LITIGATION – DIRECTORS' & OFFICERS' LIABILITY

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Important developments have taken place in Canada recently regarding the potential for directors and officers to incur liability, specifically in the areas of (i) timely disclosure obligations; (ii) the duties of directors and officers in the context of a company that is up for sale; and (iii) the ability of directors and officers to receive indemnification payments from the companies they serve. Each of these topics is discussed in detail below along with a brief update on civil statutory liability for continuous disclosure violations.

TIMELY DISCLOSURE OBLIGATIONS

Canadian securities laws impose obligations on a publicly traded issuer (and, in effect, its directors and officers) to immediately disclose any material changes regarding the issuer (often referred to as "timely disclosure obligations"). A "material change" is defined under Ontario securities laws as a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any securities of the issuer; a material change includes a decision by the issuer's board of directors to implement such a change or a decision by senior management to implement the change in the belief that the board is likely to confirm the decision. Similar definitions exist under securities legislation in the other Canadian provinces and territories.

In the context of merger and acquisition transactions (referred to in this article simply as merger transactions or mergers), it is often difficult to pinpoint the exact time when negotiations between parties have reached a point where a material change (as defined under securities laws) has occurred. Exacerbating this difficult question from a liability perspective is the Supreme Court of Canada decision in *Kerr v. Danier Leather Inc*. In that case (which dealt with disclosure in a prospectus context), the Court rejected any application of business judgment to a securities law disclosure question, thereby subjecting directors and officers to hindsight second-guessing by securities regulators as to whether a disclosure violation had occurred.

However, the Ontario Securities Commission (OSC) in *Re AiT Advanced Information Technologies Corp*. subsequently provided much-needed clarity regarding the application of timely disclosure obligations in the context of merger transactions.

AiT

In *AiT*, OSC staff brought actions against AiT and certain directors and officers for timely disclosure violations in connection with 3M Company's acquisition of AiT. AiT issued a news release about the acquisition when the definitive merger agreement was entered into between the companies. OSC staff alleged that disclosure of a possible transaction should have been made earlier than that because, among other reasons, prior to that time, the AiT board had made certain approvals relating to the transaction and the parties had entered into a non-binding letter of intent.

The OSC, however, agreed with AiT that no material change had occurred prior to the execution of the definitive merger agreement. In reaching this conclusion, the OSC focused largely on the question of when both parties to the transaction became firmly committed to its completion. With respect to the board approvals noted above, the OSC essentially viewed these as approvals to continue the negotiation process with 3M, rather than approval to enter into a definitive agreement with 3M (which came in conjunction with entering into the definitive merger agreement). With respect to the non-binding letter of intent, the OSC noted that the principle term contained in the letter of intent – the proposed purchase price – was not firm because it was subject to a detailed due diligence review, yet to be completed; several key terms contemplated by the letter of intent (including the break fee and voting agreements from key shareholders) had not yet been negotiated; and 3M was clearly not committed to completing the transaction.

The OSC noted that in certain circumstances it may be appropriate to conclude that a material change occurred at a letter of intent stage, and that an issuer should make timely disclosure of the material change on the basis of a determined level of commitment of the parties to complete the transaction — even though no definitive agreement had been negotiated or entered into. However, the OSC stated in this regard that "in the context of whether a board decision constitutes a material change, an issuer's disclosure obligations arise not when a potential transaction is identified and discussed with the board, but instead, when the decision by the board to implement the potential transaction is based on its understanding of a *sufficient commitment from the parties to proceed and the substantial likelihood that the transaction will be completed* [emphasis added]."

It is worth pointing out that bad faith was not alleged in this case. In fact, OSC staff clarified that no allegation was made of any intentional violation of securities law, attempt to mislead the market or impropriety on behalf of the directors. Although not an explicit factor in the OSC's decision, regulators are likely to resist holding directors and officers liable for a securities law violation if they had in fact attempted to comply with securities laws. Such resistance is likely to lead to decisions in favour of directors and officers in those circumstances.

Lessons from *AiT*

Notwithstanding the OSC's decision in *AiT* in favour of the issuer and its directors and officers, lessons can be gleaned from *AiT* to reduce the likelihood of a timely disclosure action being brought. First, any letters of intent used in a merger context should be carefully drafted to (i) make clear that the parties are not committed to completing the transaction; (ii) explicitly note key matters that have not yet been agreed upon; and (iii) describe key activities still to take place to confirm commitment to the transaction (due diligence, board approval of an agreement whose key terms have been negotiated, and so forth). Second, the board process must clearly indicate (in board minutes and other meeting records) which transaction

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steps are clearly preliminary, as opposed to the step that the board takes in providing its approval to enter into a definitive agreement committing the issuer to complete the transaction.

DIRECTORS' DUTIES

A Company for Sale and the *BCE* Litigation

In *Peoples Department Stores Inc. (Trustee of) v. Wise*, in 2004, the Supreme Court of Canada definitively stated that irrespective of a company's particular circumstances, the fiduciary duty of directors to act in the best interests of the company remains at all times an obligation to the company as a whole, rather than an obligation to any particular stakeholders of the company, including shareholders and creditors. Furthermore, the Court noted that in determining the best route to satisfy that duty, it was legitimate for directors to consider interests of non-shareholder stakeholders, including employees, suppliers, creditors and consumers, depending on the circumstances.

Subsequent to the *Peoples* decision, lawyers practising in the merger field struggled with how the decision in *Peoples* (whose facts did not involve a merger) could be reconciled with the long-held view (supported by case law and by securities regulators) that in the context of a sale of a company, the fiduciary obligation of directors became one to maximize value for shareholders. The fiduciary duties of directors in this context, and the intersection of *Peoples* with those duties, was at the heart of the Supreme Court of Canada's decision concerning the proposed privatization of BCE Inc.

Under the proposed privatization, certain bondholders of Bell Canada, a wholly owned subsidiary of BCE, were likely to lose significant market value in their bonds because of an expected credit downgrade resulting from debt guarantees that Bell Canada was to provide. While there were many elements to *BCE v. A Group of 1976 Debentureholders*, the essential questions that were litigated, from the perspective of directors' duties and liabilities, were the following: Were the directors of BCE correct in focusing on maximizing value for shareholders in the context of the sale of BCE? And should the directors have taken account of the interests of the bondholders in reaching their decision to sell BCE?

In its decision, the Court endorsed the approach to directors' duties as set forth in *Peoples* and that was relied on by the bondholders in this case. According to the Court, acting with a view to the best interests of the company requires directors to consider the interests of all affected stakeholders and not to equate the interests of the company with the interests of shareholders alone. The Court also explicitly rejected the shareholder value maximization approach in the context of a company sale.

However, the Court ultimately ruled against the bondholders because the BCE directors had acted to ensure that the contractual rights of the bondholders would be upheld as part of the privatization. This was considered sufficient by the Court for the directors to have discharged their duty to consider the interests of the bondholders. In reaching its decision, the Court provided directors with wide leeway to resolve conflicting stakeholder interests at play during a company sale transaction by applying a business judgment test. The Court noted that there "is no principle that one set of interests – for example, the interests of shareholders – should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way."

Accordingly, as long as directors make a business decision that is in the range of reasonableness, that decision should be granted deference by courts and be upheld.

Implications of *BCE*

Notwithstanding the Supreme Court's explicit rejection of shareholder value maximization as a legal principle, the *BCE* decision tacitly endorsed this approach by requiring deference to the business judgment of directors. The directors of BCE had sought to maximize share value, and the Court, by concluding that reasonable business decisions had been made, did not overturn their actions.

In future company sales, directors faced with pressure from shareholders, coupled with a judicial view that preaches deference to their business decisions, will be driven to maximize shareholder value. However, it will be important in such a process that the legal rights of all affected stakeholders be respected and the consequences to all affected stakeholders be appropriately considered.

Reliance on Fairness Opinions

In *Re Hudbay Minerals Inc.*, a hearing panel of the OSC stated its view that a fairness opinion prepared by a financial advisor who is being paid a success fee does not assist board members in demonstrating the due care they have taken in complying with their fiduciary duties. While the OSC view is not binding on courts, we nevertheless expect this viewpoint to be persuasive with them. Accordingly, boards may want to consider, in a particular circumstance, obtaining a fairness opinion from a second firm of financial advisors that is not entitled to a success fee on the transaction.

DIRECTORS' AND OFFICERS' INDEMNITIES

Indemnity Arrangements

A recent US decision emphasizes the need for directors to pay close attention to the indemnity arrangements they have with the companies they serve. Typically, directors receive indemnification through one of two avenues (or through both): first, company bylaws usually require directors, including former directors, to be indemnified to the maximum extent permitted by law; second, many directors enter into separate stand-alone indemnification agreements with the companies they serve. However, *Schoon v. Troy*, a recent Delaware Court of Chancery decision, highlights the difficulties that directors may face if they rely on bylaw indemnification provisions alone.

In *Schoon*, a former director requested indemnity payments in respect of legal costs and expenses relating to claims made against him by the company. After the director left the company, but before the company brought an action against him, the company's bylaws were amended so that they no longer provided indemnification to former directors. The former director argued that he was still entitled to indemnification because at the time he left, the bylaws provided this indemnification. However, the Court held that the former director was not entitled to indemnification since the claim against him in respect of which he requested indemnification was brought *after* the bylaw amendments removed indemnification of former directors.

The simple message to take from *Schoon* is that it is strongly advisable for directors to enter into stand-alone indemnity

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agreements with the companies they act for. Such agreements can cover a wide variety of circumstances beyond those typically covered in bylaw provisions (including obligations on the company to obtain director and officer insurance) and, more important, cannot be amended without the consent of the director (or former director).

Securities Regulators Restrict Access to Company Indemnification

A recent OSC settlement with directors and officers of a public issuer in connection with option grants specifically prohibited those directors and officers from seeking or accepting any indemnification from the issuer for payments required by or associated with the settlement. As a practical matter, it is also unlikely that those directors and officers could access any director and officer insurance for those payments because insurance coverage is typically provided only where the issuer may not by law make the indemnity payments or cannot do so because of insolvency. Where a director or officer could still access insurance, he or she would likely be responsible for a deductible.

CIVIL LIABILITY FOR SECONDARY MARKET DISCLOSURE VIOLATIONS

At the start of 2006, legislation (colloquially referred to as "Bill 198") went into effect to amend Ontario's *Securities Act* by providing for a regime of statutory civil liability for issuers, directors and officers for secondary market disclosure violations. Specifically, the legislation provides for liability in respect of misrepresentations contained in documents released by the issuer and in oral statements made on behalf of the issuer. It also provides for liability for the issuer's failure to make timely disclosure of material changes. In addition, the legislation removes the key common law hurdle of shareholder plaintiffs having to establish reliance on misrepresentations in order for an action to be successful, and provides a scheme for calculating damages.

Bill 198 requires that leave from a court be obtained to prevent so-called strike suits, unmeritorious claims and early settlement of such claims by defendants concerned about legal costs and damage to reputation. Therefore, a proceeding may be commenced only with leave of a court and if the court is satisfied that (i) the action is being brought in good faith and (ii) there is a reasonable possibility that the action will be resolved at trial in favor of the plaintiff.

The leave requirement is intended to weed out frivolous actions by requiring a merit-based hearing early on. To date, there have been approximately 13 Bill 198 actions (two of which have settled or are in the process of settling). However, none of them has reached the stage of a decision being issued in respect of a leave hearing. Those decisions will play an important role in determining the scope of civil liability for secondary market disclosure violations.

Aaron Emes's practice focuses on corporate governance, corporate finance, and mergers and acquisitions. He has advised a variety of public companies or their directors on governance matters, including advice on board and committee mandates and structures, directors' duties and liabilities, directors' and officers' insurance and indemnity agreements, and S-Ox matters. He authored the Canadian chapter of the U.K. Institute of Directors' *The Handbook of International Corporate Governance*. He is a member of Torys' Mergers and Acquisitions Practice Group. Aaron was admitted to the Ontario Bar and the New York bar in 2000. He obtained his LLB from the University of Toronto in 1998.

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