

Are “shelf corporations” a thing of the past?

Here at LAWPRO we take an interest in practice management trends (which means we’re always grateful for your input about the way you practice law today!).

Sometimes, the decline of trends is just as noteworthy as their emergence. One example is the declining use of “shelf corporations” in corporate-commercial practice.

A “shelf corporation” is (or was) a business corporation created and registered by a law firm and kept at-the-ready for the convenience of clients who might require incorporation on very short notice.

Prior to the introduction of electronic registration for Ontario and federal corporations, this offered a real advantage: accommodating a client who arrived in the afternoon to request a speedy incorporation meant a scramble to get all the documentation in order and signed before racing to the ministry to stand in line before the 4:30 pm closing time. Having a pre-registered shelf corporation available meant that the lawyer could instead simply amend the necessary corporate information, including addresses and director names.

(In rarer circumstances, explains Violet French of Torkin Manes, a shelf corporation would come in handy for a client who, to appropriately paper a transaction, “needed a company that was of a certain vintage.”)

The practice of “stocking” shelf corporations was not without pitfalls even when it was in fashion. Nicky Huq, a Toronto corporate lawyer, reports that she herself never created shelf corporations: “It just wasn’t necessary,” she explained, “in the context of my particular practice.” But Huq was nevertheless familiar with some of the potential pitfalls. “For example,” she noted, “the Ontario Business Corporations Act (OBCA) has made it challenging to replace a ‘first director.’”

The first directors of shelf corporations were usually, of course, firm lawyers or clerks. Citing the 1991 Tax Court of Canada decision in *Zwierschke v. M.N.R.* (92 DTC 1003; 1991(2) CTC 2783), Huq pointed out that the OBCA, at the time, contained a provision (s.119(2)) that seemed to preclude the effective resignation of a first director until the first meeting of the shareholders. This created potential exposure, for lawyers, to directors’ liability in the event that the corporate client recipient of the shelf corporation later failed to co-operate in the election of replacement directors. Says Huq, “you can’t force a client to hold a meeting, or to replace a director.”

The current iteration of s. 119(2) seems to contemplate an effective resignation for a first director, prior to a first board meeting, *if* a substitute director is appointed in the first director’s place; however, the law firm would still presumably have to rely on its corporate client to make that appointment, and to obtain the replacement director’s consent. And of course, the lawyer director would have to actually *remember* to resign,

would have to do it in time to avoid liability, and would have to resign in a manner that is compliant and, therefore, effective.

In the years since *Zwierschke*, some additional legal protection has emerged for lawyer first directors. First, a 1994 amendment to the OBCA, which introduced the concept of “deemed directors” for corporations with no directors (s. 115(4)) specifically excluded from the list of potential deemed directors, at s. 115(4)(b) “a lawyer, accountant or other professional who participates in the management of the corporation solely for the purposes of providing professional services.” Second, recent case law such as the 2008 decision in *Hartrell v. Canada* ([2006] T.C.J. No. 386 (Tax Court of Canada) appeal dismissed in [2008] F.C.J. No. 228 (Federal Court of Appeal)) has tended to support the view that a lawyer named as a first director for practical purposes ought not be held liable for acts of the corporation (for example, the failure to make remittances under employment law statutes).

It seems, however, that these (partial) protections for the creators of shelf corporations arrived just in time to be replaced by a new potential pitfall: earlier tax obligations. Explains Violet French: “[when a corporation is registered, the Canada Revenue Agency] opens up the Business Number (BN) for income tax automatically which means returns need to be filed. In the ‘old days’ it took a lot longer for CRA to issue a BN number so it was relatively easy to set up some shelf companies and hold onto them without too much tending and mending.”

It appears then that the hassle of tending and mending, lingering concerns about directors’ liability, the ease of electronic registration – or more likely a convergence of all three factors – have contributed to a significant decline in the practice of creating and “stocking” shelf corporations. If you are one of the few lawyers who continues this practice, have you given recent consideration to the pros and the cons? We’d be happy to hear your thoughts on the issue.