Process, Process, Process: Advising the Target Board or Special Committee in Canada

Law Department Management

Background

The CEO of your Canadian affiliate listed on the Toronto Stock Exchange (TSX) has just called and is

anticipating an unrelated third party takeover bid. The CEO has asked you to identify the immediate priorities to assist the board of directors (the board) in organizing itself to consider and respond to a takeover bid.

Being a director of a public company in Canada is increasingly challenging. It is therefore crucial for corporate counsel to work with outside counsel and the board to ensure that the board:

- Is aware of its fiduciary duties;
- Conducts the transaction process, and acts in a manner consistent with those duties; and,
- Is seen by stakeholders to be doing so.

The following is intended to provide a high-level summary of key principles under Canadian law, as well as recent developments in Canadian takeover bid rules.

Why is it important to review directors' duties?

When considering embarking upon any review of the corporation's strategy, in which the end result could be a change of control transaction, it is important that directors be advised of their duties.

Even experienced directors should be reminded of the requirements imposed upon them by corporate law and be brought up to date on the current law and how their duties may be met in a change of control transaction.

In a public company context, the process followed by the board will be summarized in public disclosure documents. It is therefore important that members of the board be — and be seen to be — cognizant of their duties and responsibilities and to be conducting themselves accordingly. Process may not be everything, but it is very important to set the stage for the defence of decisions undertaken by the board and for the protection of individual directors from claims that they have not acted in accordance with their duties.

General corporate duties of directors in Canada

Duty of care in a change of control transaction

In Canada, all of the directors owe the same duty of care to the corporation. This is regardless of change of control transaction proposed and whether or not a special committee is established to review a proposed transaction.

Although the board may come to rely a great deal on the recommendations of a special committee, the directors cannot abdicate their responsibilities to a special committee and must conduct their own examination of the issues relating to a proposed transaction. Most often, special committees are recommended where one or more of the target's board of directors has interests inconsistent with the interests of the shareholders as a whole. Often such inconsistent interests will arise for directors who also hold senior management positions with the corporation and who may lose their position following a change of control. A special committee usually retains its own legal and financial advisors, independent of the full board's advisors.

> In Canada, as in the United States, the duty of care does not require perfection.

In properly discharging duties to the corporation, each director must exercise such care, diligence, and skill as a reasonably prudent person in a similar position would use in comparable circumstances. Satisfying this duty of care generally means:

- Having adequate knowledge of the proposed transaction;
- Conducting an independent examination of the proposed transaction;
- Allowing sufficient time to gather, digest, and analyze the facts relating to the proposed transaction;
- Seeking independent legal, financial, and other advice where appropriate;
- Questioning, examining, and verifying any information or advice provided;
- Summarizing in a logical fashion the conclusions or recommendations reached; and,
- Otherwise ensuring that any decision is made objectively and on an informed basis.

In Canada, as in the United States, the duty of care does not require perfection. The courts will look to see that the directors made a reasonable decision, not a perfect one.

Fiduciary duty in a change of control transaction

The fiduciary duty of members of a special committee is no different than their duty as directors on the full board, which is to act honestly, in good faith, and in the best interests of the corporation. In satisfying their fiduciary duty, they are expected to undertake a review of the same factors and considerations as would the full board of directors.

Corporate constituency

Prior to the December 2008 decision of the Supreme Court of Canada in *BCE Inc. v. 1976 Debentureholders*, there was often a debate regarding the corporate constituency to which the directors owed their principal fiduciary duty. In certain circumstances, such as where a corporation was put “into play” as a result of an offer to acquire its assets or its shares, it was often asserted (based primarily on Delaware case law) that the directors’ principal duty became the maximization of shareholder value.

The Supreme Court of Canada’s decision in *BCE*, however, clarified directors’ fiduciary duties in Canada. Directors are to act in the best interests of the corporation. Often the interests of shareholders and other stakeholders are co-extensive with the interests of the corporation. But if they conflict, the directors’ duty is clear — it is to the corporation and not to shareholders or any other particular group of stakeholders.

How broad is the duty?

In Canada, the fiduciary duty of board members or a special committee is a broad, contextual concept, and it is not confined to short-term profit or share value. Where the corporation is a going concern, directors must look to the long-term interests of the corporation.

Although the content of the duty will vary with each situation, at a minimum, it requires the board or special committee to ensure the corporation meets its statutory obligations. Depending on the context, however, there may also be other requirements.

Notably, the Supreme Court of Canada explicitly refused to endorse the application of the *Revlon* duties, whereby directors of Delaware corporations are required to maximize value for

shareholders once a sale or break-up of the corporation is inevitable.

Under these circumstances:

- Directors must consider the impact of corporate decisions on shareholders or other stakeholders (employees, creditors, consumers, governments, the environment, etc.) and treat individual stakeholders affected by the corporate actions equitably and fairly. Failure to do so risks a claim under the oppression remedy provisions of corporate legislation in Canada;
- Boards, in general, are not required to prefer (or defer only to) the interests of shareholders;
- When evaluating a change of control transaction, directors must not only consider the legal rights of stakeholders but also their “reasonable expectations;”
- If there are conflicting stakeholder interests, directors must resolve conflicts in a way that is in the best interests of the corporation and that provides fair treatment to the stakeholders;
- A successful oppression claim under corporate legislation in Canada results from harsh and abusive conduct and is not likely to be triggered by a reasoned decision of the board that, while in the best interest of the corporation, benefits one group at the expense of another; and,
- Canadian courts are prepared to defer to a great extent to the business judgement of the directors, provided their decisions are found to be within the range of reasonable choices that they could have made in weighing conflicting interests.

Duty of loyalty and fairness

In Canada, as in the United States, where a transaction involves a perceived or actual conflict of interest, the duties imposed on the directors are heightened. In addition, any such transaction is likely to undergo more rigorous scrutiny from the public, regulatory authorities, and shareholders alike.

If ever challenged in court, a transaction will likely be considered in light of the efforts taken by the directors to insulate the decision-making process from any potential conflict of interest and to demonstrate that the transaction is fair and reasonable to the corporation and is not motivated by self-interest.

Under these circumstances, creation of a special committee, if appropriate, is designed to materially enhance the proof of the fairness of any transaction to the corporation.

What is fairness?

The case law in Canada on this subject indicates that the concept of fairness implies two things:

- Fairness in dealing and in the negotiation and consummation of a transaction; and,
- Closure and analysis of the facts relating to that transaction.

Procedures for conducting the deliberations of a board or special committee are principally aimed at ensuring fair dealing. Appendix A contains examples designed to materially enhance the proof of the fairness of any transaction to the corporation.

The importance of independence

An important factor for the board or special committee to consider is that of independence, not only of its own members, but also of its financial and legal advisors. The determination of independence is a question of fact that must be considered in the context of the particular transaction and in the case of advisors, the nature and terms of their engagement. If facts come to light that appear to compromise the independence of any member or advisor, the board or special committee must give due consideration to removing or replacing such member or advisor or establishing a process to ensure that the matter can be dealt with in a manner that does not compromise the impartiality of the member or advisor.

Regulatory guidance

While determination of independence is a matter for the board, Multilateral Instrument 61101 Protection of Minority Security Holders in Special Transactions (MI 61101), which has been adopted by the Ontario Securities Commission (OSC) and Québec's *Autorité des marchés financiers* and as a requirement of the TSX Venture Exchange, provides key guidance for determining the standard of independence of directors appointed to a special committee. MI 61-101 should also be read against the arguably higher standard applicable to audit committees as set out in National Instrument 52110 - Audit Committees. Reference to this regulatory guidance should be considered as part of the process to determine director independence.

Similarly, MI 61-101 provides guidance as to the independence and qualifications of financial advisors who are to be appointed to conduct a formal valuation of the corporation required for a transaction subject to the provisions of MI 61-101. While MI 61-101 does not apply in circumstances where a financial advisor has been engaged only to provide a fairness opinion, some of the same considerations that apply to the engagement of a valuator can be applied in the context of fairness opinions.

Delaware case law: Royal Bank/Rural Metro

Financial advisor independence was also considered in a recent case in *Delaware, In Re Rural Metro Corporation Stockholders Litigation* in March 2014. Royal Bank of Canada (RBC) acted as financial advisor to the target, Rural Metro Corporation (Rural Metro), in a bidding process. RBC convinced Rural Metro's special committee to run their process concurrently with a competing company's bidding process to try to get a better deal by combining synergies. RBC, however, was actively attempting to obtain a role in financing the bids for the competing process. The combined process actually limited the number of offers for Rural Metro. The court found that RBC was also pitching for the financing work for the ultimate successful bidder of Rural Metro, including sharing matters regarding board dynamics. Ultimately, the court found that Rural Metro had not conducted a reasonable sale process, in part because RBC had failed to properly serve its role as financial advisor to the Rural Metro board.

The decision in *Rural Metro* notes that boards must be active and reasonably informed participants in merger and acquisition transactions. In particular, boards have an obligation to identify, consider, and proactively respond to actual or potential material conflicts of interest involving their financial advisors.

MI 61-101 considerations

MI 61-101 regulates certain types of special transactions, including "related party transactions"

involving one or more reporting issuers. Any proposed transaction involving reporting issuers in Ontario and Québec (and therefore all TSX companies) will need to be considered to determine if:

- It may be a “related party transaction,” “business combination,” or “insider bid” for the purposes of MI 61101; and,
- Whether the requirements of MI 61-101 for (a) a disinterested shareholder approval of the transaction (majority of the minority shareholder approval) or (b) a formal valuation of the subject matter of the transaction, are triggered.

Notably, while the underlying policy rationale of MI 61101 is that all security holders should be treated in a manner that is fair and perceived to be fair, the use of special committees is only mandated in certain circumstances (assessment of formal valuations and determinations of collateral benefits).

Recent changes to Canada’s takeover bid regime

Significant changes to Canada’s takeover rules came into effect in Canada on May 9, 2016 and already impact the way a board or special committee, as applicable, may respond to unsolicited takeover bids.

In Canada, the traditional defensive tactic that was most commonly adopted by target boards, either “tactically” in response to an unsolicited takeover bid, or “strategically” as a shareholder-approved general defence, was a shareholder rights plan or a “poison pill.” Poison pills were designed to allow more time for boards to consider and respond to bids, as the previous takeover bid regime provided for a relatively short 35-day deposit period. The usual sequence of events in a hostile bid was that, after an appropriate amount of time (in the range of 60 days), a bidder would apply to a Canadian securities commission to have the poison pill cease trade on the basis that the target board had been afforded sufficient time to respond to the bid.

Among other changes, the new rules provide target boards with substantially more time to react, thereby effectively reducing or eliminating the need for poison pills and rendering poison pill hearings unnecessary.

The key principles of the new takeover bid regime are:

- Fifty percent minimum tender condition: The new regime requires that a minimum of more than 50 percent of all outstanding target securities owned or held by persons other than the bidder and its joint actors be tendered and not withdrawn before the bidder can take up any securities under the bid. This requirement allows for collective action by security holders — in effect a “shareholder vote” on the bid (i.e., a majority of security holders must show they are in favour of the bid by tendering).
- Ten-day extension period: If the minimum tender condition is met, and all other terms and conditions of the bid have been complied with or waived, the bid must be extended for an additional 10 days. The extension requirement allows other shareholders to tender once they know that a majority of security holders are in favour of the bid. It also alleviates the concern of Canadian regulators that security holders may otherwise have felt “pressure to tender” to a bid for fear of being “left behind” if the bidder received sufficient tenders from other security holders.
- Deposit period of 105 days: The minimum period that a takeover bid must remain open is 105 days, provided that:
    - The target company may, by news release, reduce the minimum period to as little as

35 days, in which case the reduced period will apply to all outstanding bids (if the bidder files a notice of variation) and all subsequent bids; and,
    - If the target company, by news release, announces that it will effect an “alternative transaction” (generally a transaction that requires a vote of security holders, such as a plan of arrangement), the minimum period for all outstanding bids (if the bidder files a notice of variation) and subsequent bids will be 35 days.

The deposit period was reduced to 105 days from the originally proposed 120 days to allow bidders to effect “compulsory acquisitions” under certain Canadian corporate statutes. These compulsory acquisition provisions state that if a takeover bid is completed within 120 days of being launched and under the bid the offeror acquires more than 90 percent of the shares subject to the bid, the offeror can compulsorily acquire the remaining shares. A 105-day bid period together with a 10-day extension period will allow bidders to complete bids within the required 120-day period.

The 50 percent minimum tender condition and the 10-day extension period are intended to allow security holders to make “voluntary, informed, and coordinated tender decisions” and the longer deposit period is intended to provide target boards with more time to consider and respond to takeover bids — effectively giving boards much more bargaining power in dealing with prospective bidders.

Appendix: Procedural examples in a change of control transaction

- Convene an initial meeting, either in person or by telephone conference, in order to:
    - Discuss the background, timing, and nature of the proposed transaction;
    - Determine whether a special committee of the board should be appointed;
    - Review and confirm the composition and independence from management of the members of the board or special committee;
    - Adopt a mandate of the special committee. It is important that a special committee have a clear mandate that is reflected in the written record and understood by the special committee members. In the past, courts in Canada have criticized special committees as being structurally flawed where each of the committee members had a materially different understanding of the committee’s mandate;
    - Appoint an independent lead director of the board (if the corporation’s chair is not independent) or chair of the special committee;
    - Appoint a secretary to keep minutes of the meetings and deliberations of the board or special committee. Each member of the board or special committee should approve the minutes much in the same way the minutes of a regular board meeting are approved;
    - Review the credentials and independence of proposed legal counsel and financial advisor to the board or special committee;
    - Retain a legal advisor to assist the board or special committee in discharging its responsibilities, including keeping a record of its meetings and deliberations, ensuring the board or special committee has full access to all necessary information relevant to the proposed transaction. This advisor should counsel the board or special committee as required regarding legal issues and assist the special committee in writing its report by articulating a recommendation. The board or special committee should assist its advisors in every way possible, particularly by ensuring that its financial and legal advisors have full and unfettered access to the information which they need to advise the board or special committee;
    - Review the duties and responsibilities of members of the board or special committee

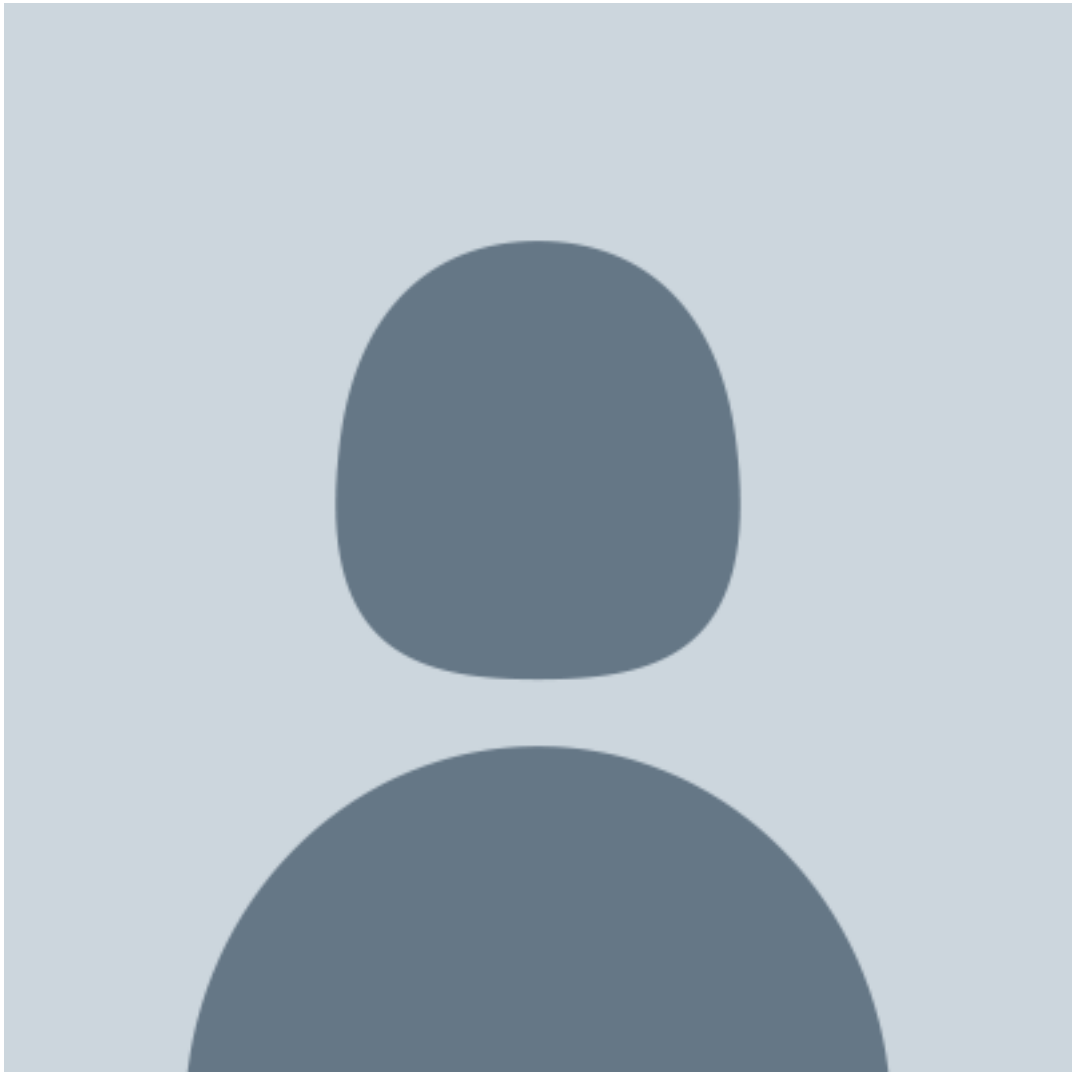
with legal counsel;
    - Engage an independent financial advisor:
        - To assist in identifying and analyzing all financial and valuation issues relevant to the proposed transaction and the consequences to the corporation and its shareholders; and
        - If applicable, to provide an opinion to the board or special committee as to the fairness of the proposed transaction, from a financial point of view, to the shareholders of the corporation; and
- Settle an action plan for the board or special committee that reconciles conflicting time schedules, but provides for sufficient meeting time to fulfill its mandate. The board or special committee should conduct its deliberations in such a manner as to ensure that a reasoned, unhurried decision is reached on a fully-informed basis and, where required, with such advice as the members of the board or special committee consider appropriate.
- Convene meetings with senior management to review the work that it and its advisors have carried out with respect to the proposed transaction. A process should be put in place to ensure that the board or special committee is kept abreast of the ongoing work of management.
- With the assistance of its legal counsel, put in place a procedure to ensure that solicitor/client privilege is not endangered as a result of the flow of information between the board or special committee and its advisors and management.
- Convene meetings to review the proposed transaction generally and verify the facts and assumptions that are material to the proposed transaction with the assistance of the financial advisors or legal counsel to the board or special committee. The board or special committee is obligated to undertake a considered review and comment process with respect to any and all documentation considered material to the proposed transaction. The board or special committee should also be prepared to provide their comments on this documentation and approve the final versions thereof.
- Convene meetings to consider all reasonably available courses of action and to fully consider and understand the risks, opportunities, challenges and values associated with each of the alternatives under consideration. It is important to conclude that the approved alternative is in the best interest of the corporation and is the best one reasonably available to the corporation in the circumstances.
- If applicable, meet with financial advisors to the board or special committee to receive presentations as to the conclusions on and analysis underlying the fairness of the proposed transaction, with a final meeting to receive the financial advisors' verbal fairness opinion and a draft of their written opinion.
- If significant or material concerns relating to fairness are identified in the proposed transaction, propose (and possibly negotiate) amendments to the proposed transaction.
- Review and comment on the draft public disclosure documentation required to be prepared in connection with the proposed transaction.
- Where a special committee has been appointed, prepare a written report to the board. The importance of producing a complete and well-reasoned recommendation report that demonstrates the thorough consideration by the special committee of the proposed transaction cannot be over-emphasized. The recommendation report should:
    - Describe in chronological order the historical basis for the proposed transaction;
    - Describe the process relating to the formation of the special committee and the rationale behind the choosing of its members, if applicable;
    - Outline the process relating to the retaining of legal and financial advisors;
    - Set out the procedures and deliberations taken by the special committee including a summary of all material negotiations and communications with third parties (and

communications with the board) regarding the terms of the proposed transaction and the structure thereof;
    - Describe the terms and/or structure of any revisions to the proposed transaction (if any) which resulted from the efforts of the special committee; and,
    - Issue the recommendation of the special committee.

Needless to say, considerable care should be devoted to the preparation of this report, as it will constitute the most visible record of the diligence of the board and the special committee in its review of the proposed transaction. More importantly, however, it will form the primary basis for any public disclosure upon which the shareholders will make a decision relating to the proposed transaction.

- Communicate with the board on a continuing and ongoing basis with respect to their views as to the fairness and/or adequacy of the terms or structure of the proposed transaction.

Kent Kufeldt



Partner

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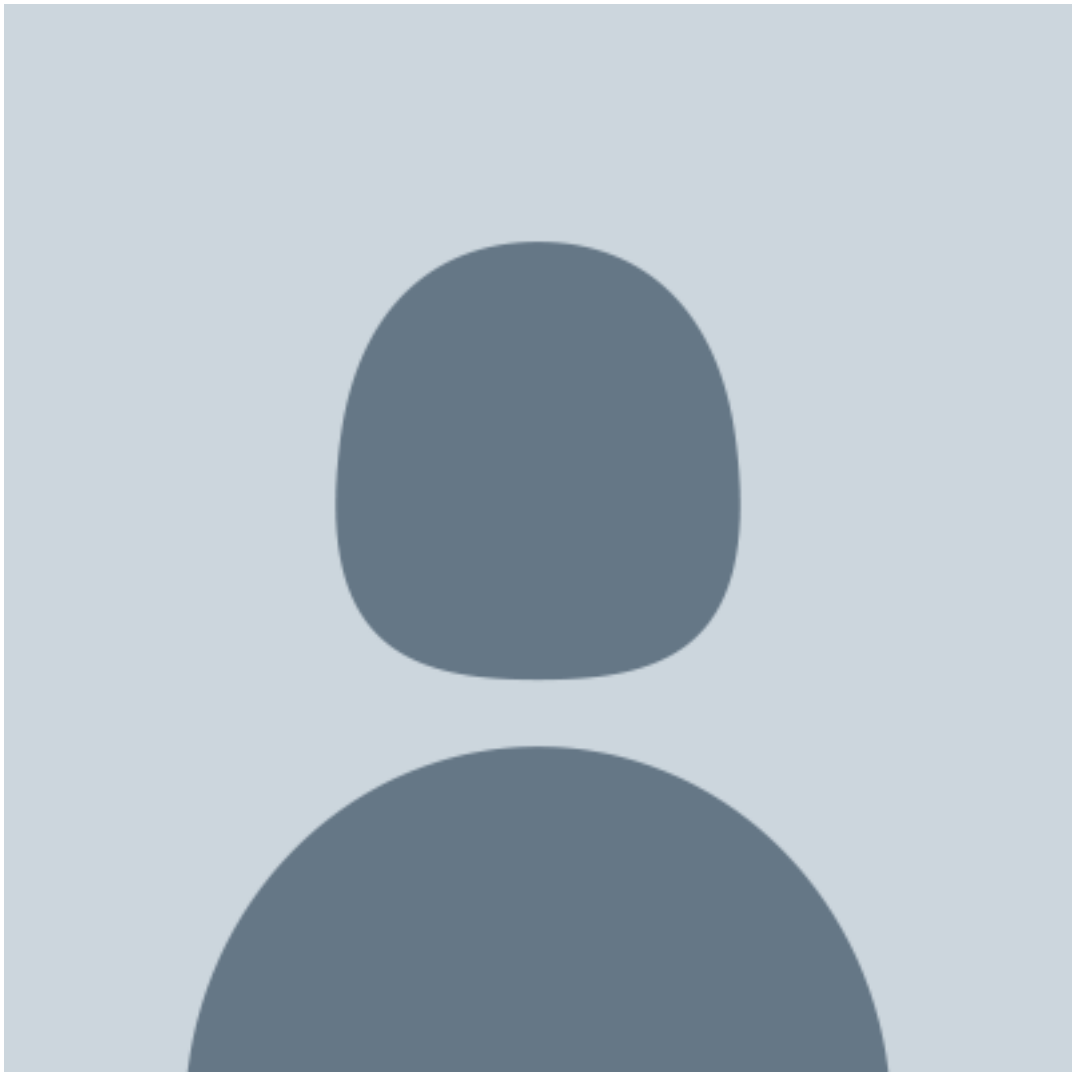

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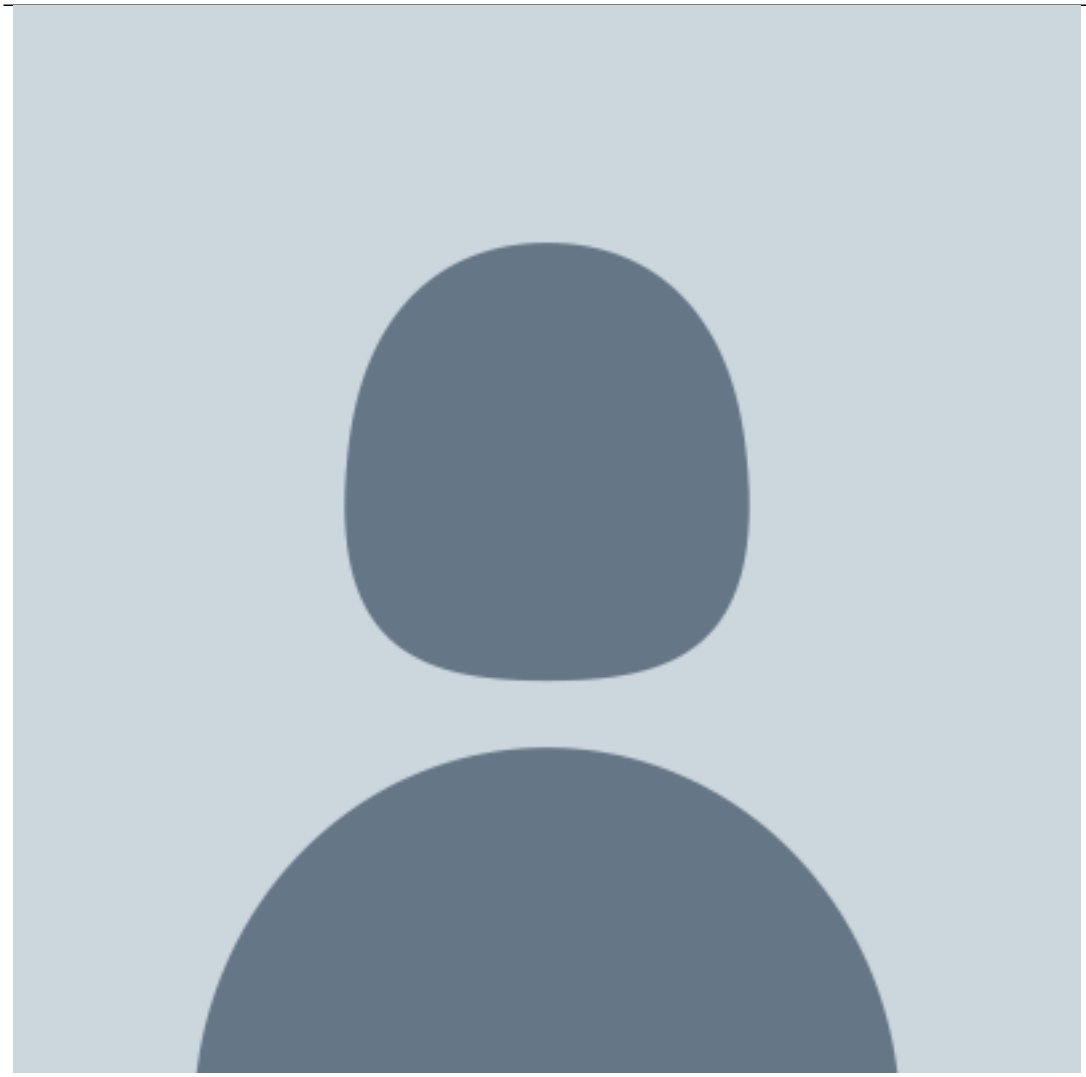

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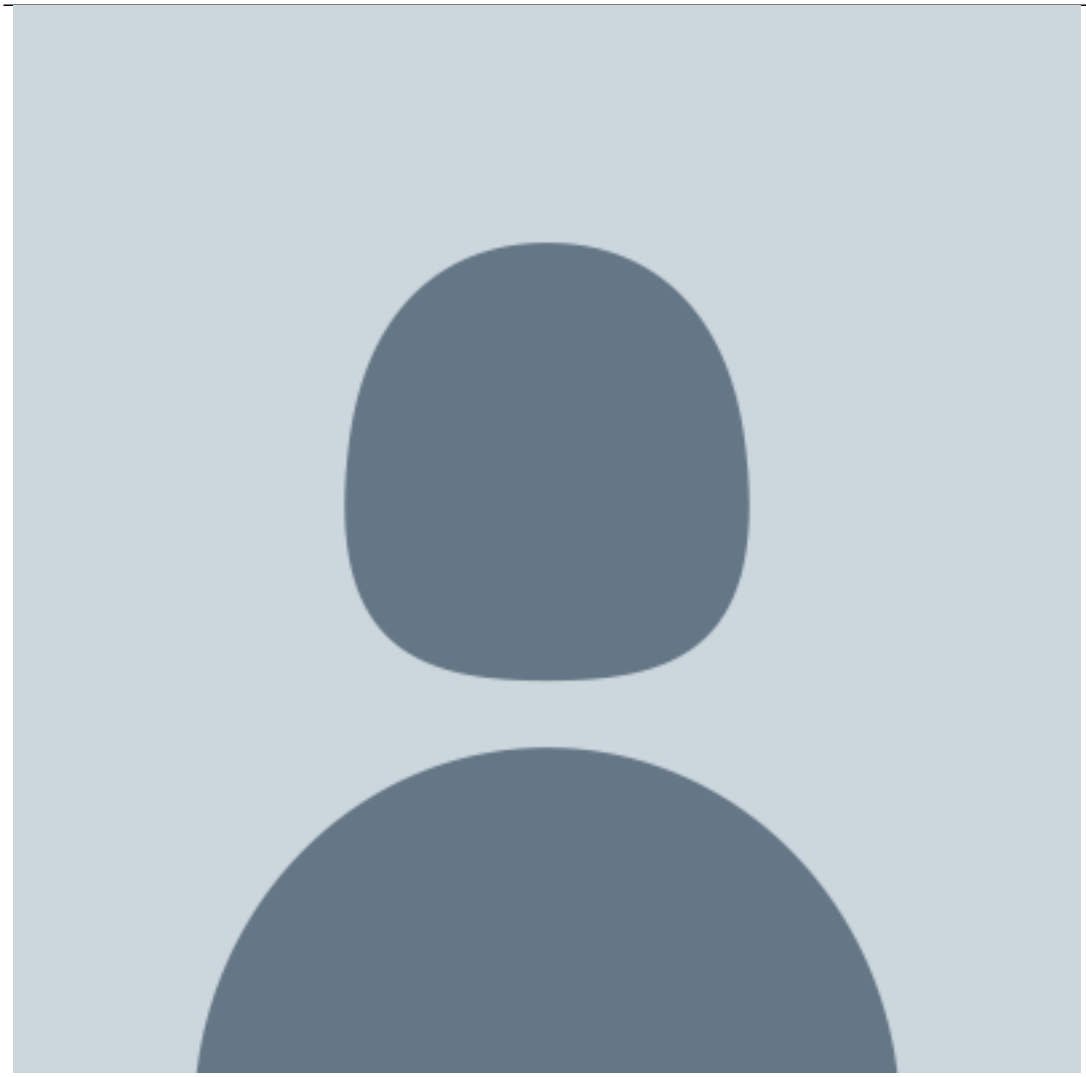

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