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The chilling effect of crypto winter on directors and officers

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The crypto winter persists. In the "winter months", some entities and investors may be "left out in the cold". On July 14, 2022, Celsius Network LLC, a large international crypto-based finance platform, became the latest crypto-related company to file for bankruptcy in the United States. This follows shortly on the heels of insolvency filings made by Three Arrows Capital, Ltd. (a digital asset hedge fund) and the subsequent collapse of Voyager Digital Holdings, Inc. (a crypto asset trading platform) and its related entities.

In this Update, we consider the personal liability of directors and officers who steward digital asset companies faced with insolvency. While directors and officers are generally protected against personal liability where they act prudently, in good faith, and with regard to the best interests of the company, there are important exceptions. For example, where a director or officer benefits personally from an improvident transaction that they directed, Canadian courts have shown a willingness to impose personal remedies (i.e., to "pierce the corporate veil").

Refresher on the duties of directors and officers

As detailed in our guide, Directors' Responsibilities in Canada, directors and officers in Canada are subject to two main duties. First, a fiduciary duty to act in the best interest of the company.[1] Second, a duty of care to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances.[2] Typically, these duties will be satisfied with respect to decisions that were made prudently and on a reasonably informed basis; i.e., pursuant to reasonable "business judgment".[3] Rather than demanding perfection, Canadian courts will consider whether the decision lies within a range of reasonable alternatives.[4]

The fiduciary duty does not "shift" in the "vicinity of insolvency", as in some other jurisdictions.[5] Where the interests of the company and the interests of stakeholders are not co-extensive (e.g., because of a potential insolvency), the duty of directors and officers lays with the corporation.[6] That said, stakeholders have statutory remedies that can be pursued where their interests are unfairly disregarded (as further discussed below),[7] in addition to any contractual rights.

Statutory liability

Directors and officers can be found personally liable under a number of statutes:[8]

- **Impairment of capital**: Where a director authorizes the purchase, redemption or

acquisition of share capital, authorizes a dividend or pays a shareholder, the director can be held personally liable where that transaction would cause the company to: (a) be unable to pay its liabilities as they come due; or (b) have realizable assets less than the aggregate of its liabilities and outstanding share capital.[9] Relatedly, directors and officers will be held liable for authorizing the issuance of share capital for non-monetary consideration where the consideration received is less than the fair market value of the shares.[10]

- **'Lookback' period**: Where a company becomes insolvent, the court will scrutinize the affairs of company leadership in the preceding period (the 'lookback' period). For example, directors and officers will be held personally liable where they are found to have acquired or conveyed assets of the company at undervalue,[11] and with respect to termination pay or benefits paid to company executives in certain circumstances.[12]
- **Indemnification**: Where a director or officer authorizes the indemnification of another director or officer who failed to act honestly and in good faith (or who acted unlawfully in the absence of reasonable grounds to believe the conduct was lawful), the director or officer who authorized the indemnity can be found personally liable.[13]
- **Employee-related claims**: Company directors are personally liable to employees for up to six months' of unpaid wages,[14] which in some provinces includes vacation pay.[15] These amounts can add up and, importantly, there is no 'business judgment' defence to such employee-related claims.
- **Pension-related claims**: Pension-related claims can arise against directors and officers where a sponsor does not make a pension contribution when due, or where the company acts as pension administrator and those duties are delegated to an individual.[16]
- **Tax-related claims**: Directors and officers can be held personally liable with respect to failures by the company to: remit or deduct prescribed amounts with respect to payments to employees and payments to non-employees subject to withholding tax;[17] or remit sales tax.[18] Directors and officers also will be liable for tax offences that they "directed, authorized, assented to, acquiesced in or participated in".[19]
- **Environmental claims**: Under federal environmental legislation, directors and officers will be found personally liable where they directed, authorized, assented to, acquiesced in or participated in the commission of an environmental offence, or where they failed to "take all reasonable care" to ensure the company complies with environmental regulation.[20]
- **Foreign corrupt practices (bribery)**: Directors and officers that engage in bribery with a real and substantial connection to Canada may be subject to fines and imprisonment.[21]

Liability for self-serving acts

The common law has evolved to hold directors and officers liable for wrongful acts that are more properly attributable to the director or officer than the company itself (even where such conduct is arguably in the best interests of the company). On this basis, directors and officers have been held personally liable with respect to:

- conduct that unfairly disregarded the interests of a corporate stakeholder (i.e., oppression), where personal liability was the appropriate remedy;[22]
- torts, such as fraudulent misrepresentation, committed in the officer's personal capacity;[23] and
- a breach of trust, where the directors had full knowledge of the actions of the corporation and, thus, knew of the breach of trust.[24]

It should also be noted that claims by regulatory bodies against directors in their personal capacity often will be treated separately from the directors' corporate obligations. Accordingly, these claims will typically survive insolvency and class action settlements.[25]

Implications for crypto companies

It is important for participants in the Canadian crypto space to understand that there are no "special sets of rules" for crypto companies, and company executives must be attuned to each of the foregoing areas of potential liability.

The nature and structure of many crypto-related companies may add further risk. Typically, in addition to being owners of a company's equity shares, directors and officers are owners of the crypto assets that are issued, sold or traded by the company, or users of its services. This intermingling of rights and interests can create scenarios where it may be easier to argue that actions purportedly taken on behalf of the company were, in actuality, designed to benefit the directors or officers personally. For example:

- Many crypto companies engage in the storage and/or rehypothecation of clients' digital assets. In insolvency proceedings, the question arises as to whether those client assets are protected against claims made by creditors against the company. Were insolvency risks properly explained to users? Were the assets of directors and officers subject to special priorities as compared to the assets of users? To the extent client assets are held in trust, directors and officers can be found personally liable for knowingly assisting in a breach of that trust.
- Many crypto companies rely on securities-law exemptions with respect to the sale of products and/or fundraising. In the absence of a prospectus, directors and officers may need to make representations to the prospective purchaser directly. In such cases, it may be more arguable that the representation was made in the director or officer's personal capacity.
- Securities laws with respect to insider trading apply to crypto companies, and to crypto assets that are properly designated as securities (a topic for another day). In addition to crypto asset issuers, crypto asset trading platforms may have advance 'insider' knowledge that can affect trading prices.[26]

These risks are heightened by the typical unavailability of insurance for crypto assets and related products, and the relative uncertainty as to how creditor priority rules will be applied in insolvency to the wide range of different corporate structures and custodial arrangements employed by platforms.[27] Certain of these issues may be tested (in many cases for the first time) with respect to the proceedings that will ensue with respect to Voyageur and Celsius.

For questions regarding these trends or any inquiries relating to Canada's digital asset ecosystem, please contact the members of Osler's Digital Assets and Blockchain Group.

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[1] *Canada Business Corporations Act*, RSC 1985, c C-44 ("*CBCA*") at s. 122(1)(a)

[2] *CBCA* at s. 122(1)(b)

[3] *Peoples Department Stores Inc. (Trustee of) v. Wise, 2004 SCC 68* ("*Peoples*") at para. 67.

[4] *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69 ("*BCE*") at para. 40

[5] *Peoples* at para. 46.

[6] *BCE* at para. 37.

[7] *CBCA* at s.239 (derivative) and s. 241 (oppression).

[8] This liability typically can be joint or several (i.e., a single director can be held liable for the entire amount).

[9] *CBCA* at s. 118(2), referencing ss. 34, 35, 36, 42 and 190. See also *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 ("*BIA*") at s. 101.

[10] *CBCA* at s. 118(1).

[11] *BIA* at s.96.

[12] *BIA* at s.101.

[13] *CBCA* at s. 124

[14] *CBCA* at s. 119. Note, this does not include 'termination pay'.

[15] *Business Corporations Act*, RSO 1990, c B.16 ("*OBCA*") at s. 131.

[16] *Pension Benefits Act*, RSO 1990, c P.8 at ss. 109 and 110.

[17] *Income Tax Act*, RSC 1985, c 1 (5th Supp) ("ITA") at s. 227.1.

[18] *Excise Tax Act*, RSC 1985, c E-15 at s. 323(1).

[19] *ITA* at s. 242.

[20] *Canadian Environmental Protection Act*, 1999, SC 1999, c 33 at s. 280.1.

[21] *Corruption of Foreign Public Officials Act*, SC 1998, c 34 at s. 3.

[22] See our prior publication, Supreme Court clarifies test for personal liability of directors for oppressive conduct.

[23] *Meridian Credit Union Limited v. Baig*, 2016 ONCA 150.

[24] Referred to as "knowing assistance". *Air Canada v. M & L Travel Ltd.*, [1993] 3 SCR 787.

[25] See our prior publication, Directors Liabilities – Even After Settlement.

[26] For example, as to when a crypto asset will be listed on the platform.

[27] Certain platforms have expressly indicated that, in the event of a bankruptcy, client assets may not be recoverable at all.