

LOCAL GOVERNMENT SUBSIDIARIES

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I. INTRODUCTION

Municipalities can incorporate by using their natural person powers under section 8(1) of the *Community Charter* (the “*Charter*”). Regional Districts, while lacking natural person power, are authorized by section 263(1)(f) of the *Local Government Act* (the “*LGA*”) to “engage in commercial, industrial and business undertakings and incorporate a corporation or acquire shares in a corporation for that purpose”. While incorporating a company has many practical benefits for a local government, there are several factors it must consider and requirements it must adhere to both during the incorporation process and once the corporation is up and running. In this paper, we’ll discuss the advantages of incorporating or acquiring a corporation, review the incorporation process, including those steps unique to local governments, and, finally, consider the issues that local governments may face during the creation and use of subsidiaries.

II. ADVANTAGES OF INCORPORATION

A. Limited Liability

Likely the most well-known and discussed benefit of incorporation is the limitation of personal liability. Under British Columbia’s *Business Corporations Act* (the “*BCA*”), except in the case of unlimited liability corporations, the liability of a corporation’s shareholders is limited to the amount the shareholder agreed to pay for its shares. To take full advantage of this, shareholders of private corporations will often purchase shares for nominal consideration. This feature is attractive to local governments because it allows them to protect their constituents from risk associated with the business it chooses to undertake via the corporation. It is important, however, to keep in mind that this limitation of liability is not absolute, as there are situations, discussed later in this paper, in which shareholders can face liability beyond their initial share investment.

B. Specific Focus

Corporations have natural person powers, meaning they are unique entities that can do anything that an individual can do, which allows them to carry on business independently. Additionally, a corporation’s directors are usually responsible for managing the corporation’s business and affairs (although, as we’ll explore later, these management powers can be restricted). As a result, government-owned corporations can focus on carrying out specific functions and meeting specific business goals. This freedom to focus has several benefits. First, once a local government identifies the goals it wants its corporation to achieve, the local government can engage directors with expertise in those areas. Second, transferring management responsibilities to the directors frees up a local government’s council’s time to focus on other matters. Third, because the corporation has a specific focus, it may be able to

make decisions and respond to changing conditions more quickly than a local government can. Fourth, a corporation can keep much of its day-to-day business separate from a local government's business, which may make organization and record keeping of the corporation easier. All told, these factors may lead to a local government's corporation operating more efficiently and effectively.

C. Partnering with Other Municipalities

Multiple local governments can use a corporation to jointly provide a service. This may be especially attractive where governments are considering providing the service over a large geographic area where the costs of startup, infrastructure and operating associated would be prohibitive for an individual local government acting alone. Taking advantage of economies of scale may allow multiple municipalities to provide services they couldn't otherwise provide.

III. BASICS OF INCORPORATION

An individual or entity (who we'll refer to as an incorporator) that wishes to incorporate does so via the incorporation process governed by the *BCA* and British Columbia's Registrar of Companies. Below is a brief outline of the steps involved in the process:

A. Choosing a Name

The Registrar of Companies must approve of a corporate name prior to a company incorporating under such name. While there are several criteria governing name approval, acceptable names typically consist of:

- A distinctive element such as a coined word, geographical location or personal name ("ABC");
- A descriptive element which describes the nature of the business ("manufacturing"); and
- A corporate designation such as ltd., incorporated, or corp. (note that there are different designations for Community Contribution Corporations, Extra-provincial Companies, and not-for-profit societies).

Once a name is selected, an incorporator will apply for approval of the name with the Registrar. Local governments should also be aware that certain types of names or words within names are specifically prohibited, including those that suggest the corporation is connected with the government, like "provincial", "ministry", "branch", and "department".

B. Articles

The articles of incorporation essentially serve as the rules that a corporation and its management and shareholders must abide by. Given the impact these rules will have on the structure, ownership, and management of the corporation, incorporators should turn their mind to the content and form of their articles early in the incorporation process. Specifically, the *BCA* requires articles to include every restriction on the business that it carries out and the powers that it exercises, as well as the special rights or restrictions that are attached to its shares.

The *BCA* includes model articles that a corporation can choose to adopt rather than creating its own, and many corporations choose to do this. However, while a local government incorporator may be tempted to adopt the model articles wholesale, it should consider tailoring the articles to ensure that they will allow the local government to achieve its goals while maintaining acceptable levels of control and risk.

C. Forming the Corporation

Section 10 of the *BCA* governs the actual formation of a corporation, which occurs when an incorporator enters into an incorporation agreement and files it with the Registrar. Under the incorporation agreement, each incorporator must take one or more shares in the corporation. The incorporation agreement must also include the full name and mailing address of the incorporator(s), the name of the corporation, and the notice of articles. Prior to submitting the notice of articles, the incorporating entity must finalize its articles, name its first directors, determine its share structure, and decide where the corporation's registered and records office will be located. Once complete, the incorporator submits the incorporation application to the Registrar for approval. Once approved, the notice of articles and articles become binding contracts on the shareholders and the corporation.

D. Annual Requirements

Once a corporation is created, it must hold its first annual general meeting within 18 months of incorporation. Following this, it must meet at least once each calendar year and not more than 15 months after the last annual general meeting.¹ However, the corporation has the right to hold the meeting earlier, defer, or waive the holding of the annual general meeting by a council resolution. Generally, the annual general meeting consists of a presentation of financial statements, appointment of an auditor, and election of directors.

¹ *Business Corporations Act, S.B.C. 2002, c. 57, s 182(1).*

In addition to holding an annual general meeting, the corporation will need to ensure that annual reports are filed with the Registrar within 2 months after each anniversary of the date on which the corporation was recognized under the *BCA*.² Failure to file annual reports with the Registrar for 2 consecutive years may result in dissolution of the corporation.³ If the corporation has assets at the time of dissolution, its assets (in the case of land) will escheat to the Province in accordance with section 4(1) of the *Escheat Act*.

IV. INCORPORATION CONSIDERATIONS FOR MUNICIPALITIES

A. Requirements of the Inspector of Municipalities

As mentioned, local governments are empowered to incorporate via the *Charter* the *LGA*, and, like any other entity incorporating a company, they do so by following the basic steps outlined above. However, before it can submit its incorporation application to the Registrar, or acquire the shares of an existing corporation, a local government must meet a few additional requirements imposed by section 185(1) of the *Charter*:

185 (1) A municipality may only

(a) incorporate a corporation other than a society, or

(b) acquire shares in a corporation

with the approval of the inspector or as authorized by regulation.

An equivalent provision in section 265 of the *LGA* places the same restrictions on regional districts. The “inspector” is the Inspector of Municipalities. The power these sections grant to the inspector may seem broad at first glance, especially considering neither the *Charter* or *LGA* expand any further on the inspector’s approval process or specify any approval requirements. Fortunately, the Ministry of Community Services provides some guidance on the approval process via a guide titled “Launching and Maintaining a Local Government Corporation”. The guide states that the inspector’s purpose is to ensure that a government’s acquisition or incorporation of a company is in the public interest. Accordingly, the guide outlines the practical steps of the approval process, which involves submitting an application that adequately addresses the following issues:

- **The government’s objectives in creating the corporation and why a corporation is an optimal vehicle for meeting these goals** – As noted above, there are several reasons why a local government might choose to incorporate or acquire

² *Business Corporations Act, S.B.C. 2002, c. 57, s 51.*

³ *Business Corporations Act, S.B.C. 2002, c. 57, s 422(1).*

a company. In its application, the government should outline these reasons and explain why using a corporation allows it to achieve its goals better than alternative approaches.

- **The degree of control that council will exercise over the corporation through share ownership, representation on the board, and other restrictions or requirements in the articles** – This section is especially important where a local government will be one of many shareholders, especially if any municipal assets are being transferred to the corporation, as the government must show how it intends to protect such assets. A local government can meet this requirement by submitting articles that clearly govern the issues of director appointment, management powers of directors and share ownership, allotment, and disposal. If the corporation will have multiple shareholders, the incorporator may also submit the relevant shareholder’s agreements.
- **The financial exposure of the municipal shareholder** – To address this issue, a local government’s application should include a business plan detailing the assets it intends to contribute to the corporation and highlight any borrowing restrictions or general restrictions in the articles.
- **Conflict of interest potential** – The incorporator’s application should specifically outline how potential conflicts of interest between the corporation and the local government will be avoided or managed, such as through the selection and education of directors and the establishment of rules and guidelines governing their conduct.
- **Duty of directors** – The application must outline how a local government intends to educate and train its directors on the legal and ethical duties imposed on them by virtue of their position.
- **Consultation and public input** – The local government should indicate the extent and form of its consultation of its constituents on the incorporation or acquisition, including by reporting on public meetings, and submitting copies of notices that it has provided to the public and public feedback it has received.

B. Meeting the Inspector’s Requirements and Other Considerations in Articles

As mentioned above, a corporation’s articles of incorporation govern its conduct, and, as a result, they have a significant impact on a corporation’s governance and structure. A local government should carefully consider the contents of its articles to ensure that they meet the inspector’s requirements as well as the local government’s own goals. Below are a few important factors that a local government should consider when crafting its articles, including information on how the *BCA*’s model articles address these issues.

1. Management Responsibility

Section 136 of the *BCA* indicates that the directors of a corporation must manage or supervise the management of the business affairs of a corporation. However, the management and supervisory role of the directors is subject to the articles of the corporation, and section 137 of the *BCA* indicates that the corporation can transfer such powers, wholly or partly, to one or more other persons. The model articles leave management powers in the hands of the corporation, but local governments can choose how they wish to delegate such management powers, and including well-crafted provisions can allow the local government to balance the protection of its interests while also allowing it to take advantage of the expertise of the corporation's directors.

2. Board of Directors and Related Powers

This consideration is especially important if the corporation's articles leave management responsibilities in the hands of the directors, as the local government will want to ensure that its comfortable with the directors who are managing the corporation. While the *BCA* requires the shareholders to elect the company's directors at every annual general meeting, the model articles allow the directors to appoint one or more additional directors (although the number of additional directors that the directors can appoint is limited to 1/3 of the current number of directors). Additionally, if a "casual vacancy" (which is a vacancy in the board of directors caused when a director ceases to be a director) occurs, the model articles allow the remaining directors to fill that vacancy. If a local government would prefer to retain control over the composition of the board of directors, it can include provisions in the articles indicating vacancies can only be filled by the shareholders and prohibiting the directors from appointing additional directors.

3. Share Structure

Shareholders have an interest in the value of the company as well as contractual rights stemming from the articles and notice of articles of the corporation. Unless otherwise stated in the articles, shares are presumed to be equal. Generally, shareholders are entitled to vote at general meetings and cast one vote per share. While the specific powers of shareholders depend on the content of the articles, at the very least, shareholders are usually responsible for electing and removing the corporation's directors, which may have a large impact on the corporation's management and general direction. As such, in order to ensure that shareholder power stays in the hands of acceptable parties, a local government may want to consider placing restrictions on when and to whom shares can be issued, as the model articles allow the directors to, at their discretion, issue shares. For the same reason, local governments may wish to place restrictions on how shares can be transferred, as the model articles do not restrict the transfer of shares (aside from requiring that certain formal requirements are met).

C. Separate Existence

It is imperative for local governments to understand that a subsidiary is a completely separate legal entity from its creator. An obvious misunderstanding is for local governments to fail to diligently treat and operate its subsidiary as a separate legal entity, as most local governments and their subsidiaries, generally, may have the same employees, governance, operations or premises. Thus, it is important for local governments and their subsidiaries to ensure they recognize their separate existence through formal requirements. Some formal requirements include ensuring the subsidiary complies with section 27 of the *BCA*, which requires that every corporation display its name in legible English or French characters:

- In an obvious place at each place the corporation carries on business in British Columbia;
- In its notices and other official publications;
- On all contracts, letters and orders, invoices, statements of accounts, and receipts; and
- All bills of exchange, promissory notes, endorsements, cheques, and money orders.

Although, in practice, this differentiation may at times be difficult to administer, it is essential for local governments and their subsidiaries to comply with all the rules that are applicable to them.

V. POST-INCORPORATION CONSIDERATIONS

A. Taxation

A municipal corporation is generally exempt from paying income taxes if it operates within the municipal boundaries. However, municipal corporations are not exempt from property transfer tax as local governments, although, a municipal corporation may qualify as a “para-municipal” organization and be treated the same as a local government for General Sales Tax purposes. With respect to property taxation, municipal corporations do not enjoy the exemption from property taxes that local governments do unless a permissive exemption is granted under a partnering agreement.

B. Capacity to Borrow

Corporations, using the natural person power, can borrow for the purpose of carrying out the corporation’s objectives. However, it is important to review the corporation’s articles or memorandum to determine whether there are any restrictions placed on its power to borrow.

Borrowing money is a common method used by local governments to capitalize a subsidiary. Municipal corporations may borrow funds from the Municipal Finance Authority or from private lenders. However, private lenders will not lend money unless the loan is guaranteed by the local government.

VI. ISSUES LOCAL GOVERNMENTS AND SUBSIDIARIES MAY ENCOUNTER

A. Personal Liability

Directors and officers can be held personally liable for a variety of statutory provisions under the *BCA* and under common law. For instance, under the *BCA*, a director can be liable to shareholders for actions that resulted in the corporation suffering damages and for improper use of corporate assets. Directors and officers can also be held liable for unpaid employee wages under the *BCA* and environmental remediation costs.

B. Corporate Veil

As mentioned previously, one of the main objectives for creating a corporation is the protection that is generally afforded to shareholders from the liabilities of the corporation. However, the protection from liability can be lost through piercing of the corporate veil, which is a rare exception to the separate legal entity principle. The corporate veil is pierced when a court can find a strong connection between the wrongdoing subsidiary and its parent corporation. In such an event, a court may decide to lift the corporate veil and attach liability to the parent corporation. It is used in the cases of fraud or other exceptional circumstances and usually determined on a case by case basis.⁴ Generally, a court will consider the following factors when determining whether to lift the corporate veil:

- The corporation was incorporated for an illegal, fraudulent or improper purpose;
- It would be “just and equitable” to do so and if not enforced it would be flagrantly opposed to justice;
- The subsidiary is completely dominated and controlled by the parent corporation;
- The subsidiary corporation was carrying on the business of the parent corporation;
- The parent corporation owns all the shares of the subsidiary;
- Where the profits of the subsidiary are treated as profits of the parent corporation;

⁴ See *Dole Foods v. Patrickson*, (2003) 538 U.S. 468

- The subsidiary and parent corporations share the same employees, directors, and officers;
- The parent corporation was the head and brains of the subsidiary; and
- The parent corporation was in effectual and constant control.⁵

It is important for local governments to be cognizant of the restrictions, requirements and limitations that surround their financial powers. Especially, when operating its subsidiary for borrowing, lending, using and disposing assets for the purpose of avoiding the requirements of the *LGA*.

C. Funding a Corporation

When funding a subsidiary to carry on its business, local governments will be confronted with section 273 of the *LGA*, which prohibits local governments from providing assistance to a business, except under a partnering agreement where the business provides a service on behalf of the local government. The Court in *Nelson Citizen's Coalition v Nelson (City)*, [1997] BCJ No 138, concluded that "assistance", within the context of the *Charter*, means "conferring of an obvious advantage". As such, providing a corporation financial grants, advantages, loans, guarantees, disposition of land less than market value, share purchases, advances, and tax exemptions can all be forms of assistance. Assuming that a local government is providing assistance to a subsidiary, it may lend money to the subsidiary for assistance as long as the subsidiary enters into a partnering agreement.

It is important to note that the subsidiary will need to provide a service on behalf of the local government in order to enter into a partnering agreement. Moreover, since a local government is not authorized to delegate to a corporation, no government powers, duties, or functions may be delegated to the subsidiary under the partnering agreement.

⁵ *Dole Foods v. Patrickson*, (2003) 538 U.S. 468; *Clarkson Co. Ltd. v. Zhelka et al.*, 1967 CanLII 189 (ON SC); *Transamerica Life Insurance Co. of Canada v. Canada Life Assurance Co.*, 1996 CanLII 7979 (ON SC); and *De Salaberry Realities Ltd. v. M.N.R.*, (1974) FCA.

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