Introduction

The directors of a corporation are required to manage, or supervise the management of, the business and affairs of the corporation. The directors have two broad categories of duties:

**Fiduciary Duty** - They must act honestly and in good faith with a view to the best interests of the corporation and its shareholders as a whole. This point is particularly relevant where there is a controlling or significant shareholder who is a proponent of, or has a direct interest in, any transaction being considered by the corporation.

**Duty of Care** - They must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. This requires them to make decisions on a fully informed basis. To do so, they must play an active role in the decision-making process and understand and take the time required to fully consider all relevant issues.

Most decisions made by directors are business decisions. Generally, in considering business decisions made by directors, Canadian courts will apply the business judgement rule, which is in effect a presumption that an informed, disinterested board of directors of a corporation will act in the best interests of the corporation. Accordingly, if directors act honestly and in good faith and make business decisions that are reasonable in the circumstances, and appropriate processes are followed in reaching those decisions, Canadian courts will not substitute their judgement for that of the directors.

The business judgement rule will not, however, protect business decisions made by directors where there is a conflict of interest or evidence that the directors acted for an improper purpose. In practical terms, directors must take care to avoid circumstances in which there is a conflict (real or apparent) between their personal interests and those of the corporation.

In related party transactions, the accepted method of dealing with conflicts of interest (eg, directors who are employees of or dependent on the related party) and protecting the interests of minority shareholders is to establish a special committee composed of directors who are independent and do not have a conflict of interest.

Use of Special Committees

**Insider Bids**

There is no legal obligation to establish a special committee except in limited circumstances. For example, securities rules require the use of an independent or special committee where an insider of a corporation makes a take-over bid.

The decision of the Ontario Securities Commission (OSC) in a hearing relating to the insider bid made by Sears Holdings for the common shares of Sears Canada owned by public shareholders was noteworthy for the comments made by the OSC with respect to the role of special committees in insider bids. After noting that the conduct of Sears Holdings with respect to its dealings with the special committee of Sears Canada formed to consider the insider bid “fell short of the conduct that we would expect of even the most determined offeror in pursuit of its insider bid”, the OSC commented as follows:

“The role of the Special Committee in the context of an insider bid is a critical component of the protections afforded to minority shareholders pursuant to Rule 61-501 (Re Hollinger Inc. (2005), 28 O.S.C.B. 3309). It is understandable that all bidders, including insider bidders, will want to successfully complete their bid at the lowest price reasonably possible in the circumstances. In
fact, it is to be expected that parties will act rationally and in their own economic interests. For this very reason, minority shareholders cannot be expected to look to the insider making the bid to protect their rights and interests. Rather, it is the statutorily mandated role of the Special Committee in such circumstances to safeguard the rights and interests of the public shareholders of the company during the course of an insider bid by, among other things, obtaining a formal valuation from an independent valuator of it’s choice and making an informed recommendation to the shareholders in relation to the insider bid.

Insiders who wish to make an insider bid for a public company and take it private assume an obligation to co-operate with the Special Committee as it discharges its important and statutorily mandated function.”

Related Party Transactions

In addition to mandating the use of a special committees in connection with insider bids, securities rules encourage, and good corporate governance practices mandate, the use of a special committee in connection with material related party transactions. In these circumstances, a special committee will ensure that persons who have an interest that may be at odds with the interest of the corporation and its shareholders as a whole do not influence the decision-making process of the directors. In a related party transaction, the effect of establishing a special committee is to return to the directors some or all of the judicial deference given to them in a non-related party transaction. If a special committee is established to consider a related party transaction, Canadian courts and securities regulatory authorities will expect that directors who are nominees of the related party or members of management will not be members of the committee or participate in the deliberations of the committee.

If, in considering a related party transaction, the board of directors of a corporation has acted on the advice of a special committee composed of directors who are independent and do not have a conflict of interest, and the committee has made a fully informed recommendation with respect to the transaction, the business judgement rule will apply.

Other Corporate Transactions and Events

Special committees are also used in connection with other corporate transactions and events such as special litigation, critical strategic decisions and insolvency proceedings. In these circumstances, there may be no conflict issues to manage; instead, the committee may be formed to increase the efficiency and critical thought involved in decision-making.

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“(6) To safeguard against the potential for unfair advantage accruing to an interested party as a result of that party’s conflict of interest or informational or other advantage in respect of the proposed transaction, it is good practice for negotiations respecting a transaction involving an interested party to be carried out by or reviewed and reported upon by a special committee of disinterested directors. Following this practice normally would assist in addressing the Commission’s interest in maintaining capital markets that operate efficiently, fairly and with integrity. While the Rule only mandates independent committees in limited circumstances, the Commission is of the view that it generally would be appropriate for issuers involved in a material transaction to which the Rule applies to constitute an independent committee of the board of directors for the transaction. Where a formal valuation is involved, the Commission also would encourage independent committees to select the valuator, to supervise any formal valuation, supervise the preparation of the valuation and review the disclosure regarding the formal valuation.

(7) A special committee should, in the Commission’s view, include only directors who are independent from the interested party. While a special committee may invite non-independent board members and other persons possessing specialized knowledge to meet with, provide information to, and carry out instructions from, the committee, in the Commission’s view non-independent persons should not be present at or participate in the decision-making deliberations of the special committee.”
Special committees are increasingly being used in connection with M&A transactions which are not related party transactions. In these circumstances, a special committee may, in addition to enhancing the efficiency of the decision making process, also function to supervise the fairness of the transaction process (eg, auction process, market canvass or third party negotiation), mitigate the potential influence of a CEO on the process and/or manage possible conflicts between the interests of shareholders and management (eg, where management may have a potential bias to favour a purchase by a financial purchaser as opposed to a strategic buyer).

**Recommended Practices**

The following is a list of recommended practices (derived from Canadian and US experience) with respect to the use of special committees.

**Timing**

A special committee should be established as soon as possible in the process and before the material terms and conditions of the relevant transaction are fixed.

**Composition**

The members of a special committee should have no interest in the relevant transaction other than that of a shareholder and should be free of any disabling conflicts. The independence of the members of a special committee is a context-driven determination (ie, independence for general securities law purposes may not be sufficient). The use of questionnaires (distributed to and completed by members of the committee and reviewed by counsel) is one way to focus attention on the determination of independence.

A multi-member committee is preferable to a single member committee.

**Compensation**

Since considerable time will normally be required to carry out their work, the members of a special committee are entitled to special compensation. The fees payable to the members of the special committee should not be conditional on the outcome of the relevant transaction or so significant as to suggest that their loyalty has been purchased.

**Mandate**

A special committee must be given a clear mandate that has been approved by the board of directors, reflected in the written record and understood by the members of the special committee. In addition to being given the authority to act with respect to the relevant transaction (eg, to recommend approval or rejection to the board of directors), the special committee should be given the authority to negotiate (in the context of related party or going private transactions) or to negotiate or supervise negotiations (in the context of transactions that are not related party transactions). It must also be given the authority to retain and compensate its own professional advisors.

**Negotiations**

The degree to which a special committee should be involved in negotiating the terms of the relevant transaction will depend on the circumstances of each case. In Ontario, the courts have accepted that senior management may be involved in negotiating the terms of the relevant transaction provided that they act properly and under the direction of the special committee. For it to be in a position to pass on the fairness of a transaction, a special committee must be fully informed of, and prepared to suggest changes to, the transaction.

In the context of related party and going private transactions, the special committee may be required to take a lead role in the negotiations (in practice, this role may be constrained where the transaction involves a controlling shareholder who is the only practical purchaser).
Counsel

Depending on the nature of the transaction, a special committee should have its own legal advisors who should be retained first so they may begin advising the special committee of its duties and assist in the selection of financial advisors. The special committee should also have access to the corporation’s internal and external counsel so that it has the benefit of their knowledge as part of its process.

Financial Advisor

Directors of a corporation are protected from liability if they rely in good faith on financial information with respect to the corporation or the relevant transaction provided by an appropriate officer or the auditor of the corporation or on a report of a professional advisor. For example, in transactions with financial implications, retaining and obtaining the advice of a financial advisor (e.g., an investment banker) is an effective way for directors to demonstrate that they have acted on an informed basis and to protect themselves. Financial advisors bring expertise and experience from numerous other transactions and are able to provide valuations and fairness opinions. If the relevant transaction involves the sale of the corporation or a substantial part of the corporation, a special committee must have an experienced financial advisor.

The fees of a financial advisor should not be structured to bias the financial advisor in favour of a particular outcome. Generally, a flat fee is preferable to a success fee. Counsel to the special committee should review and comment on the engagement letter between the special committee and the financial advisor.

The special committee should take care not to lose control of its processes or to let its professional advisors make decisions for them. Only the business decisions of directors have the benefit of the business judgement rule. Professional advisors should advise, not decide.

Deliberations

A special committee must act in an informed, deliberate and careful manner. Given the spectre of self-interest and the usually small size of special committees, the courts may look carefully at the number, length and frequency of meetings and the attendance of each member. In person meetings are more desirable than telephone meetings, particularly for important deliberations.

Fairness of Different Treatment of Shareholders

In transactions involving different treatment of different classes of shares, a special committee should examine not only the absolute fairness of the relevant transaction to each class of shares but also the relative fairness of the different treatment of each class of shares.

Privilege

Counsel to a special committee must be sensitive to issues of attorney-client privilege. The client is the special committee, so disclosure to management or other directors will waive privilege.

Liability, Indemnification and Insurance

Counsel to a special committee should consider and advise the members of the special committee of litigation and personal liability risks to which they may be exposed. This will necessarily involve a careful review of the indemnities and insurance coverage provided by the corporation to directors.

Minutes

Reasonably detailed minutes should be kept of all meetings of a special committee. The minutes should describe the time spent, the deliberations undertaken, the issues discussed, the advice received and considered and the decisions taken by the special committee. The minutes should be prepared by counsel to the special committee.
Developments in Directors Liability

The most significant recent development in terms of directors liability is the adoption in December 2005 of civil liability for directors and others for misrepresentations in continuous disclosure documents.

Right of Action

Effective January 1, 2006, a person (a securityholder) who buys or sells securities of a public company that has a real and substantial connection to Ontario (eg, a reporting issuer in Ontario) at a time when the company’s public continuous disclosure record is incorrect or incomplete will, depending of the circumstances, have a right of action for damages against one or more of the following persons (defendants):

(a) in the case of incorrect disclosure involving:

   (1) a public document released by the company or a representative of the company or a public oral statement made by a representative of the company:

       • the company,
       • in the case of a public document, the directors of the company and those officers of the company who authorized, permitted or acquiesced in the release of the document,
       • in the case of a public oral statement, those directors and officers of the company who authorized, permitted or acquiesced in the making of the statement,
       • each influential person and those of its directors and officers who knowingly influenced the release of the public document or the making of the public oral statement, and
       • each expert (eg, an accountant, actuary, engineer, geologist or lawyer) who expertized the public document or the public oral statement (ie, consented to the use of a summary or quote from a report, statement or opinion of the expert in the document or statement);

   (2) a public document released by an influential person or a representative of an influential person or a public oral statement made by a representative of an influential person:

       • the influential person,

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2 A company’s public continuous disclosure record is incorrect if:

(a) the company, or a person (a representative) with actual, implied or apparent authority to act or speak on behalf of the company, releases a public document or makes a public oral statement that relates to the business and affairs of the company and contains a misrepresentation; or

(b) a person (an influential person) who is in a position to influence the conduct of the company (eg, an insider, a 20% shareholder or a promoter of the company), or a representative of an influential person, releases a public document or makes a public oral statement that relates to the business and affairs of the company and contains a misrepresentation.

3 A company’s public continuous disclosure record is incomplete if the company does not make timely disclosure of a material change in the business and affairs of the company.
those directors and officers of the influential person who authorized, permitted or acquiesced in the release of the public document or the making of the public oral statement,

if a director or officer of the company authorized, permitted or acquiesced in the release of the public document or the making of the public oral statement, the company and those of its directors and officers who authorized, permitted or acquiesced in the release of the document or the making of the statement, and

each expert who expertized the public document or the public oral statement; and

(b) in the case of incomplete disclosure:

• the company,

• those directors and officers of the company who authorized, permitted or acquiesced in the failure to make timely disclosure, and

• each influential person and those of its directors and officers who knowingly influenced the failure to make timely disclosure.

Procedural Matters

An action may not be commenced without the leave of the Ontario court. The court may only grant leave if it is satisfied that the action is being commenced in good faith and has a reasonable possibility of success.

The limitation period for commencing an action is the earlier of three years after the date of the incorrect or incomplete disclosure and six months after a press release is issued announcing that the Ontario court has granted another securityholder leave to commence an action in respect of the incorrect or incomplete disclosure.

The OSC may intervene in an application for leave to commence an action and in the action itself.

The Ontario court must approve any proposed settlement of an action. The prevailing party in an action is entitled to costs as determined by the court.

Burden of Proof

Incorrect Disclosure

In an action against any defendant for incorrect disclosure in a public document (a core document) that the company is required to prepare and file with the securities regulatory authorities on a regular basis (e.g., an annual information form, annual and interim financial statements and related MD&A and a material change report), a securityholder need only prove that it purchased or sold securities of the company at a time when the company’s public continuous disclosure record was incorrect.

In an action against any defendant for incorrect disclosure in a non-core document or a public oral statement, the securityholder must also prove that the defendant knew that the document or statement contained a misrepresentation, deliberately avoided acquiring that knowledge or was guilty of gross misconduct in connection with the release of the document or the making of the statement.
Incomplete Disclosure

In an action against the company or an officer of the company for incomplete disclosure, a securityholder need only prove that it purchased or sold securities of the company at a time when the company’s public continuous disclosure record was incomplete.

In an action against any other defendant for incomplete disclosure, the securityholder must also prove that the defendant knew of the change and that it was material, deliberately avoided acquiring that knowledge or was guilty of gross misconduct in connection with the failure to make timely disclosure.

Defences

Defendants have a variety of possible defences, including the following:

(a) knowledge of plaintiff: the plaintiff was aware of the incorrect or incomplete disclosure;

(b) due diligence: the defendant conducted or caused to be conducted a responsible investigation and had no reasonable grounds to believe that there was incorrect disclosure or that timely disclosure would not be made;

(c) experts: the defendant relied upon a report, statement or opinion of an expert, did not know and had no reasonable grounds to believe that the report, statement or opinion contained a misrepresentation and the public document or public oral statement fairly represented the report, statement or opinion; and

(d) no knowledge and corrective action: except in the case of the company, the incorrect or incomplete disclosure occurred without the knowledge or consent of the defendant and, when it became aware of the incorrect or incomplete disclosure, the defendant took prescribed corrective action.

There is no liability for incomplete disclosure if the company makes a confidential disclosure filing with the OSC and prescribed conditions are met. The use of confidential disclosure filings will likely have limited utility for companies that are also subject to the securities laws of foreign jurisdictions that do not permit confidential disclosure filings.

There is no liability for a conclusion, forecast or projection in forward looking information contained in a public document or public oral statement if, proximate to the forward looking information, the document or statement contains reasonable cautionary language, states the material factors or assumptions that were applied in drawing the conclusion or making the forecast or projection and identifies the material factors that could cause actual results to differ materially from the conclusion, forecast or projection, and there is a reasonable basis for drawing the conclusion or making the forecast or projection.

Liability

If guilty, the defendants will be liable for any loss in value of the securities purchased or sold by the securityholder that is attributable to the incorrect or incomplete disclosure.

Generally, each defendant will only be liable for its proportionate share of the loss (ie, to the extent that it has contributed to the loss) as determined by the court.

The following are the limits of a defendant’s liability:

(a) the company or a corporate influential person: the greater of C$1 million and 5% of the defendant’s market capitalization;
(b) **an individual:** the greater of C$25,000 and 50% of the individual’s compensation from the company or the influential person and its affiliates for the 12 months preceding the violation; and

(c) **an expert:** the greater of C$1 million and the expert’s revenues from the company and its affiliates for the 12 months preceding the violation.

If a defendant has knowingly made incorrect or incomplete disclosure, proportionate liability and the foregoing limits may not apply and the defendant may be fully liable for the entire loss.

**Comments**

Most actions are likely to be class actions. The procedural rules described above should discourage strike suits.

Public companies should develop (and review periodically) formal procedures for the public disclosure of company information, whether in public documents or public oral statements. They should also consider establishing a formal disclosure committee to review and approve all public disclosure of company information.

Conditional letters of intent in connection with M&A transactions involving public companies (particularly those that contain indicative pricing) may be more likely to be disclosed (on the basis that failure to do so may constitute incomplete disclosure).

Significant shareholders of public companies who wish to have their directors and officers serve as directors and officers of the company should take note of this development.

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