



M&A Building Blocks



Duties of the Board or Special Committee

In the context of a merger, plan of arrangement, significant acquisition or disposition, or a takeover bid, the board of directors of a corporation (the “Board”) must take control of the process and ensure that, among other things, they fulfill their duties as directors.

Directors should familiarize themselves with their fiduciary duties in the context of the circumstances faced by the corporation and review these duties periodically as decisions are made. For public companies, where a transaction is subject to shareholder approval, it is important to remember that the process undertaken by the Board will be described in either a Directors’ Circular or in an Information Circular prepared as part of the transaction and therefore the process undertaken will form part of shareholders’ and the public’s views of the transaction.

Key Issues/Process Points

1 Directors' Fiduciary Duties

It is a fundamental principle of corporate law that directors are responsible to manage or supervise the business and affairs of the corporation. In managing the corporation, the directors owe certain duties to the corporation:

- a fiduciary duty / duty of loyalty; and
- a duty of care.

2 Fiduciary Duty

A director's fiduciary duty (duty of loyalty) is a duty to act honestly, in good faith and with a view to the best interests of the corporation. In satisfying this duty a director must avoid conflicts of interest, not use their position for personal gain, and maintain a duty of confidentiality.

It is clear in Canadian law that the director's fiduciary duty is owed to the corporation but requires consideration of the interests of all stakeholders. Those other stakeholders could include employees, creditors, consumers, governments, or the environment.

In the *BCE* case, the Supreme Court of Canada went further, stating that the fiduciary duty comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. The failure to do so could result in an oppression action under applicable corporate law. The incorporation of the oppression concept into directors' duties could be considered to be a third duty - the duty to act equitably and fairly. Where conflicting interests arise, it falls to the directors to resolve conflicts in a way that is in the best interests of the corporation and provides fair treatment to the stakeholders.

How does this impact a change of control transaction? *BCE* does not say that a corporation cannot maximize profit and shareholder value. However, if that is the decision of the Board, it must not do so by treating individual stakeholders unfairly (as fair treatment is a fundamental reasonable expectation of stakeholders).

3 Duty of Care

In exercising their powers and discharging their duties directors must use the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. This is an objective standard and the duty is owed to the corporation and its shareholders. In order to satisfy their duty in the context of a change of control transaction, directors should generally:

- have adequate knowledge of the proposed transaction;
- conduct an independent examination of the proposed transaction;
- allow sufficient time to consider and analyze the proposed transaction;
- where appropriate, seek independent legal, financial or other advice;
- question information provided;
- make decisions on an objective and informed basis; and
- rely, where appropriate, on the advice of professionals.

In exercising their duty of care, directors will receive protection from the business judgement rule. Generally speaking, courts are reluctant to second-guess a Board's decision on matters of business judgement even where hindsight uncovers flaws in their decisions, provided that the decision falls within a range of reasonableness and in making their decision the Board follows appropriate processes and arrives at a conclusion reasonable in the circumstances

In conducting themselves in the context of a change of control transaction, directors are required 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 and to conclude that, in their view, the approved alternative is in the best interests of the corporation and is the best one reasonably available to the corporation. Alternatives to be considered must be reflective of the context and the



circumstances in which the corporation finds itself. Some alternatives to consider, include, but are not limited to, the status quo, the possibility of bids or proposals made by third parties, or other alternatives (e.g. financing or refinancing alternatives).

No matter which approach is chosen, directors must have a reasonable basis to conclude that the alternative chosen is the best alternative available in the circumstances.

4 Conflicts of Interest and the Importance of Independence

The independence of directors and a consideration of whether directors are free of conflicts and other competing interests that could reasonably be viewed as impacting their judgement should be considered at the outset of a potential change of control transaction, as this directly impacts whether directors will have discharged their fiduciary duty / duty of loyalty. In undertaking this, consideration should be given to not only actual conflicts but also to a perception of outside interests that could affect a directors' judgement.

Where there are conflicting interests, the appointment of an independent or special committee should be considered by the Board to assist in considering transactions or decisions which raise a concern about potential conflicts of interest.

5 Use of Special Committees of the Board

Canadian law does not expressly mandate that a special committee be established, however, applicable securities laws in certain circumstances such as related party transactions (see Multilateral Instrument 61-101 – *Protection of Minority Securityholders in Special Transactions*), requires the Board to constitute a special committee. In the case of conflicts of interest, establishing a special committee of independent directors functions as a procedural safeguard to ensure that any decision is made by those without ancillary interests.

In other cases, the Board may determine that because of the significance of the decision and the short time in which it must be made, a smaller group of directors should undertake an intensive review that the full Board is unable to conduct in the circumstances. In this way, the Board ensures that a detailed review is completed efficiently and is freed from the practical constraints of gathering the full Board for several meetings within a short time. This smaller working group has the mandate of investigating matters fully and bringing recommendations back to the Board to consider as a whole. In this way, a special committee may not only help directors discharge their fiduciary duty / duty of loyalty, but also their duty of care in following an appropriate process enabling them to reach an informed decision.

There are two common circumstances where a Board may choose to establish a special committee in the context of an M&A transaction:

1. Where a corporation is facing a particular change of control transaction, the Board will often establish a special committee comprised of non-management directors to provide independence from the interests of majority or significant shareholders whose interests may differ from other shareholders or to provide independence from the influence of management representatives on the Board who may be influenced by the effects of a transaction on them personally.
2. A Board may determine that an evaluation of strategic alternatives is necessary. These alternatives may include a change in the direction of the business of the corporation, a recapitalization or reorganization transaction or a sale of the corporation. In these circumstances, the Board may wish to evaluate these alternatives with the assistance of senior management and, potentially with outside legal and financial advisors.

If the Board decides to appoint a special committee, there are three general considerations that should be taken into account in determining the composition of the special committee:

- independence;
- expertise and experience; and
- time commitment and the ability of the committee members to work together as a group.

With respect to independence, the key to evaluating any special committee process is to ensure that the decision at issue is made, and perceived to be made, on the merits, unclouded by outside considerations. In making this assessment, a perception that outside interests could affect the judgement of a committee member can be as important as the existence of an actual conflict.

Use of Special Committees of the Board | *Continued*

Where a Board has acted on the advice of a special committee composed of persons having no conflict of interest, that decision will generally be respected under the business judgement rule and afforded deference provided that the committee has acted independently, in good faith and made an informed recommendation.

6 Documenting Board/Special Committee Deliberations

In the context of a change of control transaction it is important for the Board / special committee to properly document the process undertaken, the advice received and the decisions made. Doing so assists in the recording of the process in the “Background to the Transaction” section of the disclosure document and forms the basis for establishing a business judgement rule defense.

An important element of this documentation is proper minute taking of Board / special committee meetings and deliberations. The goal of minute taking is to document decisions and to assist the parties in remembering / documenting the “whys” decisions were made, how conflicts were analyzed and resolved, etc. While there is no standard approach to minute taking it will be important to draft minutes that contain enough detail to identify the key factors the Board / special committee considered, including the input of advisors and the reasons why the Board / special committee did what they did, but are not so short as to lack any context



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