CONFLICTS OF INTEREST AND CORPORATE OPPORTUNITIES:

SOLVING THE PROBLEMS CREATED BY BEING A DIRECTOR OF MORE THAN ONE JUNIOR MINING COMPANY

These materials were prepared by Michael Varabioff, Partner, Axium Law Group, Vancouver, BC for a conference held in Vancouver, BC hosted by Pacific Business & Law Institute, February 18, 2004

TABLE OF CONTENTS

I. INTRODUCTION

It is commonplace in the junior mining sector for persons to serve as directors and officers of more than one junior mining company. There are perhaps valid business reasons for this, namely risk diversification in a very risky industry. Nevertheless, the practice invites significant legal risk for those involved. With the recent focus on corporate governance and the conduct of directors, the risks have become even greater.

The purpose of this paper is to briefly review the legal risks resulting from acting as a director or officer of more than one company, and then suggest a code of conduct in order to minimize these risks.

II. DIRECTORS' FIDUCIARY DUTIES

The starting point for understanding the law in this area is Section 118 of the Company Act (British Columbia) (the "BCCA") which states in part:

Duties of Directors

118 (1) Every director of a company, in exercising the director's powers and performing the director's functions, must

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

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

Subsection 118 (1) codifies hundreds of years of common law and is the provision from which all of the duties discussed below flow. Section 122 of the Canada Business Corporations Act ("CBCA") is similar, and reads in part:

122. (1) Duty of care of directors and officers - Every director and officer of a corporation in exercising their powers and discharging their duties shall,

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

These provisions impose what are commonly referred to as directors' fiduciary duties. Some of the duties flowing from these brief but powerful statements are: the duty to disclose significant information within their knowledge to the company; the duty not to disclose confidential information about the company to outsiders; the duty not to take advantage of corporate opportunities belonging to the company; and the duty not to place their private interests in conflict with their duties to the company by for example entering into transactions with the company unless certain procedural rules are complied with. We will examine each of these in turn.

It should be noted at the outset that the law does not prohibit a person from serving as a director for two or more companies at the same time however, as will be seen below such a practice is fraught with the potential for conflict as the director tries to satisfy the conflicting fiduciary duties owed to the two corporations.

A. Duties of Confidentiality and Disclosure

Suppose a Mr. Director serves as a director of two junior mining companies, ABC Gold and XYZ Resources. While at a board meeting for ABC Gold, Mr. Director learns some information that would be very valuable to XYZ Resources, but would be very detrimental to ABC Gold if disclosed. What should Mr. Director do?

Directors have a fiduciary duty not to disclose confidential information about the company to outsiders. Disclosure of confidential information may also result in a breach of insider trading rules which carries a significant penalty.

On the other hand, directors have a duty to disclose all significant information within their knowledge to the company. For example, in *PWA Corp v. Gemini Automated Distribution Systems Inc.* (a 1993 decision of the Ontario Court of Appeal), a corporation served as the general partner of a limited partnership that operated an airline computer reservations system for several major airlines, including PWA and Air Canada, who were competitors. PWA appointed three directors to the corporation's board of directors. On instructions from PWA, the three directors withheld important information from the rest

of the board. The Ontario Court of Appeal found that the three directors breached their fiduciary duties by withholding vital information.

In this case, Mr. Director has a problem. He owes a duty to ABC to keep the information confidential but he owes a conflicting duty to XYZ to disclose the information. Clearly he cannot satisfy both of these obligations. In these circumstances, some would suggest that Mr. Director has no choice but to resign from one or both boards.

B. Corporate Opportunities

Suppose Mr. Director, while on a trip to South America on company business for ABC Gold, learns of some new "hot" properties in the vicinity of those held by his company. Can Mr. Director acquire those claims personally (or through a new company formed by him), or must he present them to ABC Gold?

The general rule is that opportunities acquired by Mr. Director by virtue of his position as a director, are the property of the company. A good illustration of this is the case of *Canadian Aero Service Ltd. v. O"Malley*. (a 1974 decision of the Supreme Court of Canada). In that case, two directors and officers of Canaero developed a business opportunity for Canaero. Then they formed a new company, resigned from Canaero, and obtained the business opportunity for themselves through their new company. Afterwards, Canaero sued its former directors and officers for breach of fiduciary duty. The Supreme Court of Canada found the former directors and officers liable for breach of their duty of loyalty to Canaero and entered judgment for $125,000 against each of them. Their resignations did not relieve them from their fiduciary duty because the men resigned to acquire the opportunity previously sought by Canaero. The court found that the former directors and officers could not divert to themselves Canaero's business opportunity, except upon full disclosure and with Canaero's approval.

What if ABC Gold rejects the opportunity? Can a director then personally pursue the matter? In *Peso Silver Mines Ltd. (N.P.L.) v. Cropper* (a 1966 decision of the Supreme Court of Canada), the company (Peso) was in the mining exploration business. Mr.

Cropper was the managing director of the company. He was also the president of several other mining companies. Peso owned mining claims in the Yukon. A prospector approached Peso wanting to sell the company some highly speculative claims near those already owned by Peso. At the time, it was usual for Peso to receive two or three offers every week to buy mining claims. Peso's board of directors carefully considered the prospector's offer, but rejected it. The trial judge found that the board made its decision in good faith and that none of the directors pursued personal motives by rejecting the prospector's offer.

Later, after the matter had passed from Cropper's mind, a geologist suggested that he and Cropper and two others form a group to purchase the prospector's claims, which they did. After control of Peso changed, the new board caused Peso to sue its former director for breach of fiduciary duty and an accounting of his profits from the purchase of the prospector's claims. The Supreme Court of Canada excused the director from liability.

Peso's board rejected the prospector's offer for sound business reasons. The court found that after the company rejected the proposal, the geologist approached Cropper as a private individual and not in his capacity as a director of Peso. There was no suggestion that the director, in privately taking up the opportunity, used any confidential information derived from his role as one of Peso's directors. In addition, Cropper used his own resources, not Peso's, to invest in the group that purchased the prospector's offer.

Corporate management who take advantage by using their positions as directors or officers to appropriate a business opportunity, even in situations where the company is unable to accept the opportunity, have a conflict of interest. If they divert the opportunity to themselves, they will breach their fiduciary duty to the company and be liable to account for any profits or other gain that they make as a result. On the other hand, if the board of directors, acting in good faith and in the company's best interests, rejects the opportunity, it may be available to directors or officer in their private capacities. In such circumstances, directors and officers who privately pursue such opportunities must scrupulously avoid using any confidential information or other corporate resources available to them in their capacities as members of management. Since personal liability

in these cases can be very large, directors or officers who wish to privately pursue such opportunities should also first seek legal advice before taking any steps.

C. Transactions Where Directors Have an Interest

Suppose Mr. Director, while on holidays in Peru, comes across some hot mining prospects and decides to acquire them for himself. His company is not doing business in Peru at the time. A short time later, there is a major discovery near the Peruvian property and the value of these Peruvian claims increases substantially. Mr. Director offers to sell the claims to ABC Gold. Can he do this?

The BCCA contains express rules regarding how directors must deal with situations where they have an interest in transactions with a company. In summary, the BCCA requires directors to disclose any interest, direct or indirect, in a proposed contract or transaction with the company. This disclosure must be made at the directors' meeting at which the contract or transaction is first considered. If the director learns about the interest after that meeting, he or she must disclose it at the next directors' meeting. See Sections 120 and 121 of the BCCA attached as Schedule A hereto for the complete text of the rule.

The BCCA provides that a director is not deemed to have an interest in a contract or transaction merely because one or all of the following conditions exist:

(a) the proposed contract or transaction relates to a loan to the company, and the director, or a corporation or firm in which he or she has an interest, is guaranteeing any part of the loan;

(b) the proposed contract or transaction is for the benefit of an affiliated corporation in which the director also serves as a director or officer;

(c) the proposed contract or transaction relates to indemnifying the director or to acquiring liability insurance for persons serving as directors of officers;

(d) the proposed contract or transaction relates to the director's remuneration as a director.

A director can comply with the disclosure requirements by giving a general notice in writing to the other directors. The notice is sufficient if it sets out that the director is a member, director, or officer of a specified corporation, or a partner in, or owner of, a specified firm, and that he or she has an interest in that corporation or firm.

A director will avoid liability if the director discloses his or her interest to the other directors, who subsequently approve the contract or transaction. The director who has declared an interest in the matter must not vote on the resolution to approve the contract or transaction. Alternatively, if a director fails to disclose his or her interest to the rest of the board, the director can still avoid liability if the contract or transaction was reasonable and fair to the company and, following full disclosure, the shareholders approve the contract or transaction by special resolution. A director who fails to take these steps must account to the company for any profit that he or she makes as a result of the company entering the contract or transaction. In addition, the company or any interested person can apply to the court to set aside the contract or transaction or make any order that the court considers appropriate.

It is important to note that Section 121 of the BCCA provides relief to the director from liability provided he complies with the statutory provisions. In the other cases referred to above (i.e. duty of confidentiality, duty of disclosure and duty not to take advantage of corporate opportunities), if the director breaches these duties, there is no statutory relief and the director will be liable.

VI. SUGGESTED CODE OF CONDUCT FOR DIRECTORS OF JUNIOR MINING COMPANIES

The following is a suggested code of conduct for directors of junior mining companies:

A. Serving as a Director

(i) Don't serve as a director. Is it really worth it?

(ii) If you decide to serve as a director, do as much due diligence as possible on the company and the other directors. Also insist on having the company provide you with an indemnity agreement and director and officer liability insurance.

(iii) Don't serve as a director of more than one company. This will simplify your life.

(iv) If you must sit on more than one board, pick companies that don't compete and won't likely be competing.

B. Confidentiality

(i) Keep all company information confidential.

C. Disclosure

(i) Disclose all significant information to the company.

D. Corporate Opportunities

(i) Promptly and fully disclose to the board in writing your interest in any corporate opportunity.

(ii) Refrain from participating in any proceedings in which the company considers whether to pursue the opportunity and ensure that same is recorded in the minutes of any meetings.

(iii) Confirm in writing that the company wishes, for demonstrable business reasons, to reject the opportunity, having made the decision equipped with the director's or officer's previous disclosure.

(iv) Obtain the written approval of the directors to privately pursue the opportunity, or alternatively, obtain such approval from the shareholders by special resolution in a general meeting.

(v) Refrain from participating in any meeting where the subject of permitting the director or officer to privately pursue the opportunity is discussed and ensure that the same is recorded in any minutes.

(vi) Refrain from voting on any resolutions concerning the company's decision to permit the director or officer to pursue the opportunity privately.

E. Transactions with the Company

(i) Avoid these as much as possible.

(ii) If you have an interest in a transaction with the company, disclose this interest in writing and abstain from voting on the transaction.

SCHEDULE A

Sections 120 and 121 of the Company Act (British Columbia)

Director to disclose interest

120

(1) Every director of a company who, in any way, directly or indirectly, is interested in a proposed contract or transaction with the company must disclose the nature and extent of the director's interest at a meeting of the directors.

(2) The disclosure required by subsection (1) must be made

(a) at the meeting at which a proposed contract or transaction is first considered,

(b) if the director was not, at the time of the meeting referred to in paragraph (a), interested in a proposed contract or transaction, at the first meeting after the director becomes interested, or

(c) at the first meeting after the relevant facts come to the director's knowledge.

(3) For the purpose of this section, a general notice in writing given by a director of a company to the other directors of the company to the effect that the director is a member, director or officer of a specified corporation, or that the director is a partner in, or owner of, a specified firm, and that the director has an interest in a specified corporation or firm, is a sufficient disclosure of interest to comply with this section.

(4) A director of a company is not deemed to be interested or to have been interested at any time in a proposed contract or transaction merely because

(a) if the proposed contract or transaction relates to a loan to the company, the director or a specified corporation or specified firm in which the director has an interest has guaranteed or joined in guaranteeing the repayment of the loan or any part of the loan,

(b) if the proposed contract or transaction has been or will be made with or for the benefit of an affiliated corporation, the director is a director or officer of that corporation,

(c) the proposed contract or transaction relates to an indemnity under section 128 or to insurance under section 128, or

(d) the proposed contract or transaction relates to the remuneration of a director in that capacity.

Director liable to account

121

(1) Every director referred to in section 120 (1) must account to the company for any profit made as a consequence of the company entering into or performing the proposed contract or transaction, unless

(a) he or she discloses his or her interest as required by section 120,

(b) after his or her disclosure the proposed contract or transaction is approved by the directors, and

(c) he or she abstains from voting on the approval of the proposed contract or transaction,

or unless

(d) the contract or transaction was reasonable and fair to the company at the time it was entered into, and

(e) after full disclosure of the nature and extent of his or her interest, it is approved by special resolution.

(2) Unless the articles otherwise provide, a director referred to in section 120 (1) must not be counted in the quorum at a meeting of the director at which the proposed contract or transaction is approved.