Defining Directors' Duties

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In *BCE Inc.*, the Supreme Court of Canada weighs in on directors' responsibilities to all parties associated with a corporate restructuring.

The Supreme Court of Canada (SCC) has released its reasons in *BCE Inc. v. 1976 Debentureholders et al.* (BCE Inc.), providing clarification into the duties and obligations of the corporate directors. In *BCE Inc.*, the court seized upon not only the opportunity to provide an overview of some of the fundamentals of directors duties, it also provided guidance into the tests for oppression under Section 241 of the *Canadian Business Corporations Act* (CBCA) and the test under Section 192 of the CBCA for court approval of a change to a company's corporate structure.

The decision has been described as one of the most significant business cases of 2008 and has reverberated throughout the insurance industry, the legal community and the halls of corporate Canada. For those insurers writing directors and officers (D&O) liability coverage, the *BCE* decision will be of great significance, to both underwriters and specialty claims personnel.

By examining the decision-making practices followed by the directors of a prospective insured, and determining whether they are of such a nature and quality as to attract potential liability under the CBCA or the companion provincial legislation, underwriters will now be better equipped to assess the risks they face.

Furthermore, *BCE Inc.* gives more clarity to the area of D&O liability, allowing specialty claims personnel to better understand and appreciate whether the oppression claim being faced by their insured is valid and, in particular, whether the directors have fairly and fully met their duty to act in the "best interests of the company."

BACKGROUND

The facts of *BCE Inc.* are now fairly well known. BCE found itself under pressure due to technological, regulatory and competitive changes; eventually, after securing legal and financial advice, the board of directors decided to allow competing bids to be made for its outstanding shares through an auction process.

Three competing bids were made. Each required

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Bell Canada, a wholly owned subsidiary of BCE Inc., to incur substantial debt. The BCE board accepted an offer valued at $52 billion, representing a 40% premium on the trading price of BCE shares at the relevant time. BCE Inc.'s board members believed the offer was in the best interests of BCE and its shareholders.

Although an overwhelming 97.93% of BCE's shareholders approved the offer, the plan of arrangement was strongly opposed by a group of financial and other institutions that held debentures issued by Bell Canada. The debenture holders argued that the actions of the board in accepting the offer were oppressive: if the sale proceeded, they observed, the short-term trading value of the debentures would decline by an average of 20% and could lose investment grade status. The debenture holders brought an oppression action under section 241 of the CBCA. They suggested the tests found in section 192 of the CBCA, requiring court approval for a change in corporate structure, could not be met, thereby precluding the takeover.

The trial judge agreed with BCE, finding that the company was at liberty to proceed with the transaction. The Quebec Court of Appeal, on the other hand, found that the actions of the board were oppressive. BCE Inc.'s directors ought to have considered a plan of arrangement that not only provided a satisfactory price to the shareholders, but also avoided an adverse effect on the debenture holders, the appellate court ruled.

A DIRECTOR'S DUTIES

The Supreme Court of Canada set the stage for its decision by providing an overview of directors' duties generally.

An essential component of a corporation is its capital stock, divided into fractional parts known as "the shares." While the corporation is ongoing, shares confirm no right into its underlying assets.

A share is not an isolated piece of property but a bundle of interrelated rights and liabilities. These rights include the right to a proportionate part of the assets of the corporation upon wind-up, and the right to oversee the management of the corporation by its board of directors by way of votes at shareholder meetings.

The directors are subject to two duties: a fiduciary duty to the corporation and a duty to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances.

The fiduciary duty of directors to the corporation, and particularly the fair treatment component of this duty, is fundamental to the reasonable expectations of the stakeholders claiming an oppression remedy.

The fiduciary duty of directors to act in the best interests of the corporation is mandatory. Although the interests of shareholders and other stakeholders are often coextensive with the interests of the corporation, if they conflict, the director's duty is clearly to the corporation first.[1]

In considering the best interests of the corporation, the directors may look to the interests of the shareholders, employees, creditors, consumers, governments and the environment, among

others, to inform their decisions. The courts should give appropriate deference to the business judgement of directors, so long as the business judgement of the directors lies within a range of reasonable alternatives.

If, when determining the best interests of the company, the directors are faced with conflicting interests among stakeholders, the duty of directors cannot be confined to particular rules governing which stakeholders get priority in every case; rather, it is the function of business judgment to determine what is in the best interests of the corporation.[2]

THE *BCE INC.* DECISION

The Oppression Claim

In examining whether the directors' decision to accept the purchaser's proposal was oppressive to the debenture holders, the court was faced with determining what was just and equitable as measured against the reasonable expectations of the affected parties. In this case, the interests of the shareholders, who would realize a 40% premium on the share price, conflicted with the interests of the debenture holders.

In assessing these conflicting interests, the Supreme Court stated that the directors must resolve the conflict in accordance with their fiduciary duty to act in the best interests of the corporation. They must treat individual stakeholders affected by the corporate actions equitably and fairly. In all of the circumstances, they must treat affected stakeholders in a fair manner and in accordance with the corporation's duties as a responsible corporate citizen.

If it's impossible to please all stakeholders, as in this case, the court looked at each of the competing bids for BCE and noted that all bids required Bell Canada to assume additional debt. The court afforded deference, according to the Business Judgment Rule, to the business decisions of the directors.

Perhaps more significantly, it was noted the debenture holders did not establish that they had a reasonable expectation that the directors of BCE would protect their economic interests by putting forth a plan of arrangement that would maintain the investment grade status of their debentures. The court found leveraged buy-outs were not unusual or unforeseeable and the debenture holders could have negotiated protections in their debentures but did not do so. The court therefore found the corporation's best interests arguably favored acceptance of the purchaser's offer and the debenture holders' claim for oppression failed.

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The Section 192 Approval Process

The debenture holders also argued the sale should not be approved because it unfairly changed the corporate structure of BCE Inc. The approval process under section 192 of the CBCA assesses whether the proposed transaction, viewed objectively, is fair and reasonable. "Its purpose is to permit changes in corporate structure to be made while ensuring that individuals whose rights are affected may be treated fairly, and its spirit is to achieve a fair balance between conflicting interests."

Having regard to the purpose of section 192, which applies to security holders whose legal rights stand to be affected by the proposal, the court found that the proposed transaction affected only the economic interests of the debenture holders and not their legal rights, since the legal rights found in the debentures were not altered. The debenture holders were not found to constitute an affected class under section 192.

Therefore, recognizing that there is no such thing as a perfect arrangement, the court found that the arrangement was fair and reasonable in all of the circumstances and would not disturb or veto what was agreed to by almost 98% of the shareholders simply because the trading value of the debentures could be affected.

ANECDOTAL COMMENTS

A couple of anecdotal comments are worthy of mention.

First, the Supreme Court of Canada acted with uncommon dispatch in this case, granting leave to BCE to appeal in early June 2008, hearing argument on June 17, 2008 and rendering its decision without reasons on June 20, 2008. Reasons were finally delivered for their decision on Dec. 19, 2008.

Second, and as an interesting footnote to the saga of the $52-billion leveraged buyout of BCE, only a few weeks prior to the Court's reasons being delivered, BCE was unable to meet solvency requirements and the transaction collapsed and died. However, the Supreme Court of Canada's decision in BCE Inc. remains a leading case in the often-confusing jurisprudence on directors' duties and obligations.

1 This clarifies the SCC's decision in Peoples Department Stores (Trustee of) v. Wise, [2004] 3 S.C.R. 461)

2 The court thereby rejected the Revlon line of cases (Delaware) and the suggestion that shareholder interests should always prevail over those of other stakeholders, such as creditors, in a hostile takeover situation.