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MERGERS AND ACQUISITIONS

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## The Role of Management of a Potential M&A Target – Keeping the Board Involved

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### Overview

The propriety of senior officers shopping their companies has been put into question a number of times in high-profile cases over the past year. In Canada, the CEO and in-house counsel of Movie Distribution Income Fund were dismissed in August 2006, amidst allegations that the officers had breached their obligations by, among other things, withholding material information from the board.<sup>1</sup> The issue, as reported in the press, was that the executives had allegedly been working on a sale of Alliance Atlantis' interest in the fund to a private equity firm and were not keeping the directors sufficiently apprised of what was happening.<sup>2</sup> The allegations were never tested in court and the matter settled.<sup>3</sup>

Conflict between management and directors, due to management's discussions with private equity firms, is in the news in the United States as well. Earlier this April, Dow Chemical Co. ("Dow") terminated Pedro Reinhard, a senior advisor and board member, and Romeo Kreinberg, a senior executive, alleging that Messrs. Reinhard and Kreinberg had been engaging in unauthorized talks with a consortium of investors about making a bid

for Dow. Reinhard has denied the allegations.<sup>4</sup> However, the episode has placed the issue of management conflicts in the spotlight. Stefan Selig, Vice-Chairman of Global Investment Banking at the Bank of America is reported to have said that this is a wake-up call regarding the appropriate process when engaging in discussions that involve "shopping" the company or responding to interest from private equity firms or strategic buyers:

While you can have casual conversations with [private equity] sponsors, if they develop into something more serious, management is well-advised to have the consent of their board or their lead director.<sup>5</sup>

In a different context, there have been concerns raised that the role of BCE Inc.'s CEO in bringing together a consortium led by the Canadian Pension Plan Investment Board ("CPP") might have a stifling effect on an auction of BCE Inc. if CPP was perceived to be favoured.<sup>6</sup> The board has attempted to correct any such misperception.

The Chancery Court in Delaware has also sounded an alarm in *NetSMART Technologies, Inc. Shareholder Litigation (In re) ("NetSMART")*.<sup>7</sup> Vice-Chancellor Strine referred to the case as a "microcosm of a current dynamic in the mergers and acquisitions market"<sup>8</sup> and voiced criticism of the board and special committee. Vice-Chancellor Strine concluded that the board and special committee had failed to be alert to the potential bias that management would have to pursue private equity. Unlike in a takeover by a strategic buyer, private equity firms would more likely retain the existing management and offer management incentives, including a continuing equity interest in the business. Vice-Chancellor Strine concluded that boards must strengthen their oversight of senior management in these situations and should give

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<sup>1</sup> Movie Distribution Income Fund, Press Release, August 18, 2006.

<sup>2</sup> Gayle MacDonald, Grant Robertson and Shirley Won, "The plot thickens," *The Globe & Mail*, August 19, 2006.

<sup>3</sup> Movie Distribution Income Fund, Press Release, September 29, 2006.

<sup>4</sup> James Politi, "Dow fires executives in 'sale' discussions," *The Financial Times*, April 13, 2007.

<sup>5</sup> *Ibid.*

<sup>6</sup> Andrew Willis, Sinclair Stewart and Boyd Erman, "BCE faces push for open bidding," *The Globe & Mail*, April 25, 2007.

<sup>7</sup> Delaware Court of Chancery (Court File No. 2563-VCS), March 14, 2007, [http://courts.delaware.gov/opinions/\(ifrij555arkd4gfensjgh3u\)/download.aspx?ID=89210](http://courts.delaware.gov/opinions/(ifrij555arkd4gfensjgh3u)/download.aspx?ID=89210).

<sup>8</sup> *Ibid.* at 1.

careful consideration to engaging in market checks for strategic buyers.<sup>9</sup>

This article begins with a discussion of Vice-Chancellor Strine's criticisms of the role of management in *Netsmart*. We conclude that his concerns are not new or limited to public to private transactions with private equity buyers. They are variations on themes that are endemic to transactions in which minority shareholder interests may not be adequately considered. In *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* ("*WIC Western*"),<sup>10</sup> Blair J. quoted with approval the following statement made now 20 years ago regarding the unenviable conflicts faced by officers and directors of companies in takeover bid situations:

The directors' position is not an enviable one in such circumstances. As Professor R.C. Clark of Harvard University Law School has expressed it:

Directors and officers of a corporation whose shares are subject to a hostile takeover bid face a serious conflict of interest. Indeed, we could well conclude that *in no other context is the conflict of interest as serious as in the takeover situation*. Often the managers' jobs are at stake. The temptation to find that what is best for oneself is also best for the corporation and shareholders (for example, to assert that the company's stock is "undervalued" and that shareholders will eventually do better if the pending offer fails), the temptation to spend corporate resources extravagantly in the attempt to fend off the raider (it's always easier to spend other people's money), and the temptation to sacrifice the shareholders' interests (as by paying exorbitant amounts

of greenmail), must be overwhelming. No human being can be expected to resist such temptations.

R.C. Clark, *Corporate Law* (Boston: Little Brown, 1986) at pp. 588-589. [emphasis in original]<sup>11</sup>

We argue that it would be neither practical nor desirable for senior management to be prohibited from engaging in preliminary investigations of shareholder maximization strategies. Nor would it be sensible for management to be excluded entirely from responding to potential bidders once a company is in play. The existing jurisprudence suggests that the conflicts inherent to management's unenviable position can be adequately addressed by ensuring that there is awareness that senior management are fiduciaries of the company and have an obligation to bring opportunities for shareholder value maximization to the attention of the board. Senior management should report to and seek instructions from the board regularly with respect to opportunities for shareholder value maximization and must do so before engaging in discussions about management's future role with potential private equity bidders or strategic bidders, which may lead to conflicts of interest. Furthermore, directors have a duty to supervise management in any ongoing negotiations with private equity bidders or strategic bidders. Directors should be alert to the fact that prudent board supervision may require the formation of a special committee of independent directors at an early stage before particular options are ruled out.

### **Netsmart: A Cautionary Tale?**

In *Netsmart*, minority shareholders sought an injunction restraining the company from proceeding with a shareholders' vote on a public to private transaction with a private equity buyer. The shareholders made two broad allegations. They argued that members of the special committee breached their *Revlon*<sup>12</sup> duties by failing to consider and pursue a market canvass for a strategic buyer. From the outset, the board was focused on private equity investors. Vice-Chancellor Strine agreed. He concluded that:

<sup>11</sup> *Ibid.* at 769.

<sup>12</sup> *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (U.S. Del. Super. 1985).

<sup>9</sup> Vice-Chancellor Strine's opinion has sparked much commentary from legal advisors. See, e.g., Skadden, Arps Slate, Meagher & Flom LLP & Affiliates, "Delaware Court Enjoins Netsmart Deal" (March 20, 2007), [http://www.skadden.com/content/Publications/Publications1234\\_0.pdf](http://www.skadden.com/content/Publications/Publications1234_0.pdf); Duane Morris LLP, "Duties of the Board of Directors When a Company is for Sale." (April 7, 2007), <http://www.duanemorris.com/alerts/alert2465.html>; Mayer, Brown, Rowe & Maw LLP, "New Delaware Guidance on Conducting a Sale Process" (March 28, 2007), <http://www.mayerbrownrowe.com/publications/article.asp?id=3389&nid=6>.

<sup>10</sup> (1998), 39 O.R. (3d) 755 (Gen. Div. [Commercial List]).

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[T]he plaintiffs have demonstrated a reasonable probability that they will later prove that the board's failure to engage in any logical efforts to examine the universe of possible strategic buyers and to identify a select group for targeted sales overtures was unreasonable and a breach of their *Revlon* duties.<sup>13</sup>

In addition, the shareholders argued that the special committee breached its *Revlon* duties in the course of the targeted auction of the company to private equity firms. Vice-Chancellor Strine levelled harsh criticism at the company for permitting management to control the process. He concluded that there was an inherent conflict of interest in situations where management will likely continue to be employed following a private equity transaction. Ultimately, however, he held that the special committee pursued the best deal it could get within the limited auction and that the defects in its process due to management's involvement did not have significant negative effects.<sup>14</sup> Although the directors were vindicated in this aspect of their process, other directors may not be as fortunate and it is this part of Vice-Chancellor Strine's opinion that is most interesting for the purposes of this article.

### Background

Netsmart is a supplier of specialized healthcare information technology software. It operates in a niche market among mental health and substance abuse service providers.<sup>15</sup> By 2006, it had grown to be the largest player within its market niche primarily by acquiring other companies, including its largest direct competitor, CMHC Systems, Inc. ("CMHC").<sup>16</sup> James Conway ("Conway") had been Netsmart's CEO since the 1990s. The board of directors was comprised of Conway, two other top executives and four independent directors.<sup>17</sup> Vice-Chancellor Strine noted that "Netsmart's management had pondered the prospect of outgrowing its market for some time and considered what could be done to address that concern."<sup>18</sup> Conway attempted to find a larger firm to

acquire Netsmart beginning in the late-1990s. When Conway approached larger healthcare IT firms, he told them that Netsmart was interested in a "strategic alliance." Given Netsmart's relative size, this was supposed to signal "a green light for an acquisition proposal."<sup>19</sup> None of these approaches resulted in an expression of interest.

In 2003, Netsmart engaged William Blair & Company ("William Blair") as investment bankers in connection with the CMHC acquisition, which was not completed until 2005. Netsmart gave William Blair the right to a fee if Netsmart was eventually sold and an additional fee if William Blair was selected to provide a fairness opinion in connection with the sale. However, William Blair was not authorized "to market Netsmart as if its board had decided to sell the company; rather, it simply gave [William] Blair a right to compensation if the board later went down that road."<sup>20</sup> The extent of the board's consideration, if any, of the William Blair retainer is not clear from Vice-Chancellor Strine's opinion. However, from late-2003 through 2005, William Blair "regularly trolled for business" and "dropped Netsmart's name."<sup>21</sup> No serious market canvass was conducted.

### Initial Approaches Not Reported to the Board

Shortly after the CMHC acquisition in October 2005, Vista Equity Partners ("Vista"), a private equity firm, approached William Blair to express an interest in Netsmart. William Blair reported this interest to Conway. However, Conway did not inform the board at that time.<sup>22</sup> In mid-February 2006, Francisco Partners ("Francisco") approached Netsmart's Executive Vice President, Kevin Scalia ("Scalia"), to discuss whether Netsmart would be interested in a transaction.<sup>23</sup> This also was not immediately reported to the board. Instead, in late-March 2006, Francisco and Netsmart's managers, including Conway, met to discuss the possibility of a transaction. Only after that meeting did Conway report Francisco's interest to the board.<sup>24</sup>

<sup>13</sup> *Supra* note 7 at 51.

<sup>14</sup> *Ibid.* at 44.

<sup>15</sup> *Ibid.* at 1.

<sup>16</sup> *Ibid.* at 7.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.* at 10.

<sup>19</sup> *Ibid.* at 11.

<sup>20</sup> *Ibid.*

<sup>21</sup> *Ibid.* at 12.

<sup>22</sup> *Ibid.* at 12-13.

<sup>23</sup> *Ibid.* at 13.

<sup>24</sup> *Ibid.* at 13.

Following the Francisco meeting, Conway, certain key advisors and William Blair began to work on various options for a period of six weeks without direct board involvement.<sup>25</sup> During this time, the management team and William Blair settled on a strategy of pursuing a public to private transaction with a private equity buyer. Conway then asked Scalia to create a presentation of various options for Netsmart's board meeting, which was held in the first half of May 2006.<sup>26</sup> In one version of Scalia's presentation slides, Scalia wrote that one of the benefits of a private equity buy-out was a "Second bite at the apple."<sup>27</sup> Vice-Chancellor Strine concluded:

This reference obviously refers to the potential for management to not only profit from the sale of its equity (including exercised options) in the going private transaction itself, but from future stock appreciation through options they were likely to be granted by a private equity buyer, a class of buyers that typically uses such incentives to motivate managers to increase equity value.<sup>28</sup>

### Management Involvement in the Decision to Proceed

Following Scalia's presentation to the board, there was a meeting of the independent directors. Conway was present for at least part of that meeting.<sup>29</sup> No special committee was struck nor did the board take over the process. Instead, management continued to work with William Blair directly while William Blair began its own assessment of Netsmart's options. William Blair presented its recommendations to the board eight days later on May 19, 2006.<sup>30</sup> Following the presentation and discussion, Netsmart's directors concluded that Netsmart should focus on a private equity buyer and should not engage in an active canvass of strategic buyers.<sup>31</sup> This crucial meeting with William Blair was not minuted.

Nearly two months passed following the crucial May 19, 2006 meeting before a special committee was formed in response to an expression of interest from a third private

equity firm, Thomas Cressey Equity Partners ("Cressey"),<sup>32</sup> which had been working with Netsmart management to conduct preliminary due diligence.<sup>33</sup> At its initial meeting, the special committee decided to conduct a targeted approach to only six private equity firms in addition to Cressey and, in addition, decided to retain William Blair as its advisor.<sup>34</sup> This first special committee meeting was not minuted. This omission drew severe criticism from Vice-Chancellor Strine, who said that the meeting might just as well not have occurred.<sup>35</sup>

### Management Control of the Due Diligence Process

The special committee canvass of private equity firms took place over a compressed two-week period of time. Netsmart's management controlled the due diligence process, which left management with the opportunity to subtly direct the process for their own benefit. Vice-Chancellor Strine agreed that this was a cause for concern; however, he did not find any credible evidence of actual bias.

In what was to be the pattern throughout, the Netsmart side of the due diligence process was handled by company management with little involvement from the Special Committee or its advisors. This occurred despite the fact that Netsmart management was keenly interested in the future incentives that would be offered by the buyers, including what, if any, option pool would be offered to them in the resulting private company. *Given its lack of participation in this process, the Special Committee had virtually no insight into how consistent management was in its body language about Netsmart's prospects to the various private equity firms in the bidding process.* But no plausible allegations of favoritism by management toward particular private equity firms among the seven have been made by the plaintiffs, and no evidence from which one can infer that Conway or other Netsmart managers had any pre-existing relationship or bias toward any of the bidders has been presented.<sup>36</sup> [emphasis added]

<sup>25</sup> Ibid. at 13.

<sup>26</sup> Ibid.

<sup>27</sup> Ibid. at 15.

<sup>28</sup> Ibid. at 15-16.

<sup>29</sup> Ibid. at 16.

<sup>30</sup> Ibid. at 17.

<sup>31</sup> Ibid. at 18-19.

<sup>32</sup> Ibid. at 26.

<sup>33</sup> Ibid. at 25-26.

<sup>34</sup> Ibid. at 26.

<sup>35</sup> Ibid. at 27.

<sup>36</sup> Ibid. at 28.

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Ultimately, the targeted approach produced three additional offers to the Cressey expression of interest. The special committee decided to target the two highest bidders and provided them with the opportunity to conduct additional due diligence. Again, the due diligence was conducted without the involvement of the special committee, even though, at the same time, there were preliminary discussions between the bidders and the CEO about potential management incentives.

In the end, the highest bidder lowered its bid significantly and the second highest bid lapsed. The company was without an offer. It authorized William Blair to make an approach to the third initial bidder and ultimately, after a serious negotiation, a deal was struck.<sup>37</sup>

### Vice-Chancellor Strine's Criticism

Although Vice-Chancellor Strine concluded that there was not a realistic probability that the plaintiffs would succeed in demonstrating that the special committee breached its *Revlon* duties in its conduct of the targeted auction, he was critical of the way in which the special committee conducted itself and noted that there was significant potential for mischief. In particular, Vice-Chancellor Strine found fault with the following elements of the process:

- The special committee was formed after management and the board were well-advanced in the pursuit of a private equity bidder.<sup>38</sup>
- William Blair "was well along in its work with management" by the time that it was retained as the financial advisor to the special committee.<sup>39</sup>
- The special committee largely deliberated with the CEO present, along with the company's general counsel, and other of the CEO's subordinates.<sup>40</sup> Indeed, the special committee gave the CEO virtually unlimited access to its deliberations.<sup>41</sup>
- William Blair participated in the executive sessions of the special committee, despite

its close working relationship with management.<sup>42</sup>

- The CEO directed the due diligence process without oversight.<sup>43</sup>
- The CEO was left to negotiate without oversight, which raised concerns since "some bidders might desire to retain existing management or to provide them with future incentives while others might not."<sup>44</sup>

In the end, Vice-Chancellor Strine concluded that these deficiencies in the process did no real harm to minority shareholders. However, by identifying the issue of management's conflict of interest and the special committee's obligation to ensure that the process was not tainted by management's interests, *Netsmart* will undoubtedly heighten shareholder scrutiny of public to private transactions.

### Navigating the Potential Conflicts: Guidance From the Existing Jurisprudence

Vice-Chancellor Strine's criticisms in the *Netsmart* case should be borne in mind when companies pursue public to private transactions. There is a tendency for management to be permitted to dominate the process of identifying and negotiating potential transactions given their knowledge of the business and their availability. There is also a danger that special committees might be set up only after the field has been narrowed to a very limited set of expressions of interest. Furthermore, special committee deliberations might inadvisably include the participation of management, management's financial advisors and non-independent directors. This participation of non-special committee members in the special committee's deliberations may make sense in some situations; however, the members of the special committee must be careful to demonstrate that such participation has not inadvertently compromised the special committee's ability to come to an independent view of the issues that are before it.

We argue for a balanced approach. It is not necessary that management be prevented from making initial investigations of shareholder

<sup>37</sup> *Ibid.* at 31-33.

<sup>38</sup> *Ibid.* at 51.

<sup>39</sup> *Ibid.* at 39.

<sup>40</sup> *Ibid.*

<sup>41</sup> *Ibid.* at 40.

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

<sup>44</sup> *Ibid.* at 41.

maximization strategies, whether private equity or otherwise. Nor is it necessary to exclude management from negotiations once there is a field of bidders, in order to protect the interests of minority shareholders. Instead, properly read, Vice-Chancellor Strine's opinion in *Netsmart* is an important reminder of the guiding principles for directors and officers in reviewing shareholder maximization alternatives. In this section, we revisit those guiding principles, as they have been articulated in the Canadian jurisprudence, and suggest that these principles are as relevant whether the context is a takeover by a private equity or strategic buyer.

**Senior Management Are Fiduciaries of the Company and Should Avoid Conflicts of Interest by Bringing Opportunities for Shareholder Value Maximization to the Attention of the Board**

Without question, officers such as CEOs have fiduciary obligations to the company by virtue of their managerial authority to direct and guide the business of the company.<sup>45</sup> These fiduciary obligations emanate from statutory provisions as well as from common law and equitable principles. One of the strongest statements yet by the Supreme Court of Canada regarding the strict fiduciary obligations of officers (and directors) in the statutory context is found in *Peoples Department Stores Ltd. v. Wise*<sup>46</sup> ("*Peoples*"), in which Justices Major and Deschamps wrote:

*Considerable power over the deployment and management of financial, human, and material resources is vested in the directors and officers of corporations. For the directors of CBCA corporations, this power originates in s. 102 of the Act. For officers, this power comes from the powers delegated to them by the directors. In deciding to invest in, lend to or otherwise deal with a corporation, shareholders and creditors transfer control over their assets to the corporation, and hence to the directors and officers, in the expectation that the directors and officers will use the corporation's resources to make reasonable business decisions that are to the corporation's advantage.*

<sup>45</sup> Kevin Patrick McGuinness, *The Law and Practice of Canadian Business Corporations* (Toronto: Butterworths, 1999) at §8.155.

<sup>46</sup> (2004), 49 B.L.R. (3d) 165 (S.C.C.).

The statutory fiduciary duty requires directors and officers to act honestly and in good faith vis-à-vis the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. *They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position.* Directors and officers must serve the corporation selflessly, honestly and loyally ...<sup>47</sup> [emphasis added]

Justices Major and Deschamps further noted that the specific obligation imposed upon a fiduciary may vary "in its specific substance depending on the relationship."<sup>48</sup> This suggests that officers must be attuned to the specific situation of the company and the scope of their managerial powers when considering, for example, whether they are abusing their position to gain personal benefit. The existing jurisprudence suggests, therefore, that a prudent fiduciary will report shareholder value maximization opportunities to the board and that senior management should not allow discussions with potential acquirors to advance beyond the most preliminary expressions of interest without notifying the board.

**Senior Management Need Not Be Prohibited From Identifying and Negotiating With Potential Private Equity or Strategic Buyers**

A total prohibition on management involvement in identifying and negotiating with potential private equity or strategic buyers is neither desirable nor practical. Management knows the business and, in many instances, it will be through the contacts of senior management that synergistic or strategic opportunities will be identified. The potential for conflict of interest in allowing senior management to deal with bidders and advisors directly must be balanced in any particular case against the benefits of that direct contact. In *Pente Investment Management Ltd. v. Schneider Corp.*<sup>49</sup> ("*Schneider*"),

<sup>47</sup> *Ibid.* at 181.

<sup>48</sup> *Ibid.*, citing with approval *B.(K.L.) v. British Columbia*, 2003 SCC 51 (S.C.C.) per McLachlin, C.J. at paragraphs 40-41.

<sup>49</sup> (1998), 42 O.R. (3d) 177 (C.A.) per Weiler J.A.

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the Ontario Court of Appeal adopted the analysis of the trial judge in concluding that what is important is whether management is appropriately supervised, whether there are safeguards in the decision-making process, and whether the facts demonstrate incentives that minimize the conflict of interest.

Farley J. recognized that in allowing Dodds and to a lesser extent Hooper, the Chief Financial Officer of Schneider, to deal with bidders directly, a potential conflict of interest existed but that this had to be balanced against the benefits to be obtained. He stated:

It would be appropriate, however, to comment as well [th]at the use of the two management directors, Dodds and Hooper, in dealing with the bidders and advisors directly, would not seem inappropriate. Potentially there could be conflict, but that must be balanced against the reasonable benefits to be obtained. They knew the operations of the business – what the bidders would be interested in and they were guided by the advisors. They reported to the Special Committee which could make the “final” decisions and give directions. Potential conflict was minimized by the bail-out packages granted them.<sup>50</sup>

Thus, courts have not categorically disqualified senior management from participating in negotiations and deliberations with respect to change of control transactions. Neither, however, have they given senior management broad discretion to do so. Instead, the appropriate boundaries of management’s activities depend upon effective management supervision by the board from an early stage and the particular facts of the situation.

### **However, Senior Management Should Be Careful to Avoid Taking Steps That Limit the Ability of the Company to Engage in an Auction**

As stated in *WIC Western*, once a public company is in play, the fiduciary obligations of officers and directors require them to take active steps to maximize shareholder value, which in many instances will mean at least considering whether the company should be auctioned:

In the context of a hostile take-over bid situation where the corporation is “in play” (i.e., where it is apparent there will be a sale of equity and/or voting control) the duty is to act in the best interests of the shareholders as a whole and to take active and reasonable steps to maximize shareholder value by conducting an auction. As Callaghan A.C.J.H.C. said, in *Corona Minerals Corp. v. CSA Management Ltd.* (1989), 68 O.R. (2d) 425 (Ont. H.C.), at p. 429:

The purpose of an auction in the securities industry is to try and achieve the highest value for the shareholders of the target companies for their shares. That in my view is an acceptable purpose ...

In the American authorities this shareholder maximization-through-auction duty is known as the “Revlon Duty”, based on the decision of the Delaware Supreme Court in *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (U.S. Del. Super. 1985). At p. 182 of that report, the court said:

The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit. This significantly altered the board’s responsibilities ... the directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.<sup>51</sup>

It is clear that, absent rights under a unanimous shareholders agreement, a director or officer cannot prevent the sale of a business for his or her own personal interests, whether the company is private or public.<sup>52</sup> Senior management should be cautious to avoid limiting the ability of the company to engage in an auction by ruling out alternatives at an early stage. Senior management should not, therefore, turn away prospective private equity or strategic buyers, without full consideration of these opportunities by the company’s board of directors. The board must also take steps to avoid management entrenchment, including, if necessary, by creating a special committee to oversee management’s dealings with potential buyers.

<sup>51</sup> *WIC Western*, supra note 10 at 768.

<sup>50</sup> *Ibid.* at 196.

**One Indicia of Prudence, Diligence and Good Faith Is the Use of a Special Committee to Review Significant Transactions That Involve Conflicts of Interest**

A precondition of the application of the business judgment rule is that the court must determine that “the directors have acted honestly, prudently, in good faith and on a reasonable belief that the transaction is in the best interest of the company.”<sup>53</sup> As stated in *WIC Western*:

In assessing whether or not directors have met their fiduciary and statutory obligations, as outlined earlier in these Reasons, Canadian courts have generally approached the subject on the basis of what has become known as the “business judgment rule”. This rule is an extension of the fundamental principle that the business and affairs of a corporation are managed by or under the direction of its board of directors. It operates to shield from court intervention business decisions which have been made honestly, prudently, in good faith and on reasonable grounds. In such cases, the board’s decisions will not be subject to microscopic examination and the Court will be reluctant to interfere and to usurp the board of director’s function in managing the corporation.<sup>54</sup>

Courts have held that the failure to remit a significant transaction in which management directors are involved to a special committee of independent directors may deprive officers and directors of the application of the business judgment rule to impugned transactions.<sup>55</sup> Similarly, the Ontario Securities Commission (“OSC”) has stated in its Companion Policy to Rule 61-501 that it believes that it is good practice for boards to create special committees in order to negotiate transactions involving an interested party even where companies are not strictly required to do so:

To safeguard against the potential for an unfair advantage for an interested party as a result of that party’s conflict of interest or informational or other advantage in connection with the proposed transaction, *it is good practice for negotiations for a transaction involving an interested party to be carried out by or reviewed and reported upon by a special committee of disinterested directors.* Following this practice normally would assist in addressing the Commission’s interest in maintaining capital markets that operate efficiently, fairly and with integrity. While the Rule only mandates an independent committee in limited circumstances, the Commission is of the view that it generally would be appropriate for issuers involved in a material transaction to which the Rule applies to constitute an independent committee of the board of directors for the transaction. *Where a formal valuation is involved, the Commission also would encourage an independent committee to select the valuator, supervise the preparation of the valuation and review the disclosure regarding the valuation.*<sup>56</sup> [emphasis added]

The message is clear both from courts and the OSC that the failure to strike a special committee in situations where insiders have some conflict of interest will result in a heightened level of scrutiny. As previously mentioned, a special committee need not result in the sidelining of management. Moreover, it is in senior management’s interest to ensure that their hard work in bringing together an opportunity for shareholder maximization is not second-guessed by a court because management resisted early supervision and oversight by independent directors.

**Special Committees Should Be Truly Independent**

Both the Ontario Court and the OSC were critical of the composition of the special committee in their reasons in *WIC Western*. In that case, the special committee included the President and CEO of the company and he was given responsibility for leading the negotiations. The Court concluded:

Not only was Mr. Lacey a member of the Special Committee, however; he was in practical terms the member who was charged with

<sup>52</sup> *Beamish v. Solnick* (1980), 10 B.L.R. 224 (Ont. H.C.).

<sup>53</sup> *Corporacion Americana de Equipamientos Urbanos S.L. v. Olifus Marketing Group Inc.* (2003), 38 B.L.R. (3d) 156 per Ground J. at 160 (“OMG”). Also, *Peoples*, supra note 46 at 191.

<sup>54</sup> *WIC Western*, supra note 10 at 774.

<sup>55</sup> *OMG*, supra note 53 at 161.

<sup>56</sup> (2004) 27 O.S.C.B. 5975 at 6.1(6).

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the responsibility of leading its activities and, in particular, negotiating the Shaw Communications deal. *The conflict is apparent. He is senior management. His job is on the line. Indeed, Mr. Spafford as much as told us during testimony that, based on his experience in many takeover bid situations, Mr. Lacey's job would likely be gone following the outcome of the bid process! In addition to this inherently conflicting position, Mr. Lacey was placed in the position of negotiating with Mr. Shaw, who represented the existing 49.96% shareholder of controlling stock, which had openly declared its intention of running the Company. As Ms. Block and Mr. Tory submitted, he was negotiating with his potential boss. Or his potential employment executioner. Either way, his presence on the Special Committee, and the role he played, were not in keeping with the sort of independence which is the very *raison d'être* of such a committee. The OSC was critical of the composition and role of the Special Committee in its decision relating to the shareholders' rights plan/poison pill, characterizing the committee as being "set up for the purposes of convenience only, and not as an independent committee", and stating:*

*In our view, in a take-over bid context a committee which includes as an active participant the president and chief executive officer of the corporation and, as an observer and resource, a representative of a shareholder which has 50% of the votes, is not an independent committee. The fact that Mr. Lacey has a "golden parachute" agreement, does not in our view change this position.*

In these circumstances, it is our view that we must place less reliance on the review by the Special Committee of the Bid, and possible alternative methods of achieving a more beneficial result to shareholders, than we would if the Special Committee had been truly an independent committee.<sup>57</sup> [emphasis added]

In *Schneider*,<sup>58</sup> the Ontario Court of Appeal reaffirmed that the fundamental purpose of a special committee is to protect the interests of minority shareholders, and that

<sup>57</sup> *WIC Western*, supra note 10 at 780, citing (1998), 38 B.L.R. (2d) 230 (O.S.C.).

<sup>58</sup> Supra note 49.

including senior management on a special committee may undermine that purpose and cause the court to place less reliance on its assessment.

The *raison d'être* of a Special Committee independent of management and the controlling shareholder is to protect the interests of minority shareholders and to bring a measure of objectivity to the assessment of bids. If, as was the case in *CW Shareholdings*, senior management in the target company is a member of the Special Committee, the purpose in setting up the Special Committee might be compromised and less reliance placed on its assessment of a particular bid than if the committee were truly independent.<sup>59</sup>

In most cases, therefore, it will be desirable not to have inside directors as members of the special committee, in order to avoid heightened scrutiny. However, including inside directors will not be fatal to the special committee's purpose, depending on what other precautions are taken. The question for the court is whether the members "felt at all times free to deal with the impugned transaction upon its merits."<sup>60</sup> The court will consider the background of the directors and the history of their relationship with dominant shareholders and senior management, including other business interests.<sup>61</sup>

### **A Special Committee Should Be Formed Early Enough to Have an Impact on the Process**

Given that one of the most important purposes of the special committee is to protect minority shareholder interests, a special committee should be formed early enough that it can retain independent legal and financial advisors and investigate and effectively consider the circumstances and potential alternatives. In *WIC Western*, Justice Blair described these important functions as follows:

Retaining independent legal and financial advisors, and the establishment of independent or special directors' committees to

<sup>59</sup> *Ibid.* at 195.

<sup>60</sup> *Brant Investments Ltd. v. KeepRite Inc.* (1987), 60 O.R. (2d) 737 (H.C.J.) at 756 aff'd (1991), 3 O.R. (3d) 289 (C.A.) per Weiler J.A. at 313.

<sup>61</sup> *Greenlight Capital Inc. v. Stronach* (2006), 22 B.L.R. (4th) 11 (S.C.J.) per Ground J., at 28 to 30.

assess and respond to the hostile bid, are the classic mechanisms to which boards of directors have traditionally resorted in order to cope with their difficult duties and conflicting position ... Resort to these devices enables the directors to investigate and consider the circumstances – including the triggering bid, and the various alternatives available to the corporation in respect of it, having regard to the interests of the shareholders – with a degree of independence. In the end, they must make a decision and exercise their judgment in an informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable grounds for believing that their actions will promote and maximize shareholder value ....<sup>62</sup>

The further along the process of identifying and negotiating a transaction is before a special committee is formed, the more difficult it may be for the special committee to impact the outcome. One of the main criticisms of the board in *Netsmart* was that the special committee was not formed until the company was committed to a limited auction exclusively to private equity investors:

By acknowledging these incentives, I do not mean to imply in any way that Netsmart management or William Blair consciously pursued objectives at odds with getting the best price. Rather, I simply point out the reality that the Netsmart board rapidly narrowed its options to a channel consistent with those incentives. By the time the Special Committee began its work, the inertial energy of the sales process was already clearly directed at a private equity deal. The record evidence regarding the consideration of an active search for a strategic buyer is more indicative of an after-the-fact justification for a decision already made, than of a genuine and reasonably-informed evaluation of whether a targeted search might bear fruit.<sup>63</sup>

Had the special committee been formed early and retained independent financial advisors, there might have been early consideration as to whether that approach was prudent from the perspective of minority shareholders. The ultimate conclusion may have been the same but the deliberative process would have

reassured the Court that the directors were entitled to the application of the business judgment rule. Early formation of a special committee does not mean that it is necessary in a particular case to meet continuously. However, in order for a special committee to fulfill its purpose, it should meet at important junctures in the sale process to consider whether there are alternatives that should be explored.

### **The Presence of Management or Other Non-Independent Persons During Deliberations of the Special Committee May Undermine Its Function**

In its decision cease trading the shareholders' rights plan in *WIC Western*, the OSC concluded that the special committee was set up for convenience only. The OSC doubted that the special committee could fulfill its purpose given the active participation of the CEO and the observer status of the dominant shareholder. Management involvement in special committee deliberations also caused Vice-Chancellor Strine a great deal of concern in *Netsmart*.<sup>64</sup>

In order to be effective, the special committee will require information from management and will want to consider the advice of management and the company's advisors. However, the presence of management and company advisors may be perceived to taint the deliberative process. Where management or other non-independent persons, such as management advisors, participate in the special committee's deliberations, it will be important to document that process carefully to dispel any suspicion that the board has struck a special committee as a matter of form only.

### **Conclusions**

Recent expressions of concern with respect to management's dealings with private equity firms are important reminders of the conflicts of interest that can arise, given the potential for management to continue to have a stake in the company following a public to private transaction with a private equity buyer. However, this article advances the argument that it would be incorrect to conclude that management's dealings with a private equity

<sup>62</sup> *WIC Western*, supra note 10 at 769.

<sup>63</sup> *Netsmart*, supra note 7 at 51.

<sup>64</sup> *Netsmart*, ibid. at 39.

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buyer should always be suspect or that the issues involved are substantially different from those in other types of transactions, such as a takeover bid by a strategic buyer. We argue that in the vast majority of cases, it is desirable to have management involvement in a public to private transaction with a private equity buyer for the same reasons that it is desirable that management identify and negotiate with a potential strategic buyer. However, what is required, for the same reasons as in a strategic takeover bid, is that management

fulfill their fiduciary obligations to the company by bringing opportunities to the board's attention at an early stage and before any discussion of management's ongoing role following a potential transaction. Boards should not hesitate in forming special committees to supervise management's discussions, and care should be taken to ensure that any such special committee is truly independent and, as a factual matter, operates independently in its deliberations.