Blakes
CANADIAN LAWYERS

THE BALANCING ACT: DIRECTORS' DUTIES IN CANADA VS. THE U.S.

By Matthew Merkley and Stefania Zilinskas, Blake, Cassels & Graydon LLP

When evaluating major corporate decisions, such as potential merger-and-acquisition opportunities, a corporation's board of directors is tasked with exercising its management or supervisory role with a view to the best interests of the corporation. Interpretation of what or who makes up "the corporation", however, and particularly which stakeholder interests may be validly considered when making corporate decisions, varies between jurisdictions.

In the United States, this notion of a director's duty is generally interpreted to be synonymous with the best interests of the corporation and its shareholders and, particularly, shareholder value is to be prioritized. In Canada, on the other hand, the notion is not as wedded to maximizing shareholder value, as a director may properly take into account the interests of shareholders, as well as other stakeholders such as employees, creditors, consumers, the environment and the community at large in determining the best interests of the corporation.

However, while there are differences in the interpretations of the legal scope of directors' duties between Canada and the U.S., in practice, boardroom discussions can generally be expected to be quite similar in both jurisdictions.

BACKGROUND

Canadian and U.S. judicial interpretations of directors' fiduciary duties have historically differed.

U.S.

The maxim that the best interests of the corporation are generally synonymous with those of the shareholder dates back to at least the 1919 Michigan Supreme Court decision in *Dodge v. Ford Motor Company*, 204 Mich. 459, 170 N.W. 668, 3 A.L.R. 413 (1919). *Dodge v. Ford Motor Company* concerned a dispute between Ford Motor Company and brothers John and Horace Dodge, shareholders of Ford Motor Company, who objected to a decision by Henry Ford to withhold special dividends in favour of investing profits back into the company.

Henry Ford's rationale for using the profit to expand the business rather than pay a special dividend, as quoted by the Court in its reasons, was "to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes." The Michigan Supreme Court, in finding Henry Ford's "philanthropic and altruistic" sentiments improperly applied as corporate policy, held that "[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."

This conception of the role of the corporation and the directors who guide it has become a basic tenet of U.S. corporate law, informing subsequent developments such as the *Revlon* duty (which provides that directors must act reasonably to maximize the short-term value of the consideration to be received by shareholders in a sale or change of control transaction). Overall, American jurisprudence is generally clear: boards of directors are responsible for maximizing shareholder value above all other considerations, especially when the company is the target of an acquisition or sale transaction.

Canada

The duties owed by directors to a corporation in Canada consist of two distinct facets: the duty to act honestly and in good faith with a view to the best interests of the corporation (commonly referred to as the "duty of loyalty"), and the duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (commonly referred to as the "duty of care").

The duty of loyalty and the duty of care, often collectively referred to as the "fiduciary duties" of directors, apply whenever directors act in furtherance of corporate ends. Canadian courts have held that such fiduciary duties are owed by directors to the corporation itself, rather than to the shareholders of the corporation.

In addition, Canadian courts abide by the "business judgment rule" pursuant to which appropriate deference is given to a good faith decision by directors, provided that the decision is reached on an informed basis and is within a range of reasonable alternatives.

In the seminal case of *BCE Inc. v. 1976 Debentureholders*, [2008] 3 S.C.R. 560, 2008 SCC 69 (the "BCE Decision"), Canada's highest court considered, among other concepts, the duty of loyalty and held that in determining what is in the best interests of the corporation, directors of a Canadian corporation may look at the interests of a variety of stakeholders, including shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. The Supreme Court of Canada clarified that, unlike the predominant view in the U.S. context, there is no principle in Canada that one set of stakeholders' interests, such as the interests of shareholders, should automatically prevail over all other interests. Instead, it is a matter for the directors' business judgment as to what is in the best interests of the corporation in any particular situation. Importantly, the court also noted that, where the corporation is a going concern, directors should be looking to the long-term interests of the corporation in exercising their duties.

SHAREHOLDER VALUE VS. CORPORATE VALUE

One context in which Canadian directors may be afforded greater leeway than their U.S. counterparts to consider alternative courses of action may arise when faced with an activist shareholder proposal. While there is an ongoing debate regarding the role and consequences of shareholder activism, it is fair to say that, historically, some courses of action initiated by activist investors have positively impacted long-term corporate value, while others have negatively impacted long-term corporate value.

An activist shareholder may propose, for example, remedying a perceived underperforming stock by engaging in a share buyback, issuing debt, increasing dividends, downsizing or engaging in another corporate activity that could be expected to result in an immediate increase in shareholder value. Such corporate action, designed to have the effect of raising shareholder value in the short term, may adversely affect the corporation's long-term prospects. For example, downsizing may result in a loss of customers, or taking on debt may limit the company's flexibility to make value-enhancing investment in research and development, staff training and capital expenditures.

Rather than creating corporate value, which can be imagined as growing the size of the "pie", certain of such proposals may in fact just shift value between stakeholders, such as from employees or creditors to shareholders, thereby reallocating the pieces of the same-sized corporate value "pie" onto the plates of shareholders. In the Canadian context, such value-shifting initiatives may be properly criticized as prioritizing the interests of shareholders over other stakeholders, which may not result in corporate actions that are in the best interests of the corporation. Whereas in the U.S. context, directors might not be faulted for increasing shareholder value in such a manner.

This difference may help to explain why shareholder class actions typical in the U.S., such as "stock drop" cases, are less common in Canada. As long as a board's decision can be justified as being in the best interests of the corporation as a whole, such decision is protected by Canada's business judgment rule, even if it fails to maximize short-term (or even long-term) shareholder value.

Another context in which Canadian directors may be afforded greater leeway to consider alternative courses of action is when a Canadian corporation becomes the target of a take-over bid. Like in the U.S., the board of a Canadian target corporation may determine to support a bid, even if a higher-priced bid has been proposed by another suitor (such as Family Dollar Stores Inc.'s board, which supported Dollar Tree Inc.'s lower-priced bid as it was perceived to involve fewer anti-trust hurdles, and therefore a greater likelihood of consummation, than a competing bid from Dollar General Inc.). However, unlike in the U.S., in the Canadian context, a lower bid could also be supported as being in the best interests of the corporation based on consideration of the impact on stakeholders apart from the shareholders.

SHAREHOLDER INTERESTS MATTER

Although directors of Canadian corporations are afforded with the additional flexibility to consider the interests of a myriad of stakeholder groups, the interests of shareholders still matter. As in the U.S., ultimately most transformative corporate decisions require shareholder support, either by way of a shareholder vote or through the tendering of shares.

Accordingly, a board of directors that seeks to pursue a decision that may, for example, forego an immediate increase in share price will need to convince shareholders that such a long-term view is in fact in the shareholders' best interests. The success of such a campaign can depend heavily on the types of investors comprising the shareholder group.

Further, while a board's decision to not support an activist shareholders' proposal or a premium take-over bid may be legally justified, in the context of a proxy battle, directors that fail to convince shareholders of the benefits of such a decision may ultimately be replaced by alternate candidates put forward by dissident shareholders. That is not to say, however, that the new replacement directors will ultimately make determinations to appease upset shareholders, as such directors are also equally tasked with acting in the best interests of the corporation as a whole. In the U.S., this was clearly demonstrated when three nominees of Air Products and Chemicals, Inc. were elected to the board of Airgas, Inc. and subsequently sided with the other members of Airgas' board in determining to reject Air Products' offer to acquire.

Blakes
CANADIAN LAWYERS

BOARD PROCESS

While there are differences in how directors' duties are viewed in Canada as compared to the U.S., in practice the process undertaken by Canadian boards in considering shareholder proposals or transformative transactions can be expected to be similar to that of their U.S. counterparts. Examples of such accepted cross-border best practices are as follows:

Engage. Ensure that all concerns are heard and that there is a clear and obvious process for communicating with stakeholders and managing their issues. Create a dialogue aimed at coming to a collaborative solution to such issues. In many cases, costly and protracted proxy or legal battles may be avoided by proactive engagement.

Act in good faith. Irrespective of whether shareholders as well as other stakeholder groups may be considered when taking corporate action, the directors taking such action must be independent and disinterested, they must have an honest belief that the action to be taken is in the best interests of the corporation, and there must be a rational business purpose for the transaction.

Follow a good process. Take "due care" in making decisions. The directors must have exercised "reasonable diligence" in informing themselves of all material information reasonably available to them. While it may not be necessary to go through a checklist to consider the impact of a corporate action on each stakeholder group, none should be unfairly disregarded. In particular, actions that are oppressive or unfairly prejudicial to the interests of a stakeholder may give rise to an oppression action under Canadian corporate law.

Document. Create a paper trail memorializing the steps taken by the board in ensuring that it is well informed, acting in good faith and has reached an appropriate decision. Any conflicts should be carefully documented and corporate minutes should show that board members acted with due care. Documentation is important when a board's decision faces after-the-fact scrutiny.

To conclude, while the judicial interpretation of what is in the best interest of a corporation may differ as between Canada and the U.S., in practice (i) on either side of the border, shareholder interests must be considered, (ii) the process that U.S. board members follow—especially when dealing with activist shareholders or competing take-over bid proposals—can be expected to be quite similar to that followed by Canadian boards, and (iii) it will be a rare occasion that the conclusions determined by a Canadian board will differ from a U.S. board in similar circumstances.

ABOUT THE AUTHORS

MATTHEW MERKLEY AND STEFANIA ZILINSKAS

MATTHEW MERKLEY is a partner in the Blakes Toronto office. He represents clients in a wide variety of capital markets transactions and securities regulatory matters. He has acted for issuers and underwriters in public offerings of debt and equity, as well as bidders, target companies, and financial advisers in public and private acquisitions and contested corporate transactions. He also has expertise with respect to advising public issuers.

STEFANIA ZILINSKAS is an associate in the Blakes New York office. Her practice focuses on advising clients in a wide variety of capital markets transactions and securities regulatory matters, including financings, mergers and acquisitions, private placements, and corporate governance and compliance matters.

ABOUT THE FIRM

As one of Canada's top business law firms, Blake, Cassels & Graydon LLP (Blakes) provides exceptional legal services to leading businesses in Canada and around the world.