The Siren Song of the Delaware Courts

No seaman ever sailed his black ship past this spot without listening to the honey-sweet tones that flow from our lips and no one who has listened has not been delighted and gone on his way a wiser man.

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Introduction

> *No seaman ever sailed his black ship past this spot without listening to the honey-sweet tones that flow from our lips and no one who has listened has not been delighted and gone on his way a wiser man.*
>
> (The Sirens, *The Odyssey*, Book XII at 186-190)

The passage above comes from Homer's description of the voyage of Odysseus as he returned from the Trojan War. Odysseus struggled with his desire to hear the sirens' song, knowing the danger in sailing too close to them.[1] The analogy to the topic of this paper (admittedly contrived) is the lure of Delaware decisions for Canadian corporate lawyers. We are irresistibly drawn to those decisions, although Canadian law is signalling a different course.

Delaware is the leading corporate law jurisdiction in the United States. Given the influence of the U.S. on Canada, it is not surprising that Canadian lawyers look to Delaware for guidance in advising their clients.[2] Because Canadian corporate statutes have drawn heavily on U.S. state law (and on the *Model Business Corporations Act*), similarities in themes and statutory language are inevitable. The Canadian and U.S. business communities are closely intertwined – the U.S. is Canada's largest trading partner (with Canada second to China among U.S. trading partners).[3] Businesses in Canada deal with issues that are very similar to the issues that American businesses face.

The quality and practicality of Delaware case law has been an enormous resource for Canadian lawyers advising boards of directors. *Smith v. Van Gorkum*,[4] *Caremark*[5] and *Disney*[6] are only a few examples. There are, however, core distinctions between corporate law in Canada and in Delaware that make it important for Canadians to navigate carefully around Delaware principles.[7] Canadian courts have reminded us that, in Canada, directors do not have a fiduciary duty to shareholders, there is no "*Revlon* duty" and the courts apply the business judgement rule without invoking the "enhanced scrutiny" or "entire fairness" standards of review.

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1 Homer, *The Odyssey*, translation by Emile V Rieu, revised translation by Dominic C H Rieu (Baltimore: Penguin Books, 2003) at 132.

2 This paper refers loosely to "Canadian corporate law". There are fourteen corporate law statutes in Canada – a federal statute, 10 provincial statutes and a statute in each of Canada's three territories. There are no material differences in the corporate law across Canada with respect to the matters discussed in this paper. Further background on Canada and it's legal system is set out in the schedule to this paper.

3 United States Census Bureau, U.S. International Trade Data (June 2017), online: <https://www.census.gov/foreign-trade/statistics/highlights/top/top1706yr.html>.

4 *Smith v Van Gorkom*, 488 A2d 858 (Del Supr 1985).

5 *In re Caremark International Inc Derivative Litigation*, 698 A2d 959 at 960 (Del Ch 1996).

6 *In re Walt Disney Co Derivative Litigation,* 906 A2d 27 at 52 (Del Supr 2006).

7 See Background, appended to this paper.

1. No Fiduciary Duty Owed to Shareholders

a) Codification of Fiduciary Duty

Under Canadian law, directors owe their fiduciary duty only to the corporation. They owe no fiduciary duty to the shareholders of the corporation.

How did Canadian law develop so differently from U.S. law on an issue as fundamental as fiduciary duty? Part of the explanation lies in the codification of the fiduciary duty of directors (and officers) in the Canadian statutes.[8] In discharging his or her duties, a director must act ". . . honestly and in good faith with a view to the best interests of the corporation."[9] The phrase "with a view to the best interests of the corporation" recognizes that a corporation may have a variety of stakeholders. As stated in a report that influenced the drafting of Canada's federal corporate statute, the notion of "best interests of the corporation" was purposely left imprecise, so as to leave judges to develop the law and to allow "directors to take into account whatever factors they consider relevant in determining corporate policies".[10]

Over the years, Canadian practitioners have advised their clients that a director's duty was to the corporation and to the shareholders "taken as a whole". This concept has also found its way into judicial decisions (although it was not the basis for those decisions).[11] In most contexts, this may not seem to be a controversial statement, but as discussed below, it is not the law in Canada.

b) Pre-Gheewala Decisions Trigger Clarification of Directors' Duties

We generally think of the interests of the shareholders as being the same as the interests of the corporation when the corporation is financially healthy (in other words, if it is good for the corporation, it is good for shareholders). However, when insolvency leaves the shareholders with no remaining economic interest in the corporation, the creditors step forward. In Delaware, prior to the decision in *Gheewala*,[12] creditors argued successfully that directors owed a fiduciary duty to creditors when the corporation entered the vicinity of insolvency[13] (in the *Gheewala* decision in 2007, the Delaware Supreme Court held that this was not the case).[14]

Creditors in Canada argued that the Delaware concept that directors owe a fiduciary duty to creditors in the context of an insolvency should also apply in Canada. In 2004 (i.e. pre-*Gheewala*) the Supreme Court of Canada rejected this premise. It held not only that directors do not owe a fiduciary duty to creditors, but further that directors do not owe a fiduciary duty to any stakeholder of the corporation (including shareholders):

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8 See eg *Canada Business Corporations Act*, RSC 1985, c C-44, s 122(1)(a) [CBCA]; *Business Corporations Act* (Ontario), RSO 1990, c B 16, s 134(1)(b) [OBCA].

9 See eg *CBCA, supra* note 8, s 122(1)(a); OBCA *supra* note 8, s 134(1)(a).

10 Robert W V Dickerson, John L Howard and Leon Getz, *Proposals for a New Business Corporations Law for Canada* (Ottawa: Information Canada, 1971) Vol I at para 241.

11 *347883 Alberta Ltd v Producers Pipelines Inc*, [1991] 4 WWR 577, 1991 CarswellSask 185 at para 35 (SKCA).

12 *North American Catholic Educational Programming Foundation, Inc v Gheewala*, 930 A2d 92 (Del Supr 2007) [*Gheewala*].

13 See eg *Blackmore Partners, LP v Link Energy LLC*, 2005 WL 2709639 at 3 (Del Ch, October 14, 2005); *In re Buckhead America Corp*, 178 BR 956 at 968 (USDC Del 1994).

14 *Gheewala, supra* note 12 at 94 (Del Supr 2007) [*Gheewala*] ("When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners").

> At all times, directors and officers owe their fiduciary obligation to the corporation. The interests of the corporation are not to be confused with the interests of the creditors or those of any other stakeholders.[15]

Several years later, Canadian creditors argued that directors owe a fiduciary duty to creditors in a change of control context. The Supreme Court of Canada affirmed its reasoning in its previous decision, but went on to discuss how the directors should deal with a situation in which the interests of corporate stakeholders (the shareholders on the one hand and the creditors on the other, for example) conflict. The Supreme Court left it with the directors, exercising reasonable business judgement to resolve the conflict:

> Where there is a conflict between the interests of different corporate stakeholders, it falls to the directors to resolve such conflicts in accordance with their fiduciary duty to act in the best interests of the corporation, having regard to all relevant considerations, including the need to treat the affected stakeholders fairly, commensurate with the corporation's duties as a responsible corporate citizen.[16]

2. No Revlon Duties

Canadian practitioners have also followed the decisions of the Delaware courts in M&A transactions. The "*Revlon* duty" (i.e. the duty of directors to maximize shareholder value in a change of control transaction) was particularly attractive. However, the Ontario Court of Appeal held that "*Revlon* is not the law in Ontario. In Ontario, an auction need not be held every time there is a change in control of a company."[17]

This decision made it clear that, in Canada there is no specific formula for directors of the target company to apply in every case, including an obligation to permit and facilitate an auction. The Court stated that "the real question is whether the directors of the target company successfully took steps to avoid a conflict of interest."[18] The business judgment rule will apply where the board of directors has acted on the advice of a committee composed of persons having no conflict of interest, and that committee has acted independently, in good faith, and made an informed recommendation as to the best available transaction for the shareholders in the circumstances. The Court stated further that an auction is merely one way to prevent the conflicts of interest that may arise when there is a change of control by requiring that directors act in a neutral manner toward a number of bidders.[19]

In a subsequent case 10 years later, the Supreme Court of Canada held as follows:

> What is clear is that the Revlon line of cases has not displaced the fundamental rule that the duty of the directors cannot be confined to particular priority rules, but is rather a function of business judgment of what is in the best interests of the corporation, in the particular situation it faces.[20]

15 *People's Department Stores Ltd (1992) Inc, Re,* 2004 SCC 68 at para 43.

16 *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at paras 81-82 [*BCE*].

17 *Pente Investment Management Ltd v Schneider Corp,* [1998] OJ No 4142, 1998 CarswellOnt 4035 at para 61 (ONCA).

18 *Ibid* at para 38.

19 *Ibid* at para 62.

20 *BCE, supra* note 16 at para 87.

3. No Enhanced Scrutiny or Entire Fairness: Business Judgement Rule

The courts in both Delaware and Canada are concerned with whether directors have acted reasonably and fairly.

The Supreme Court of Canada articulated the business judgment rule applicable in Canada today, as developed through the Canadian jurisprudence:

> In considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule. The 'business judgment rule' accords deference to a business decision, so long as it lies within a range of reasonable alternatives.[21]

Change of control transactions attract particular judicial attention. To protect against directors' abuse of unfettered discretion in situations rife with potential impropriety, the Delaware courts have adopted an enhanced scrutiny standard. In applicable situations,[22] this standard shifts the onus to the directors to establish that the impugned action or transaction was reasonable in relation to a legitimate objective.[23] No such standard applies in Canada. The British Columbia Court of Appeal noted that no reverse onus or "enhanced scrutiny" standard applied in determining the reasonable grounds for the directors' view of the corporation's best interests.[24] The Alberta Court of Appeal held that the onus was on the plaintiff to prove the board's actions were contrary to the best interests of the corporation in considering defensive tactics against a take-over bid.[25]

The explanation for the difference in approach between the Delaware courts and the Canadian courts lies in part with the role and powers of Canadian securities regulators. The Canadian constitution makes securities law an exclusively provincial matter,[26] and the securities commissions of each province and territory have broad authority to create rules[27] and make findings that any act or omission was "against the public interest".[28]

Canadian securities regulators have developed procedural protections[29] to help ensure that all

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21 *Ibid* at para 40.

22 The Delaware Court of Chancery gave the following examples of applicable contexts: defensive action against hostile takeovers, proxy contests, board actions affecting stockholder voting rights, and final stage transactions: *Reis v Hazelett Strip-Casting Corp*, 28 A3d 442 at 457-458 (Del Ch 2011) ("Enhanced scrutiny applies when the realities of the decision-making context can subtly undermine the decisions of independent and disinterested directors.").

23 *Ibid* at 457; *Mercier v Inter-Tel (Del) Inc*, 929 A2d 786 at 810 (Del Ch 2007).

24 *Icahn Partners LP v Lions Gate Entertainment Corp*, 2011 BCCA 228, 2011 CarswellBC 1135 at para 58. See also para 76 ("In Canada, it has been clear since *Teck* that where directors have carried out reasonable enquiries to inform themselves as to where their company's best interests lie and are *bona fide* of the belief, based on reasonable grounds, that a proposed takeover will run contrary to those interests, they are entitled to use their powers to take defensive measures").

25 *Shefsky v California Gold Mining Inc*, 2016 ABCA 103 at para 51.

26 *Constitution Act, 1867*, RSC 1985, App II, No 5, s 92 (Granting provincial legislatures the exclusive right to create laws regarding "Property and Civil Rights in the Province".). The SCC recently upheld the exclusive jurisdiction of provinces for securities matters that do not engage the federal criminal jurisdiction: *Reference re Securities Act (Canada)*, 2011 SCC 66.

27 See eg *Securities Act* (Ontario), RSO 1990, c S 5, s 132(1).

28 See eg *ibid*, s 127.

29 *Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions*, OSC MI 61-101 (9 May 2016) [MI 61-101].

shareholders of an issuer receive complete and accurate information and fair treatment in respect of transactions between the issuers and persons that are related to the issuer.[30] These protections are set out in specific requirements and recommended procedures for insider bids,[31] issuer bids,[32] business combinations[33] and related party transactions.[34] Depending on the type of potentially unfair transaction, the procedural protections include enhanced disclosure,[35] independent valuations[36] and majority of the minority approval.[37]

If any transactions or directors' actions are still improper despite adhering to this or any other rule, the securities commissions have the ability to default to their "public interest" powers to fill in the gaps to ensure that directors' acts were reasonable and not contrary to the public interest.[38]

The end result of the Canadian regime for directors is similar to the conclusions drawn in Delaware courts. The application of the business judgment rule in the context of a controlling stockholder buyout is illustrative. In *Kahn v M & F Worldwide Corp* ("*Kahn*"), the Delaware Supreme Court held that the default business judgment rule standard, not enhanced scrutiny or entire fairness, applies to controlling stockholder buyouts when:

> *if, and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[39] (emphasis in original)

In Canada, a going-private transaction such as in Kahn could be considered a "related party transaction", "insider bid" or "business combination", and similar protections would apply to those discussed in Kahn as triggering the default business judgment rule.

Closing Thoughts

Canadian lawyers will continue to look to the decisions of the Delaware courts to inform their advice to boards of directors and to frame the legal arguments necessary to protect them. The challenge will be to benefit from the reasoning and judgement of those decisions within the parameters of Canadian law.

> *This was the sweet song the Sirens sang, and my heart was filled with such a longing to listen that I ordered my men to set me free, gesturing with my eyebrows. But they swung forward over their oars and rowed ahead . . .*
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> (Odysseus, *The Odyssey*, Book XII at 193-196)

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30 *Companion Policy 61-101CP - To Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions*, OSC MI 61-101CP, s 1.1 ("we recognize, however, that these transactions are capable of being abusive or unfair, and have made the Instrument to address this").

31 MI 61-101, *supra* note 29, s 1.1, "insider bid".

32 *Ibid*, s 1.1, "issuer bid".

33 *Ibid*, s 1.1, "business combination".

34 *Ibid*, s 1.1, "related party", "related party transaction".

35 *Ibid*, Parts 2–5.

36 *Ibid*, Parts 2–6.

37 *Ibid*, Parts 4–5.

38 See eg the Ontario Securities Commission's discussions regarding their public interest authority: *Canadian Tire Corp, Re*, (1987) 10 OSCB 857; *Magna International Inc, Re*, (2010) 34 OSCB 1290.

39 *Kahn v M & F Worldwide Corp*, 88 A3d 635 at 645 (Del Supr 2014).

Background

Political Divisions, Geography and Population

- Canada is a confederation of 10 provinces and three territories.
- Canada is a member of the Commonwealth of Nations.
- Canada has a population similar in size to California, almost two thirds of which reside in Ontario and Quebec (British Columbia and Alberta are the next largest by population).
- Canada is the second largest country in the world geographically, but approximately 90% of the Canadian population lives within 100 miles of the US border.[40]
- Toronto is the most populous city in Canada with 2.7 million residents – 7.8% of the Canadian population.[41]

The Canadian Legal System

- Canada has a bi-jurisdictional legal system, with responsibilities divided between the federal governments and the provincial (or territorial) governments.
- Corporations may be formed under the federal statute, the 10 provincial statutes, or the three territorial statutes.
- Corporate matters are tried in provincial courts, but the decisions of provincial (or territorial) courts of appeal may be appealed to the Supreme Court of Canada.
- Canada's first commercial court was established by Ontario in 1991 for commercial matters relating to Toronto.
- Amendments to corporate law are typically initiated by government. There is no institutionalized process for the private bar to initiate amendments to the corporate statutes.
- Securities law is matter of provincial jurisdiction. Canada does not have a uniform or national securities law or regulation – accordingly, there are 13 securities commissions in Canada, one for each province and territory.
- Provincial (and territorial) securities regulators sometimes agree on standards or rules to be applied nationally, but often times they cannot come to a collective agreement. This creates differing securities law standards and regulations between the provinces (or territories).

40 Central Intelligence Agency, "World Fact Book – Canada: Geography" (5 September 2017), online: <https://www.cia.gov/library/publications/the-world-factbook/geos/ca.html>.

41 Statistics Canada, "Census in Brief: Municipalities in Canada with the largest and fastest-growing populations between 2011 and 2016" (8 February 2017), online: <http://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016001/98-200-x2016001-eng.cfm>.

What We Do

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Our expertise is on both the legal and the governance side. We are lawyers grounded in corporate and securities law with extensive experience in corporate transactions. We have acted for the full range of stakeholders in meeting challenges of all kinds.

We go beyond advising our clients on what is required or permitted by law. We are experts on practices followed by a wide range of organizations and on existing and emerging expectations of investors and regulators. We have worked with many boards, management teams, and investors to help meet their business objectives and deal with the legal, organizational, and strategic challenges along the way. We are alert to issues of personal liability and to potential exposure of any process to legal and regulatory scrutiny. We equip our clients with the most effective legal and governance tools to promote and protect their interests.

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