

Not Unique: Ontario Court of Appeal Reaffirms That Reliance on Business Judgment Rule Requires Compliance by Directors With Duty of Loyalty

The Ontario Court of Appeal has recently reconfirmed that the court's deference to business decisions made by boards of directors, known as the "business judgment rule", will not apply where the directors have breached their statutory duty of loyalty. The Court also confirmed that contractual provisions that have the effect of contracting out of the statutory duties imposed on directors and officers by the Ontario *Business Corporations Act* ("OBCA")¹ will not be upheld. The Court of Appeal rejected the claim by a former CEO of Unique Broadband Systems, Inc. ("UBS"),² for payment of certain compensation awards and overturned the lower court's ruling that the CEO was entitled to receive a 'golden parachute' severance payment.

Gerald McGoey was a director and the CEO of UBS, a TSX Venture Exchange listed company, and was also a director and the CEO of its 51.8% owned subsidiary, Look Communications Inc. ("Look"). UBS had in place a share appreciation rights ("SAR") plan, pursuant to which participants would be paid an amount per SAR unit equal to the difference between the unit strike price and the market price of the UBS shares upon the occurrence of a triggering event. In

¹ RSO 1990, c. B16 [OBCA].

² *Unique Broadband Systems, Inc. (Re)*, 2014 ONCA 538 [UBS].

December 2008, Look initiated a court-supervised process to sell a significant portion of its assets. The UBS directors determined that completion of the sale by Look would be deemed to be a triggering event for purposes of the SARs. The sale of the Look assets was completed in May 2009, but contrary to expectations, the market price of the UBS shares did not appreciate following completion of the sale, continuing to trade in the \$0.15 range. In June 2009, the UBS board met and decided to cancel the outstanding SARs in exchange for aggregate payments to SAR holders of \$2.3 million, which amount was based on an assumed \$0.40 market price for the UBS shares. All of the directors held SARs and declared their interest. Cancellation of the SARs would result in McGoey receiving \$600,000, as compared to a payment of \$75,000 under the original terms of the SAR plan. The UBS board also established an aggregate bonus pool of \$3.4 million, of which McGoey would receive \$1.2 million. Prior bonus payments to McGoey had been in the \$400,000 range. Similar actions were also taken by Look's board of directors, with the result that the total amount to be funded by UBS under both companies' plans would be approximately \$14.6 million, or in excess of 97% of the market capitalization of UBS.

Dissident UBS shareholders convened a meeting in July 2010 and were successful in replacing the incumbent directors. McGoey took the position that as he had not been re-elected as a UBS director, he had been terminated as its CEO without cause and brought an action seeking payment of the SAR cancellation and bonus amounts, as well as his severance entitlements under his contract with UBS. The severance entitlement was equal to 300 percent of McGoey's annual compensation. The trial judge rejected McGoey's claims for the SAR cancellation and bonus amounts but upheld his claim to receive the golden parachute payment.

The OBCA requires directors and officers to act honestly and in good faith with a view to the best interests of the corporation.³ This duty

³ *OBCA*, *supra* note 1, s 134(1). See also *Canada Business Corporations Act*, RSC 1985, c C-44, s 122 [*CBCA*].

of loyalty requires that directors act in an impartial, disinterested manner with decisions being taken based on reasonable beliefs and for rational business purposes, and not for purposes of self interest. The Court noted that officers and directors must "*scrupulously avoid*"⁴ conflicts of interest with their corporation and not abuse their position for personal gain. The OBCA also requires directors and officers to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.⁵ This does not mean that every decision of the directors must be found in hindsight to be perfect. Canadian courts have adopted and continue to strongly endorse the business judgment rule, whereby courts will defer to the business judgment that the board has exercised in a particular manner, provided that the directors have made an informed and reasonable decision. As previously stated by the Supreme Court of Canada:

*Courts are ill suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making, but they are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made.*⁶

The Court found there was no credible evidence of the *bona fides* of the SAR cancellation payments, including the \$0.40 per share valuation. The UBS board implemented the SAR cancellation without the benefit of independent oversight (as all of the directors held SARs) or third party advice. The \$0.40 valuation had not been determined by any objective means and did not reflect the actual market price of the UBS shares. While fixing the SAR value was clearly beneficial to the holders, there was no reciprocal benefit to

⁴ *UBS, supra* note 2 at para 46.

⁵ *OBCA, supra* note 1, s 134(1).

⁶ *Peoples Department Stores Inc. (Trustee of) v Wise*, 2004 SCC 68 at para 67.

UBS. Similarly, the UBS board had not received any expert advice on an appropriate bonus structure, nor did it have any documentation reflecting comparable or other market data on executive compensation. While disclosure by a director or officer of his personal interest in a transaction was required as an initial step, it was not sufficient to relieve a director of his obligation to act honestly and in the best interests of the corporation.

The Court characterized the business judgment rule as a "*rebuttable presumption*"⁷ that in reaching the decision made, the directors had acted on an informed basis, in good faith and in the best interests of the corporation. However, this presumption will only apply where the preconditions of honesty, prudence, good faith and a reasonable belief that one's actions were in the best interests of the corporation, had been met. The Court concluded that the presumption had been rebutted, noting that: "*Courts will defer to business decisions honestly made, but they will not sit idly by when it is clear that a board is engaged in conduct that has no legitimate business purpose and that is in breach of its fiduciary duties*".⁸

The Court also refused to allow the golden parachute payment to McGoey. Section 134(3) of the OBCA provides that: "*no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act...or relieves him or her from liability for a breach thereof*".⁹ The Court refused to interpret a contractual provision so as to exclude a breach of fiduciary duty as a ground for termination, since this would "*eviscerate*"¹⁰ the prohibition in s.134(3).

⁷ *UBS*, *supra* note 2 at para 72.

⁸ *Ibid* at para 72.

⁹ *OBCA*, *supra* note 1. See also *CBCA*, *supra* note 3, s 122(3).

¹⁰ *UBS*, *supra* note 2 at para 97.

The Court's decision in UBS is consistent with previous Canadian decisions, including the Ontario Court of Appeal's decision in Repap,¹¹ which also involved executive compensation. Decisions by directors will continue to be protected to the extent that their actions actually evidence the exercise of business judgment. In Repap, an extremely lucrative employment agreement was awarded to the Chairman after a seven minute meeting of the compensation committee, which although having received an outside consultant's opinion, had provided the consultant with only cursory information and had not questioned the consultant's opinion or the basis of its recommendation. The Committee and the consultant had also not been advised by the Chairman that other directors had resigned rather than approve the employment agreement. The Court of Appeal upheld the lower court's decision to set aside the employment agreement, having concluded that the Chairman had breached his fiduciary duty to the corporation and that the other directors had violated their duty of care by not making a decision on an informed and reasoned basis. The directors had not informed themselves sufficiently or given proper oversight to their outside advisor, and therefore could not be said to have exercised their business judgment.

What does this mean for directors? Avoid conflicts of interest and the appearance of conflicts of interest. Obtain independent advice from experts, but do not rely on their advice unquestioningly. Any decision process must be characterized by the elements of independence, investigation, due deliberation and the exercise of business judgment.

It is also important to note that while unnecessary to its decision, the Court in UBS foreshadowed its willingness to consider the use of the

¹¹ *UPM-Kymmene Corp. v UPM-Kymmene Miramichi Inc.*, 2002 CanLII 49507 (ON SC), (2002), 214 DLR (4th) 496 (Ont SC), aff'd 2004 CanLII 9479 (ON CA), (2004), 183 OAC 310 (CA).

oppression remedy in cases such as this by noting that the oppression remedy may have provided a remedy in the circumstances and that it may be used by a court to "*rectify corporate malfeasance*".¹²

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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¹² *UBS, supra* note 2 at para 107.