Blake, Cassels & Graydon LLP December 2008

Blakes Bulletin

Litigation/Mergers & Acquisitions

Supreme Court of Canada Releases Reasons for Decision in BCE

JEFF GALWAY AND MICHAEL GANS

While the decision has been known for months, the Canadian business and legal communities have eagerly awaited the Supreme Court of Canada's Reasons for Judgment in the *BCE* case for clarification of directors' duties in change of control and other fundamental change transactions. In June 2008, the Supreme Court overturned the Québec Court of Appeal and rejected arguments put forth by a group of BCE debentureholders that (i) the BCE directors acted in an oppressive manner in approving the sale of BCE; and (ii) in any event, the proposed plan of arrangement to implement the transaction was not fair and reasonable. In what will become a footnote to the ruling, the BCE transaction failed earlier this month when a mutual closing condition was not met on the outside date for completion.

This decision will be mandatory reading for all mergers and acquisitions lawyers and corporate/commercial litigators and of considerable interest to directors of both public and privately held companies in Canada. While the focus of the Reasons is on the nature and scope of the oppression remedy and on the test for approving a plan of arrangement, the decision also provides a good summary of a director's statutory duties as well as the remedies available to stakeholders who feel that their legal or equitable rights have been infringed. The decision grants greater leeway to Canadian directors to balance competing interests in a change of control situation than their Delaware counterparts who are bound by value maximizing *Revlon* duties, and also reaffirms the commitment of Canadian courts to the business judgment rule, which will continue to protect directors who make reasonable and informed decisions. As discussed in further detail below, however, the many general and open-ended statements by the Supreme Court as to factors that should be considered by directors when facing a change of control transaction may prove challenging to both directors and their financial and legal advisors.

BACKGROUND

At issue in BCE was a C$52-billion transaction, the largest leveraged buy-out in history, to be effected by plan of arrangement under Canadian law. Under the arrangement, a consortium led by Ontario Teachers' Pension Plan Board agreed in June 2007 to purchase BCE for an approximately 40% premium to the closing price of BCE shares before rumours of the transaction began to circulate. Under the arrangement, Bell Canada, a wholly-owned subsidiary of BCE, would have guaranteed approximately C$30-billion of new BCE debt and the consortium would have invested approximately C$8-billion in new capital to acquire BCE. The arrangement was approved in September 2007 at a special meeting of BCE common and preferred shareholders by more than 97% of the votes cast. By the time the plan of arrangement went before the Québec Superior Court for approval, the existing Bell Canada debentures had been downgraded below investment grade due to the pending significantly increased leverage on the company, causing the debentures to decrease in value by approximately 20%.

CONT'D ON PAGE 2

Highlights

- Seminal corporate law ruling from Supreme Court of Canada
- Business judgment rule affirmed once again
- Directors' duty to act in the best interests of the corporation is very broad; board may consider interests of shareholders, employees, creditors, consumers, governments and the environment, among others
- No *Revlon* duty *per se* in Canada
- Courts considering claims for oppression should look at business realities, not merely narrow legalities
- Plan of Arrangement approval process: absent exceptional circumstances, look to impact of plan on legal rights

CONT'D FROM PAGE 1

At first instance, the Québec Superior Court dismissed the claim for oppression on the grounds that the debt guarantee to be provided by Bell Canada had a valid business purpose, that the transaction did not breach the reasonable expectations of the debentureholders, that the transaction was not oppressive by reason of rendering the debentureholders vulnerable, and that BCE and its directors had not unfairly disregarded the interests of debentureholders. The Court also dismissed the debentureholders' claim for voting rights on the arrangement on the grounds that their legal interests were not compromised by the arrangement and it would be unfair to allow them in effect to veto the arrangement that had been approved by shareholders. The Court went on to consider the fairness of the proposed arrangement with respect to both the shareholders and the debentureholders and found that the arrangement addressed the debentureholders' interests in a fair and balanced way.

In a ruling that surprised corporate Canada for its apparent deviation from the widely accepted principle of maximizing shareholder value in a change of control situation, the Québec Court of Appeal allowed an appeal of the Superior Court's judgment. The Court of Appeal held that representations made by Bell Canada over the years in a variety of offering materials and public reports could have created reasonable expectations above and beyond the contractual rights of debentureholders and that in such circumstances, the directors were under a duty not simply to accept the best offer, but to consider whether the arrangement could be restructured in a way that provided a satisfactory price to the shareholders while avoiding an adverse effect on the debentureholders. Absent any evidence as to such efforts, the Court of Appeal held that BCE had not discharged its onus of showing that the arrangement was fair and reasonable.

DIRECTORS' FIDUCIARY DUTIES

The case afforded the Supreme Court an opportunity to restate the nature and scope of directors' fiduciary duties in Canada. Under the *Canada Business Corporations Act* (the CBCA), directors have both a duty to act in the best interests of the corporation and a duty to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances. The debentureholders' challenge in this case put in issue the first of these duties. In far reaching commentary, the Court noted that in exercising the duty owed to the corporation, where the corporation is ongoing, directors should be looking to the long-term interests of the corporation, which duty will vary with the situation at hand.

In considering what is in the best interests of the corporation, the Court went on to note that the directors may look at the interests of *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. In doing so, the Court confirmed that there is no principle in Canada that one set of interests, for example the interests of shareholders, should prevail over another set of interests. The Court has likely put to rest any suggestion that the Delaware *Revlon* duty, which directs Delaware directors to prefer the interests of shareholders where there is a cash offer for a company, is the law in Canada. Rather, the Court is clear that Canadian directors should not be confined to priority rules, it being a function of business judgment as to what is in the best interests of the corporation in any particular situation. The Court also made it clear that Canadian courts should give appropriate deference to the business judgment of directors who take into account the various interests referred to above, as reflected by the business judgment rule, provided that the decision of the board lies within a range of reasonable alternatives.

OPPRESSION REMEDY

The CBCA provides for a remedy where the acts or omissions of a corporation have been conducted in a manner that is oppressive or unfairly prejudicial or that unfairly disregards the interests of a stakeholder (which is broadly defined in the Act) of the corporation. The Court noted that the oppression remedy seeks to ensure fairness, namely what is "just and equitable" in the circumstances, which differentiates the oppression remedy from the narrower plan of arrangement approval process discussed below. It follows that when considering claims for oppression, courts should look at business realities and not merely narrow legalities. The Court went on to hold that the cornerstone of the oppression remedy is the "reasonable expectations" of the corporation's stakeholders. The concept of reasonable expectations is objective and contextual, the actual expectation of a particular stakeholder not being conclusive.

CONT'D ON PAGE 3

©2008 Blake, Cassels & Graydon LLP

CONT'D FROM PAGE 2

In assessing whether a reasonable expectation exists, the Court observed that factors that emerge from the case law include: 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 terms of corporate practice, the Court held that a departure from normal business practices that have the effect of undermining or frustrating the complainant's exercise of his or her legal rights will generally (although not inevitably) give rise to a remedy. With respect to the nature of the corporation, the Court noted that courts may accord more latitude to the directors of a small, closely held corporation to deviate from strict formalities than to the directors of a larger public company. In terms of relationships, the Court stated that relationships between shareholders based on ties of family or friendship may be governed by different standards than relationships between arm's-length shareholders in a widely held corporation. As for past practice, the Court stated that past practice may create reasonable expectations, especially among shareholders of a closely held corporation, on matters relating to participation of shareholders in the corporation's profits and governance, although the Court went on to note that practices and expectations can change over time. In terms of preventive steps, the Court held that it may be relevant whether the claimant could have taken steps to protect itself against the prejudice it claims to have suffered. The Court also held that shareholder agreements may be viewed as reflecting the reasonable expectations of the parties and that such expectations may also be affected by representations made to stakeholders or to the public in terms of promotional material, prospectuses, offering circulars and other communications.

Taken as a whole, the Court held that the case law confirms that the duty of directors to act in the best interests of the corporation comprehends the duty to treat individual stakeholders affected by corporate actions equitably and fairly. It noted that fair treatment is the essential theme running through the oppression jurisprudence and is most fundamentally what stakeholders are entitled to reasonably expect.

To maintain a claim for oppression under the CBCA, however, the Court went on to hold that not only must the complainant establish that its reasonable expectations have been thwarted, but that the failure to meet those expectations involved unfair conduct or prejudicial consequences within the oppression provisions of the Act. In this regard, the Court noted that not every failure to meet a reasonable expectation will give rise to the equitable considerations that found an action for oppression. Specifically, a court must be satisfied that the conduct in issue falls within the concepts of "oppression", "unfair prejudice" or "unfair disregard" of the claimant's interests. These concepts indicate the type of wrong that the oppression remedy is aimed at and do not represent watertight compartments.

The debentureholders argued that they had a reasonable expectation that BCE would protect their economic interests as debentureholders in Bell Canada by putting forth a plan of arrangement that would maintain the investment grade trading value of their debentureholders. In the alternative, the debentureholders submitted that they at least had a reasonable expectation that the directors would consider their economic interests in maintaining the trading value of their debentures.

The Court rejected both of these arguments, agreeing with the trial judge that neither of the expectations stated above had been made out by the debentureholders. The Court accepted that the only reasonable expectation on the part of the debentureholders was that the BCE directors would consider the position of the debentureholders in making their decision on the various offers under consideration, which the evidence established that the directors did. Having considered the debentureholders' interests, the BCE directors concluded that while the contractual terms of the debentures would be honoured, no further commitments could be made. The Court held that this fulfilled the duty of the directors to consider the debentureholders' interests. In reaching this conclusion, the Court noted that the BCE board faced difficult circumstances and in making the decision that it did, it acted in what it perceived to be the best interests of the corporation.

CONT'D ON PAGE 4

©2008 Blake, Cassels & Graydon LLP

CONT'D FROM PAGE 3

PLAN OF ARRANGEMENT PROCESS

Having dismissed the debentureholders' allegation that the transaction amounted to oppression, the Court then turned to the debentureholders' second argument that the Superior Court should have withheld its approval of the plan of arrangement on the basis of fairness. The Court noted that while the oppression remedy is a broad and equitable remedy that focuses on the reasonable expectations of stakeholders, the arrangement approval process focuses primarily on the interests of the parties whose legal rights are being arranged.

The Court held that in determining whether a plan of arrangement is fair and reasonable, the court considering the arrangement must be satisfied that the arrangement has a valid business purpose and adequately responds to the objections and conflicts between the different affected parties. Whether these requirements are met is determined by taking into account a variety of relevant factors, including the necessity of the arrangement to the corporation's continued existence, the approval, if any, of a majority of shareholders and other securityholders entitled to vote, and the proportionality of the impact on affected groups.

In assessing whether a transaction has a valid business purpose, the Supreme Court held that an important factor to consider is the necessity of the arrangement to the continued operations of the corporation. To the extent that the plan of arrangement is necessary for the corporation's continued existence, courts will more willingly approve the arrangement despite its potential prejudicial effect on some securityholders. In those situations where the arrangement is not mandated by the corporation's financial and commercial situation, however, courts should be more cautious and will undertake a more careful analysis of the arrangement.

In assessing whether the objections of those whose rights are being arranged have been resolved in a fair and balanced way, the Court held that an important factor will be the extent of the majority of the securityholders who have voted on the arrangement. While the outcome of the vote by securityholders was stated not to be determinative of whether court approval of the arrangement should be granted, the Court noted that this factor has received considerable weight in the case law. A slim majority approving the arrangement casts doubt as to whether the arrangement is fair and reasonable. Other *indicia* of fairness were said to be the proportionality of the compromise between affected securityholders, whether the plan has been approved by a special committee of independent directors, the presence of a fairness opinion from a reputable expert and the access of shareholders to dissent and appraisal remedies.

Turning to the debentureholders' arguments that court approval of the arrangement should have been denied, the Court held that the real debate before them focussed on whether the rights of those being arranged had been resolved in a fair and balanced way. In this regard, the debentureholders main contention was that the process adopted by the directors in negotiating and concluding the arrangement had failed to adequately consider their interests, specifically the fact that the arrangement would reduce the trading value of their debentures and in some cases result in a downgrade of the debentures to below investment grade rating.

In dismissing this argument, the Court noted that, subject to exceptional circumstances (and unlike the broader oppression remedy), the focus of the analysis is on a party's legal rights. Here debentureholders' legal rights had been left intact and the fact that they faced a reduction in the trading value of their securities did not constitute exceptional circumstances which would otherwise require the reviewing court to consider these interests in determining whether to grant approval of the arrangement. Accordingly, the debentureholders did not constitute an affected class who were entitled to a separate vote. In any event, the Court agreed with the trial judge's finding that the arrangement had addressed the debentureholders' interests in a fair and balanced way.

UNANSWERED QUESTIONS

While the Reasons for Judgment provide a good overview as to the relevant factors to be considered and the balancing exercise to be undertaken by directors of a public company facing a change of control, the open-ended nature of many of the statements made by the Court in its decision may create uncertainty for directors and their advisors going forward. For example, in discussing directors' fiduciary duties, the Court referenced its prior decision in *People's Department Stores* where it held that although directors *must* consider the best interest of the corporation, it may also be appropriate, although *not mandatory*,

CONT'D ON PAGE 5

©2008 Blake, Cassels & Graydon LLP

CONT'D FROM PAGE 4
to consider the impact of corporate decisions on shareholders or particular groups of stakeholders. The Court went on to state that in considering what is in the best interest of the corporation, directors may look at the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments, and the environment to inform their decision. Notwithstanding this permissive language, the Court's approach to the oppression remedy seems to suggest that at a minimum directors should be turning their minds to the reasonable expectations of all stakeholders before making significant decisions. The weight to be given to these various considerations is unclear. For example, what weight should directors give to the fact that a proposed transaction may result in significant employee terminations or plant closures? Can an offer to acquire a Canadian company be recommended over a higher offer if the acquirer is willing to make significant job or capital commitments to the government? Given the variety of inter-connected factors evaluated by corporate boards in change of control situations, questions like these are limitless.

In the context of oppression, the Court went on to indicate that the need to treat affected stakeholders in a fair manner must be done commensurate with the corporation's duties as a "responsible corporate citizen". It is not clear how referencing the corporation's role as a "responsible corporate citizen" impacts the balancing exercise that directors must undertake when dealing with competing stakeholder interests.

Notwithstanding the current slowdown in M&A activity, there is no question that Canadian directors will struggle with these issues in the future. Fortunately, the broad protection afforded in Canada by the business judgment rule to those directors who act in an informed and reasonable manner should ensure that they are not subject to a judicial standard of perfection in their decision making and that deals continue to get done.

For further information, please contact Jeff Galway at 416-863-3859 or jeff.galway@blakes.com or Michael Gans at 212-893-8416 or michael.gans@blakes.com or any member of our national Litigation Group or Securities Group.

Go to **blakes.com/english/subscribe.asp** to subscribe to other Blakes Bulletins.

Blakes periodically provides materials on our services and developments in the law to interested persons. If you do not wish to receive further bulletins or other materials from Blakes, please contact Blakes Marketing Department at 416-863-3036 or **dorothy.byers@blakes.com**. For additional information on our privacy practices, please contact us at **privacyofficer@blakes.com**. *Blakes Bulletin* is intended for informational purposes only and does not create a lawyer-client relationship. The transmission of this information does not suggest Blakes or any of its lawyers are practising law of any jurisdiction other than Canada. The information provided in this bulletin is summary in nature and does not constitute legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For permission to reprint articles, please contact Blakes Marketing Department at 416-863-2403 or **lynn.spencer@blakes.com**. ©2008 Blake, Cassels & Graydon LLP.