Directors' Duties and Special Committees in Public M&A

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1. Overview

Public M&A is high stakes both for the company and its board and the decisions made throughout the process can be subject to market and legal scrutiny.

While appeasing all stakeholders may be difficult, directors can take comfort that courts will generally not second-guess a board's business judgment provided its decision-making is diligent, informed and impartial. The focus is on process rather than an expectation of perfect decision-making as judged with the benefit of hindsight.

To help boards ensure their public M&A deliberations meet the requisite level of rigour and independence, we've synthesized key strategic and legal considerations. Taking care to ensure a well-run process is typically a worthy investment for assisting in the board's satisfaction of its duties and for increasing deal certainty for all parties.

2. Immediate Considerations

Although each of the following are discussed in greater detail later in this guide, it is important they are addressed by directors as early as reasonably possible during the dealmaking process.

(a) Director Independence and Potential Conflicts

Questions of independence and potential conflicts of interest are critical to a proper board process. Business reality is such that many directors, particularly independent or outside directors, have relationships and interests beyond the company that can give rise either to an actual or perceived conflict of interest. This is a highly situation-specific analysis that turns on the circumstances of the particular director, potential transaction and related parties.

(b) Whether to Form a Special Committee

While forming a special committee is only mandated in limited situations, doing so remains best practice in many circumstances. Numerous factors require consideration and balancing. Where a special committee is deemed required or prudent, attention then turns to crafting an appropriately scoped formal (and board-approved) mandate. The internal practical and political issues a special committee and its mandate can sometimes raise may also require careful navigation.

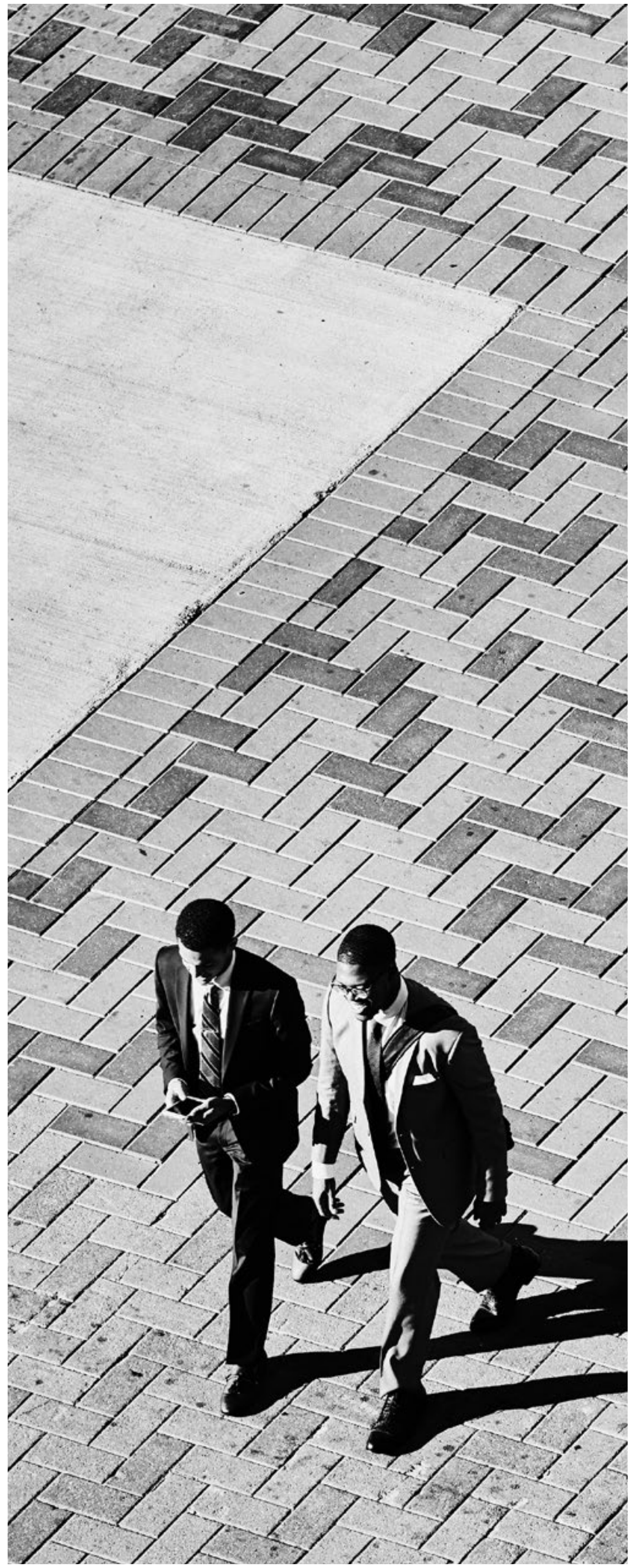
(c) Conflict of Interest Transactions

Certain public M&A transactions attract increased regulatory burdens and scrutiny. These are (1) insider bids, (2) issuer bids, (3) business combinations, and (4) related party transactions, collectively known as "conflict of interest transactions." Given that regulators have detailed specific (and heightened) expectations in these circumstances, target boards should approach these deals particularly cautiously.

Regulators have detailed specific (and heightened) expectations in conflict of interest transactions that involve material conflicts of interest. See Canadian Securities Administrators' Staff Notice 61-302 - Staff Review and Commentary on Multilateral Instrument 61-101.

(d) The Importance of Recordkeeping

Diligent recordkeeping from the inception of a potential transaction is crucial to avoiding problems later on. Among other things, this greatly facilitates (1) demonstrating compliance with the board's duties, (2) attracting the protection of the business judgment rule, (3) preparing the transaction's public disclosure (e.g., information circular, court materials, etc.), and (4) responding to any regulator requests for information or materials.



3. Director Independence

Per the fiduciary duty of loyalty, from the inception of a potential change of control transaction all directors must disclose any relationships or interests that create (or could reasonably be seen as creating) a conflict in connection with the deal. This duty remains ongoing over the deal and as a director's personal circumstances might change.

Independence is highly situation-specific and depends on the circumstances of the particular director, potential transaction and related parties. The critical consideration is whether the director's impartiality or judgment could actually be impaired or, equally importantly, be reasonably questioned by shareholders or regulators, as a result of a particular relationship or interest.

Independence is a question of fact that must be carefully considered depending on the specific circumstances.

Certain directors are generally not considered independent in the public M&A context:

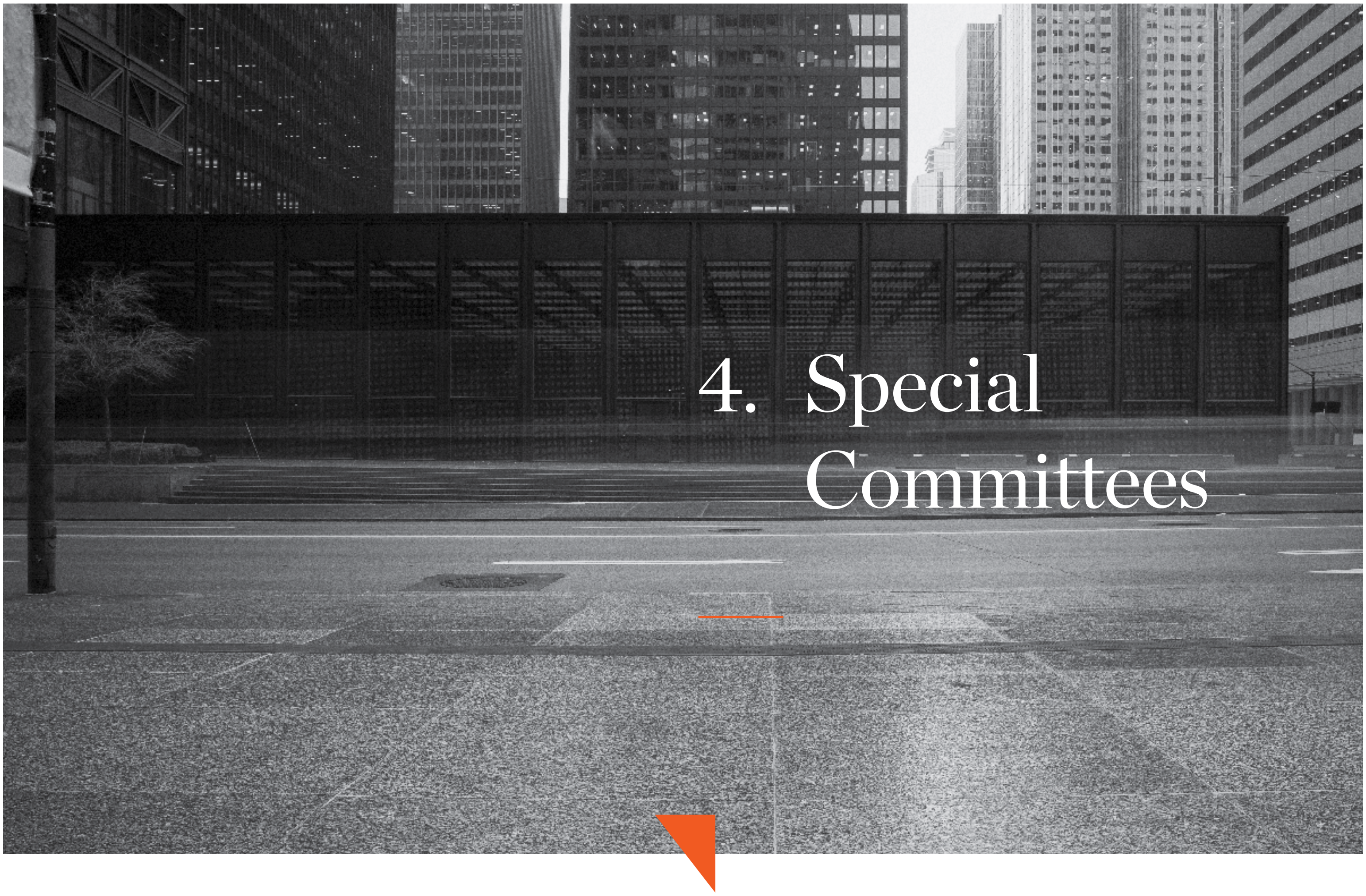
- Management directors for the inherent conflict of interest as employees of the company susceptible to being replaced post-closing.
- Directors with a significant equity interest in, or some other material relationship with, a counterparty (or likely counterparty or reasonably anticipated competing bidder).

While casual social connections typically don't raise concerns, joint or related business interests can raise reasonable doubts regarding the director's impartiality. However, courts have acknowledged that a potential conflict of interest should be balanced against the reasonable benefit obtained by including the director in dealmaking, e.g., their particular expertise and experience in M&A.

Deliberations regarding a director's independence should be recorded. In particular, where it's decided a director's external relationships or interests do not compromise the director's impartiality, this may need to be publicly disclosed and explained.

Guidance from Courts: *In the context of an unsolicited takeover bid and in rejecting allegations of non-independence of two special committee members, the court noted: "In a perfect world, it would be better if corporate directorships and corporate transactions could be meticulously cleansed of any and all possible sources of conflict. In the real world of business affairs... this sort of perfection is not always possible."*

Optics are important: the appearance of potential non-independence can be as problematic as actual non-independence.



4. Special Committees

A special committee in public M&A is an *ad hoc* group of independent directors selected to lead or oversee the deal and report back to, and make recommendations to, the full board. It is important to note that a special committee will generally not have decision-making responsibility for material matters; rather, the board will typically reserve the responsibility for making key decisions with respect to a potential transaction in the context of a special committee's recommendations.

The formation of a special committee is only strictly required by securities law in public M&A in connection with an insider bid. However, they are commonly used – and considered best practice – in numerous other public M&A contexts for both legal and business reasons. A special committee can:

- Effectively neutralize actual or perceived conflicts of interest, and have regularly been endorsed by securities regulators and courts towards this end.
- Resolve various practical challenges raised by public M&A dealmaking, including its high intensity, extensive materials and frequent meetings (often called on short notice) for which the broader board may not have time or capacity.

Forming a special committee in public M&A greatly assists with (1) satisfying the fiduciary duties of the board, (2) attracting the protection of the business judgment rule, and (3) reducing the risk of director personal liability.

A board will typically establish a special committee when conducting an auction of a public company (e.g., to run the auction process and evaluate offers) or upon an unsolicited takeover bid (e.g., to contemplate defensive measures). However, special committees are also very often formed amid friendly, bilateral public M&A deals (e.g. to ensure an impartial evaluation of the proposed transaction's merits in light of all applicable stakeholder interests).

(a) Timing of Formation

Whether to form a special committee should be addressed as early as reasonably possible during dealmaking. Similarly, once decided prudent to form a special committee, doing so should promptly follow. Generally speaking, the only negative to premature formation is additional costs and resources. However, an appropriately scoped special committee mandate and process should mitigate against unnecessary expense.

A special committee should be formed well before material deal negotiations or dealmaking alternatives become in any way limited.

On the other hand, securities regulators have strongly criticized – and delayed deals – for tardy special committee formation. They have also warned that, in conflict of interest transactions, special committees should not be bound by negotiations predating the committee's involvement.

Overall, the benefits of the special committee will be greatly diminished if established past a point where alternatives are limited or, in hindsight, the full board's ultimate decision appears having already been a foregone conclusion.

Guidance from Securities Commissions: *In a conflicted going private transaction where the buyer group included management shareholders, securities regulators criticized management for making certain key business decisions prior to the special committee's formation. One result was mandated additional disclosure to security holders regarding these issues and decision-making throughout the deal process, significantly delaying the deal's completion.*

(b) The Committee's Mandate

Critical to a special committee's work is its formal mandate, which should be written and approved by the broader board. This should clearly address:

- Those responsibilities delegated by the board to the committee.
- The committee's authority to discharge the delegated responsibilities, e.g., to establish its own operating procedures and to engage independent advisors.
- Those matters or decisions that remain with the full board.
- Requiring that management cooperate with the committee.
- Committee member compensation.

The mandate of a special committee in public M&A typically includes:

- Conducting a market check or formal auction, if advisable.
- Reviewing and rating offers.
- Negotiating or supervising the negotiation of material deal terms.
- Considering strategic alternatives.
- Making a recommendation to the full board.

The benefits of a special committee will be greatly diminished by an unduly narrow mandate.

The committee's mandate should be finalized in consultation with external counsel, including to ensure appropriate scoping in the circumstances and consistency with prevailing corporate governance best practices. Just as the value of a special committee will suffer for being formed too late during dealmaking, so too will the benefits of a committee be diminished by an unduly narrow mandate. A thoroughly scoped and discussed committee mandate will also mitigate against the risk of subsequent internal tension flowing from the committee's work. To preserve the committee's impartiality, their compensation should not include any success-fee.

Guidance from Securities Commissions:
In a high value transaction to collapse the public company's dual class share structure, securities regulators criticized the special committee's mandate for being too narrow in scope. Issues taken with the mandate were that it (1) was limited to assessing only the proposal developed by management, (2) did not empower the committee to negotiate terms directly with the counterparty, and (3) did not require the committee to do more than simply decide whether the deal should be submitted to a shareholder vote.

(c) Potential Internal Political Issues

A potential change of control transaction is a period of great stress within a company. Forming a special committee can increase this tension as certain committee best practices may be unfamiliar or unwelcome among leadership and thus create conflict.

Key here is that, to preserve independence, the committee's deliberations are typically conducted *in camera* with only the committee's advisors. This can result in the exclusion of senior executives or directors accustomed to material strategic decision-making and who contest the advisability of such an approach. The potential for internal dispute along these lines should therefore be anticipated and addressed during the formalization of the committee's mandate.

Potential internal political issues raised by forming a special committee should be addressed with management up front when formalizing the committee's mandate.

Another important issue is who will serve as the committee's chair and whether this is better decided by the committee or the board. Committee members should also be chosen with a view to a healthy working dynamic. As the board will rely on the committee's work, it's in the board's direct interest that the committee functions smoothly.

Guidance from Courts: In an insider bid to take the company private, the special committee's mandate was scoped to include assessing not only the insider bid, but to also consider alternatives. A senior company officer (who was associated with the bidder) later insisted the committee had been created solely to assess the insider bid, and the court deemed this inappropriate interference with the committee by management and the bidder.

(d) <u>The Role of Management</u>

Notwithstanding the potential conflicts of interest inherent in management amid a potential change of control, they need not necessarily be excluded from the special committee's work. Indeed, the exercise of prudent business judgment by the committee likely requires regular consultation with those executives having the deepest familiarity with the company, its intrinsic value and business prospects, and its operations.

> ***<u>Guidance from Courts:</u>*** *Although neither were members of the special committee, the target's CEO and CFO were both actively involved in negotiating with bidders. The court balanced their conflict of interest against the benefit of having senior management participation, namely their superior understanding of the company's operations.*

Moreover, in public M&A, there are several transactional matters that management must inevitably assist with or drive, including:

- Identifying and working with consultants.
- Establishing and populating virtual data rooms.
- Responding to due diligence requests.
- Leading the negotiations (if appropriate) and/or commenting on transaction agreements.
- Drafting disclosure schedules.

The key is that management contributions of this nature do not carry over to direct involvement in committee deal deliberations and decision-making.

> ***<u>Guidance from Courts:</u>*** *The court was critical of the presence of the target's President and CEO on the special committee and the leading role he played in negotiations with bidders amid competing offers, which the court deemed inconsistent with the independence expected of the committee.*

(e) <u>Duties (and Potential Liability) of the Full Board</u>

The full board maintains a duty to supervise a special committee to ensure it meets its mandate and to justify the full board's reliance on the committee's ultimate report and/or recommendations. Only reasonable reliance by the full board on the committee's work safeguards the full board from liability deriving from failures in the diligence, informativeness or independence of the committee's work.

It is therefore typical for the board to require periodic updates from the committee. The board will also desire a final report that presents a reasonably comprehensive roadmap to the committee's recommendation, including:

- The process followed.
- The independent advice and financial analysis sought and received.
- Alternatives considered.
- The rationale for the committee's recommendation.

The board may also desire to review the report with its own legal and financial advisors.

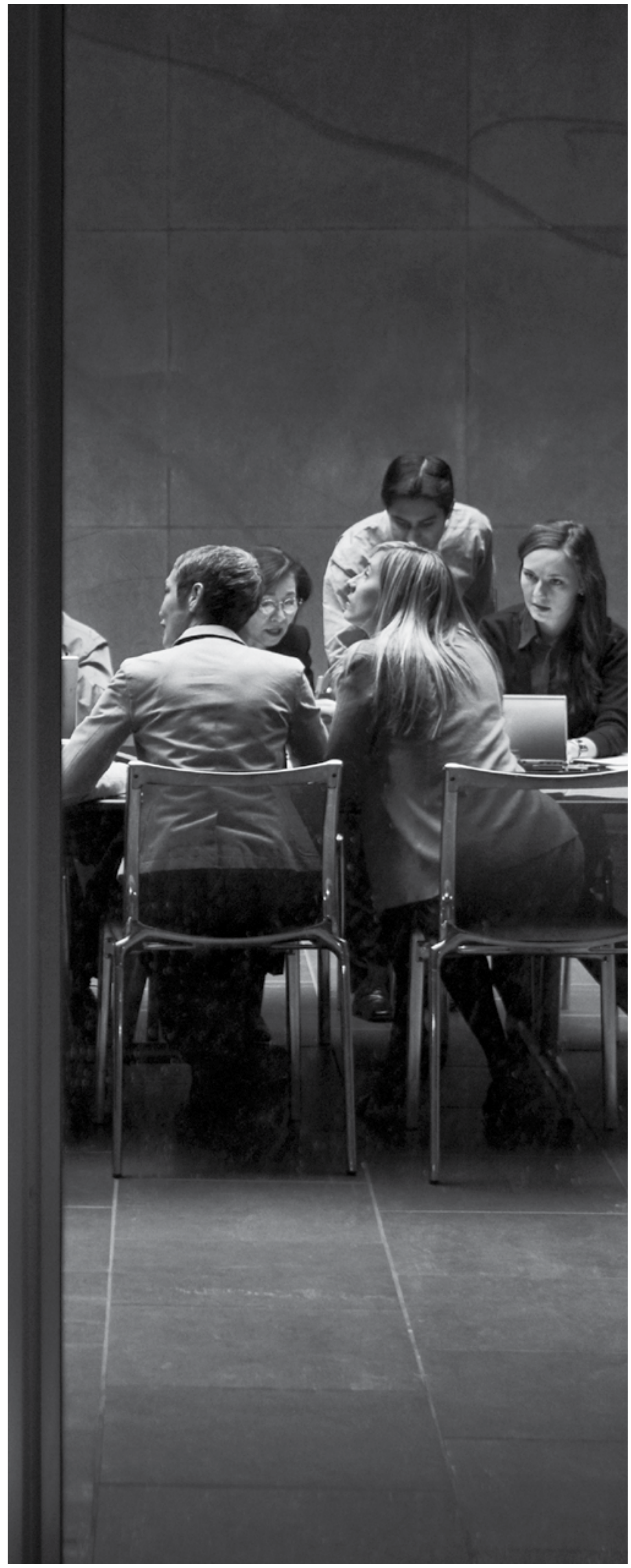
Because a diligent, informed and independent special committee process pursued in good faith will attract the protection of the business judgment rule, the full board should be very careful in considering rejecting the committee's recommendation, particularly as the full board will not have undertaken nearly the same level of work or made nearly the same level of inquiry as the committee. The only reasonable exception to this general rule is where the board's review of the committee's work raises significant concerns of a flawed process.

> **Because a proper committee process will support the protection afforded by the business judgment rule, the full board should generally be very careful in considering rejecting the committee's recommendation.**

(f) Public Disclosure and Material Non-Public Information

Considerations relating to public disclosure and material non-public information are critical in connection with forming a special committee. While the creation of a special committee will typically not require public disclosure, the matter that led the board to form the committee may be subject to leaks and may constitute material non-public information. As such, a contingency communications plan will typically be implemented concurrently with forming a special committee to address potential leaks, rumors and/or disclosure requests from securities regulators that may arise. Moreover, in deciding whether to form a special committee amid a nascent transaction, consideration should be given to the fact that, if public disclosure is warranted later in the process further to a request from authorities in response to unsual trading patterns in the stock, it will likely need to reference the special committee's creation, which may fuel a more intense market reaction than if no committee is yet in place. In addition, measures such as a self-imposed blackout on trades of the company's securities will also often be implemented to address issues relating to material non-public information.

While the creation of a special committee will typically not require public disclosure, the matter that led the board to form the committee may be subject to leaks and may constitute material non-public information. A contingency communications plan is therefore often prudent.



5. Conflict of Interest Transactions

Certain public M&A transactions attract increased regulatory burdens[1] and regulatory scrutiny.[2] These are (1) insider bids, (2) issuer bids, (3) business combinations, and (4) related party transactions, collectively known as "conflict of interest transactions."[3]

The concern is ensuring the fair treatment of minority security holders where a deal involves a party that may have superior access to information regarding the transaction and/or significant influence over the transaction. The additional hurdles imposed to address this concern include: (1) enhanced public disclosure, and (2) absent an exemption, obtaining (A) "majority of the minority" approval, and (B) a formal valuation.

Given regulators have articulated specific (and heightened) expectations for conflict of interest transactions that involve material conflicts of interest, target boards should navigate these deals particularly carefully. While the regulators' guidance largely reflects prevailing public M&A best practice, it also highlights the deal risks raised by falling short.

1 See MI 61-101 Protection of Minority Security Holders in Special Transactions.

2 See Multilateral Staff Notice 61-302 Protection of minority Security Holders in Special Transactions.

3 While Staff Notice 61-302 was only issued by securities regulators in Ontario, Quebec, Alberta, Manitoba and New Brunswick (and not by all securities regulators), almost all Canadian public companies are subject to MI 61-101 and Staff Notice 61-302 by virtue of being reporting issuers in these jurisdictions or being listed on the TSX or TSXV or Cboe Canada.

(a) Special Committees

Although only strictly required in connection with an insider bid, regulators instruct a special committee is advisable for all material conflict of interest transactions. Regulators also emphasize the importance of:

- Forming the committee from the inception of dealmaking.
- Ensuring all committee members are fully independent.
- Ensuring a sufficiently robust committee mandate, including to engage independent advisors and operate free of any interference.

The special committee should generally drive the negotiation of a material conflict of interest transaction as any lesser role might undercut the committee's purpose.

Notably, where the special committee hasn't been involved in preliminary negotiations, regulators indicate it is critical the committee isn't bound by such negotiations. Regulators further stress that, while non-independent officers or directors can contribute their specialized knowledge of the target to the committee, they should not attend or participate in the special committee's deliberations or decision-making.

Guidance from Courts: A special committee was formed by the company to consider a series of related party transactions between the company and its affiliates. Although the court rejected allegations of non-independence of committee members and undue influence of management over the committee, the court stated that, in the context of non-arm's length transactions, shareholders may have a reasonable expectation of the formation of a special committee.

(b) "Real Time" Regulatory Review

Regulators caution that they will review material conflict of interest transactions in "real time" for compliance purposes immediately upon filing of the deal's disclosure document. Regulators may contact the company with questions and requesting additional information and materials, including special committee mandates, board and committee minutes, and associated work product.

Where non-compliance concerns are identified, regulators may require corrective disclosure or take other enforcement action (e.g., a cease-trade order). As this can lead to delay and transaction risk, boards should ensure rigorous processes, recordkeeping and associated disclosure to withstand regulatory scrutiny.

(c) Enhanced Public Disclosure

Regulators tie good disclosure to good process by indicating satisfactory disclosure can't be made in the absence of a fulsome process. Directors should therefore appreciate that where regulators perceive disclosure deficiencies they may assume the cause is procedural deficiencies.

Regulators tie good disclosure to good process: where they perceive disclosure deficiencies they may assume the cause is procedural deficiencies.

Potential disclosure issues regulators will watch for include:

- Insufficient detail of the deal's background and context.
- Insufficient detail regarding the directors' process and chronology, and rationale for supporting the deal.
- Failure to disclose any directors' dissenting views regarding the desirability of the deal.
- Overly one-sided disclosure that recommends the deal without identifying any potential concerns or available alternatives.

(d) Conflicts with Minority Shareholder Interests

Notably, regulators instruct that, where the board recommends a material conflict of interest transaction, the disclosure shouldn't be limited to why they view the deal as in the company's best interest but should also expressly address the interests of minority shareholders.

Moreover, if there is a conflict between the company's best interests and the minority security holders' best interests, the disclosure should explain how the conflict factored into the board's decision to recommend the transaction for approval by the minority security holders.

(e) Formal Valuation

A formation valuation of the company will be required for insider bids and issuer bids and may be required for a business combination or related party transaction. Where a formal valuation is obtained, the board must disclose the basis upon with the valuator has been determined qualified and independent.

Factors relevant to identifying potential bias include:

- The valuator's financial interest in future business involving the company.
- The valuator's involvement as a lead or co-underwriter for the company during the last 24 months.
- Any previous evaluation, appraisal or review of the financial status of the company by the valuator.

6. Board and Committee Recordkeeping

Board's must take care in documenting their public M&A deliberations, including reasonably detailed information regarding the process undertaken and the decisions made, including:

- The alternatives weighed.
- How potential or actual conflicts were analyzed and resolved.
- The advice sought and received from financial and legal advisors.
- The basis for the course of action chosen.

Diligent recordkeeping of these matters serves four important purposes. First, demonstrating compliance with the board's duties. Second, establishing a business judgment rule defence. Third, informing the substance of the transaction's public disclosure (e.g., a management circular or director's circular). Fourth, responding to regulator requests for additional information or transaction materials or work product.

Diligent recordkeeping from the inception of a potential transaction is crucial to avoiding problems later on.

Should particular directors have more extensive discussions with financial advisors, legal advisors or third parties than the wider board or special committee regarding the proposed deal, these directors should inform the wider board or committee of their substance as soon as reasonably possible. These discussions should then be incorporated into the transaction's wider records, as appropriate.

Overall, best practice is to consolidate discussions at the board or committee level as much as possible and to document them with minutes to serve as the main record of the directors' deliberations. This will discourage disparate or loose communications and the taking of personal notes which, taken out of context, could come to haunt directors if they were ever required to be produced amid contentious legal proceedings instituted by a disgruntled party.

Best practice is to consolidate deal discussions at the board or committee level to the extent possible, including to discourage disparate or loose communications or notetaking.

Guidance from Courts: *In a billion-dollar conflict of interest transaction, the company retained a financial advisor to assist in conducting a market check. The Delaware Court compared the deal's public disclosure against meeting minutes to hold the public disclosure misrepresented the extent of the market check made by the financial advisor. In doing so, the court advised: "Boards, committees, and their advisors should take care in accurately describing the events and the various roles played by board and committee members and their retained advisors."*

7. Directors' Duties and Defences

The board's responsibility to oversee the company's business is a foundational principle of corporate law. This duty is owed directly to the company and not to the shareholders or any other stakeholder.

However, the Board can, and may be required to, weigh the interests of particular stakeholders (including shareholders) in deciding the company's best interests. This balancing act is key to the board satisfying its duties in public M&A.

(a) <u>The Duty of Loyalty</u>

The fiduciary duty of loyalty requires that directors act honestly, in good faith and with a view to the company's best interests. The director must maintain a duty of confidentiality, avoid conflicts of interest, and not use their position for personal gain.

In public M&A, the duty of loyalty requires (1) full disclosure of a director's dealings related to any potential deal and the parties thereto, and (2) the avoidance of all possible material conflicts of interest between the director and the company regarding any potential deal.

> ***<u>Guidance from Courts:</u>*** *In a US$115 million take-private transaction the court allowed claims against the directors and officers to proceed based on evidence they were biased in favour of private equity bidders (over strategics) during an auction because a private equity buyer was thought more likely to retain existing management and offer management incentives.*

(b) The Duty of Care

Directors have a duty to exercise the care, skill and diligence a reasonably prudent person would exercise in comparable circumstances. This standard is objective and in public M&A generally requires that the board:

- Fully familiarize themselves with the deal.
- Allow sufficient time to analyze and investigate the deal.
- Obtain expert and independent financial, legal and other advice.
- Engage in active, careful deliberation, including asking probing questions and not relying on advice received in an uncritical manner.
- Make their ultimate decision on an objective and informed basis.

> ***Guidance from Courts:*** *The target's board breached its duty of care by approving a merger after a mere 20-minute presentation and two hour discussion. The directors had no prior notice of the merger meeting, and had not informed themselves regarding either how the sales price had been reached nor of the intrinsic value of the target. Nor did the board request or receive any legal advice or a fairness opinion, nor consider or reserve the right to solicit higher offers.*

A higher standard or care may be imposed on directors who have specialized expertise or experience.

(c) The Business Judgment Rule

The business judgement rule recognizes that courts are ill-suited (and so should be reluctant) to second guess a board's business judgment even where hindsight suggests a different decision may have been optimal.

However, the board's decision must fall within a range of reasonable alternatives and be made in careful compliance with the board's duty of loyalty and duty of care. The court's scrutiny will therefore be focused on the board's decision-making process: in particular, was an appropriate degree of prudence and diligence applied in an informed and impartial manner in reaching the board's decision at the time it was made?

In public M&A this requires that the board consider options reasonably available and weigh the different value, risks and obstacles associated with each. Alternatives to consider include:

- Accepting a proposed offer.
- Seeking to negotiate materially different terms.
- Exploring talks with other potential suitors.
- Maintaining the status quo.

> ***Guidance from Courts:*** *The business judgment rule was applied to defend against claims of breached directors' duties and oppression where the target's board, in response to an unsolicited takeover bid, negotiated a deal granting the "white knight" a 2.6% break fee and asset purchase option regarding the target's radio media division.*

Whichever approach is chosen, the board must have a reasonable basis for concluding the course of action was in the company's best interests. The board must also act honestly, in good faith and free from conflict of interest.

(d) Directors' Duties and Special Committees

The formation of a special committee assists in satisfying the board's duties in multiple ways. Regarding the duty of loyalty, by segregating and removing conflicted or interested directors. Regarding the duty of care and attracting the protection of the business judgment rule, by demonstrating diligent, cautious and informed decision-making.

Forming a special committee assists in satisfying the board's directors' duties and attracting the protection of the business judgment rule in several ways.

8. Overseeing the Deal

(a) <u>The Primacy of Process</u>

To support the protection afforded by the business judgment rule in public M&A, the board should be guided by the rule's underlying principles as well as the closely related oppression remedy under corporate law. A fulsome and judicious decision-making process is once again critical. The board should:

- Identify all stakeholders reasonably affected by the potential transaction and how their interests would be impacted. This will certainly include shareholders, creditors and employees. However, other stakeholders may also warrant close attention, such as local communities, customers and suppliers.
- Consider what reasonable expectations these stakeholders may have in the circumstances. Whether or not a reasonable expectation exists depends on the particular situation and stakeholder and, among other things, may arise from general commercial practice or specific representations previously made by the company to stakeholders.
- Should a conflict between the interests of different stakeholders arise, strive to resolve these in a fair and equitable way as circumstances reasonably allow. However, the ultimate driver must always remain the company's best interests in the particular circumstances.
- Ensure the board's ultimate decision falls comfortably within a range of reasonable alternatives. If the board has undertaken a robust and rigorous process in full compliance with its duties, a range of reasonable alternatives should be reasonably apparent.

If the board has undertaken a robust and rigorous process in full compliance with its directors' duties, a range of reasonable alternatives should be reasonably apparent.

- Dutifully record the board's deliberations and decision-making regarding the foregoing.

Importantly, in addition to supporting the protection afforded by the business judgment rule, a robust and rigorous board process will also greatly assist in:

- Obtaining court approval of a negotiated arrangement,[4] where the court will seek assurance that any competing stakeholder interests were resolved in a fair and balanced way.
- Avoiding any oppression claim by a security holder, where liability can arise from conduct that is oppressive or unfairly prejudicial or that unfairly disregards the security holder's interests.

> ***Guidance from Courts:*** *In a $52 billion leveraged buyout that represented a 40% premium and was supported by 98% of shares voted, a 20% decline in value (and loss of investment grade status) of certain target bonds did not mean the transaction was not fair and reasonable nor constitute oppression of the bondholders.*

(b) Maximizing Shareholder Value

In the U.S., the well-known (but sometimes misunderstood) "*Revlon*" doctrine provides that, in certain change of control situations, the board is obligated to essentially assume the role of "auctioneer" per an overriding duty to maximize shareholder value.

Canadian courts have been clear that *Revlon* is not the law in Canada and that directors' duties are owed to the company and not to any particular stakeholder, whether shareholders or otherwise. That said, maximizing shareholder value is not prohibited and is an entirely acceptable result provided appropriate process is followed.[5]

> ***Guidance from Courts:*** *In the context of an unsolicited takeover bid, the court held that no public expectation was created that an auction would occur. Having undertaken a market canvass, the special committee was not obligated to turn the canvass into an auction, including because doing so risked causing the competing offers the market canvass had generated to be withdrawn.*

That maximizing shareholder value is basic market practice in Canadian public M&A is evidenced by the customary definition of a "superior proposal" in arrangement agreements, which requires (among other things) that the competing offer is more favourable to the target's shareholders from a financial perspective.

While "*Revlon*" is not the law in Canada, maximizing shareholder value should not result in any potential director liability provided an appropriate board process produces this outcome.

4 For further discussion, see Fasken's guide to Acquiring a Canadian Public Company.

5 Once again, the question is whether, in arriving at this outcome, the board has done so (1) in compliance with its directors' duties, (2) pursuant to a diligent, informed and impartial process, (3) having sought to resolve any competing shareholder interests equitably and fairly, and (4) in a manner that (A) falls within a range of reasonable alternatives, and (B) is not oppressive or unfairly prejudicial or that unfairly disregards other stakeholders' interests.

9. Negotiating Deal Protection

Amongst the most strategic and contested contractual terms in public M&A are deal protection provisions. The reason is that these are negotiated against the specific backdrop of (1) the target board's directors' duties, and (2) the potential market for the target and the sales process conducted (or not conducted) surrounding the deal.

Amongst the most strategic and contested contractual terms in public M&A are the deal protection provisions.

A fine balance is at play. To facilitate the target board's duties, the target seeks reasonable room to change its recommendation and/or terminate the transaction should a subsequent and superior offer emerge. The buyer, by contrast, negotiates for deal protection in pursuit of the greatest degree of deal certainty notwithstanding this accommodation of the target's directors' duties.

The target board will demand an escape hatch. This push and pull determines how wide or narrow the escape hatch will be.

(a) Fiduciary Outs and Superior Proposals

The "Fiduciary Out" allows the target board to change its recommendation to shareholders and/or terminate the deal to accept a subsequent "Superior Proposal" in certain limited circumstances. Typical conditions of a Superior Proposal include:

- The competing offer must be more favourable to the target's shareholders from a financial perspective.
- The competing offer must be reasonably capable of being closed without undue delay and without unreasonable closing risk (e.g., due diligence risk, financing risk and/or regulatory risk).
- The competing offer can't have resulted from any breach by the target of its undertakings, including any "no shop" restrictive undertaking.

Guidance from Courts: The target held a public auction and bidder A made the highest offer. Bidder B, who had earlier dropped out of the auction, made a topping offer outside of the official sales process. Bidder B had executed a standstill agreement as part of the auction, and bidder A argued the terms of its agreement with the target required the target to enforce the standstill and cease its dealings with bidder B. The court ruled the Fiduciary Out in the agreement between the target and bidder A didn't overrule the target's standstill undertakings. The auction process as a whole satisfied the target directors' duties notwithstanding that the topping offer couldn't be pursued.

The Fiduciary Out is the target board's escape hatch. Its interaction with the other deal protection terms decides how wide or narrow the hatch will be.

(b) No Shops, Window Shops, Go Shops, Match Rights and Force-the-Votes

The primary counterbalance to the Fiduciary Out is the "**No Shop**". While the Fiduciary Out allows exit for a Superior Proposal, the No Shop prohibits the target from actively soliciting competing offers. No Shops are typically detailed and multifaceted, involving a series affirmative and negative undertakings.

Should a competing offer emerge notwithstanding the target's compliance with the No Shop, a "**Window Shop**" allows the target to discuss it with the interloper, subject to various conditions. Most importantly, the target board must have, following consultation with its financial and legal advisors, decided the competing offer is (or could be reasonably expected to lead to) a Superior Proposal.

Where the target board seeks to accept an offer it deems attractive but circumstances have not allowed for the conduct of a market check, the target and offeror may agree to a "**Go Shop**". This permits the target board, typically for a set period ranging between 30 to 60 days, to conduct a market check to see whether a Superior Proposal might emerge and thereby discharge the board's fiduciary duties.

A "**Match Right**" grants the initial buyer the opportunity to match or improve upon any subsequent Superior Proposal received by the target before the target's board can accept or recommend the Superior Proposal. Match rights can be continuous or "one time." Another point of negotiation is the length of the match right period. The target typically agrees to negotiate in good faith with the initial buyer during the match period.

A "**Force-the-Vote**" is typically triggered upon receipt of a competing offer and requires the target to submit the initial buyer's deal to a shareholder vote notwithstanding the target board having deemed the competing offer to be a Superior Proposal. Buyers like them as they effectively give the target's shareholders final say over whether the competing offer is indeed a Superior Proposal. Force-the-Votes are common in "merger of equals" transactions.

(c) Breaks Fees

The Break Fee is payable by the target to the buyer where the target exercises its Fiduciary Out. This deters competing proposals as the amount of the fee would be absorbed as part of a successful Superior Proposal. The other instances in which the fee is payable (e.g. target breach) are as fiercely negotiated as the fee's quantum.

> ***Guidance from Securities Commissions:*** *The target agreed to a break fee of $27.2 million representing approximately 3.5% of the offer price under an arrangement agreement with a white knight following an unsolicited takeover bid. Securities regulators ruled the fee was necessary to induce the white knight's agreement to the deal and that at 3.5% the fee's quantum was within the "usual range."*

The target directors must negotiate the Break Fee cognizant of their duties. These push against the target accepting too large a fee as the higher the fee the less likely subsequent competing offers become. A disproportionately high fee could also be interpreted by a court as an attempt to coerce the target's shareholders into voting for the deal. While Canadian caselaw hasn't set bright line rules, break fees in Canadian public M&A typically fall within the range of 2.5-5% of transaction value.

> ***Guidance from Securities Commissions:***
> *The target and white knight agreed to a $350 million break fee which represented 2.3% of the target's enterprise value and 4.2% of its equity value. Because the target had significant debt, securities regulators held that enterprise value was the better measure. However, even using equity value, 4.2% remained "within reason" because of the "atypical risks" the white knight faced in pursuing its topping offer.*

(d) Reverse Break Fees

Unlike Break Fees, which feature in essentially all Canadian public M&A, Reverse Break Fees are more deal-specific and typically only included in response to one or more risks arising from the particular deal (e.g., financing or regulatory risk). Because Reverse Break Fees aren't subject to the same directors' duties considerations and constraints applicable to Break Fees, it's not uncommon for their quantum to exceed the Break Fee.

Unlike Break Fees, Reverse Break Fees aren't subject to directors' duties considerations and constraints.

10. Legal and Financial Advisors

(a) <u>Good Faith Reliance Defence</u>

In any public M&A deal the target's directors must ensure they fully understand (1) all material legal issues, including (but not limited to) the demands of their directors' duties, and (2) the company's value and all factors materially informing such value.

The statutory good faith reliance defence protects directors who in good faith rely on the advice of professionals and experts.

This often necessitates engaging independent legal and financial advisors. It may also be prudent to retain additional experts in specialized areas, such as a mining engineer in the context of mining M&A. Relatedly, directors enjoy a statutory good faith reliance defence whereby compliance with their duties can be established by good faith reliance on the report of a professional advisor.

<u>Guidance from Courts</u>: Relying on the advice of legal counsel that later proved incorrect, the directors acted unlawfully amid a takeover bid. The court held the directors were not personally liable given they reasonably relied on the advice of counsel who had held himself out as having M&A expertise.

(b) Independence of Advisors

In retaining legal advisors, directors should assess whether potential counsel has any ongoing or prior relationship with any of the deal parties. Applicable law society rules may prevent the company's typical external counsel from acting.

However, even where a strict legal conflict doesn't arise, it may be prudent for the directors or special committee to have different counsel advise them. This is particularly the case where management is conflicted as executives often work with external counsel on a day-to-day basis.

Retaining separate legal counsel will typically be perceived as indicative of a robust process. However, existing external counsel conserve their duty to the company, and a variety of circumstances may lead directors to rely on their normal external counsel, including the absence of conflicts, company and industry knowledge possessed by existing counsel, and sensitivity to costs and efficiency. Market practice on this topic therefore varies and separate counsel are not systematically retained in all circumstances.

Even where a strict legal conflict doesn't arise, it may be prudent for a the target board or special committee to consider retaining independent external counsel.

The analysis is similar regarding financial advisers: does or has a prospective financial advisor provided financial services or advice to any deal parties with interests adverse to the company?

Compensation of the financial advisor can also affect the advisor's independence, including where it is largely contingent on the successful completion of the applicable transaction.

Other potential issues may also arise. For example, the company's financial advisors (or their institutional affiliates) may wish to offer "stapled" debt financing to prospective buyers. Advantages of this approach include potentially enabling more prospective buyers to make offers given that financing is available from a bank already familiar with the target. A disadvantage, however, is the conflict of interest raised by the significant lending fees the bank stands to gain from the financing, which may dwarf the transactional advisory fees being paid by the target.

Guidance from Courts: *A hostile bidder engaged a financial advisor who had previously advised the target. As the facts indicated the financial advisor had confidential information of the target and this information was used in preparing the hostile bid, serious issues were raised regarding whether the financial advisor had breached the terms of its duties of loyalty and confidentiality to the target. Pending a full trial, the court enjoined (1) the financial advisor from assisting the bidder, and (2) the bidder from continuing its bid.*

11. Fairness Opinions

(a) Fairness Opinions Generally

Fairness opinions are an integral part of the deal process in friendly (i.e., negotiated) public M&A. While not strictly required, they are typically obtained, including to help the court determine the arrangement is fair and reasonable to all classes of affected security holders, thereby facilitating the court's approval of the transaction.

Whereas the Canadian approach to fairness opinions was previously more standardized, a series of critical court rulings in 2016-2017 has since resulted in more varied approaches to fairness opinions based on situation-specific considerations, including (1) transaction value, (2) cost sensitivity, (3) the robustness of the sales process and board process conducted, including whether a special committee was formed, (4) the potential for any perceived conflicts of interest among target management or the board regarding the deal, (5) the potential for shareholder challenge, (6) the potential for a competing offer, and (7) the target's jurisdiction of incorporation.

The approach taken to fairness opinions in Canadian public M&A has become deal-specific. Considerations include (1) cost sensitivity, (2) the likelihood of a shareholder challenge, and (3) the applicable corporate statute.

The result of this deal-specific analysis has been a greater variety of approaches to fairness opinions in Canadian public M&A. Examples include:

- The opinion including more disclosure of the valuation methodologies employed, although not necessarily the fulsome financial analysis that resulted.
- More frequent disclosure of the nature of the fee paid to the financial advisor, i.e., whether it is on a fixed-fee or success-fee basis (but not necessarily disclosure of the amount of the fee).
- The greater regularity of the target obtaining a second fairness opinion on an independent, fixed-fee basis, typically in higher value transactions (e.g., over $500 million) or where opposition to the deal is anticipated from one or more shareholders.
- The greater regularity of a bifurcated approach to the financial advisor's fee, i.e., a success-based fee relating to the transaction overall and a separate fixed-fee for the fairness opinion.

__Guidance from Courts__: The court blocked a billion dollar acquisition notwithstanding approval by over 80% of shares voted and a market standard fairness opinion from a leading global investment bank. Even though a special committee had been formed, the court found it to have been fairly passive, merely receiving reports from management who led the negotiations. The court also took issue with inadequate disclosure to shareholders and an alleged CEO conflict of interest. It instructed that in these circumstances the board should have obtained an independent fairness opinion for a fixed fee.

(b) Fairness Opinions in Material Conflict of Interest Transactions

While fairness opinions are not strictly required in material conflict of interest transactions, they remain best practice. Moreover, where a fairness opinion is obtained in this context, securities regulators have issued specific direction regarding their expectations. These prescriptions go beyond those made by courts outside of the conflict of interest transactions context.

Fairness opinions in conflict of interest transactions are subject to more demanding regulator scrutiny and expectations.

Specifically, regulators have instructed that the company's disclosure regarding the fairness opinion should:

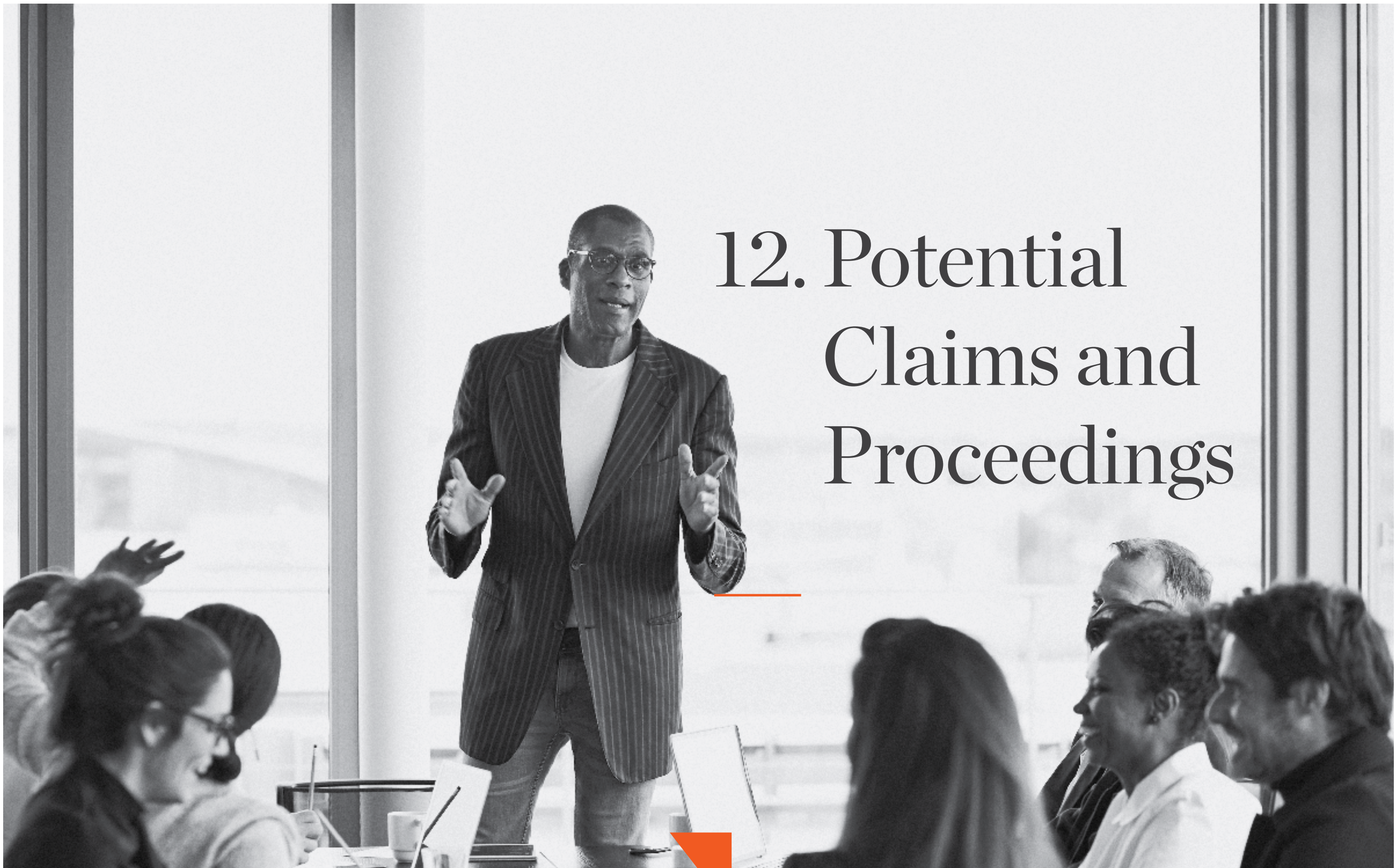
- Disclose the fairness opinion's fee structure (i.e., a flat fee, a fee contingent on delivery of the opinion, or a fee contingent on closing of the deal).
- Explain how the fee structure was taken into account by the directors when considering the financial advisor's advice.
- Disclose any other target relationship with the financial advisor that could give rise to a perceived lack of independence on the part of the financial advisor.

Guidance from Courts: *In a billion dollar conflict of interest transaction (a squeeze-out), the Delaware Court held the company's disclosure to shareholders regarding the special committee's financial advisors was inadequate for (1) not disclosing the financial advisor's proprietary equity investment in the controlling shareholder (even if the equity was only a very small percentage of the advisor's portfolio), and (2) only indicating the financial advisor "may in the future" invest in private equity funds managed by the controlling shareholder when in fact the financial advisor had already done so.*

- Clearly summarize the methodology, information and analysis underlying the opinion (including applicable financial metrics, and not merely a narrative description) sufficient to enable security holders to understand the basis for the opinion.
- Explain the relevance of the fairness opinion to the board's or special committee's decision to recommend the transaction.

Regulators also advise that, if a fairness opinion has been requested and a financial adviser declines to provide one, the disclosure should explain the advisor's reasons for not providing the opinion and how the directors took this decision into account and its relevance to any recommendation made to security holders regarding the deal.

Lastly, in a material conflict of interest transaction structured as a court-approved arrangement, targets would be ill-advised to rely exclusively on a "short form" fairness opinion from a financial advisor compensated on the basis of a success fee and could jeopardize their ability to receive court approval without a concurrent "long form" fairness opinion from a second financial advisor compensated on a fixed-fee basis.



12. Potential Claims and Proceedings

(a) Oppression Claims

An oppression claim is unique to Canadian corporate law and is a broad and potentially powerful statutory remedy, including as it grants the court wide discretion in devising any resulting relief. Because of this flexibility, it is important that target directors are familiar with its ambit and how it could be used by a disaffected stakeholder.

To be successful, the shareholder (or other securityholder, creditor or stakeholder) must establish the conduct complained of was oppressive or unfairly prejudicial or unfairly disregarded the shareholder's (or other stakeholder's) interests. The stakeholder interests protected by the oppression remedy are those the stakeholder could reasonably have expected the company to protect. Such "reasonable expectations" are generally situation specific and can arise in multiple ways. Notable examples in the public M&A context include reasonable expectations arising from (1) general commercial practice, and (2) specific representations previously made by the company to stakeholders.

Guidance from Courts: *Amid a series of successive takeover bids by an activist bidder intent on replacing the incumbent board, the target exchanged existing convertible notes into new convertible notes on terms designed to encourage conversion. The notes were promptly converted, reducing the company's debt by $100 million. However, this also diluted the activist bidder's share from 37.9% to 33.5% while increasing the share of an investor supportive of the board from 19.8% to 28.9%. The court rejected the activist's oppression claims, holding the primary purpose of the conversion was to reduce the company's debt and that this had in good faith been deemed in the company's best interests. Nor did the activist have a reasonable expectation the company wouldn't act to defend against the activist's campaign.*

As previously discussed (see “Overseeing the Deal” above), provided the directors have considered the potential reasonable expectations of the company’s stakeholders in the circumstances, and have not acted in a manner that is unfairly prejudicial to or unfairly disregards any such reasonable expectations, the probability of liability under an oppression claim should be low.

(b) Derivative Actions

A derivative action is where the shareholder seeks to pursue a claim not in its own name but on behalf of the company. The classic example of a derivative action is a claim against the company’s directors for breach of their directors’ duties.

Unlike an oppression claim, a shareholder must first seek court approval to bring a derivative action. As a result, an oppression claim (or the threat of an oppression claim), rather than a derivative action, is typically the first recourse of a disaffected shareholder in Canada.

As previously discussed (see “Directors’ Duties and Defences” above), provided the directors have (1) acted in an informed, impartial and diligent manner, (2) decided in good faith that the course of action is in the company’s best interests, and (3) acted within a range of reasonable alternatives, the probability of any liability for breach of directors’ duties should be low.

Provided target directors engage in a fulsome M&A process that abides by their directors’ duties, respects the principles underlying the oppression remedy, and attracts the protection of the business judgment rule, the probability of a successful shareholder (or other stakeholder) claim against the board or target should be low.

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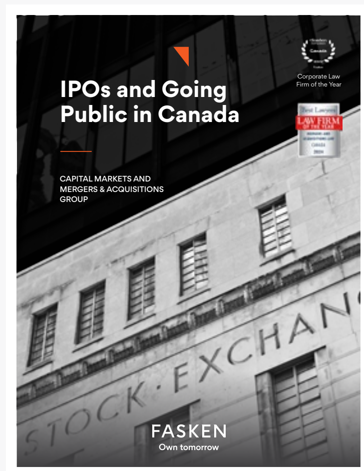

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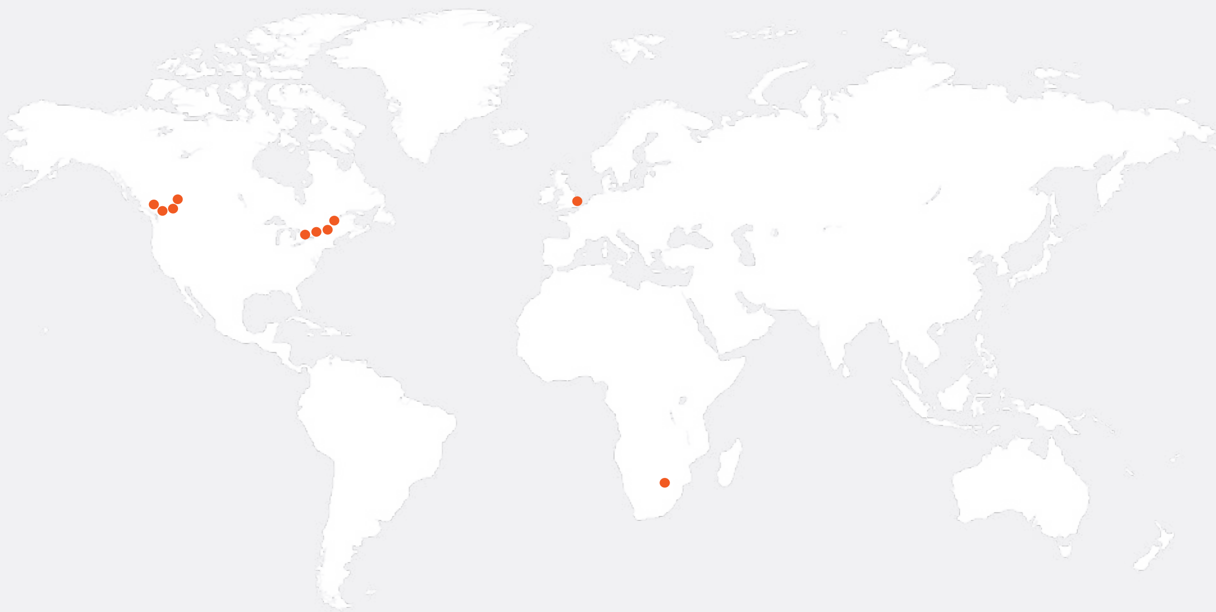

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