IADC COMMITTEE NEWSLETTER

# BUSINESS LITIGATION

*OCTOBER 2016*

### IN THIS ISSUE

*The Canadian judicial law on takeovers has been inspired by the Delaware takeover law, both revolving around the Director Discretion Model. This article summarizes the Canadian law as per the seminal BCE case.*

# The Canadian Judicial Takeover Law Landscape

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**Introduction**

The past several decades have enabled us to witness a surge of takeovers on the global stage.[1] This wave is the result of numerous factors, which include the increased globalization of world markets, rising commodity prices, low interest rates, the growing influence of private equity firms, corporate consolidations and government interventions[2]. Regardless of their true objectives, takeover transactions raise fundamental issues for companies, investors, financial and legal advisors, as well as governments and regulators.

In Canada, the highly publicized takeovers of several iconic corporations by foreign corporations have generated much controversy. A mixture of national pride and concerns surrounding the local economy have meant that the flood of acquisitions has not been met with universal praise. As control over domestic players such as Alcan, Cirque du Soleil, Falconbridge, Inco and Rona have fallen into foreign hands, and as others such as Potash Corporation become the target of hostile takeovers, many commentators have expressed concern[3].

In this article, we will outline the state of Canadian judicial law on takeovers before the 2008 case *BCE Inc.* v. *1976 Debentureholders* ("***BCE***") case. Thereafter, we will present the gist of the two principal schools of thought on takeovers, the Shareholder Choice vs Director Discretion Models, which are opposed as to whom, within the target company, should ultimately be entitled to decide the fate of a hostile takeover. Thereafter, we will outline the Delaware takeover law, which at the time of the *BCE* case, had slowly made its way into the Canadian legal system. Finally, we will explain the gist of the *BCE* ruling and the state of Canadian law after such a case.

**The State of Canadian Judicial Law on Takeovers Before the Seminal *BCE* Case**

The dramatic increase of takeovers in the early 2000's put the Canadian legal framework through a rigorous test. First and foremost, the larger size of target companies and the increasingly short timeframes of the takeover process presented new challenges that directors had seldom previously faced. Furthermore, many of these transactions

[1] Claire Hill, Brian Quinn & David Davidoff Solomon, Mergers and Acquisitions: Law, Theory, and Practice (Minneapolis: West Academic Publishing, 2016) at 1-14. Regarding previous takeovers, see Bernard S. Black, "The First International Merger Wave (and the Fifth and Last U.S. Wave)" (2000) 54 *U. Miami L. Rev.* 799.

[2] Hill, Quinn & Solomon, supra note 1 at 15-20; " Riding the Wave ", online: (2013) The Economist, <http://www.economist.com/news/business/21587207-corporate-dealmakers-should-heed-lessons-past-merger-waves-riding-wave>.

[3] Eric Reguly, "The Hollowing Out of Corporate Canada" (2002) 1: 2 Corporate Knights 16 ; "Hollowing Out' is Hardly a Myth", online: (2008) The Star, <https://www.thestar.com/opinion/2008/01/30/hollowing_out_is_hardly_a_myth.html>.

involved unsolicited or even hostile bids. In Canada, the high concentration of ownership of public corporations meant that this type of takeover had previously been rare. When targeting public corporations, potential acquirers typically had to negotiate with the most important shareholders because their support was essential to the transaction.[4] The legal issues thus revolved more around the protection of minority shareholder rights.

In 2008, the most important case on the law governing takeovers in Canada, the *BCE* case[5], came to surface. The *BCE* case quickly found itself before the Supreme Court of Canada.

In 2007, the BCE board of directors formed a strategic surveillance committee which decided to go forward with a bidding process. Upon the completion of the bidding process, three groups, including the Ontario Teachers' Pension Plan ("**Teachers**"), submitted offers. Each envisioned the privatization of BCE through a leveraged-buyout ("**LBO**") that involved the assumption of significant debt by the target. Following negotiations with the three groups and on the recommendation of its advisors, the board of directors accepted Teachers' offer at $42.75 per share. This represented a transaction valued at approximately $52 billion. Unhappy with the indebtedness incurred by BCE and its subsidiary Bell Canada as a result of the transaction, which stood to materially affect the market value of the debentures, the debentureholders initiated legal action to prevent the transaction from occurring.

At the time of the *BCE* case, case law in Canada was not mature regarding the conduct of board members during takeovers. Canadian legal advisors therefore turned to Delaware, the leading American corporate law jurisdiction, which had an abundant body of case law dealing with takeovers. Delaware's takeover case law had thus slowly made its way into the Canadian legal system, moving gradually from the boardroom to the court room.

However, the transposition of Delaware's takeover case law had been somewhat piecemeal and the Supreme Court of Canada in *BCE* was therefore faced with the delicate task of defining the scope of the fiduciary duties of directors (to act prudently and diligently, in good faith and with loyalty)[6] in the context of a proposed change of control transaction.

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[4] *Benson* v. *Third Canadian General Investment Trust Ltd.*, (1993) 14 O.R. (3d) 493, 273 (Ont. Gen. Div.): See also *Pente Investment Management Ltd.* v. *Schneider Corp.*, (1998) 113 O.A.C. 253 (Ont. C.A.), aff. (1998) 40 B.L.R. (2d) 244, par. 57 (Ont. Gen. Div.).

[5] *Aegon Capital Management Inc.* v. *BCE inc.*, 2008 QCCS 907 (CanLII); *BCE inc. (Arrangement relatif à)*, 2008 QCCA 935 (CanLII); *BCE Inc.* v. *1976 Debentureholders*, [2008] 3 SCR 560, 2008 SCC 69 (CanLII).

[6] *Canada Business Corporations Act,* RSC 1985, c C-44, sect. 122 (1); *Business Corporations Act,* CQLR c S-31.1, sect. 119 al. 2 ; *Civil Code of Québec*, CQLR c CCQ-1991, art. 322.

**The Shareholder Choice vs Director Discretion Models**

An internal debate inevitably arises within corporations targeted by a hostile takeover. Indeed, there is often diverging interests among directors, shareholders and other stakeholders. This has led to two principal schools of thoughts, opposed about who within the target company should ultimately be entitled to decide the fate of a hostile takeover: the shareholders or the directors?

At one end of the spectrum, there are the proponents of protecting the fundamental rights of shareholders to sell their shares to a hostile bidder (the "**Shareholder Choice Model**"). These proponents are worried that directors and officers of a target company would naturally encourage a transaction which serves their interests, even if it does not maximize the corporation's value. Moreover, they are worried that the directors and officers would oppose a transaction which maximizes the corporation's value, because it can threaten their position within the corporation, thus undermining the disciplinary effect of the takeover market on managerial performance. Therefore, according to this school of thought, case law surrounding takeovers should be crafted to protect the rights of the shareholders to decide the fate of a hostile takeover[7].

At the other end of the spectrum, we find the proponents in favor of protecting the fundamental duty entrusted to directors and officers to manage in the best interests of the corporation (the "**Director Discretion Model**"). This model embraces a conception by which the fiduciary duties of the directors are not owed to the shareholders, but rather to the corporation itself, which includes all of its stakeholders. Therefore, the directors, in possession of all of the corporate information, including information not known by the market, should be allowed to "*Just Say No*" and use defensive tactics to protect their long term business plan and thwart an opportunistic hostile bidder offering short-term value, but harming long term value as well as the interests of other stakeholders. Therefore, according to this school of thought, case law surrounding takeovers should be crafted to protect the managerial duties of the directors and only them should decide the fate of a hostile takeover.[8]

[7] See, amongst numerous articles: R.B. THOMPSON et D.G. SMITH, " Toward a New Theory of the Shareholder Role : “Sacred Space” in Corporate Takeovers ", (2001) 80 *Tex. L. Rev.* 261; L.A. BEBCHUK, " The Case against Board Veto in Corporate Takeovers ", (2002) 69 *U. Chi. L. Rev.* 973; N. KANJI, " Business (Mis) Judgment : Corporate Governance and the Role of Courts and Securities Regulators in Reviewing Target Defensive Tactics ", dans P. PURI (dir.), *Corporate Governance and Securities Regulation in the 21st Century*, Toronto, Butterworths, 2004.

[8] See, amongst numerous articles: B. BLACK et R.H. KRAAKMAN, " Delaware’s Takeover Law : The Uncertain Search for Hidden Value ", (2002) 96 *Nw. U. L. Rev.* 521; S.M. BAINBRIDGE, " Director Primacy: The Means and Ends of Corporate Governance ", (2003) 97 *Nw. U. L. Rev*. 547; P. DEY et R. YALDEN, " Keeping the Playing Field Level : Poison Pills and Directors’ Fiduciary Duties in Canadian Takeover Law ", (1990) 17 *Can. Bus. L. J.* 252.

Faced with this great debate during the Eighties and Nineties, the Delaware Supreme Court established a sophisticated takeover case law within which the Director Discretion Model governs[9], but where concerns stemming from the Shareholder Choice Model are also addressed.

**Outline of the Delaware Takeover Law**

Under Delaware takeover law, following the seminal *Unocal* v. *Mesa Petroleum* case by the Delaware Supreme Court, directors enjoy a large amount of discretion to protect the corporation from threats posed by unsolicited and opportunistic hostile bidders.[10] However, Delaware courts have established that the use of defensive measures by directors in the face of a hostile bid will be subject to an *Enhanced Judicial Scrutiny* rather than to the application of the normal and deferent standard of judicial review, namely the *Business Judgment Rule*. This *Enhanced Judicial Scrutiny* criteria aims at repealing the use by directors of defensive measures to protect their own interests rather than to protect the corporation from a threatening bid.

In the *Airgas* case, the directors of the target company were allowed, by the Delaware Chancery Court, to "*Just Say No*" to an inadequately priced hostile bid threatening their long term business plan, by using a poison pill to avoid that the bid be considered by the shareholders.[11] As such, Delaware has adopted the Director Discretion Model, where directors manage the corporation to **maximize the long-term interests of the shareholders**, which gives room for them to consider the interests of other stakeholders.[12]

However, when a board of directors proactively decides to engage in a transaction where the control of the target corporation will pass to another suitor, there is no longer any rational to let the target directors protect the corporation and their long term business plan under the *Unocal* line of cases. In such a change of control context, according to the *Revlon* case and its

[9] Voir L.E. STRINE, « Categorical Confusion : Deal Protection Measures in Stock- for- Stock Merger Agreements », (2001) 56 *Bus. Law* 919, text accompanying footnotes 19 to 21: " In the early 1980s, Delaware was forced to choose between two competing models as to how corporation law should address contests for corporate control. One model gave primacy to the stockholders' right to react to tender offers without substantial target board involvement. The other model was director-centered and empowered boards to mediate between the stockholders and interested buyers of their shares. As we all know, the director-centered model won out ".

[10] *Unocal* v. *Mesa Petroleum*, 493 A.2d 946 (Del. Supr. 1985). See also *Paramount Communications, Inc.* v. *Time, Inc.*, 571 A.2d 1140 (Del. Supr. 1989); *Unitrin, Inc.* v. *American General Corp.*, 651 A.2d 1361, 1377-78 (Del. Supr. 1995).

[11] *Air Prods. & Chems., Inc.* v. *Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011). But see *Chesapeake Corp.* v. *Shore,* 771 A.2d 293, 296-297 (Del. Ch. 2000).

[12] B. BLACK et R.H. KRAAKMAN, " Delaware's Takeover Law : The Uncertain Search for Hidden Value ", (2002) 96 *Nw. U. L. Rev.* 521, 527; *Katz* v. *Oak Industries, Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) : " It is the obligation for directors to attempt, within the law, to maximize the long- run interests of the corporation's stockholders ".

progeny[13], directors must, to discharge their fiduciary duties, maximize short-term share value. In *Revlon* mode, the directors cannot play favorites with the contending factions, for example, in using defensive measures to circumvent a bid competing against the corporation's *White Knight* bid. In other words, when the corporation goes from (a) the "*Unocal zone*", where the directors are protecting the corporation and can decide the fate of a hostile bid to (b) the "*Revlon zone*", where they are selling the control of the corporation and where the shareholders decide the fate of a hostile bid, Delaware law adjusts from a Director Discretion centric regime to a Shareholder Choice centric one.

**Canadian Judicial Takeover Law post *BCE***

In the *BCE* case, the central issue for the Supreme Court of Canada was whether the BCE directors had breached their fiduciary duties by favouring short-term share value within the *Revlon* framework to the detriment of the debentureholders' interests. In other words, in realizing a LBO takeover transaction, were the BCE directors allowed to give priority to the interests of one group of stakeholders within the corporation, i.e. its shareholders?

The Supreme Court indicated that **at all times**, the fiduciary duties of the directors are owed to the corporation and in considering what is in the **best interests of the corporation**, directors may look to the interests of other stakeholders and their decision will be protected by the *Business Judgment Rule*.[14] As such, the Court went towards a Director Discretion Model where directors manage with a view to **maximize the long-term interests of the corporation**:

> *[38] The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is <u>not confined to short-term profit or share value</u>. Where the corporation is an ongoing concern, it looks to <u>the long-term interests of the corporation</u>. The content of this duty <u>varies with the situation at hand</u>.* (our emphasis)[15]

In the context of a change of control transaction, the Court suggested that the **best interests of the corporation** may align with a share value maximization objective, depending on the situation at hand.[16]

The Court rejected the debentureholders' challenge and upheld the transaction:

[13] *Revlon Inc. v. MacAndrews and Forbes Holdings Inc.*, 506 A.2d 173 (Del. Supr. 1986); See also *Barkan* v. *Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. Supr. 1989); *Paramount Communication Inc.* v. *QVC Network Inc.*, 637 A.2d 34 (Del. Supr. 1994); *C&J Energy Services, Inc.* v. *City of Miami General Employees' and Sanitation Employees' Retirement Trust,* 2014 WL 7243153 (Del. Supr. 2014).

[14] *BCE Inc.* v. *1976 Debentureholders*, [2008] 3 SCR 560, 2008 SCC 69 (CanLII), para 40.

[15] *Ibid*., para 38. See also *Brassard* c. *Forget*, 2010 QCCS 1530 (CanLII), para 161.

[16] *BCE Inc.* v. *1976 Debentureholders,* [2008] 3 SCR 560, 2008 SCC 69 (CanLII), para 87.

> *[112] The best interests of the corporation arguably favoured acceptance of the offer at the time. BCE had been put in play, and the momentum of the market made a buyout inevitable. The evidence, accepted by the trial judge, was that Bell Canada needed to undertake significant changes to continue to be successful, and that privatization would provide greater freedom to achieve its long-term goals by removing the pressure on short-term public financial reporting, and bringing in equity from sophisticated investors motivated to improve the corporation's performance. […]* (our emphasis)[17]

Previously, directors were required to focus on the short-term interests of shareholders, representing a Canadian integration of the *Revlon* case law.[18] However, *BCE* made it clear that this is no longer the case, and that directors must take into account the interests of shareholders and those of other stakeholders, which could justify the use of defensive measures to protect the corporation against opportunistic hostile takeover bids deemed against the best interests of the corporation.

On this point, it is worth quoting from the British-Columbia Court of Appeal in the *Lions Gate* case, a company subject to a hostile bid by American billionaire shareholder activist Carl Icahn:

> *[84] From the board's point of view – a point of view the chambers judge found to be reasonable in the circumstances – Lions Gate was under siege by a person who makes it his business to obtain control, or threaten to obtain control, of operating businesses, extract large amounts of money from them, and leave them vastly weakened, if not bankrupt. Icahn could not have reasonably expected that the board would, to quote Farley J. in Rogers Communications, supra, "roll over and play dead. If it were completely passive, it would be soundly criticized for not doing anything to maximize the situation for the target organization."* […](our emphasis)[19]

**Conclusion**

Like Delaware, Canadian corporate law closely scrutinizes the conduct of directors in the context of takeover transactions, while also recognizing the need to afford them room to make decisions in the best interests of the corporation. The Supreme Court of Canada in *BCE* provided a solid foundation in the context of takeover transactions,

[17] *Ibid*., para 112.

[18] *Pente Investment Management Ltd* v. *Schneider Corp.,* (1998) 113 O.A.C. 253 (Ont. C. A.), conf. (1998), 40 B.L.R. (2d) 244 (Ont. Gen. Div.) *; Gazit (1997) Inc.* v. *Centrefund Realty Corp.,* [2000] O.J. No. 3070 (Ont. Gen. Div.); *Golden Star Resources Ltd.* v. *Iamgold Corp.,* [2004] O.J. No. 2869, par. 16 (Ont.S.C.) *; Ventas, Inc.* v. *Sunrise Senior Living Real Estate Investment Trust,* 2007 ONCA 205 (Ont. C. A.).

[19] *Icahn Partners LP* v. *Lions Gate Entertainment Corp.*, 2011 BCCA 228, par. 84.

crafting a result centered around the Director Discretion Model, but also leaving room for consideration of the Shareholder Choice Model.

For an in-depth analysis of Delaware and Canadian takeover law, we refer to the following volume published in September 2016 (available in French): Stéphane ROUSSEAU and Patrick DESALLIERS, *Les devoirs des administrateurs lors d'une prise de contrôle - Étude comparative du droit du Delaware et du droit canadien*, Montréal, Éditions Thémis, 2nd ed.

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