
LITIGATION – CORPORATE COMMERCIAL

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Important developments have taken place this past year regarding litigation related to transactions and capital markets that will have long-term consequences for the structuring of transactions and the obligations of directors and officers. The proposed acquisition of BCE Inc. by a private equity consortium led to litigation that dealt with significant legal issues in respect of directors' duties and the statutory oppression remedy and culminated in the Supreme Court of Canada's approval of the transaction. Other recent decisions have advanced the law relating to the scope of prospectus and continuous disclosure requirements, and regulatory and civil liability for violations of these disclosure obligations.

BCE: DIRECTORS DUTIES AND THE OPPRESSION REMEDY IN A CHANGE-OF- CONTROL TRANSACTION

On June 20, 2008, the Supreme Court of Canada announced that it had allowed the appeal in *BCE Inc. v. A Group of 1976 Debentureholders*, the challenge launched by Bell Canada bondholders to prevent the leveraged buyout of BCE. The Supreme Court's reasons for decision were released on December 19, 2008.¹

In June 2007, BCE announced that it had entered into an agreement with a consortium of investors, under which the investors proposed to acquire all BCE's outstanding shares. The parties agreed that the transaction would be structured as a plan of arrangement under the *Canada Business Corporations Act*, which requires both shareholder and court approval. If completed, the acquisition would be the largest leveraged buyout in Canadian history, with a transaction value of \$33 billion.

The transaction contemplates the addition of substantial new indebtedness to be guaranteed by Bell Canada, BCE's wholly owned subsidiary. In response to the transaction, the market value of bonds issued by Bell Canada declined by about 20 per cent, or \$1 billion.

At the court-approval stage of the plan of arrangement, the bondholders opposed the transaction. They argued that the arrangement was unfair and oppressive to their interests and therefore should not be approved by the court. The bondholders' arguments relied on the terms of the bond trust indentures, the statutory oppression remedy and the test applicable to the court's

approval of plans of arrangement, which requires, among other things, that an arrangement be fair and reasonable.

The Québec Superior Court dismissed the bondholders' claims.² The Québec Court of Appeal reversed this decision, deciding that the proposed transaction was not fair and reasonable to Bell Canada bondholders.³ The Supreme Court allowed the appeal from the Québec Court of Appeal's decision.

The *BCE* litigation raises two key issues. First, it focuses attention on the role of the directors of a corporation in the context of a change-of-control transaction. The litigation revisits the Supreme Court's earlier decision in *Peoples Department Stores Inc. (Trustee of) v. Wise*⁴ in which the Court considered and reformulated the duties of directors. Second, the litigation involves consideration of the scope of the statutory oppression remedy and the range of stakeholder interests that it protects.

Directors' Duties After *Peoples*

In the *Peoples* decision, the Supreme Court considered both the duty of care and fiduciary duties of corporate directors, and made two findings that had the effect of reformulating traditional corporate law principles. With respect to the duty of care, the traditional corporate law principle is that the directors owe such a duty to the corporation and not directly to any particular stakeholder. The Supreme Court in *Peoples* held that directors owed a duty of care directly to creditors. On the basis of that reasoning, the duty of care could also be owed directly to shareholders and other corporate stakeholders.

While the Supreme Court confirmed in *Peoples* that the fiduciary duty is owed to the corporation and not to shareholders or other stakeholders directly, it also held that this duty requires directors to act with a view to making a "better" corporation. In fulfilling that requirement, the Court held that directors could consider the interests of not only shareholders but also a broad range of other stakeholders and interests, including creditors. However, the Court provided no guidance as to how, in practice, directors can reconcile those interests when they conflict.

The *BCE* litigation highlights the conflict that can arise for directors under the duties as reformulated by *Peoples* in a change-of-control transaction. Put simply, are directors obliged to maximize shareholder value only, or are they also required to consider or even protect other stakeholder interests?

The duty of directors to maximize shareholder value when a company is "in play" is well-established in Canada. This is commonly known as the "Revlon duty," named after the seminal Delaware case, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* In the *BCE* litigation, the bondholders relied on *Peoples* to argue that the fiduciary duty of directors to act in the best interests of a corporation that is in play requires the directors to protect the interests of creditors in addition to those of shareholders. This is contrary to the Revlon duty, which contemplates only maximizing shareholder value. The bondholders claimed that maximizing shareholder value at the expense of the economic interests of creditors was a breach of the directors' duties under *Peoples*.

The Québec Superior Court's *BCE* decision reconciled the Revlon duty with the *Peoples* decision. The Superior Court held that when a corporation is in play, directors should, in addition to maximizing shareholder value, consider the interests of creditors in determining whether a transaction is in the best interests of

the company. Importantly, the Court held that creditors' interests are to be determined by reference to their contractual rights and that directors are not required to do more for creditors than to ensure that contractual rights are respected.

The Québec Court of Appeal reached a different conclusion on this issue. This Court of Appeal held that even when the corporation is in play, the directors' duties are not limited to maximizing value for shareholders; in addition, the interests and reasonable expectations of all stakeholders, including creditors, must be considered. The Court held that bondholders' reasonable expectations are primarily derived from their contract and the company's offering documents, but reasonable expectations can also be derived from public statements of the company (as discussed in the next section, below). The Court concluded that the BCE directors were obliged to consider the economic interests of the bondholders – not only their contractual rights – in deciding whether to approve the acquisition of BCE. Since the directors had failed to do that, the Court held that BCE had not established that the transaction was fair.

The Supreme Court reaffirmed its conclusion in *Peoples* that directors' duties are owed to the corporation and must be exercised with a view to the interests of a range of stakeholders. The Court rejected the shareholder primacy model of directors' duties underlying the Revlon duty, and found that no single group of stakeholder interests necessarily trumps others as a matter of principle. According to the Court, directors are required to treat all stakeholders equitably and fairly. The resolution of conflicting stakeholder interests, including in the context of a change-of-control transaction, is a function of the directors' business judgment as to the best interests of the corporation in a particular situation.

The Supreme Court's approach to directors' duties in *BCE* is highly deferential. As a result, future challenges to directors' decisions will likely focus primarily on the decision-making process. This is consistent with the Supreme Court's affirmation of the business judgment rule in *Peoples*: the decisions of non-conflicted directors are entitled to deference provided that they fall within a range of reasonableness. In *BCE*, the Supreme Court found that the directors' decisions with respect to the transaction, and the treatment of bondholders, were within a "range of reasonable choices that they could have made in weighing conflicting interests." The Court declined to judge these decisions against a standard of perfection.

The Scope of the Oppression Remedy

The statutory oppression remedy provides courts with extremely broad and flexible jurisdiction to make orders correcting oppressive and unfairly prejudicial corporate conduct. The oppression remedy protects the reasonable expectations of corporate stakeholders who qualify as complainants, including shareholders and, in certain circumstances, creditors.

In the *BCE* litigation, the Bell Canada bondholders relied on the oppression remedy as a basis to challenge the transaction. The bondholders argued that BCE and Bell Canada failed to protect their reasonable expectations that Bell Canada (i) would respect representations it had made to investors regarding its intention to maintain investment-grade credit ratings for the debentures, and (ii) would not incur \$30 billion of debt without the bondholders' receiving a corresponding benefit. The bondholders argued that they could

rely on statements made on behalf of BCE and Bell Canada in conference calls with analysts, presentations to institutional investors and elsewhere about Bell Canada's intention to maintain its investment-grade ratings.

The Québec Superior Court rejected the bondholders' arguments. It held that the rights of bondholders are defined by the trust indentures and related offering documents. The trust indentures under which the Bell Canada bonds were issued contained no change-of-control or credit-rating covenants. The Court refused to use the oppression remedy to create an implied covenant that the bondholders had not bargained for in the indentures. Relying on the decision of the Southern District of New York in *Metropolitan Life Ins. v. RJR Nabisco Inc.*, the Court held that the reasonable expectations of the bondholders derive from the trust indentures that govern the terms of the bonds and from the related offering documents. The Court held that the bondholders assumed the risk that the value of their investments might be adversely affected by a change-of-control transaction, including a leveraged buyout; had the bondholders wanted additional protections, they could have negotiated and paid for them.

The Québec Court of Appeal came to a different conclusion. It stated that BCE's representations had created a reasonable expectation that the board of directors would have concern for the bondholders' interests.

The Supreme Court used the occasion of the BCE transaction to consider the oppression remedy in detail. The Court concluded that to establish oppression, a complainant must first establish a breach of reasonable expectations, and then also establish that the conduct complained of constituted "oppression," "unfair prejudice" or "unfair disregard." Confirming that oppression is always fact-specific, the Court identified seven factors that may be relevant in establishing reasonable expectations: general commercial practice; the nature of the corporation; the relationship between the parties; past practice; steps the claimant could have taken to protect itself; representations and agreements; and the fair resolution of conflicting interests between corporate stakeholders.

In this case, the Supreme Court found that the bondholders could not have had a reasonable expectation that the board of BCE would have structured the transaction in a way that went further than considering and respecting the bondholders' contractual rights. The Supreme Court relied on two facts in reaching this conclusion: (i) a leveraged buyout is not an unusual or unforeseeable transaction, and (ii) the trust indenture governing the bonds could have included – but did not include – a creditrating covenant or a change-of-control covenant that would have provided the bondholders with the contractual protections they sought through the oppression remedy.

SECURITIES DISCLOSURE OBLIGATIONS AND LIABILITY

Statements made by corporations and their directors and other agents may not only lead to claims under the oppression remedy but also result in regulatory and civil liability under securities laws. In the last year, the nature of that risk in the context of both prospectus and continuous disclosure was considered.

Danier and Prospectus Disclosure

*Kerr v. Danier Leather Inc.*⁵ was the first prospectus class action in Ontario to go to trial. Danier offered shares in an initial public offering in May 1998. The prospectus for the

IPO contained a forecast of anticipated revenue and earnings for the fourth quarter of its fiscal year. After the prospectus had been finalized, but before the closing of the IPO, senior management prepared an internal analysis that showed that the intra-quarterly results for the fourth quarter lagged behind the forecast. Senior management continued to believe that the original forecast was achievable and therefore did not update the prospectus. Following the closing of the IPO, and on the basis of new information, the company issued a revised forecast; the share price then dropped significantly. Ultimately, Danier substantially achieved the original forecast. A class action was commenced under section 130 of the *Securities Act* (the section that creates a statutory cause of action for prospectus misrepresentation). The plaintiffs alleged that as a consequence of the internal analysis prepared before the IPO closed, the original forecast in the prospectus was a misrepresentation. The Supreme Court dismissed the plaintiffs' case.

The Supreme Court held that if a prospectus, or an amendment to a prospectus, contains no misrepresentation on the date it is filed, failure to disclose subsequent information that amounts to a material fact – but not a material change – will not give rise to liability for prospectus misrepresentation under section 130 of the *Securities Act*. A “material change” is a “change in the business, operations or capital of an issuer that would reasonably be expected to have significant effect on the market price or value of any of the securities of the issuer.” A “material fact,” in contrast, is broader and extends to any fact that would reasonably be expected to have a significant effect on the market price or value of the issuer's securities, whether or not it involved a change in the business, operations or capital of the issuer. The Supreme Court concluded that a change in intra-quarterly results is not itself a change in the issuer's business, operations or capital and therefore does not constitute a material change requiring disclosure.

The Supreme Court rejected the plaintiffs' argument that section 130 of the *Securities Act* creates any disclosure obligations in addition to the specific requirements of the prospectus regime. This decision provides certainty with respect to the disclosure obligations in the prospectus context.

AiT and Continuous Disclosure Obligations

Although *Danier* concerned an issuer's prospectus disclosure obligations, the distinction between material changes and material facts is also critical to an issuer's timely disclosure obligations and to the secondary market liability regime under the *Securities Act*. This is highlighted in the decision of the Ontario Securities Commission (OSC) in *Re AiT Advanced Information Technologies Corp.*⁶

The *AiT* decision is important for mergers and acquisitions practitioners, because it clarifies the requirements for continuous disclosure under securities law. The OSC's decision gives direction to target corporations for determining when a material change occurs in the course of a merger and acquisition transaction, and therefore when a disclosure obligation arises.

3M Canada Company made an unsolicited approach to AiT about a potential acquisition in February 2002. Executives of the two companies held meetings to discuss a transaction. 3M conducted some initial due diligence and then, on April 24, indicated that it would consider proposing a transaction at a price of \$2.88 per share. The next day, AiT's board approved a recommendation to its shareholders

of 3M's acquisition at a purchase price of \$2.88 per share, subject to receiving a fairness opinion and the execution of a definitive agreement to be approved by the board. On April 26, AiT signed a non-binding letter of intent with an exclusivity clause. The letter of intent contained a number of conditions that had to be satisfied before 3M would commit to a transaction, many of which were beyond AiT's control, including the completion of a favourable due diligence report. The 3M board approved the acquisition of AiT on May 14, subject to its CEO's approval of the due diligence report. 3M's CEO approved the transaction on May 21, and the AiT board approved the definitive merger agreement on May 22. The agreement was executed the following day and AiT then announced the transaction and filed a material change report.

The OSC commenced a proceeding against AiT, its CEO and a director, Deborah Weinstein, alleging that a material change occurred and disclosure was required by April 26, when the letter of intent was executed and also during the due diligence period that followed. After a contested hearing, the OSC dismissed the allegations against Ms. Weinstein, finding that a material change had not occurred until the signing of the definitive merger agreement on May 23.⁷

In the *AiT* decision, the OSC confirmed the significance of the distinction between a material fact and a material change, set out above, and held that the distinction applied in the context of disclosing merger negotiations. In this case, the OSC found that the negotiations between AiT and 3M were material to AiT. The materiality of the negotiations with 3M meant that insiders of AiT were prohibited from trading or tipping as a result of the negotiations. However, the existence of a material fact alone did not give rise to a material change and the need to make disclosure.

The OSC concluded that the determination whether a material change has occurred is not a bright-line test. The assessment will depend on the facts and circumstances of each case. The OSC noted that a material change could occur before the signing of a definitive binding agreement, although one had not occurred in this case. The OSC also found that a decision by a board of directors to pursue a potential transaction it cannot yet put into effect is not normally a material change or a decision to implement a change unless the board has reason to believe that (i) the other party is also committed to the transaction, and (ii) a substantial likelihood exists that the transaction will be completed. In the context of a proposed merger and acquisition transaction, if the transaction is conditional and surrounded by uncertainties, a commitment from one party to proceed will be insufficient to constitute a material change. For there to be a substantial likelihood that a proposed transaction will be completed, there needs to be sufficient signs of commitment on behalf of all the parties involved to proceed with the transaction.

In *AiT*, there was no material change or decision to implement a material change when the AiT board decided on April 25 to recommend an acquisition by 3M at a price of \$2.88 per share. At that stage, nothing had been received in writing from 3M on the terms of any proposed transaction. A material change also did not arise when the letter of intent was executed the following day. The OSC held that a material change does not automatically arise upon the signing of a letter of intent. To assess whether a letter of intent or an agreement in principle constitutes

a material change requires considering the conditions that have to be satisfied, how central they are to the proposed transaction and their likelihood of being satisfied. While, in this case, AiT was clearly committed to completing the proposed transaction with 3M, the AiT board could not conclude at the letter of intent stage that 3M was also committed and that there was a reasonable likelihood of completing the transaction. The OSC identified a number of factors indicating the lack of certainty, including that AiT was dealing with a 3M executive several levels below the CEO and that 3M had a highly structured due diligence process that had to be completed before the 3M board and the CEO would approve the transaction. Those hurdles were not overcome until shortly before the definitive merger agreement was approved and executed by the parties, and it was at that point that a material change occurred.

Disclosure Obligations and the Business Judgment Rule

The Supreme Court in *Danier* considered whether the business judgment rule has any application to an issuer's disclosure decisions under the *Securities Act*. The Court concluded that the rule does not apply and hence courts will not defer to management and the directors in determining whether an issuer has met its disclosure obligations.

The business judgment rule is the principle according to which courts defer to management and the directors on business decisions. As long as the business decision falls within a "range of reasonableness," the courts will not substitute their judgment for that of management and the directors as to the course of action that is in the corporation's best interests. The Supreme Court affirmed this principle in *Peoples*.

The Supreme Court in *Danier* distinguished between business decisions, to which this principle applies, and disclosure decisions, to which the principle does not apply. Business decisions involve a range of alternatives requiring a relative assessment of risk and reward. Disclosure decisions, in contrast, involve the application of a legal standard prescribed by the *Securities Act*, and can have only one legally correct answer.

The Supreme Court's ruling that disclosure decisions are not protected by the business judgment rule potentially has serious implications for the exposure to liability of issuers, directors and officers under the secondary market liability regime of the *Securities Act* and regulatory liability for breaches of the timely disclosure obligations. Assessments of materiality, on which disclosure decisions are based, can be very difficult judgment calls, given that they turn on an assessment of the likely market impact of the information in question. The prospect of these decisions being second-guessed by courts and securities regulators, perhaps with the benefit of hindsight, was an unwelcome development for issuers and their directors and officers.

Mindful of the *Danier* decision, the OSC in its decision in *AiT* found that it could not defer to the business judgment of the AiT board to determine when or if a material change had occurred. However, the OSC also found that where a board's governance process is effective, it is difficult to interfere with judgments about disclosure that are the product of that process and, furthermore, that it was not appropriate to evaluate disclosure decisions on the basis of hindsight. This refinement of the reasoning in *Danier* provides helpful guidance for issuers on the risk of liability for disclosure decisions in the merger and acquisition context.

1. 2008 SCC 69.
2. The Québec Superior Court released a number of separate judgments, the most significant of which is *BCE Inc.*, [2008] Q.J. No. 1788 (S.C.J.).
3. *BCE Inc.*, [2008] Q.J. No. 4173 (C.A.).
4. [2004] 3 S.C.R. 461 [*Peoples*].
5. 2007 SCC 44 [*Danier*].
6. (2008) 31 O.S.C.B. 646 [*AiT*].
7. Staff of the OSC settled with AiT and its chief executive officer, but after the decision in the contested proceeding, the OSC revoked its orders approving those settlements on October 9, 2008. The panel reasons can be found at <www.osc.gov.on.ca/Enforcement/Proceedings/RAD/rad_20081009_ait.jsp>.



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