LITIGATION — CORPORATE COMMERCIAL

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In 2004, there were important decisions in three areas of corporate litigation: (i) debenture-holders' right to pursue legal action and the effect of "no-action clauses" in trust indentures; (ii) the duties of directors of an insolvent or near-insolvent corporation; and (iii) the operation of reasonable expectations and the business judgment rule in oppression law.

DEBENTURE-HOLDERS' LITIGATION AND NO-ACTION CLAUSES

The Ontario Court of Appeal in January 2004 released an important decision on the effect of "no-action" clauses in trust indentures. In *Casurina Limited Partnership v. Rio Algom Limited*, the court upheld the decision of Spence J., who dismissed an oppression application brought by debenture-holders, on the basis that the no-action clause in the trust indenture required legal proceedings to be pursued through the trustee on behalf of all debenture-holders, and barred individual debenture-holder proceedings unless certain preconditions were met. More significantly, the courts adopted a policy rationale for no-action clauses that could lead to courts interpreting such clauses more broadly.

The applicants held convertible debentures issued by Rio Algom, which were governed by a trust indenture containing covenants that required that Rio Algom be a reporting issuer and that its shares remain TSX-listed. The debentures were convertible into common shares of Rio Algom at the debenture-holder's option—at $40 per common share—redeemable by Rio Algom at a formula prescribed in the trust indenture. At the relevant time, the debentures were redeemable at par only if the common shares of Rio Algom were trading at an average price equal to 125% of the conversion price.

In 1999–2000, Rio Algom was faced with an unwelcome takeover bid from Billiton Plc. Rio Algom's directors ultimately recommended that the shareholders accept Billiton's offer, through which Billiton intended to acquire all the shares of Rio Algom, if necessary through the compulsory acquisition provisions of the Ontario *Business Corporations Act*. Billiton's successful completion of its proposed transaction would inevitably result in an event of default under the terms of the trust indenture because Rio Algom's shares would be delisted from the TSX. On this assumption, Billiton factored into the cost of the transaction the expense of redeeming the debentures at par. Billiton did eventually offer to redeem the debentures at par, but this proposal was not approved by the necessary two-thirds majority of debenture-holders.

Three groups of debenture-holders commenced an oppression action alleging that Rio Algom breached the covenant in the trust indenture requiring that its shares be TSX-listed, and unfairly disregarded the debenture-holders' interests by frustrating the conversion rights of the debentures, a key component of their economic value. The debenture-holders argued that they reasonably expected that Rio Algom's common shares would always remain TSX-listed, that there would be no redemption of the debentures except according to the formula in the trust indenture, and that Rio Algom was prohibited from entering into a merger or acquisition without protecting the debenture-holders' conversion rights. The debenture-holders also challenged the post-takeover transactions in which Billiton caused certain Rio Algom subsidiaries to be transferred to Billiton subsidiaries.

THE NO-ACTION CLAUSE

Spence J. dismissed the oppression application on the basis that the debenture-holders were barred from pursuing litigation by the no-action clause in the trust indenture, which stated that the trustee was entitled, in its discretion, to enforce the debenture-holders' rights by taking legal action after an event of default. The clause prohibited a debenture-holder from commencing proceedings to enforce payment of the principal and interest owing under the debentures, and from instituting any other legal proceedings to enforce their rights, unless certain preconditions were met: the trustee's refusal to take action following a debenture-holder vote and a request from the debenture-holders to pursue a claim.

The debenture-holders argued that although the no-action clause might prevent them from pursuing a claim for payment owing under the debentures, it did not prohibit them from instituting a proceeding for an oppression remedy. This was, in effect, the result in the earlier Ontario decision of Farley J. in *Millgate Financial Corp. v. B.F. Realty Holdings Ltd.* Spence J. distinguished *Millgate Financial* based on differences in the language in the two no-action clauses, observing that the portions of the trust indenture relied on by Farley J. in *Millgate Financial Corp.* only restricted the debenture-holders from taking action to enforce the payment of principal and interest, but did not contain the additional language in the Rio Algom trust indenture barring actions by the debenture-holders to enforce their rights. Spence J. held that under the Rio Algom trust indenture, only the trustee was entitled to institute an application for an oppression remedy unless the preconditions for individual claims by the debenture-holders had been met. The preconditions were not satisfied in this case. The court of appeal affirmed Spence J.'s interpretation of the trust indenture.

POLICY RATIONALE

The decisions of Spence J. and the court of appeal in *Rio Algom*, while based on their interpretation of the Rio Algom trust indenture, were justified by reference to policy considerations of this area's leading U.S. decision, *Feldbaum v. McCrory*, where the court concluded that the effect of a no-action clause was that debenture-holders waived their right to individually bring claims that were common to all the debenture-holders and that could be more efficiently pursued by the trustee.

The same policy rationale is reflected in the American Bar Association's *Commentaries on Model Debenture Indenture Provisions*, which considers the major purpose of no-action

clauses to be to deter individual debenture-holders from bringing independent lawsuits for unworthy or unjustifiable reasons, causing expense to the company and diminishing its assets. If a suit is worthwhile, say the authors, a standard 25% of the debenture-holders would be willing to jointly sponsor it. Another purpose is to express the legal principle that would otherwise be implied that all the indenture's rights and remedies are for the equal and ratable benefit of all the holders. The authors stress the inefficiencies of permitting debenture-holders individually to pursue claims that ratably affect all the debenture-holders' rights. If a claim is worth pursuing, it should be worth pursuing for all debenture-holders; alternatively, the trustee would be willing to pursue the claim.

These concerns have considerable force; however, the same policy concerns can be (and have been) raised regarding individual shareholders using the oppression remedy rather than the derivative action process to pursue wrongs to shareholders as a whole, and which each shareholder suffers ratably. Ontario courts have fairly consistently held that individual shareholders may pursue such wrongs through the oppression remedy rather than through derivative actions. It could be argued that the same policy concerns underlying the *Rio Algom* decision relative to debenture-holders suggest that shareholders should be required to pursue derivative wrongs through derivative actions. That process, which requires leave from the court for an individual shareholder to proceed, has the effect, like no-action clauses, of promoting efficiency and filtering out unmeritorious claims.

DIRECTORS' DUTIES AND THE INSOLVENT CORPORATION

Some Ontario courts have accepted the contention that a director may owe a duty to a corporation's creditors when the corporation is insolvent or nearing insolvency. These decisions have created uncertainty. To the extent that directors may have a duty to creditors in certain circumstances, is the duty owed to creditors directly? Or do the directors of an insolvent or near-insolvent corporation continue to owe their duties to the corporation—the only difference being that in those circumstances the corporation's interests are to be assessed by reference to creditor interests rather than shareholder interests?

In 2003, the Quebec Court of Appeal dealt with this issue in *Peoples Department Stores Inc. (trustee of) v. Wise*. The court reversed a widely discussed trial decision and held that directors do not owe a duty to the creditors of an insolvent or nearly insolvent corporation, but rather to the corporation, whose interests will be assessed by reference to the creditors' interests. The Supreme Court of Canada has granted leave to appeal the court of appeal's decision in *Wise*.

THE *WISE* DECISION

Wise Stores Inc. was a Quebec-based owner of a department store chain, incorporated under the *Canada Business Corporations Act* ("CBCA"). In 1992, Wise purchased Peoples Department Stores Inc., a division of Marks & Spencer Plc, in a highly leveraged acquisition: a portion of the purchase price paid on closing was financed by a bank loan, and the remainder was to be paid to Marks & Spencer by Peoples over eight years and was secured against Peoples' assets.

Wise's intention in acquiring Peoples was to merge the companies, but under the terms of the agreement with Marks & Spencer, this could not occur until Wise had completely paid Marks & Spencer. However, after the transaction closed, Wise's and Peoples' operations were progressively integrated, including the management of each company's inventory. Through an inventory-procurement program instituted by the companies, Peoples purchased and paid for inventory from North American suppliers on its own and Wise's behalf. Wise was to pay Peoples for the inventory procured on Wise's behalf, but became indebted to Peoples for that inventory. Wise's debt to Peoples' continued to grow, while Peoples' indebtedness to North American suppliers from inventory acquired on behalf of both companies also continued to grow. Marks & Spencer requested that the court appoint a receiver. Wise and Peoples filed notices of an intent to make a proposal, but in 1995 both companies filed for bankruptcy, at which time Wise was indebted to Peoples for around $4.4 million.

The trustee in bankruptcy for Peoples commenced an action against the directors of Peoples—the Wise brothers. Among other things, the trustee claimed that the inventory-procurement program preferred Wise's interests over Peoples' interests, and that the Wise brothers thereby breached their duty of care and their fiduciary duty as Peoples' directors. At trial, Greenberg J. found that the Wise brothers did breach their duties as Peoples' directors in instituting the inventory-procurement program. He also held that the Wise brothers' duties as directors were owed directly to Peoples' creditors, for which he purported to follow decisions of British, Australian and New Zealand courts. Greenberg J. relied in particular on the New Zealand Court of Appeal's reasons in *Nicholson v. Permakraft*:

> "The duties of directors are owed to the company. On the facts of particular cases, this may require the directors to consider *inter alia* the interests of creditors. For instance, creditors are entitled to consideration, in my opinion, if the company is insolvent or near insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardize its solvency."

Here, the rationale is that in these circumstances, only the creditors have an economically meaningful stake in the corporation; their interests conflict with the interests of shareholders who, having lost their equity, have nothing to lose by the corporation's pursuing high-risk strategies at the creditors' expense. Therefore, according to this reasoning, when a corporation is insolvent or nearly insolvent, the directors' focus should shift to the corporation's creditors.

Greenberg J. concluded: "We ... find that Canadian corporate law should evolve in that direction," finding that the Wise brothers breached their duties as Peoples' directors—duties that he held were owed directly to Peoples' creditors; and he awarded the trustees of Peoples $4.4 million in damages, the amount for which Wise was indebted to Peoples as a result of the inventory-procurement program.

The Quebec Court of Appeal unanimously reversed the trial decision, holding that as a matter of law, the directors of an insolvent or nearly insolvent corporation do not owe duties directly to the corporation's creditors. Under section 122 of the CBCA, a director owes his or her duty to the corporation. The Court of Appeal held that the corporate statute was reformed in 1978, and the federal legislature did not explicitly expand the scope of directors' duties to include duties to creditors. Such a change in direction in corporate law, had it been intended, would have had to be explicit: "A shift away from traditional thought would, in my opinion, require an explicit, clear provision."

The Court of Appeal also held that the trial judge had misunderstood the relationships between a corporation and its stakeholders. The trial judge's decision was premised, in part,

on the view that when a corporation is insolvent, the creditors displace the shareholders in having the power to deal with the corporation's assets. However, as the court of appeal observed, a corporation's assets are not the shareholders' assets—the corporation's assets belong to the corporation.

AFTER *WISE*

The uncertainty relating to directors' duties and insolvent corporations lies in a fundamental conceptual distinction. While creditors are the only stakeholders with an economically meaningful stake in a corporation when it is insolvent or nearing insolvency, directors do not at that point owe duties directly to the creditors in addition to or in place of the duties owed to the corporation. Directors are obligated to act in the best interests of the corporation in all circumstances. The question is how to assess the corporation's interests in circumstances of insolvency or near insolvency—by reference to shareholder interests, as in a solvent corporation, or by reference to creditor interests as the Quebec Court of Appeal held in *Wise*?

In *Millgate Financial Corp. v. BCED Holdings Ltd.*,[1] a group of debenture-holders argued on a summary judgment motion that the directors of the defendant corporation owed fiduciary duties directly to them as creditors, and that these duties were allegedly breached when the corporation entered into transactions with related companies governed by interlocking boards of directors. Cullity J. rejected the legal basis of the debenture-holders' argument, holding that "the notion that directors may have an obligation to consider the interests of creditors where such interests are to be considered the interests of the company does not necessarily imply that the obligation is owed directly to—and will be enforceable by—the creditors." Cullity J. concluded that he would not "depart from the established principle that directors' fiduciary duties with respect to conflicts of interest are owed to the corporation and not directly to the shareholders or creditors."

THE OPPRESSION REMEDY: REASONABLE EXPECTATIONS AND THE BUSINESS JUDGMENT RULE

REASONABLE EXPECTATIONS: THE *FORD* CASE

The Ontario Superior Court decision in *Ford Motor Company of Canada v. Ontario Municipal Employees Retirement Board*, released at the beginning of 2004, is important for numerous reasons relating to oppression law. It sheds light on the vexed question of whether a shareholder can sue under the oppression remedy for wrongs predating his or her becoming a shareholder. The court dealt with this issue by reference to the concept of reasonable expectations.

OMERS was a minority shareholder of Ford Canada, whose vast majority of shares were held by Ford Canada's U.S. parent. In 1995, the decision was made to complete a going-private transaction so Ford Canada would become a wholly owned subsidiary of Ford U.S.; a valuation was obtained for the Ford Canada shares. OMERS and other minority shareholders exercised their dissent rights, and Ford Canada brought an action for a declaration on the fair value of its shares. In a counterclaim, the dissenting shareholders alleged that the proposed valuation was inadequate and that they were subject to oppression allegedly arising from Ford's longstanding inter-corporate transfer pricing system. The dissenting shareholders alleged firstly that the prices paid by Ford Canada to the U.S. parent under this system exceeded prices that arm's-length parties would have agreed to; that the majority shareholder, Ford U.S., benefited from the transfer pricing system at the expense of the minority; that they were oppressed by this arrangement; and that the valuation of their shares for the purposes of the going-private transaction should reflect the historical effects of the transfer pricing system on Ford Canada. Cumming J. agreed with the dissenting shareholders, finding that the transfer pricing system was oppressive, that the oppression was ongoing and that the value of the dissenters' Ford Canada shares should be adjusted to reflect that historic oppression.

In his consideration, Cumming J. began with the basic principle that "the reasonable expectations analysis has become the standard analytical tool," and went on to deal with the difficult question of whether a shareholder can derive reasonable expectations of corporate conduct preceding the shareholder's acquisition of shares. Cumming J. held that a shareholder normally can only obtain relief from oppression for conduct that occurred while the shareholder was a shareholder:

> The oppression remedy protects reasonable expectations by shareholders while considering the relevant circumstances. A shareholder should not be able to claim oppression concerning an asserted reasonable expectation if it did not exist at the time of his or her share purchase. Arguably, the reasonable expectations of a new shareholder generally pertain to the future decision-making of management, unless there are past and continuing misrepresentations, which create false expectations at the point of the share purchase.

According to Cumming J.'s reasons in *Ford*, a shareholder cannot normally have reasonable expectations concerning the affairs of the corporation that preceded his or her share purchase; reasonable expectations are forward-looking and involve future corporate actions. There must be what Cumming J. called a "time-related factual nexus between the complainant and the oppression complained of." In other words, a shareholder cannot "buy into the oppression." If a shareholder acquires shares when the oppression is ongoing, the shareholder's reasonable expectations relate only to that portion of the ongoing oppression that occurs after the shares are acquired.

Cumming J.'s conclusion that a shareholder cannot have reasonable expectations of past corporate actions breathes new life into the distinction between the oppression remedy and derivative actions. Although a shareholder may not be able to pursue an oppression proceeding for past corporate actions, this should not affect the shareholder's standing to seek leave to commence a derivative action. The derivative action seeks to remedy harm to the corporation rather than to protect a shareholder's personal expectations; therefore, the time at which that shareholder acquired shares should not be relevant.

BUSINESS JUDGMENT RULE: THE *REPAP* DECISION

Another key principle in oppression jurisprudence is the "business judgment rule," which calls for judicial deference to business decisions made by unconflicted directors after careful consideration. In early 2004, the Ontario Court of Appeal affirmed the trial judgment of Lax J. in U*PM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*[2] This case involved Repap Enterprises' board approval of an executive employment contract for the company's chairman and senior executive officer. The contract was set aside using the oppression remedy on the basis that, first, the chairman breached his fiduciary duties as a

director, and second, that the board members who approved the contract breached their duties of care. In deciding whether the compensation arrangement approved by the board should be set aside, the courts had an opportunity to consider the business judgment rule.

The directors were required, according to Lax J., to make a decision about the chairman's compensation in an "informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable grounds for believing that their actions will promote and maximize shareholder value." The trial judge found that the Repap directors failed to inform themselves sufficiently about the background to and economic impact of the terms of the employment agreement, thereby breaching their duties.

Lax J. considered whether the board's decision was shielded by the business judgment rule, and held that it was not. The business judgment rule reflects the courts' recognition that the board, not the court, is in the best position to understand the business of the corporation and to make decisions concerning its affairs in the interests of the corporation. The rule calls for deference to directors' business judgments; it is premised on the directors having exercised due care, taking account of the material information reasonably available. Where, as Lax J. found in this case, directors fail to inform themselves sufficiently, the rationale for judicial deference is not applicable and the court will second-guess the ill-informed business judgment of the directors. The business judgment rule is also premised on the good faith of directors. If the court finds that a director's decision falls outside the "range of reasonableness," this is a signal of bad faith and the court can intervene. Lax J.'s decision, confirmed by the Court of Appeal, makes clear that there are limits to judicial deference to directors' business judgments. While a board's decision is not subject to microscopic hindsight examination, the board's process and the surrounding circumstances will be thoroughly examined by the court, with a view to assessing directors' diligence and good faith, on which judicial deference is premised. ■

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1 Andrew Gray is co-counsel to a number of defendants in this case.

2 Andrew Gray was co-counsel to the defendant Steven Berg in the appeal.