit caps on any kind of compensation subject to negotiations between the board and the executive, be it indirectly through tax law provisions or directly through general corporate law provisions.

Concerning a cap that is imposed through tax law, such provision is not capable of ensuring that the board of directors acts in the best interests of the corporation. In the U.S., for example, the tax law provision of § 280 IRA¹³²⁷ is used for the purpose of discouraging the “golden parachute” and similar executive agreements.¹³²⁸ As I have argued, depending from the circumstances in the particular case, “golden parachutes” can actually benefit the corporation and its shareholders. They have the potential to help reduce the conflict of interest between the shareholders and the executives arising from a takeover bid and can be an effective inducement for the executive to pursue future actions in the best interests of the corporation and its shareholders. If offered from the outset, “golden parachute” provisions can also be an efficient device for attracting and retaining executives, providing substantial financial insurance against potential termination as a result from a change in control.

¹³²⁷ See *supra* at Chapter 3, II. 5. b) (2).

¹³²⁸ See Wolk, *supra* note 176 at 127.

Apart from avoiding caps by tax law, regulators should generally refrain from introducing rigid caps for executive compensation and severance packages. Such a cap has the disadvantage of implying that a certain level of payment will be regarded as reasonable. This might cause the contracting parties to totally avoid negotiations and simply agree on the highest amount permissible under the cap provision, disregarding the general obligation to only conclude a contract that represents the best interests of the corporation, i.e. one that is reasonable. Where a cap is established, on the other hand, the particularities might require that an arrangement be made that exceeds the limit in order to serve the best interests of the corporation. If the contracting parties were limited to the cap, this would constitute a limitation not only to the parties' freedom to contract, but also to the fiduciary duty of loyalty. Also, such cap would disregard the impacts of the different economic factors that are regarded as the predominant mechanisms for constraints on unfair influence over the bargaining process. Where a cap implies that a certain amount represents a fair deal, the parties will not have to fear the consequences of the relevant markets as a mechanism to bring potential discrepancies into equilibrium. Thus, rather than focussing on regulatory movements in terms of limiting executive severance agreements and "golden parachute" provisions to a certain degree, both Canadian and German legislators should rely on the means available to ensure that the contracting parties obey their respective duties and obligations when exercising their bargaining powers on the basis of their freedom to contract.

IV. Conclusion and Chapter Summary

Conclusively, the comparative analysis of the German and the Canadian system has shown that there are similarities and differences in the models that these jurisdictions apply to govern contracts between an executive and the corporation.

In Canada, the potential of managerial self-dealing is higher than in Germany, since the Canadian system encourages the presence of inside directors and allows self-dealing transactions. Acting in a dual capacity as executive and director of the corporation, inside directors have the power to divert corporate assets through special executive agreements. In Germany, by contrast, the board structure is two-tiered. Members of the management (Vorstand) are distinct and independent from the members of the supervisory board (Aufsichtsrat). That structure serves to reduce the potential for conflicts of interests of corporate executives who enter into contract with their corporation.

Neither of the systems explicitly limits the possible extent of executive compensation or

severance packages or “golden parachute” provisions. Instead, economic market factors are believed to serve as constraints on the level of such payments. Also, as part of the fiduciary duty, both jurisdictions require those agreements to be reasonable and fair arm’s length contracts. Whereas the fiduciary obligations in Canada are owed to the corporation, the German notion is that they are owed rather to the business. In both cases, though, it will primarily be the interests of the shareholders that need to be taken into account. Here, the Canadian system is more restrictive as it requires that the decision must be in the best interests of the corporation rather than just in the interests of the business as is the case in Germany.

In both regimes, certain regulatory steps have recently been taken to improve the level of information available for shareholders as a necessary condition for shareholder action. Canada and Germany have both adopted voluntary corporate governance guidelines that recommend the disclosure of compensation and severance agreements. Furthermore, Canada is presently considering several enhancements of its corporate governance guidelines on disclosure, which are also expected to set out a voluntary standard of disclosure. In addition to that, Canada has also introduced mandatory disclosure rules through securities legislation. In Germany, recent developments have proven the ineffectiveness of voluntary disclosure rules. Despite current outrage among German executives, it can be expected that German legislation will introduce mandatory disclosure of executive compensation in the near future.

The choices for judicial review of executive agreements are essentially distinct in both countries. With the derivative action and the oppression remedy, Canada gives shareholders two direct remedies to pursue alleged breaches of duty by corporate insiders. In practice, the oppression remedy has appeared to be the more powerful remedy, since it does not face the same procedural obstacles as the derivative suit. In Germany, on the other hand, shareholders are mostly limited to relying upon either the Vorstand to pursue legal action against the Aufsichtsrat or, respectively, upon the Aufsichtsrat to go after the Vorstand on behalf of the Aktiengesellschaft. Direct shareholder action, in contrast, is not available at German corporate law. A minority of at least 20% of the shareholders, however, can solicit that an action is brought on behalf of the corporation.

Neither Canadian nor German legislation generally disallows the use of “golden parachutes”. When used as a means to compensate for a breach of contract occurred in connection with a takeover or similar change in control, “golden parachutes” are used for legitimate business purposes. However, they must be the result of a fair and reasonable arm’s length bargaining process and must not be for an unreasonable amount. “Golden parachutes” can

also be legally used as defensive measures in both, Germany and Canada. If Germany decides not to opt-out of Article 9 of the E.U. Takeover Directive, "golden parachutes" will be subject to prior shareholder approval in the future because of their potential to influence the takeover negotiations.

In conclusion, the Canadian regime appears to be sufficiently capable of dealing with shareholder concerns about excessive executive severance and "golden parachute" packages. Although Canada should contemplate as a proposal for reform the change to a two-tier board system, it has already moved to more independence of the board by certain requirements for independent committees or the voluntary use of external independent consultants. The remaining potential for managerial self-dealing is addressed by an effective system of disclosure and subsequent shareholder action. Aggrieved shareholders, who feel that certain executive agreements are the result of a breach of duty, unfair or unreasonable, can achieve judicial review mainly through the oppression remedy. In light of this, no further regulatory steps should be considered, such as the introduction of statutory caps on executive severance packages or "golden parachute" payments, as this would impose a substantial limit on the exercise of the duty to assess the fairness and reasonableness of such payment in the particular circumstances of each case. Germany, in turn, can learn its lesson from Canada. The two-tier board system cannot completely prevent the influence of executives over members of the Aufsichtsrat, especially that caused by indirect interlocks in the market. In an attempt to increase minority shareholder protection, Germany should contemplate the adoption of the oppression remedy, which has resulted in being a powerful remedy for aggrieved minority shareholders of Canadian corporations.

CONCLUSION

Whereas the increasing level of executive compensation packages have frequently been subject to empirical and academic research over the last decades, executive severance packages have only recently been brought to public attention. Outrage has been experienced in the U.S., Canada and European countries. Especially the German Mannesmann affair has called for legal scrutiny of the legitimacy of "golden handshakes" and "golden parachutes" to corporate executives.

In this thesis, I have accordingly examined the legal framework for executive severance packages as it exists in Canadian law. My analysis has focused on the main areas of law that govern the severance agreements between the executive and the corporation: contract law, employment law, and corporate law, including supplementary laws and regulation.

My survey of Canadian contract law has shown that there are two alternatives for the executives to ensure entitlements for severance payments. The contracting parties can either incorporate a specific severance provision in the original executive service contract concluded between the executive and the board of directors on behalf of the corporation. Given the recent market tendency to terminate executives prior to the end of the contractual term, executives are well advised to negotiate for a severance provision in order to have certainty as to their contractual entitlements in the case of their ouster. Secondly, in the absence of a valid contractual provision at the time of termination, the executive may wish to bargain a settlement agreement with the corporation that includes the respective severance entitlements in return for his consent not to sue for wrongful dismissal. In this case, in light of the level of severance agreed upon in each specific case, the agreement can also be regarded as a "golden handshake" between the executive and the corporation, although legally it simply constitutes a settlement agreement that varies the rights and obligations of both parties.

"Golden parachutes", finally, are contractual provisions that provide for special payment in the case of a takeover of the corporation. Despite the majority of "golden parachute" provisions being contingent on both a change in control of the company and the executive's early departure, they do not necessarily need to be double-triggered from a contract law perspective. As a result of the freedom of contract, the parties are basically free to conclude whatever agreement they think fits their purposes and reflects their bargaining power.

CONCLUSION

Based on my findings with regards to contract law, I have attempted to relate executive severance packages to Canadian employment law with an intention to locate certain limits as to the level of executive severance. Instead, the study of the law of wrongful dismissal has revealed that executives who are terminated prematurely by the corporation have certain minimum entitlements for severance. The law imposes the general requirement that termination without due cause is subject to reasonable notice. Accordingly, an executive who does not have the benefit of a pre-determined termination and severance clause, is entitled to be terminated upon reasonable notice or, alternatively, to receive severance pay in lieu of notice. Since employment law does not establish strict rules as to the length of the notice, both parties need to assess the relevant notice period and the respective amounts of severance pay. This uncertainty is likely to lead to a settlement agreement that provides for an executive severance package of a level that appears sufficient to both parties to finally settle all contractual claims and avoid costly litigation for wrongful dismissal. Consequently, employment law calls for minimum levels of severance and, on the other hand, does not establish any maximum restrictions on the parties' freedom of contract with regards to the overall level of the executive severance package.

Thirdly, the thesis has focused on corporate law and supplementary regulations and their impact on executive severance packages. Analyzing the governance structure of the Canadian corporation, I have identified reasons to believe that executives have substantial power to influence not only their general compensation package, but also the terms of severance and "golden parachute" provisions. Although the majority of Canadian corporations are not widely-held like their U.S. counterparts, their board structure allows executives to also serve as directors of the corporation, which may cause severe conflicts of interests.

The present one-tier board structure encourages managerial self-interested behaviour and gives executives substantial discretion to reward themselves. One form of self-dealing can be the diversion of corporate assets through excessive severance or "golden parachute" arrangements that are remote from optimal contracting. Although the law imposes the fiduciary duty of loyalty to act honestly and in the best interests of the corporation, corporate law cannot efficiently prevent executives from pursuing private goals rather than the best interests of the corporation. By way of a comparison with the German board structure, I have argued that Canadian corporate law could reduce the potential for conflicts of interests inherent in board decisions by introducing a two-tier board structure that strictly separates the functions of management and supervision of the corporation.

On the other hand, the assessment of the Canadian legal regime has shown that Canadian

CONCLUSION

shareholders can effectively oppose alleged managerial self-dealing in the form of excessive executive severance packages. Recently, Canada has improved its disclosure requirements with respect to executive compensation and severance as well as "golden parachute" arrangements in an attempt to render the decision-making process more transparent for shareholders and the public in general. Both mandatory securities regulation and voluntary corporate governance guidelines for issuing corporation have the potential to furnish sufficient information to allow shareholders to review the process and, most importantly, the outcome of the bargaining process between the corporation and the executive.

Once shareholders have identified unauthorized self-dealing or other managerial conduct they believe to be oppressive, the law provides for the oppression remedy as an effective measure to challenge executive severance or "golden parachute" packages. Regardless of the simultaneous availability of the statutory derivative action, recent case law in Canada has proven that the oppression remedy indeed is a powerful remedy especially for minority shareholders. Another conclusion of my comparative study has therefore been that Germany should consider introducing a remedy such as the oppression remedy into their corporate law statutes enabling minority shareholders to efficiently raise their concern against certain decisions of their board, even though the potential for direct self-dealing is less prevalent in German corporations. Finally, while recent regulatory movements have concentrated on limiting the diverging interests of shareholders and corporate insiders by establishing more stringent mechanisms of monitoring the board and the management in terms of improvement of disclosure requirements and shareholder remedies, I have also argued that future considerations should abstain from imposing explicit limits on executive severance packages. Particularly, Canada should not contemplate introducing a cap on those arrangements, be it directly through corporate law provisions or indirectly through tax law provisions as is the case in the U.S.

The analysis of the Canadian corporate law structure using a nexus of contracts theoretical approach implies that the parties are basically free to negotiate for their own purposes and that corporate law rules simply serve as a supplement indicating the contracts the majority would apply in their corporate endeavour that is, to some extent, influenced by several economic market forces. In this respect, my analysis of the available types of market mechanisms that might serve as a means of achieving optimal executive severance contracts indicates that they all suffer from some limitations on their ability to do so. Accordingly, I conclude that some corporate law rules are necessary in order to achieve optimal results. However, strict limits on the amounts of severance packages imposed through corporate law would interfere with the general freedom of

CONCLUSION

contract to negotiate for what can reasonably be regarded as being in the best interests of the corporation, given that the interests may vary in the particular circumstances. Especially in the field of executive severance agreements, any step of reform must take into account that severance packages to a large degree reflect the remaining entitlements under the executive compensation package. Thus, a possible starting point for future considerations should be a general reform of the structure of executive compensation rather than the introduction of limits on executive severance packages. First approaches in this area have already focused on more stringent incentive-based systems of compensation for performance. If voluntary guidelines on performance-based components of the overall compensation package are ineffective in practice, regulators could consider the introduction of express legal provisions that relate the executive compensation package to performance, thus creating incentives for the executives to maximize shareholder value and not to divert corporate assets to themselves.

Notwithstanding the difficulties in establishing an efficient performance-based compensation structure in practice, any resulting limits on the level of executive compensation provided by that reform will automatically have important implications for future executive severance packages, as they will still consist to a large degree of a compensation package reflecting entitlement for the remainder of the contractual term. In the optimal case of absence of any kind of self-dealing, the executive severance package will only constitute the level of severance the executive is entitled to receive under the law of wrongful dismissal. If the structure of executive compensation in general can be accepted as providing reasonable compensation, then such an executive severance package cannot be regarded as being "excessive".

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TABLE OF CASES

<i>2475813 Nova Scotia Ltd. v. Rodgers</i> (2001), 13 B.L.R. (3d) 1 (N.S.C.A.)	114
<i>347883 Alberta Ltd. v. Producers Pipelines Inc.</i> (1991), 3 B.L.R. (2d) 237, 80 D.L.R. (4th) 359 (Sask. C.A.).....	131
<i>369413 Alberta Ltd. v. Pocklington</i> (2000), 194 D.L.R. (4 th) 109 (Alta. C.A.).....	115
<i>484887 Alberta Inc. v. Faraci</i> (2002), 27 B.L.R. (3d) 110, 4 Alta. L.R. (4 th) 154 (Alta. Q.B.)..	142
<i>820099 Ontario Inc. v. Harold E. Ballard Ltd.</i> (1991), 3 B.L.R. (2d) 123 (Ont. Ct. (Gen.Div.))	115, 124, 146, 199, 203
<i>Aberdeen Railway Co. v. Blaikie Bros.</i> (1854), [1843-60] All E.R. Rep. 249 (H.L.)	116
<i>AC Acquisitions Corp. v. Anderson, Clayton & Co.</i> , 519 A.2d 103 (Del. Ch., 1986).....	145
<i>Act Enterprises Ltd. v. Cliger Construction Ltd.</i> (2001), A.C.W.S. (3d) 409 (B.C.S.C.)	201
<i>Addis v. Gramophone Co.</i> [1909], A.C. 488 (H.L.).....	82
<i>Addison v. M. Loeb Ltd.</i> (1986), 25 D.L.R. (4 th) 151 (Ont. C.A.)	80
<i>Algonquin Mercantile Corp. v. Cockwell</i> (1997), 43 B.L.R. (2d) 50 (Ont. Ct. (Gen. Div.)).....	114
<i>American Reserve Energy Corp. v. McDorman</i> (1998), 48 B.L.R. (2d) 167 (Nfld. T.D.).....	201
<i>Ames v. Investo-Plan Ltd.</i> , [1973] 5 W.W.R. 451 (B.C.C.A.).....	192
<i>Anangel Atlas Compania Naviera S.A. v. Ishikawajima-Harima Heavy Industries Co. Ltd.</i> (No.2), [1990] 2 Lloyd's Rep. 526.....	55
<i>Angus v. R. Angus Alberta Ltd.</i> (1988), 39 B.L.R. (Alta. C.A.), reconsideration refused (1988), 62 Alta. L.R. (2d) 33 (Alta. C.A.), additional reasons (1988), 63 Alta. L.R. (2d) 33 (Alta. C.A.).....	182
<i>Ansari v. B.C. Hydro & Power Authority</i> (1986), 2 B.C.L.R. (2d) 33 (B.C.S.C.), affirmed 1986 B.C.J. No. 3006 (B.C.C.A.)	67, 69, 81
<i>Antonacci v. The Great Atlantic & Pacific Co. of Canada Ltd.</i> (1998), 35 C.C.E.L. (2d) 1 (Ont. Ct. (Gen. Div.))	83
<i>Appotive v. Computrex Centres Ltd.</i> (1981), 16 B.L.R. 133 (B.C.S.C.).....	196
<i>Arcand v. Denharco Inc.</i> (1996), 32 C.C.E.L. (2d) 24 (Que. S.C.)	67
<i>Armstrong v. Arbour</i> , [1994] B.C.J. No. 2562 (QL) (B.C.S.C.).....	196
<i>Arnot v. General Wire & Cable Co.</i> (1982), 2 C.C.E.L. 208 (Ont. H.C.J.).....	77
<i>Aronson v. Lewis</i> , 473 A.2d 805 (Del. S.C., 1984).....	121, 144, 145
<i>ASI Holdings Inc., Re</i> (1996), 28 B.L.R. (2d) 74 (Nfld. S.C.).....	115
<i>Assouline v. Ogivar Inc.</i> (1991), 39 C.C.E.L. 100 (B.C.S.C.).....	65
<i>Atlas Supply Co. of Canada v. Yarmouth Equipment Ltd.</i> (1991), 103 N.S.R. (2d) 1 (N.S.C.A.), leave to appeal to S.C.C. granted (1991), 108 N.S.R. (2d) 270n (S.C.C.), appeal to S.C.C. discontinued April 1, 1992.....	42
<i>B.D.C. Ltd. v. Hofstrand Farms Ltd.</i> , [1986] 1 S.C.R. 228 (S.C.C.).....	139

TABLE OF CASES

<i>Baehr v. Penn-O-Tex Oil Corp.</i> , 258 Minn. 533 at 539, 104 N.W.2d 661 (1960)	53
<i>Baker v. Canadian Tygard Engine Co.</i> (1922), 23 O.W.N. 81	63
<i>Baker v. United Grain Growers Ltd.</i> , [1978] 5 W.W.R. 370 (Alta. S.C.)	62
<i>Bamford v. Bamford</i> , [1970] Ch. 212 (Eng. C.A.)	127
<i>Bank of Montreal v. Dome Petroleum Ltd.</i> (1987), 54 Alta L.R. (2d) 289 (Alta. Q.B.)	200
<i>Banks, Re</i> (2003), 34 B.L.R. (ed) 292 (Ont. Sec. Com.)	142
<i>Baranowski v. Binks Manufacturing Co.</i> (2000), 49 C.C.E.L. (2d) 170 (Ont. S.C.)	70
<i>Bardal v. Globe & Mail Ltd.</i> (1960), 24 D.L.R. (2d) 140 (Ont. H.C.J.)	66, 67, 68, 81
<i>Barrett v. Crabtree</i> , [1993] 1 S.C.R. 1027, 101 D.L.R. (4 th) 66 (S.C.C.)	73
<i>Barrette v. Wabasso Inc.</i> , 1987 CarswellQue 789 (Que. S.C.)	79
<i>Bartolic v. Canada Safeway Ltd.</i> (1998), 34 C.C.E.L. (2d) 1 (B.C.S.C.)	50
<i>Basic Inc. v. Levinson</i> , 485 U.S. 224 (1988)	193
<i>Bayer v. Beran</i> , 49 N.Y.S.2d 2, 6 (Sup. Ct., 1944)	143, 144
<i>Beard v. Elster</i> , 160 A.2d 731 (Del. S.C., 1960)	120
<i>Beechwood Cemetery Co. v. Graham</i> (1996), 64 A.C.W.S. (3d) 80 (Ont. Ct. (Gen. Div.)), affirmed (1998), 41 B.L.R. (2d) 171 (Ont. C.A.)	122
<i>Bell v. Canada Development Investment Corp.</i> (1990), 32 C.C.E.L. 16, 69 D.L.R. (4 th) 178 (Ont. H.C.J.)	83
<i>Bellman v. Western Approaches Ltd.</i> (1981), 130 D.L.R. (3d) 193 (B.C.C.A.)	197
<i>Benson v. Third Canadian General Investment Trust Ltd.</i> (1993), 14. O.R. (3d) 493 (Ont. Ct. (Gen. Div.))	145
<i>Bertolo v. Bank of Montreal</i> (1986), 33 D.L.R. (4 th) 610 (Ont. C.A.)	42
<i>Besta International Corp. v. Watercraft Offshore Canada Ltd.</i> (1994), 19 B.L.R. (2d) 257 (B.C.S.C.), additional reasons at (1995), 19 B.L.R. (2d) 257 (B.C.S.C.)	50
<i>BGH NJW 1079, 1823</i>	244
<i>BGHSt 47, 187 – “SSV Reutlingen”</i>	248
<i>BGHZ 135, 244 – “ARAG/Garmenbeck”, BGH NJW 1997, 1926, BGH ZIP 1997, 883...</i>	245, 248
<i>BGHZ 36, 296</i>	244
<i>BGHZ 64, 325</i>	244
<i>Bially v. Churchill Electric</i> (1993), 78 B.C.L.R. (2d) 305 (B.C.S.C.)	201
<i>Bilodeau v. Bata Industries Ltd.</i> , [1986] R.J.Q. 531 (C.A.)	61
<i>Birney v. B.C. Automobile Association</i> , [1988] B.C.W.L.D. 1664 (B.C.S.C.), affirmed (1989), 40 B.C.L.R. (2d) 76 (B.C.C.A.)	67, 68
<i>Black v. Wilcox</i> (1977), 70 D.L.R. (3d) 192 (Ont. C.A.)	42
<i>Blackburn v. Coyle Motors Ltd.</i> (1983), 3 C.C.E.L. 1 (Ont. H.C.J.)	80
<i>Blomidon Mercury Sales Ltd. v. John Piercey's Auto Body Shop Ltd.</i> (1981), 129 D.L.R. (3d) 630 (Nfld. T.D.)	50

TABLE OF CASES

<i>Bohemier v. Storwal Int. Inc.</i> (1983), 44 O.R. (2d) 361 (Ont. C.A.)	68, 69
<i>Bonin v. R.</i> , [2000] 2 C.T.C. 2011 (T.C.C.)	172
<i>Bonisteel v. Collis Leather Co.</i> (1919), 45 O.L.R. 195 (Ont. H.C.)	127
<i>Borkovich v. Canadian Membership Warehouse Ltd.</i> (1991), 34 C.C.E.L. 42 (B.C.S.C.)	24
<i>Boyd v. Whistler Mountain Ski Corp.</i> (1990), 20 A.C.W.S. (3d) 518 (B.C.S.C.)	64
<i>Boylan v. Canadian Broadcasting Corporation</i> (1994), 3 C.C.E.L. (2d) 64 (Alta. Q.B.)	81
<i>Boyle v. Rothschild</i> (1907), 10 O.W.R. 696 (Ont. H.C.)	114
<i>Bradford Third Equitable Benefit Building Society v. Borders</i> , [1941] 2 All. E.R. 205 (H.L.) ..	192
<i>Brandt v. A. Vimridge Manufacturing Sales & Service Ltd.</i> (1998), 81 A.C.W.S. (3d) 58 (Sask. Q.B.)	35
<i>Brant Investments Ltd. v. KeepRite Inc.</i> (1987), 60 O.R. (2d) 737 (Ont. H.C.), affirmed (1991), 3 O.R. (3d) 289 (Ont. C.A.)	133, 145, 146, 148, 200, 201
<i>Brehm v. Eisner</i> , 746 A.2d 244 (Del. S.C., 2000)	73
<i>Brehm v. Eisner</i> , 746 A.2d 244 (Del. Sup. Ct., 2000), affirming in part sub nom <i>Re Walt Disney Co. Derivative Litigation</i> , 731 A.2d 342 (Del. Ch., 1998).	9
<i>Brisbois v. Casteel Inc.</i> (1983), 2 C.C.E.L. 35 (Ont. H.C.J.)	69
<i>British & Beningtons Ltd. v. N.W. Cachar Tea Co. Ltd.</i> , [1923] A.C. 48	49
<i>Brock v. Matthews Group Ltd.</i> (1988), 20 C.C.E.L. 110 (Ont. H.C.J.), varied (1991), 34 C.C.E.L. 50 (Ont. C.A.)	76
<i>Brown v. Black Clawson-Kennedy Ltd.</i> (1989), 29 C.C.E.L. 92 (Ont. Dist. Ct.)	26, 75, 80, 85
<i>Brown v. Kinden</i> (1987), 3 A.C.W.S. (3d) 185 (N.B.Q.B.), varied 89 N.B.R. (2d) 387 (N.B.C.A.)	22, 72
<i>Brown v. Law Society of Upper Canada</i> , 1997 CarswellOnt 5934 (Ont. Ct. (Gen.Div.))	83
<i>Brown v. OK Builders Supplies Ltd.</i> (1985), 11 C.C.E.L. 243 (B.C.S.C.)	61
<i>Brown v. Shearer</i> , [1995] 6 W.W.R. 68 (Man. C.A.)	73
<i>Bruce-Vaughan v. Dalmys (Canada) Ltd.</i> (1992), 40 C.C.E.L. 112 (B.C.S.C.)	80
<i>Buchanan v. Continental Bank of Canada</i> (1984), 58 N.B.R. (2d) 333 (N.B.Q.B.)	64
<i>Buckhorn Inc. v. Ropak Corp.</i> , 656 F. Supp. 209 (S.D. Ohio, 1987), affirmed 815 F.2d 76 (6 th Circ., 1987)	137, 176
<i>Buerman v. Canada (Attorney General)</i> (1996), 19 C.C.E.L. (2d) 127 (Ont. Ct. (Gen. Div.))	81
<i>Burke v. Bodewes</i> , 250 F.Supp. 2d 262 (WDNY 2003)	29, 30
<i>Burton v. MacMillan Bloedel Ltd.</i> , [1976] 4 W.W.R. 267 (B.C.S.C.)	62
<i>Bury v. Bell Gouinlock Ltd.</i> (1984), 48 O.R. (2d) 57, 12 D.L.R. (4 th) 451 (Ont. H.C.J.)	203
<i>BVerfGE</i> 34, 103	244
<i>BVerfGE</i> 50, 290	244
<i>C.I. Covington Fund Inc. v. White</i> (2000), 10 C.P.R. (4 th) 49 (Ont. S.C.J.)	203
<i>C.N.R. Norsk Pacific Steamship Co.</i> (1992), 91 D.L.R. (4 th) 289 (S.C.C.)	139

TABLE OF CASES

<i>Calmont Leasing Ltd. v. Kredl</i> , [1995] 8 W.W.R. 179 (Alta. C.A.), additional reasons [1995] 10 W.W.R. 574 (Alta. C.A.)	115, 122
<i>Campbell v. Campbell</i> (1990), 83 Nfdl. & P.E.I.R. 340 (Nfdl. U.F.C.)	42
<i>Campbell v. J.I. Case Canada</i> (1990), 75 Alta. L.R. (2d) 292 (Alta. Q.B.)	61
<i>Canada (Attorney General) v. Granell</i> (1956), 17 D.L.R. (2d) 141 (Ont. H.C.)	117
<i>Canadian Aero Service Ltd. v. O'Malley</i> , [1974] S.C.R. 592, 40 D.L.R. (3d) 371 (S.C.C.) 39, 113, 114	
<i>Canadian Bechtel Ltd. v. Mollenkopf</i> (1978), 1 C.C.E.L. 95 (Ont. C.A.)	74
<i>Canadian Dredge & Dock Co. v. R.</i> , [1985] 1 S.C.R. 662 (S.C.C.)	179
<i>Canadian Laboratory Supplies Ltd. v. Engelhard Industries of Canada Ltd.</i> (1979), 97 D.L.R. (3d) 1 (S.C.C.) varied on rehearing, [1980] 2 S.C.R. 450 (S.C.C.)	35
<i>Canbook Distribution Corp. v. Borins</i> (1999), 41 O.R. (3d) 565 (Ont. S.C.J.)	115
<i>Cannaday v. McPherson</i> (1998), 44 B.C.L.R. (3d) 195 (B.C.C.A.)	123
<i>Cannaday v. Sun Peaks Resort Corp.</i> , 1998 CarswellBC 1323 (B.C.S.C.)	122, 123, 124
<i>Cape Breton Cold Storage Co. v. Rowlings</i> , [1929] S.C.R. 505 (S.C.C.)	182
<i>Caputo v. Pfizer, Inc.</i> , 267 F.3d 181 (2d Cir. 2001)	29
<i>Card Estate v. John A. Robertson Mechanical Contractors (1985) Ltd.</i> (1989), 26 C.C.E.L. 294 (Ont. H.C.J.)	75
<i>Cardwell v. Young Manufacturer Inc.</i> (1988), 20 C.C.E.L. 272 (Ont. Dist. Ct.)	76
<i>Carey v. F. Drexel Co.</i> , [1974] 4 W.W.R. 492 (B.C.S.C.)	79
<i>Carle v. Comité Paritaire du Vêtement pour Dames</i> (1987), 22 C.C.E.L. 281 (Que. S.C.)	80
<i>Carom v. Bre-X Minerals Ltd.</i> (1998), 41 O.R. (3d) 780 (Ont. Ct. (Gen. Div.))	193
<i>Carrick v. Cooper Canada Ltd.</i> (1983), 2 C.C.E.L. 87 (Ont. H.C.J.)	65
<i>Carter v. Bell & Sons (Canada) Ltd.</i> , [1936] O.R. 290 (Ont. C.A.)	63
<i>Carveth v. Railway Asbestos Packing Co.</i> (1913), 24 O.W.R. 151 (Ont. H.C.J.)	61
<i>Cathcart v. Longines Wittnauer Watch Co.</i> (1980), 1 C.C.E.L. 287 (Ont. H.C.J.)	69, 74
<i>Chadburn v. Sinclair Canada Oil Co.</i> (1966), 57 W.W.R. (Alta. N.S.)	63, 65, 67
<i>Chang v. Simplex Textiles Ltd.</i> (1985), 6 C.C.E.L. 247 (Ont. C.A.)	69
<i>Charlton v. B.C. Sugar Refining Co.</i> , [1925] 1 W.W.R. 546 (B.C.C.A.)	61
<i>Cheetham v. Barton</i> , [1990] CarswellOnt 2975 (Ont. Dist. Ct.)	61
<i>Chilgan v. Island Lake Band No. 161</i> , [1994] 5 W.W.R. 308 (Sask. Q.B.)	51
<i>Chotani v. Westinghouse Canada Inc.</i> , 1991 CarswellQue 1397 (Que. S.C.)	69
<i>CJMS Radio Montreal Ltée. v. Audette</i> , [1996] B.R. 756 (Que. C.A.)	76
<i>Clark v. Babcock & Wilcox Canada Ltd.</i> (1981), 9 A.C.W.S. (2d) 189 (H.C.J.), affirmed 15 A.C.W.S. (2d) 40 (Ont. C.A.)	22
<i>Clemens v. Clemens Bros. Ltd.</i> , [1976] 2 All. E.R. 268 (Ch. D.)	190
<i>Clifton v. Ground Engineering Ltd.</i> (1982), 19 Sask. R. 181 (Sask. Q.B.)	76

TABLE OF CASES

<i>Colasurdo v. CTG Ing.</i> (1988), 18 C.C.E.L. 265 (Ont. H.C.J.).....	83
<i>Colborne Capital Corp. v. 542775 Alberta Ltd.</i> (1999), 69 Alta. L.R. (3d) 265 (Alta. C.A.)....	114
<i>Commission scolaire de Sept-Iles v. Club de ski Gallix</i> , D.T.E. 91T- 653 (Que. S.C.).....	61
<i>Compagnie Idéal Body Inc. v. Canada</i> , [1989] 2 C.T.C. 187 (F.C.T.D.).....	172
<i>Compagnie Noga D'Importation et D'Exportation S.A. v. Abacha</i> , [2003] EWCA Civ 1100; [2003] All E. R. (D) 400 (Jul).....	49, 50, 51
<i>Cook v. Royal Trust</i> (1990), 31 C.C.E.L. 6 (B.C.S.C.).....	69, 75, 81
<i>Cooper v. MacMillan Bloedel Ltd.</i> (1991), 56 B.C.L.R. (2d) 341 (B.C.S.C.).....	80
<i>Corporación Americana de Equipamientos Urbanos S.L. v. Olifas Marketing Group Inc.</i> (2003), 38 B.L.R. (3d) 156 (Ont. H.C.J.)	204
<i>Corriveau v. Québec (Procureur général)</i> , [1989] R.J.Q. 1 (Que. C.A.).....	75
<i>Cosman v. Viacom Entertainment Canada Inc.</i> , 2002 CarswellOnt 1569 (Ont. S.C.).....	185
<i>Côte v. Placements M & A Brown Inc.</i> , D.T.E. 87T-956 (Que. Prov. Ct.).....	64
<i>Cougle v. Maricevic</i> , [1992] 3 W.W.R. 475 (B.C.C.A.).....	42
<i>Couture v. Volcano Inc.</i> , [1984] C.S. 546 (Que. S.C.)	76
<i>Coventry v. Nipawin & District Nursing Home</i> (1981), 12 Sask. R. 40 (Sask. Q.B.).....	62
<i>Cox v. R., Paton v. R.</i> , [1963] S.C.R. 500, 40 C.R. 52, 2 C.C.C. 148 (S.C.C.).....	185
<i>Coyes v. Ocelot Industries Ltd.</i> (1984), 33 Alta. L.R. (2d) 102 (Alta. Q.B.).....	61
<i>Crighton v. Roman</i> , [1960] S.C.R. 858 (S.C.C.).....	118
<i>Cringle v. Northern Union Ins. Co.</i> (1981), 24 D.L.R. (3d) 22 (B.C.S.C.).....	68, 69
<i>Cronk v. Canadian General Insurance Co.</i> (1995), 25 O.R. (3d) 505 (Ont. C.A.).....	66, 68
<i>Crosby v. Beam</i> , 548 N.E.2d 217 (Ohio S.C., 1989).....	121
<i>CW Shareholdings Inc. v. WIC Western International Communications Ltd.</i> (1998), 39 O.R. (3d) 755 (Ont. Ct. (Gen. Div.)).....	146, 148, 150
<i>Davis v. Louisville Gas & Elec. Co.</i> , 16 Del. Ch. 157, 142 A. 654 (Del. Ch., 1928).....	144
<i>De Freitas v. Canadian Express & Transportation Ltd.</i> (1986), 16 C.C.E.L. 160 (Ont. H.C.J.).	68
<i>Deluce Holdings Inc. v. Air Canada</i> (1992), 12 O.R. (3d) 131 (Ont. Ct. (Gen. Div.))	199, 201
<i>Denham v. Patrick</i> (1910), 20 O.L.R. 347 (C.A.).....	61
<i>Dey v. Valley Forest Products Ltd.</i> (1995), 162 N.B.R. (2d) 207 (N.B.C.A.).....	66
<i>Dickinson v. Northern Telecom Canda Ltd.</i> (1985), 7 C.C.E.L. 139 (Ont. Co. Ct.)	80
<i>Diligenti v. RWMD Operations Kelowna Ltd.</i> (1976), 1 B.C.L.R. 36 (B.C.S.C.).....	121, 201
<i>Discovery Enterprises Inc. v. Ebco Industries Ltd.</i> (1997), 40 B.C.L.R. (3d) 43, 35 B.L.R. (2d) 111 (B.C.S.C.).....	199
<i>Discovery Enterprises Inc. v. Ebco Industries Ltd.</i> (1999), 70 B.C.L.R. (3d) 299, 50 B.L.R. (2d) 207 (B.C.C.A.).....	198
<i>Dixon v. Deacon Morgan McEuen Easson</i> (1989), 41 B.C.C.R. (2d) 180 (B.C.S.C.).....	141
<i>Dodd v. Churton</i> , [1897] 1 Q.B. 562	50

TABLE OF CASES

<i>Dodge v. Ford Motor Co.</i> , 170 N.W. 668, (Mich. S.C., 1919).....	144
<i>Dombrowski v. Dalhousie University</i> (1974), 55 D.L.R. (3d) 268 (N.S.S.C.), affirmed 79 D.L.R. (3d) 355 (C.A.).....	21, 71
<i>Dominion Home Improvements Ltd. v. Knuude</i> (1986), 20 C.L.R. 192 (Ont. Dist. Ct.)	42
<i>Domnelly v. B.C. Hydro & Power Authority</i> , 1986 B.C.J. No. 1722 (B.C.S.C.)	67
<i>Douglas v. Sandwell & Co.</i> , [1978] 1 W.W.R. 439, 81 D.L.R. (3d) 508 (B.C.S.C.)	67, 79, 80
<i>Dovey v. Corey</i> , [1901] A.C. 477 (Eng. H.C.).....	140
<i>Dowling v. Halifax (City)</i> (1998), 158 D.L.R. (4 th) 163 (S.C.C.).....	63
<i>Doyle v. London Life Ins. Co.</i> (1985), 23 D.L.R. (4 th) 443 (B.C.C.A.)	81
<i>Dugdale v. Yates</i> (1976), 39 M.L.R. 680	50
<i>Duha Printers (Western) Ltd. v. Canada</i> , [1998] 1 S.C.R. 795 (S.C.C.), [1998] S.C.J. No. 41...	46
<i>Dunlop v. B.C. Hydro & Power Authority</i> (1988), 32 B.C.L.R. (2d) 334 (B.C.C.A.)	63
<i>Durand v. Quaker Oats Co. of Canada Ltd.</i> (1990), 45 B.C.L.R. (2d) 354 (B.C.C.A.).....	61
<i>Durrant v. B.C. Hydro & Power Authority</i> , [1988] B.C.W.L.D. 1665 (B.C.S.C.), reviewed in part on other grounds (1990), 49 B.C.L.R. (2d) 263 (B.C.C.A.)	69, 81
<i>Dyer v. Kekinda Snyder Partnership Inc.</i> (1998), 35 C.C.E.L. (2d) 200 (Ont. Ct. (Gen. Div.))..	62
<i>Dyer v. Mekinda Snyder Partnership Inc.</i> (1998), 35 C.C.E.L. (2d) 299 (Ont. Ct. (Gen. Div.))..	71
<i>Dynamics Corp. of America v. CTS Corp.</i> , 794 F.2d 250 (7th Cir. 1986).....	56
<i>Edgington v. Fitzmaurice</i> (1885), 29 Ch. D. 459 (C.A.)	192
<i>Edward v. Reinblatt</i> , 1995 CarswellQue 1936 (C.Q.)	73
<i>Elder v. Elder & Watson Ltd.</i> , [1952] C.S. 49 (Que.).....	200
<i>Emerald Partners v. Berlin</i> , 787 A.2d 85 (Del. S.C., 2001).....	117
<i>Erlund v. Quality Communications Products Ltd.</i> (1972), 29 D.L.R. (3d) 476 (Man. Q.B.).....	72
<i>Erskine v. Viking Helicopter Ltd.</i> (1991), 35 C.C.E.L. 322 (Ont. Ct. (Gen. Div.)).....	66
<i>Essex Universal Corp. v. Yates</i> , 305 F.2d 572 (2d Cir. 1962).....	45
<i>Eurico SpA v. Phillip Brothers</i> , [1987] 2 Lloyd's Rep. 215	41
<i>Ewasiuk v. Estevan Area Home Care District 9 Inc.</i> (1985), 9 C.C.E.L. 267 (Sask. Q.B.)	64
<i>Exchange Banking Co., Re</i> (1882), 21 Ch. 519 (Eng. C.A.).....	181
<i>Exco Corp. Ltd. v. Nova Scotia Savings & Loan Co.</i> , [1987], 35 B.L.R. 149, 78 N.S.R. (2d) 91 (N.S.C.A.)	127, 128
<i>Farber v. Royal Trust Co.</i> , [1997] 1 S.C.R. 846 (S.C.C.)	64
<i>Farish National Trust Co.</i> , [1975] 3 W.W.R. 499 (B.C.S.C.).....	192
<i>Farquhar v. Butler Brothers Supplies Ltd.</i> (1988), 23 B.C.L.R. (2d) 89 (B.C.C.A.).....	64
<i>Fawcett v. Ideal Equipment Co. Ltd.</i> (1980), 3 A.C.W.S. (2d) 382 (Ont. Co.Ct.)	72
<i>Fenner v. Blake</i> , [1900] 1 Q.B. 426	50
<i>Ferguson v. Spalding Co-operative Assn.</i> (1980), 9 Sask. R. 303 (Sask. Q.B.).....	62
<i>Ferguson v. Wallbridge</i> , [1935] 3 D.L.R. 66 (P.C.)	117

TABLE OF CASES

<i>First City Financial Corp. v. Genstar Corp.</i> (1981), 33 O.R. (2d) 631 (Ont. H.C.J.).....	130
<i>First Edmonton Place Ltd. v. 315888 Alberta Ltd.</i> (1988), 60 Alta. L.R. (2d) 122 (Alta. Q.B.)	197, 201
<i>Fisher v. Jackson</i> , 142 Conn. 734 at 737, 118 A.2d 316 (1955) at 317	53
<i>Fleming v. Safety Kleen Canada Inc.</i> (1996), 20 C.C.E.L. (2d) 140 (Ont. Ct. (Gen.Div.))	81
<i>Frame v. Smith</i> , [1987] 2 S.C.R. 99, 42 D.L.R. (4 th) 81 (S.C.C.).....	112
<i>Francis v. United Jersey Bank</i> , 432 A.2d 814 (N.J.S.C., 1981)	142
<i>Frankcom v. Tandy Electronics Ltd.</i> (1984), 4 C.C.E.L. 40 (Ont. H.C.J.)	62
<i>Freeman & Lockyer v. Buckhurst Park Properties (Mangal) Ltd.</i> , [1964] 1 All. E.R. 630	35
<i>Freeman v. Barrow</i> , (1976) 427 F. Supp. 1129 (S.D.N.Y.)	135
<i>French Protestant Hospital, Re</i> , [1951] 1 Ch. 567 (Eng. Ch. Div.)	182
<i>Furry Creek Timber Corp. v. Laad Ventures Ltd.</i> (1992), 75 B.C.L.R. (2d) 246 (B.C.S.C.).....	202
<i>G & E Vending Ltd. v. 700748 Alberta Ltd.</i> (2002), 30 B.L.R. (3d) 216 (Alta. Q.B.)	114, 122
<i>Gabco Ltd. v. Minister of National Revenue</i> , [1968] C.T.C. 313 (Ex.), 2 Ex. C.R. 511 (Ex. Ct.)	171
<i>Gaillard v. Natomas Co.</i> , 208 Cal.App.3d 1250, 256 Cal. 702 (1989)	8, 176
<i>Gardner v. Rockwell Int. of Canada Ltd.</i> (1975), 9 O.R. (2d) 105 (Ont. H.C.J.)	63
<i>Gardner v. Stan-Canada Inc.</i> (1989), 13 A.C.W.S. (3d) 411 (H.C.J.), supplementary reasons 15 A.C.W.S. (3d) 348	22, 72, 75
<i>George v. Muller Sales & Services Ltd.</i> (1984), 31 Sask. R. 201 (Sask. Q.B.)	68
<i>Giannotti v. Wellington Enterprises Ltd.</i> (1997), 69 A.C.W.S. (3d) 84 (Ont. Ct. (Gen. Div.)) .	102
<i>Gibbons v. Medical Carriers Ltd.</i> (2001), 158 Man. R. (2d) 259 (Man. Q.B.), additional reasons at (2001), 161 Man. R. (2d) 198 (Man. Q.B.).....	122
<i>Gilbert Steel Ltd. v. University Construction Ltd.</i> (1976), 67 D.L.R. (3d) 606 (Ont. C.A.)... 48, 50	
<i>Gillespie v. Bulkley Valley Forest Industries Ltd.</i> (1974), 50 D.L.R. (3d) 316 (B.C.C.A.), affirming. 39 D.L.R. (3d) 586 (B.C.S.C.).....	62, 64
<i>Gillespie v. Ontario Motor League Toronto Club</i> (1980), 4 A.C.W.S. (2d) 87 (Ont. H.C.J.).....	76
<i>Gillies v. Goldman Sachs Canada Inc.</i> (2000), 49 C.C.E.L. (2d) 236, 2000 C.L.L.C. 210-029 (B.C.S.C.).....	69
<i>Giroux v. Marchildon</i> , [1926] 2 D.L.R. 900 (Que. K.B.)	182
<i>Gismondi v. Toronto (City)</i> (2003), 64 O.R. (3d) 688 (Ont. C.A.)	70
<i>Gordon Glaves Holding Ltd. v. Care Corp. of Canada</i> (1998), 38 B.L.R. (2d) 56 (Ont. Ct. (Gen.Div.)).....	201
<i>Gorman v. Westfair Foods Ltd.</i> (1996), 114 Man. R. (2d) 228, 24 C.C.E.L. (2d) 273 (Man. Q.B.)	62
<i>Goss v. Lord Nugent</i> (1833) 5 B. & Ad. 58	50
<i>Graves v. Canada</i> , [1990] 1 C.T.C. 357 (F.C.T.D.)	172
<i>Gray v. New Augarita Porcupine Mines Ltd.</i> , [1952] 3 D.L.R. 1 (P.C.)	117, 118

TABLE OF CASES

<i>Gray v. Yellowknife Gold Mines Ltd.</i> , [1948] 1 D.L.R. 74 (Ont. C.A.).....	117
<i>Gregorio v. Intrans-Corp.</i> (1994), 115 D.L.R. (4 th) 200 (Ont. C.A.), additional reasons at (1994), 15 B.L.R. (2d) 109 (Ont. C.A.).....	50
<i>Groulx v. Commission Municipale de Québec</i> , D.T.E. 90T-739 (Que. S.C.).....	21, 71
<i>Guillaume v. Stirton</i> (1978), 88 D.L.R. (3d) 191.....	50
<i>Habitations Populaires Desjardins de Lanaudière Inc. v. Boyer</i> , [1988] R.L. 315 (Que. C.A.) 68, 69	
<i>Hague v. St. Boniface Hospital</i> , [1936] 3 D.L.R. 363 (Man. Q.B.).....	72
<i>Hall v. Grassie</i> (1982), 16 Man. R. (2d) 399 (Man. Q. B.)	42
<i>Hamer-Jackson v. McCall Pontiac Buick Ltd.</i> (1998), 38 C.C.E.L. (2d) 189 (B.C.S.C.), affirmed (2000), 3 C.C.E.L. (3d) 20 (B.C.C.A.)	82
<i>Hansen v. Viking Sprinkler Co.</i> (1981), 7 A.C.W.S. (2d) 508 (B.C.S.C.).....	62
<i>Hanson Trust plc v. ML SCM Acquisition, Inc.</i> , 781 F.2d 264 (2d Cir. N.Y. 1986)	144
<i>Hasler v. Spagnol's Wine & Beer Supplies Ltd.</i> , 1991 B.C.J. No. 3853 (B.C.S.C.)	70, 76
<i>Hawkins v. Ontario</i> (1985), 8 C.C.E.L. 183 (Ont. H.C.J.)	22, 72
<i>Hedley Byrne & Co. Ltd. v. Heller and Partners Ltd.</i> , [1963] 2 All. E.R. 575 (H.L.)	192
<i>Heinz v. Cana Construction Co.</i> (1987), 55 Alta. L.R. (2d) 382 (Alta. Q.B.).....	68
<i>Heller v. Boylan</i> , 29 N.Y.S.2d 653, 667, affirmed on rehearing, 29 N.Y.S.2d 702 (Sup. Ct. 1941), affirmed, 263 A.D. 815, 32 N.Y.S.2d 131 (1941), rehearing denied, 263 A.D. 852, 32 N.Y.S.2d 1011 (1942).....	144, 145
<i>Hely-Hutchinson v. Brayhead Ltd.</i> , [1965] 3 All. E.R. 98 (Eng. C.A.).....	35
<i>Hemmingway v. South Huron & District Assn. For the Mentally Handicapped Inc.</i> (1982), 17 A.C.W.S. (2d) 242 (Ont. Co. Ct.)	62
<i>Henderson v. Canada Timber & Saw Mills Ltd.</i> (1904), 12 B.C.R. 294 (B.C.C.A.)	63, 65
<i>Henderson v. Westfair Foods Ltd.</i> (1990), 32 C.C.E.L. 152 (Man. Q.B.).....	64
<i>Hercules Managements Ltd. v. Ernst & Young</i> (1997), 146 D.L.R. (4 th) 577 (S.C.C.).....	139
<i>Hill v. Peter Gorman Ltd.</i> (1957), 9 D.L.R. (2d) 124 (Ont. C.A.).....	51
<i>Hillhouse v. Alexander Consulting Group Ltd.</i> (1989), 28 C.C.E.L. 73 (Ont. H.C.J.).....	77
<i>Hodgkinson v. Simms</i> (1994), 117 D.L.R. (4 th) 161 (S.C.C.)	112, 113
<i>Hogg v. Cramphorn Ltd.</i> , [1967] Ch. 254 (Eng. Ch. Div.).....	127, 128, 129
<i>Horton v. Rio Algom Ltd.</i> (1995), 9 C.C.E.L. (2d) 180 (Ont. Ct. (Gen. Div.)).....	69
<i>Horvath v. Joytec Ltd.</i> (1989), 27 C.C.E.L. 269 (Sask. Q.B.)	48
<i>Hovsepian v. Westfair Foods. Ltd.</i> (2001) 17 B.L.R. (3d) 291 (Alta. Q.B.).....	114
<i>Howard Smith v. Ampol Petroleum Ltd.</i> , [1974] 1 All. E.R. 1126 (P.C.).....	115
<i>Hudson v. General Dynamics Corp.</i> , 118 F.Supp. 2d 226, 233 (D. Conn., 2000)	29
<i>Huff v. Price</i> (1990), 51 B.C.L.R. (2d) 282 (B.C.C.A.).....	82, 83
<i>Hughes v. Gemini Foods Corp.</i> (1992), 45 C.C.E.L. 113 (Ont. Ct. (Gen. Div.)), affirmed (1997), 97 O.A.C. 147 (Ont. C.A.).....	83

TABLE OF CASES

<i>Hunt v. S.E. Ry</i> (1875), 45 L.J.Q.B. 87.....	49
<i>Husson v. Alumet Mfg.</i> (1991), 37 C.C.E.L. 252 (B.C.C.A.).....	73
<i>Hyslip v. MacLeod Savings & Credit Union Ltd.</i> (1988), 62 Alta. L.R. (2d) 152 (Alta. Q.B.)....	50
<i>Iacobucci v. WIC Radio Ltd.</i> (1999), 47 C.C.E.L. (2d) 163 (B.C.C.A.).....	64
<i>Imperial Hydropathic Hotel Co., Blackpool v. Hampson</i> , [1883] 23 Ch. 1 (Eng. C.A.).....	181
<i>Imperial Oil Ltd. v. Welstlake Fuel Ltd.</i> (2001), 16 B.L.R. (3d) 1 (Man. C.A.).....	114
<i>In re Brazilian Rubber Plantations and Estates, Ltd.</i> , [1911] 1 Ch. 425 (C.A.)	140
<i>Intercontinental Precious Metals Inc. v. Cooke</i> (1993), 10 B.L.R. (2d) 203 (B.C.S.C.)....	197, 198
<i>J. Nunes Diamonds Ltd. v. Dominion Electric Protection Co.</i> , [1972] S.C.R. 769 (S.C.C.)	192
<i>Jackson v. Makeup Lab Inc.</i> (1989), 27 C.C.E.L. 317 (Ont. H.C.J.).....	69
<i>Jasmin v. Jean-Luc Surprenant Inc.</i> , 1983 WL 379798 (Que. S.C.).....	76
<i>Jeffrey v. Plant Forest Products Corp.</i> (1990), 32 C.C.E.L. 237 (Sask. Q.B.)	66
<i>Jeykal v. Nova Scotia Glass Co.</i> (1888), 20 N.S.R. 388 (N.S.C.A.).....	61
<i>Johnson, Drake and Piper Int. Corp. v. Robert</i> , [1958] B.R. 378 (Que. C.A.)	64
<i>Johnston v. Algoma Steel Corp.</i> (1989), 24 C.C.E.L. 1 (Ont. H.C.J.)	68
<i>Johnstone v. Harlequin Enterprises Ltd.</i> (1991), 36 C.C.E.L. 30 (Ont. Ct. (Gen. Div.)).....	48
<i>K.L.B. v. British Columbia</i> , [2003] 2 S.C.R. 403, 230 D.L.R. (4th) 513 (S.C.C.)	113
<i>Kamloops v. Nielsen</i> , [1984] 2 S.C.R. 2 (S.C.C.)	139
<i>Keech v. Sandford</i> (1726), 25 E.R. 223 (Eng. Ch. Div.).....	181
<i>Keho Holdings Ltd. v. Noble</i> (1987), 38 D.L.R. (4 th) 368 (Alta. C.A.)	200
<i>Keith & Hastings v. Miles</i> , 39 Miss. 442 (1860)	53, 55
<i>Kelly v. Monenco Consultants Ltd.</i> , 1987 CarswellOnt 1770 (Ont. H.C.J.).....	68
<i>Kennedy v. Gescan Ltd.</i> (1991), 41 C.C.E.L. 134 (B.C.S.C.).....	69
<i>Kerbs v. California Eastern Airways, Inc.</i> , 33 Del. Ch. 69, 90 A.2d 652 (Del. S.C., 1952)	77
<i>Kerr v. Danier Leather Inc.</i> (2004), 46 B.L.R. (3d) 167, 23 C.C.L.T. (3d) 77 (Ont. S.C.J.)	192
<i>Kesselring v. United Technologies Corp.</i> , 753 F.Supp. 1359, 1362 (D. Ohio, 1991)	29
<i>Koenings v. Joseph Schlitz Brewing Co.</i> , 126 Wis.2d 349, 377 N.W.2d 593 (Wisc. 1985)8, 137	32,
<i>Kordyban v. Riso Canada Inc.</i> , 2000 BCSC 550.....	65
<i>Krela v. OrthoSoft Inc.</i> , 2001 CarswellQue 1823 (Que. S.C.).....	201
<i>Lac Minerals Ltd. v. International Corona Resources Ltd.</i> , [1989] 2 S.C.R. 574 (S.C.C.) 112, 113	
<i>Lacouvee v. McGavin Foods Ltd.</i> (1993), 47 C.C.E.L. 131 (B.C.S.C.)	64
<i>Lafayette Glass Co. v. Laplante</i> , [1967] B.R. 757 (Que. C.A.).....	72
<i>Lamberton v. Vancouver Temperance Hotel Co.</i> (1904), 11 B.C.R. 67 (B.C.C.A.)	67
<i>Land Credit Co. of Ireland v. Lord Fermoy</i> (1869), L.R. 8 Eq. 7 (U.K.).....	181
<i>Landry v. Canadian Forest Products Ltd.</i> (1991), 34 C.C.E.L. 37 (B.C.S.C.)	68

TABLE OF CASES

<i>Landry v. Comterm Inc.</i> , J.E. 84-451 (Que. S.C.).....	64
<i>Landry v. Radio du Pontiac Inc.</i> , D.T.E. 83T-200 (Que. S.C.)	22
<i>Lang v. Modern Garment Co.</i> , [1950] R.L. 296 (Que. S.C.).....	24, 63
<i>Laporte v. Sofati Ltée.</i> , [1992] 44 Q.A.C. 161 (Que. S.C.).....	72
<i>Lawrey v. Dorset House College Inc.</i> (1987), 5 A.C.S.W. (3d) 166 (B.C.S.C.)	59
<i>Leduc v. Union Carbide du Canada</i> , 1984 WL 450292 (Que. S.C.).....	79
<i>Lee v. Parking Corp. of Vancouver</i> , (1998), 56 B.C.L.R. (3d) 170 (B.C.S.C.).....	62
<i>Leerdam v. Stirling Douglas Group Inc.</i> (1999), 99 C.L.L.C. 210-027 (Ont. Ct. (Gen. Div.)) ...	70
<i>Lees v. Arthur Greaves Ltd.</i> , [1974] I.C.R. 501 (C.A.).....	48, 49
<i>Lefebvre v. Beaver Road Builders Ltd.</i> (1993), 49 C.C.E.L. 207 (Ont. Ct. (Gen. Div.))	75, 80
<i>Legion Oils Ltd. v. Barron</i> (1956), 2 D.L.R. (2d) 505 (Alta. T.D.).....	127
<i>Levy-Russell Ltd. v. Tecmotiv Ltd.</i> (1994), 13 B.L.R. (2d) 1 (Ont. Ct. (Gen. Div.)).....	120
<i>Lewis v. Vogelstein</i> , 699 A.2d 327 (Del. Ch., 1997).....	120, 126, 145
<i>LG Düsseldorf, NJW</i> 2004, 3275	2, 245
<i>Lloyds Bank v. Bundy</i> , [1974] 3 All. E.R. 757.....	42
<i>Locke v. Avco Financial Services Canada Ltd.</i> (1987), 85 N.B.R. (2d) 93 (N.B.Q.B.).....	67
<i>London & Globe Finance Corp. Ltd. (Re)</i> , [1903] 1 Ch. 728.....	183
<i>Longpré v. Carrière & Lefebvre (1978) Inc.</i> (1989), 28 C.C.E.L. 277 (Que. S.C.)	61
<i>Loveridge Holdings Ltd. v. King-Pin Ltd.</i> (1991), 5 B.L.R. (2d) 195 (Ont. Ct. (Gen. Div.)).....	203
<i>Low v. Ascot Jockey Club</i> (1986), 1 B.C.L.R. (2d) 123 (B.C.S.C.).....	201
<i>Ludlow v. McMillan</i> , [1995] 6 W.W.R. 761, 19 B.L.R. (2d) 102, 6 B.C.L.R. (3d) 163 (B.C.S.C.)	122
<i>Lyall v. 147250 Canada Ltd.</i> (1993), 84 B.C.L.R. (2d) 234, 106 D.L.R. (4 th) 304 (B.C.C.A.) .	200
<i>Lynch v. Patterson</i> , 701 P.2d 1126 (Wyo. S.C., 1985).....	121
<i>Lyonde v. Canadian Acceptance Corp.</i> (1983), 3 C.C.E.L. 220 (Ont. H.C.J.).....	74
<i>Ma v. Columbia Trust Co.</i> (1985), 9 C.C.E.L. 300 (B.C.S.C.).....	69
<i>MacDonald v. Richardson Greenshields of Canada Ltd.</i> (1985), 69 B.C.L.R. 58 (B.C.S.C.).....	61
<i>MacDonald v. White Rock Waterworks Co.</i> (1973), 38 D.L.R. (3d) 763 (B.C.S.C.).....	65, 68
<i>MacDougall v. Gardiner</i> (1875) 1 Ch. Div. 13	195
<i>Machtinger v. HOJ Industries Ltd.</i> , [1992] 1 S.C.R. 986 (S.C.C.).....	66, 70, 71, 84
<i>MacLeod v. Dominion (Town) Board of Education</i> (1958), 16 D.L.R. (2d) 587 (N.S.S.C.)..	21, 71
<i>Madden v. Dimond</i> (1906), 12 B.C.R. 80 (B.C.C.A.)	127
<i>Maddocks v. British Columbia Hazardous Waste Management Corp.</i> (1995), 52 A.C.W.S. (3d) 810 (B.C.S.C.).....	29
<i>Maduke Foods Ltd. v. Canada</i> , [1989], 2 C.T.C. 284 (F.C.T.D.).....	172
<i>Magnumsson v. Laing Property Corp.</i> (1991), 35 C.C.E.L. 248 (B.C.S.C.).....	68

TABLE OF CASES

<i>Mahoney v. Taylor</i> , [1996] B.C.J. No 1479 (B.C.S.C.).....	201
<i>Maier v. E & B Exploration Ltd.</i> , [1986] 4 W.W.R. 275 (Alta. C.A.)	48, 51
<i>Mainville v. Brasserie Michel Desjardins Ltée</i> , D.T.E. 88T-292 (Que. S.C.), appeal abandoned September 16, 1988, C.A.M. 500-09-000185-884	22
<i>Makarchuk v. Midtransportation Services Ltd.</i> (1985), 6 C.C.E.L. 169 (Ont. H.C.J.).....	83
<i>Malcolm v. Transtech Holding Ltd.</i> (2001), 12 B.L.R. (3d) 66 (B.C.C.A.)	114
<i>Manchester, Sheffield and Lincolnshire Ry. v. Brown</i> (1883), 8 App. Cas. 703	41
<i>Mandell v. Apple Canada Inc.</i> (1990), 34 C.C.E.L. 319 (B.C.S.C.).....	75
<i>Manning v. Surrey Memorial Hospital Society</i> (1975), 54 D.L.R. (3d) 312 (B.C.S.C.)	62
<i>Maple Leaf Foods Inc. v. Schneider Corp.</i> (1998), 42 O.R. (3d) 177, 44 B.L.R. (2d) 115 (Ont. C.A.).....	146, 147
<i>Marc-Jay Investments Inc. v. Levy</i> (1974), 50 D.L.R. (3d) 45 (Ont. H.C.)	197
<i>Markou v. Water Refining Co. Ltd.</i> (1980), 2 A.C.W.S. (2d) 210 (Ont. H.C.J.)	67
<i>Marshall v. Watson Wyatt & Co.</i> (2002), 57 O.R. (3d) 813 (Ont. C.A.).....	69, 83
<i>Martin v. International Maple Leaf Springs Water Corp.</i> , (1998), 38 C.C.E.L. (2d) 128 (B.C.S.C.).....	69
<i>Matheson v. Matheson International Trucks Ltd.</i> (1984), 4 C.C.E.L. 271 (Ont. H.C.J.)	61
<i>Mattocks v. Smith and Stone (1982) Inc.</i> (1991), 34 C.C.E.L. 273 (Ont. Ct. (Gen. Div.).....	26, 85
<i>Mattson v. ALC Airlift Canada Inc.</i> (1993), 18 C.P.C. (3d) 310 (B.C.S.C.)	65
<i>McDowell v. Sunshine Coast Community Services Society</i> (1987), 15 C.C.E.L. 284 (B.C.Co.Ct.)	22, 72
<i>McGraw v. Canadian Forest Products Ltd.</i> (1989), 17 A.C.W.S. (3d) 542 (B.C.S.C.).....	68
<i>McGuire v. Wardair Canada Ltd.</i> (1969), 71 W.W.R. 705 (Alta. S.C.)	40
<i>McIntosh v. C.T.F. Supply Ltd.</i> , 2001 CarswellOnt 4643 (Ont. S.C.).....	69
<i>McIntyre v. Hockin</i> (1889), 16 O.A.R. 498 (C.A.)	61
<i>McKay v. Eaton Yale Ltd.</i> (1996), 31 O.R. (3d) 216 (Ont. Ct. (Gen. Div.)).....	67, 68
<i>McKee . NCR Canada Ltd.</i> (1986), 10 C.C.E.L. 128 (Ont. H.C.J.).....	68
<i>McKilligan v. Pacific Vocational Institute</i> (1979), 14 B.C.L.R. 109 (B.C.S.C.), varied [1981] 28 B.C.L.R. 324 (B.C.C.A.).....	81
<i>Messer v. Barret Co.</i> , [1927] 1 D.L.R. 284 (Ont. C.A.)	72
<i>Meyer v. Carstairs</i> (1984), 52 A.R. 206, 3 C.C.E.L. 258 (Alta. Q.B.).....	22
<i>Meyer v. Jim Pattison Industries Ltd.</i> (1991), 38 C.C.E.L. 101 (B.C.S.C.)	69
<i>Michaels v. Red Deer College</i> , [1976] 2 S.C.R. 324, 57 D.L.R. (3d) 386 (S.C.C.)	72
<i>Michaud v. Banque Nationale du Canada</i> , [1997] R.J.Q. 547 (Que. S.C.).....	190
<i>Michelson v. Duncan</i> , 407 A.2d 211 (Del. S.C., 1979)	53, 120
<i>Millar v. Province of Alberta</i> (1980), 25 A.R. 560 (Alta. Q.B.).....	72
<i>Miller v. Lavoie</i> (1966), 63 W.W.R. 359 (B.C.S.C.).....	42

TABLE OF CASES

<i>Mills v. Esmark, Inc.</i> , 544 F. Supp. 1275 (N.D. Ill. 1982).....	144, 145
<i>Misovic v. Acres Davy McKee Ltd.</i> (1985), 7 C.C.E.L. 163 (Ont. C.A.).....	66
<i>Mohammed v. R.</i> , [1997] 3 C.T.C. 321 (F.C.A.).....	172
<i>Mondoux v. 9041-6868 Québec inc.</i> , [2003] R.J.Q. 2596, R.J.D.T. 1545 (Que. S.C.).....	138
<i>Monga v. Canada</i> , [1997] 1 C.T.C. 2529 (T.C.C.).....	172
<i>Mongeau & Robert & Cie Ltée v. Raby</i> (1933), 55 B.R. 243 (Que. C.A.).....	24, 63
<i>Montreal Trust Co. of Canada v. Call-Net Enterprises Inc.</i> (2002), 57 O.R. (3d) 775 (Ont. S.C.J.)	132
<i>Montrela Puplic Service Co. v. Champagne</i> , (1916), 33 DLR 49 (P.C.)	103
<i>Moore v. University of Western Ontario</i> (1985), 8 C.C.E.L. 157 (Ont. H.C.J.).....	64
<i>Morin v. Honeywell Ltée.</i> , D.T.E. 90T-529 (Que. S.C.), appeal abandoned July 3, 1990, C.A.M. 500-09-000517-904.....	48
<i>Morris v. Baron & Co.</i> , [1918] A.C. 1.....	49
<i>Morrison v. Coast Finance Ltd.</i> (1965), 54 W.W.R. 257 (B.C.C.A.)	42
<i>Mosier v. Linden-Alimak Inc.</i> (1985), 8 C.C.E.L. 45 (B.C.S.C.).....	80
<i>Mothersele v. Gulf Canada Resources Ltd.</i> , [2003] 4 W.W.R. 717 (Alta. Q.B.)	61
<i>Motherwell v. Schoof</i> , [1949] D.L.R. 812 (Alta. S.C.)	103
<i>Mozley v. Aston</i> (1847), 1 Ph. 790	195
<i>MSS Inc. v. R.</i> , [1989] 2 C.T.C. 30 (F.C.A.).....	172
<i>Mullins v. Pfitzer, Inc.</i> , 147 F.Supp. 2d 95, 103 (D. Conn., 2001)	29
<i>Mutual Life and Citizens Assurance Co. Ltd. v. Evatt</i> (1970), 44 A.L.J.R. 478 (P.C.)	192
<i>Myers v. Thompson</i> (1965), [1967] 2 O.R. 335 (Co. Ct.).....	192
<i>Nanef v. Con-Crete Holdings Ltd.</i> (1995), 23 O.R. (3d) 481	204
<i>National Building Maintenance Ltd. v. Dove</i> , [1972] 5 W.W.R. 410 (B.C.C.A.).....	121
<i>Neilson v. Vancouver Hockey Club</i> (1988), 25 B.C.L.R. (2d) 235 (B.C.C.A.).....	24
<i>Nerada v. Hobart Canada Inc.</i> (1982), 1 C.C.E.L. 116 (B.C.S.C.).....	79
<i>Nevin v. British Columbia Hazardous Waste Management Corp.</i> (1995), 129 D.L.R. (4 th). 569 (B.C.C.A.)	79, 80
<i>Newlands v. Sanwa McCarthy Securities Ltd.</i> (1996), 12 O.T.C. 81 (Ont. Ct. (Gen.Div.)).....	82
<i>Neyland v. Genstar Ltd.</i> (1977), 76 D.L.R. (3d) 697 (B.C.S.C.).....	67
<i>Nischk v. Brcic</i> (1998), 164 Sask. R. 238 (Sask. Q.B.).....	50
<i>Nolan v. Parsons</i> , [1942] O.R. 358, 3 D.L.R. 190 (Ont. C.A.)	121
<i>Normandin v. Solloway Mills & Co.</i> (1931), 40 O.W.N. 429 (Ont. H.C.J.).....	72
<i>North Ocean Shipping Co. Ltd. v. Hyundai Construction Co. Ltd.</i> , [1979] Q.B. 705.....	51
<i>North-West Transportation Co. Ltd. v. Beatty</i> (1887), 12 App. Cas. 589 (P.C.).....	195
<i>Nowegijick v. Canada</i> (1983), 144 D.L.R. (3d) 193 (S.C.C.).....	170
<i>Nystad v. Harcrest Apt. Ltd.</i> (1986), 3 B.C.L.R. (2d) 39 (B.C.S.C.).....	201

TABLE OF CASES

<i>O'Callaghan v. Transair Ltd.</i> (1975), 58 D.L.R. (3d) 80 (Man. C.A.)	22, 72
<i>Occhionero v. Roy</i> , 1992 CarswellQue 1354 (Que. S.C.).....	72
<i>Olson v. Sprung Instant Greenhouse Ltd.</i> (1985), 12 C.C.E.L. 8 (Alta. Q.B.).....	24, 63
<i>Olympia & York Enterprises Ltd. v. Hiram Walker Resources Ltd.</i> (1986), 59 O.R. (2d) 254, 37 D.L.R. (4th) 193 (Ont. Div. Ct.)	115, 130, 131, 133, 146
<i>Omnicare, Inc. v. NCS Healthcare, Inc.</i> , 809 A.2d 1163, (Del. Ch., 2002).....	144
<i>Orth v. Macdonald Dettwiler & Associates Ltd.</i> (1986), 16 C.C.E.L. 41 (B.C.C.A.).....	64
<i>Ostick v. Novacorp Int. Consulting Inc.</i> (1989), 27 C.C.E.L. 286 (B.C.S.C.).....	69
<i>Owensby & Kritikos, Inc. v. C.I.R.</i> , 819 F.2d 1315 (5 th Circ., 1987).....	121
<i>Pacifica Papers Inc. v. Johnstone</i> (2001), 92 B.C.L.R. (3d) 158, 15 B.L.R. (3d) 249 (B.C.S.C.), affirmed (2001) 93 B.C.L.R. (3d) 20, 19 B.L.R. (3d) 62 (B.C.C.A.).....	192
<i>Paddon v. Phillips Barratt Kaiser Engineering Ltd.</i> (1987), 18 B.C.L.R. (2d) 170 (B.C.S.C.)..	22, 62, 71, 72
<i>Paley v. Leduc</i> (2002), 118 A.C.W.S. (3d) 355 (B.C.S.C.).....	201
<i>Palmer v. Carling O'Keefe Breweries of Canada Ltd.</i> , [1989] 41 B.L.R. 128, D.L.R. (4 th) 128 (Ont. Div. Ct.).....	115
<i>Panter v. Marshall Field & Co.</i> , 646 F.2d 271 (7 th Circ., 1981).....	121, 144
<i>Paquin v. Gainers Inc.</i> (1991), 37 C.C.E.L. 113 (Alta. C.A.).....	24
<i>Paramount Communications, Inc. v. QVC Network, Inc.</i> , 637 A.2d 34 (Del. S.C., 1994).....	144
<i>Parke v. Daily News Ltd.</i> , [1962] Ch. 927.....	115
<i>Parker v. Beeching</i> , [1923] 4 D.L.R. 35 (Alta. C.A.).....	72
<i>Pasnak v. Chura</i> (2003), 35 B.L.R. (3d) 71, 2003 BCSC 782 (B.C.S.C.).....	141, 194, 203
<i>Paterson v. Robin Hood Flour Mills Ltd.</i> (1969), 68 W.W.R. 446 (B.C.S.C.).....	62
<i>PCL Construction Management Inc. v. Holmes</i> (1994), 8 C.C.E.L. 192 (Alta. C.A.).....	68
<i>Pearl v. Pacific Enercon Inc.</i> (1985), 7 C.C.E.L. 252 (B.C.C.A.).....	64
<i>Peek v. Gurney</i> (1873) L.R. 377.....	192
<i>Peil v. Speiser</i> , 806 F.2d 1154 (3d Cir, 1986).....	193
<i>Peoples Department Stores Inc. (Trustee of) v. Wise</i> (2004), 244 D.L.R. (4 th) 564, 49 B.L.R. (3d) 165, 2004 SCC 68 (S.C.C.), affirming <i>Peoples Department Stores Inc. (Trustee of) v. Wise</i> (2003), 224 D.L.R. (4 th) 509 (Que. C.A.)	147, 148, 171, 199, 202
<i>Pepper v. Litton</i> , 308 U.S. 295 (1939).....	123
<i>Perron v. Cie Minière Québec Cartier</i> , D.T.E. 89T-290 (Que. S.C.)	63
<i>Peso Silver Mines Ltd. v. Cropper</i> , [1966] S.C.R. 673 (S.C.C.)	82
<i>Phil Lloyd's Restaurants Ltd. and Kormish v. North Forty Restaurants Ltd.</i> (1983), 25 Sask. R. 40, 47 C.B.R. (N.S.) 128 (Sask. Q.B.).....	59
<i>Photo Production Ltd. v. Securicor Transport Ltd.</i> , [1980] A.C. 827.....	41
<i>Pierce v. Canada Trust Realtor, Division of Canada Trust Realty Inc.</i> (1986), 11 C.C.E.L. 64 (Ont. H.C.J.).....	83

TABLE OF CASES

<i>Piercy v. S. Mills & Co., Ltd.</i> , [1920] 1 Ch. 77 (Eng. Ch. Div.).....	127
<i>Pigott v. Nesbitt, Thomson & Co. Ltd.</i> , [1941] S.C.R. 520, 4 D.L.R. 353 (S.C.C.)	192
<i>Place Lebourgneuf Inc. v. Autodrome de Val Belair Inc.</i> , [1985] C.A. 364.....	41
<i>Plummer v. W. Carsen Co.</i> (1985), 10 C.C.E.L. 19 (Ont. Dist. Ct.).....	68
<i>Pollard v. Gibson</i> , [1924] 4 D.L.R. 354 (Ont. C.A.).....	63
<i>Poole v. Chick Adam Ltd.</i> (1987), 5 A.C.W.S. (3d) 302 (Ont. Div. Ct.).....	71
<i>Poole v. Tomenson Saunders Whitehead Ltd.</i> (1987), 18 C.C.E.L. 238 (B.C.C.A.)	64
<i>Poon, Wong & Associates Ing. v. Wong</i> [1991] B.C.W.L.D. 1186 (B.C.S.C.)	76
<i>Primex Investments Ltd. v. Northwest Sports Enterprises Ltd.</i> (1995), 13 B.L.R. (3d) 300 (B.C.S.C.).....	197, 198, 199
<i>Prins v. Lakeview Development of Canada Ltd.</i> (1990), 33 C.C.E.L. 155 (Ont. Ct. (Gen. Div.)) 76	
<i>Printing and Numerical Registering Co. v. Sampson</i> (1875), L.R. 10 Eq. 462.....	41
<i>Punt v. Symons & Co.</i> , [1903] 2 Ch. 506 (Eng. Ch. Div.).....	127
<i>PWA Corporation v. Gemini Group Automated Distribution Systems</i> (1993), 101 D.L.R. (4 th) 15 (Ont. Ct. (Gen. Div.)).....	115
<i>R. v. Long</i> (1990), 61 C.C.C. (3d) 156 (B.C.C.A.)	184
<i>R. v. Arthurs, ex p. Port Arthur Shipbuilding Co.</i> (1967), 62 D.L.R. (2d) 342 (Ont. C.A.)	61
<i>R. v. Bata Industries Ltd.</i> (1992), 9 O.R. (3d) 329, 70 C.C.C. (3d) 394, 7 C.E.L.R. (N.S.) 245 (N.S. Prov. Div.)	35
<i>R. v. Black</i> (1983), 5 C.C.C. (3d) 313 (Ont. C.A.).....	185
<i>R. v. Doren</i> (1982), 66 C.C.C. (2d) 448 (S.C.C.).....	184
<i>R. v. Gaetz</i> , [1993] 3 S.C.R. 645 (S.C.C.).....	185
<i>R. v. Gatley</i> (1992), 74 C.C.C. (3d) 468 (B.C.C.A.).....	184
<i>R. v. Geddes</i> (1979), 52 C.C.C. (2d) 230 (Man C.A.)	185
<i>R. v. Inhabitants of Gresham</i> (1786), 1 Term. Rep. 101.....	49
<i>R. v. Lafrance</i> (1974), 13 C.C.C. (2d) 289 (S.C.C.)	184
<i>R. v. Légaré</i> (1977), 36 C.C.C. (2d) 463 (S.C.C.)	180
<i>R. v. Lemire</i> , [1965] S.C.R. 174 (S.C.C.).....	184, 185
<i>R. v. Lowden</i> (1982), 68 C.C.C. (2d) 531 (S.C.C.).....	180
<i>R. v. Milec</i> (1997), 110 C.C.C. (3d) 439 (Ont. C.A.).....	186
<i>R. v. Mugford</i> (1990), 58 C.C.C. (3d) 172 (Nfld. C.A.)	184
<i>R. v. Olan</i> (1978), 41 C.C.C. (2d) 145 (S.C.C.).....	183, 184, 185, 186
<i>R. v. Rosen</i> (1985), 16 C.C.C. (3d) 481 (S.C.C.).....	180
<i>R. v. Ruhland</i> (1998), 123 C.C.C. (3d) 262 (Ont. C.A.)	185
<i>R. v. Shaw</i> (1983), 4 C.C.C. (2d) 348 (N.B.C.A.).....	185
<i>R. v. Sinclair</i> , [1975] A.C. 819 (H.L.)	186
<i>R. v. Skalbania</i> (1997), 120 C.C.C. (3d) 217 (S.C.C.).....	179

TABLE OF CASES

<i>R. v. Thérout</i> (1993), 79 C.C.C. (3d) 449 (S.C.C.)	183, 184
<i>R. v. Zlatić</i> (1993), 79 C.C.C. (3d) 466 (S.C.C.)	183, 184, 185, 186
<i>Radtko v. Machel</i> (2000), 98 A.W.C.S. (3d) 1198 (Ont. S.C.J.).....	122
<i>Raggow v. Scougall & Co.</i> (1915) 31 T.L.R. 564.....	49
<i>Rathbone v. Imperial Oil Ltd.</i> (2001), O.T.C. LEXIS 2447 (Ont. S.C.J.)	29
<i>Re Abraham and Inter Wide Investments Ltd.</i> (1985), 51 O.R. (2d) 460 (Ont. H.C.J.).....	122
<i>Re Brake</i> , [1996] N.J. No. 126 (Nfld. S.C.).....	201
<i>Re City Equitable Fire Insurance Company Ltd.</i> , [1925] 1 Ch. 407, [1924] All. E.R. Rep. 485 (Eng. C.A.).....	140, 143, 181
<i>Re Coal Economising Gas Co.</i> (1875) 1 Ch. D. 182 (C.A.)	192
<i>Re Ferguson and Imax Systems Corp.</i> (1983), 150 D.L.R. (3d) 718 (Ont. C.A.)	201
<i>Re First Boston, Inc., Shareholders Litigation</i> , [1990] Fed. Sec. L. Rep. 322 (Del. S.C., 1990).....	144
<i>Re Gillingham and Metropolitan Toronto Board of Commissioners of Police</i> (1979), 26 O.R. (2d) 77 (Ont. Div. Ct.)	64
<i>Re Goldstream Resources Ltd.</i> (1986), 2 B.C.L.R. (2d) 244 (B.C.S.C.).....	195
<i>Re Norhtwest Forest Products Ltd.</i> , [1975] 4 W.W.R. 724 (B.C.S.C.).....	190
<i>Re R. J. Jowsey Mining Co.</i> (1969), 6 D.L.R. (3d) 97 (Ont. C.A.).....	145
<i>Re Standard Trustco Ltd.</i> (1992), 6 B.L.R. (2d) 241 (Ont. Sec. Com.).....	143
<i>Re Walt Disney Company Derivative Litigation</i> , 825 A.2d 275 (Del. Ch., 2003).....	144, 148
<i>Re William Porter & Co. Ltd.</i> , [1937] 2 All E.R. 361	51
<i>Read v. Astoria Garage (Streatham) Ltd.</i> [1952] 1 Ch 637.....	103
<i>Reber v. Lloyds Bank Int. Canada</i> (1985), 61 B.C.L.R. 361 (B.C.C.A.).....	64
<i>Regal (Hastings) Ltd. v. Gulliver</i> , [1942] 1 All. E.R. 378 (U.K. H.L.)	181
<i>Regional Steel Works (Ottawa – 1987) Inc., Re</i> (1994), 25 C.B.R. (3d) 135 (Ont. Gen. Div. in Bkcty.).....	35
<i>Reilly v. Hotels of Distinction (Canada) Inc. (Hotel Le Grand/GrandHotel)</i> , [1987] R.J.Q. 1606, 18 C.C.E.L. 91 (Que. S.C.)	79
<i>Remillard Brick Co. v. Remillard-Dandini Co.</i> , 241 P. 2d 66 (Cal. C.A., 1952)	123
<i>Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.</i> , 506 A.2d 173, 54 U.S.L.W. 2483, 66 A.L.R. 4th 157 (Del. S.C., 1985)	133, 144
<i>Reynolds v. First City Trust Co.</i> (1989), 27 C.C.E.L. 194 (B.C.S.C.).....	69, 76, 77
<i>Richardson Greenshields of Canada Ltd. v. Kalmacoff</i> (1995), 18 B.L.R. (2d) 197, 123 D.L.R. (4 th) 628 (Ont. C.A.).....	196, 197
<i>Richardson v. Koefod</i> , [1969] 1 W.L.R. 1812 (C.A.).....	62, 65
<i>Riddell v. City of Vancouver</i> (1985), 11 C.C.E.L. 288 (B.C.C.A.).....	22, 72
<i>Ringuet v. Bergeron</i> (1960) 24 D.L.R. (2 nd) 449 (S.C.C.).....	103
<i>Rioux v. Pharmacie Edmuston Ltée.</i> (1980), 34 N.B.R. (2d) 416 (N.B.Q.B.).....	63

TABLE OF CASES

<i>Risi v. Benson & Hedges (Canada) Inc.</i> , [1986] O.J. No. 2044 (Ont. Dist. Ct.)	61
<i>Rizzo & Rizzo Shoes Ltd.</i> , [1998] 1 S.C.R. 27 (S.C.C.)	26
<i>Robertson v. B.F. Goodrich Canada Inc.</i> , 1986 WL 601884 (Ont. H.C.J.)	68
<i>Robertson v. Equivest Securities Ltd.</i> (1980), 19 B.C.L.R. 274 (B.C.S.C.)	67
<i>Robinson v. Canadian Acceptance Corporation</i> (1973), 43 D.L.R. (3d) 301 (N.S.S.C.)	67
<i>Robinson v. Page</i> (1826), 3 Russ. 114	50
<i>Robson v. General Motors of Canada Ltd.</i> (1982), 37 O.R. (2d) 229 (York Co. Ct.)	62, 65
<i>Rockland Industries Inc. v. Amerada Minerals Corp. of Canada</i> (1980), 108 D.L.R. (3d) 513 (S.C.C.)	35
<i>Roe v. Western Printing & Publishing Co.</i> (1955), 37 M.P.R. 113 (Nfld. S.C.)	63
<i>Rogers v. Canadian Acceptance Corp.</i> (1982), 50 N.S.R. (2d) 537 (N.S.S.C.)	62
<i>Rogers v. Hill</i> , 289 U.S. 582 (1933)	120, 121
<i>Roscoe v. McGavin Foods Ltd.</i> (1983), 2 C.C.E.L. 287 (B.C.S.C.)	69, 76
<i>Rose & Frank Co. v. J.R. Crompton & Bros. Ltd.</i> , [1925] A.C. 445	49
<i>Rose v. Herman Miller of Canada Ltd.</i> (1989), 30 C.C.E.L. 33 (Ont. Dist. Ct.)	68
<i>Royal Crown Companies Inc. v. McMahon</i> , 359 S.E. 2d 379 (Ga. C.A., 1987)	137
<i>Royal Crown Cos. v. McMahon</i> , 183 Ga. App. 543 (Ga. Ct. App. 1987)	32
<i>Royal Exchange Assurance v. Hope</i> , [1928] Ch. 179	50
<i>Ruffin v. Mercury Record Prod., Inc.</i> , 513 F.2d 222 (6th Cir. 1975)	55
<i>Rutter v. C.I.R.</i> , 853 F.2d 1267 (5 th Circ., 1988)	121
<i>Ryshpan v. Burns Fry Ltd.</i> (1995), 10 C.C.E.L. (2d) 235 (Ont. Ct. (Gen. Div.)), appeal dismissed (1996), 20 C.C.E.L. (2d) 104 (Ont. C.A.)	76
<i>Safarik v. Ocean Fisheries Ltd.</i> (1995), 12 B.C.L.R. (3d) 342 (B.C.C.A.)	201
<i>Sagkeeng Education Authority Inc. v. Guimond</i> , [1996] 1 F.C. 387 (T.D.)	51
<i>Saint John Shipbuilding Ltd. v. Perkins</i> (1989), 24 C.C.E.L. 106 (N.B.C.A.)	69
<i>Salmi v. Greyfriar Developments Ltd.</i> (1983), 1 C.C.E.L. 82 (Alta. Q.B.), affirmed on this point (1985), 7 C.C.E.L. 80 (Alta. C.A.)	79
<i>Salomon v. Salomon & Co. Ltd.</i> , [1897] A.C. 22 (H.L.)	185, 213
<i>Salt v. Marquis of Northampton</i> , [1892] A.C. 1	41
<i>Sandelson v. International Vintners Ltd.</i> (1987), 18 B.C.L.R. (2d) 86 (B.C.S.C.)	74, 76, 77
<i>Savoie v. Les Entreprises de Tabac Bernard (1976) Ltd.</i> (1983), 47 N.B.R. (2d) 179 (N.B.C.A.)	22
<i>Saxe v. Brady</i> , 184 A.2d 602 (Del. Ch., 1962)	120
<i>Scarf v. Jardine</i> (1882), 7 App.Cas. 345	49
<i>Scholler v. Samario Construction</i> (1984), 25 A.C.W.S. (2d) 86 (Ont. Co. Ct.)	62
<i>Schumacher v. Toronto-Dominion Bank</i> (1999), 173 D.L.R. (4 th) 577 (Ont. C.A.)	76
<i>Schwann v. Husky Oil Operations Ltd.</i> (1989), 27 C.C.E.L. 103 (Sask. C.A.)	79

TABLE OF CASES

<i>Scott v. Metropolitan Police Commissioner</i> (1974), 17 C.C.C. (2d) 355 (H.L.)	183, 185
<i>Scottish Co-operative Wholesale Society Ltd. v. Meyer</i> , [1958] 3 All. E.R. 66 (H.L.), [1959] A.C. 324.....	200
<i>Shindler v. Northern Raincoat Co.</i> [1960] All E.R. 239 (C.A.)	103
<i>Shiozaki v. Expo 86 Corp.</i> (1986), 2 A.C.W.S. (3d) 130 (B.C.S.C.)	22, 72
<i>Shlensky v. Wrigley</i> , 9, Ill. App. 2d 173 (1968) at 181, 237 N.E.2d 776.....	144, 145
<i>Silvester v. Lloyd's Register of North America</i> , [2004] N.S.J. No 37 (N.S.C.A.)	70
<i>Simon Container Machinery Ltd. v. Emba Machinery AB</i> , [1998] 2 Lloyd's Rep. 429.....	55
<i>Sinclair Oil Corp. v. Levien</i> , 280 A.2d 717 (Del. S.C., 1971).....	144, 145
<i>Sinclair v. Canadian Ice Machine Co.</i> , [1955] S.C.R. 777, 5 D.L.R. 1 (S.C.C.)	72
<i>Sloan v. Union Oil Co. of Canada</i> , [1955] 4 D.L.R. 644 (B.C.S.C.).....	48, 51
<i>Smachlo v. Birkelo</i> , 576 F.Supp. 1439 (D. Del., 1983)	8
<i>Smith & Fawcett Ltd., Re.</i> [1942] 1 Ch. 304 (Eng. C.A.).....	129
<i>Smith v. Campbellford Board of Education</i> (1917), 39 O.L.R. 323 (Ont. C.A.)	64
<i>Smith v. Hanson Tire & Supply Co.</i> (1927), 21 Sask. L.R. 621 (Sask. C.A.).....	127
<i>Smith v. Kamloops & District Elizabeth Fry Society</i> (1996), 20 C.C.E.L. (2d) 303 (B.C.C.A.)..	61
<i>Smith v. Pacific National Exhibition</i> (1991), 34 C.C.E.L. 64 (B.C.S.C.).....	70
<i>Smith v. Van Gorkom</i> , 488 A.2d 858 (Del. S.C., 1985).....	144, 145
<i>Soper v. Canada</i> , [1998] 1 F.C. 124, 149 D.L.R. (4 th) 297 (Fed. C.A.)	143
<i>Sorel v. Tomenson Saunders Whitehead Ltd.</i> (1987), 16 C.C.E.L. 223 (B.C.C.A.)	67, 68, 80
<i>Soupes Campbell Ltée v. Cantin</i> , D.T.E. 91T-741 (Que. C.A.).....	63
<i>Southern Foundries (1926) Ltd. v. Shirlaw</i> , [1940] A.C. 701 H.L.	40
<i>Southern Foundries (1926) Ltd. v. Shislaw</i> [1940] A.C. 701	103
<i>Sparling v. Javelin International Ltée</i> , [1986] R.J.Q. 1073 (Que. S.C.)	203
<i>Sparling v. Royal Trustco Ltd.</i> (1984), 6 D.L.R. (4 th) 682 (Ont. C.A.), affirmed [1986] 2 S.C.R. 537 (S.C.C.)	204
<i>Speight v. Uniroyal Goodrich Canada Inc.</i> (1989), 97 N.B.R. (2d) 216 (N.B.Q.B.).....	76
<i>Spooner v. Ridley Terminals Inc.</i> (1991), 39 C.C.E.L. 65 (B.C.S.C.).....	64
<i>Spooner v. Spooner Oils Ltd.</i> , [1936] 2 D.L.R. 634	129
<i>Squires v. Corner Brook Pulp and Paper Ltd.</i> (1994), 5 C.C.E.L. (2d) 206 (Nfld. S.C.)	83
<i>St. Elizabeth Hospital v. Three Lakes No. 400 (Rural Municipality)</i> (1995), 135 Sask. R. 215 (Sask. Q.B.).....	50
<i>Stander v. B.C. Hydro & Power Authority</i> (1988), 25 B.C.L.R. (2d) 40 (B.C.C.A.).....	75
<i>Stead v. Dawber</i> (1839), 10 A. & E. 57.....	50
<i>Stech v. Davies</i> (1987), 53 Alta. L.R. (2d) 373 (Alta. Q.B.).....	122
<i>Stepper v. Laurel Credit Plan Ltd.</i> (1968), 63 W.W.R. 168 (Sask. Dist. Ct.)	42
<i>Stevens v. Electrolux Canada</i> (1985), 6 C.C.E.L. 254 (N.B.Q.B.).....	61

TABLE OF CASES

<i>Stevens v. Globe & Mail</i> (1996), 19 C.C.E.L. (2d) 153 (Ont. C.A.).....	26, 76, 80, 85
<i>Stevens v. LeBlanc's Welding & Fabricating Ltd.</i> (1982), 40 N.B.R. (2d) 389 (N.B.Q.B.) ..	22, 72
<i>Stewart v. Standard Broadcasting Corp.</i> (1989), 29 C.C.E.L. 290 (Que. S.C.).....	70, 76
<i>Stilk v. Myrick</i> (1809), 2 Camp. 317, 170 E.R. 1168 (C.P.)	48, 50, 55
<i>Stubbs v. Erickson</i> (1981), 34 B.C.L.R. 45 (B.C.S.C.).....	42
<i>Sublet v. Faco-Addo Canada Ltd.</i> (1977), 16 O.R. (2d) 791 (Ont. H.C.J.)	62
<i>Such v. RW-LB Holdings Ltd.</i> (1993), 11 B.L.R. (2d) 122 (Alta. Q.B.).....	203
<i>Suisse Atlantique Soci��t�� d'Armement Maritime SA v. N.V. Rotterdamsche Kolen Centrale</i> , [1967] 1 A.C. 361	41
<i>Sullivan v. Mack Maritime Ltd.</i> (1982), 39 N.B.R. (2d) 298 (N.B.Q.B.)	68
<i>Summa Corp. v. Trans World Airlines, Inc.</i> 540 A.2d 218 (Del. S.C., 1976)	123
<i>Suttie v. Metro Transit Operating Co.</i> (1985), 2 B.C.L.R. (2d) 145 (B.C.C.A.), affirming [1983] 42 B.C.L.R. 234 (B.C.S.C.)	67
<i>Swinamer v. Unitel Communications Inc.</i> (1996), 17 C.C.E.L. (2d) 59 (N.S.S.C.)	62
<i>Sylvester v. British Columbia</i> (1997), 146 D.L.R. (4 th) 207 (S.C.C.).....	24, 74
<i>Syros Shipping Co. S.A. v. Elaghill Trading Co.</i> , [1980] 2 Lloyd's Rep. 390	55
<i>Tarantino v. R.</i> , [2000] 1 C.T.C. 3039 (T.C.C.)	172
<i>Taupo Totara Timber Co. Ltd. v. Rowe</i> , [1977] 3 All.E.R. 123 (P.C.).....	56, 132, 133
<i>Teck Corp. v. Millar</i> (1972), 33 D.L.R. (3d) 288 (B.C.S.C.).....	124, 129, 130
<i>Telxon Corp. v. Meyerson</i> , 802 A.2d 257 (Del. S.C., 2002).....	117
<i>The Sun Trust Co. v. B��gin</i> (1937), S.C.R. 305 (S.C.C.).....	114
<i>Themadel Foundation v. Third Canadian Investment Trust Ltd.</i> (1995), 23 O.R. (3d) 7 (Ont. Ct. (Gen. Div.)).....	203
<i>Thom v. Goodhost Foods Ltd.</i> (1987), 17 C.C.E.L. 89 (Ont. H.C.J.).....	83
<i>Thom v. Saltner</i> , [1989] 1 W.W.R. 456 (Man. Q.B.).....	42
<i>Thomas v. Surveyer, Nenninger, Ch��nevert Inc.</i> , [1989] 34 Q.A.C. 61 (Que. C.A.)	63, 81
<i>Thornhill v. Neats</i> (1860), 8 C.B. (N.S.) 831.....	49
<i>Tinker-Labrecque v. Corp. de l'H��pital d'Youville de Sherbrooke</i> , [1986] R.J.Q. 1283 (C.A.). 21, 71	
<i>Toupin v. Day & Ross Inc.</i> , 2001 CarswellQue 288 (Que. C.A.)	69
<i>Tremblett v. S.C.B. Fisheries Ltd.</i> (1993), 116 Nfld. & P.E.I.R. 139, 363 A.P.R. 139 (Nfld. S.C.)	197
<i>Turner v. Canadian Admiral Corp.</i> (1980), 3 A.C.W.S. (2d) 163 (Ont. H.C.J.)..	67, 69, 74, 77, 81
<i>Tweedie v. Geib</i> (1982), 19 Sask. R. 48 (Sask. Q.B.).....	42
<i>United Dominion Trust (Jamaica) Ltd. v. Shoucair</i> , [1969] 1 A.C. 340	51
<i>United Talmud Torahs of Montreal Inc. v. Dulude</i> , D.T.E. 84T-41 (Que. S.C.).....	21, 71
<i>Unocal Corp. v. Mesa Petroleum Co.</i> , 493 A.2d 946 (Del. Sup. Ct., 1985)	8, 121, 144

TABLE OF CASES

<i>UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.</i> , [2004] 183 O.A.C. 310, 42 B.L.R. (3d) 34 (Ont. C.A.).....	203
<i>Vanbergen v. St. Edmund's Properties Ltd.</i> , [1933] 2 K.B. 233	55
<i>Veer v. Dover Corp. (Canada) Ltd.</i> (1997), 31 C.C.E.L. (2d) 119 (Ont. Ct. (Gen. Div.)), affirmed (1999), 45 C.C.E.L. (2d) 183 (Ont. C.A.).....	70
<i>Vondette v. Vancouver Port Corp.</i> (1987), 21 B.C.L.R. (2d) 209 (B.C.S.C.)	22, 72
<i>Vopni v. Groenewald</i> (1991), 84 D.L.R. (4 th) 366 (Ont. Ct. (Gen. Div.))	73
<i>Vorvis v. Insurance Corp. of British Columbia</i> (1989), 58 D.L.R. (4 th) 193 (S.C.C.).....	81, 82, 83
<i>Wade v. Kendrick</i> (1905), 37 S.C.R. 32 (S.C.C.).....	117
<i>Walker v. Copp Clark Publishing Co.</i> , [1962] O.R. 622 (H.C.J.)	22, 72
<i>Warren v. Superior Engravers Ltd.</i> [1941], 1 D.L.R. 323 (Ont. C.A.).....	103
<i>Waxman v. Waxman</i> (2002), 25 B.L.R. (3d) 1 (Ont. S.C.J.).....	122, 199
<i>Webster v. B.C. Hydro & Power Authority</i> (1992), 42 C.C.E.L. 105 (B.C.C.A.)	67
<i>Wedge v. McNeil</i> (1981), 126 D.L.R. (3d) 596 (P.E.I.S.C.), reversed on evidentiary grounds (1982), 142 D.L.R. (3d) 133 (P.E.I.C.A.).....	190
<i>Wedge v. McNeill</i> (1981), 33 Nfld. & P.E.I.R. 272 (P.E.I.S.C.).....	118
<i>Weinberger v. UOP, Inc.</i> , 457 A.2d 701 (Del. S.C., 1983)	117, 126, 145
<i>Westfair Foods Ltd. v. Watt</i> (1990), 73 Alta. L.R. (2d) 326 (Alta. Q.B.), affirmed 79 ALta. L.R. (2d) 363 (Alta. C.A.), leave to appeal to S.C.C. refused [1992] 1 W.W.R. xv . 200, 201, 202	
<i>Wiebe v. Central Transport Refrigeration</i> , [1994] 6 W.W.R. 305 (Man. C.A.).....	68
<i>Wilkinson v. Ronyx Corp.</i> (1981), 9 A.C.W.S. (2d) 476 (Ont. H.C.J.).....	67
<i>Wilks v. Moore Dry Kiln Co. of Canada</i> (1981), 32 B.C.L.R. 149 (B.C.S.C.).....	80
<i>Williams Bros. v. Aguis Ltd.</i> , [1914] A.C. 510	49
<i>Williams v. Roffey Bros. & Nicholls (Contractors) Ltd.</i> , [1991] 1 Q.B. 1.....	55
<i>Wollock v. Sochaczewski</i> , 1995 CarswellQue 1806 (Que. S.C.)	72
<i>Wood v. Brown Boveri Canada Inc.</i> (1986), 15 C.C.E.L. 178 (B.C.C.A.).....	80
<i>Woodward v. Sound Insight Ltd.</i> (1986), 73 N.S.R. (2d) 396 (N.S.S.C.).....	61
<i>Worth v. Huntington Bancshares, Inc.</i> , 43 Ohio St.3d 192, 540 N.E.2d 249 (1989) . 8, 32, 33, 176	
<i>Wright v. Donald S. Montgomery Holdings Ltd.</i> (1989), 39 B.L.R. (2d) 266 (Ont. Ct. (Gen.Div.))	122
<i>Wright v. Wright</i> (1994), 51 A.C.W.S. (3d) 676 (B.C.S.C.).....	29
<i>Young v. Okanagan College Board</i> (1984), 5 C.C.E.L. 60 (B.C.S.C.).....	62
<i>Zaglanikis v. Dana West Hotels Ltd. and Courtyard Inns Ltd.</i> (1980), 3 A.C.W.S. (2d) 461 (B.C.S.C.).....	22, 72

TABLE OF STATUTES AND REGULATION

- Aktiengesetz (AktG)* (German Stock Corporation Act), BGBl. I 1965, 1089, as amended
- British Columbia Business Corporations Act*, S.B.C. 2002 c.57, as amended
- British Columbia Companies Act*, R.S.B.C. 1960, c. 67
- Bürgerliches Gesetzbuch (BGB)* (German Civil Code), 1896, RGBl. 1896, 195, as amended
- Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as amended
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- Ontario Securities Commission Rule 51-801 Implementing National Instrument 51-102 Continuous Disclosure Obligations* (April 2, 2004)

TABLE OF STATUTES AND REGULATION

Ontario Securities Commission Companion Policy 51-801CP to Ontario Securities Commission Rule 51-801

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