



Canadian Securities Administrators Will Not Require Internal Control Audits

The Canadian Securities Administrators (“CSA”) have announced that they will not be proceeding with proposed Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* (“Proposed MI 52-111”).¹

Under Proposed MI 52-111, management of an issuer would have been required to evaluate the effectiveness of the issuer’s internal control over financial reporting against a suitable control framework. In addition, the issuer would have been required to file with securities regulatory authorities:

- a report of management on its assessment of the effectiveness of the issuer’s internal control over financial reporting, including a statement as to whether the issuer’s internal control over financial reporting was effective; and
- a report of the issuer’s auditor prepared in accordance with the CICA’s auditing standard for internal control audit engagements.²

The CSA is now proposing to expand National Instrument 52-109 *Certification of Disclosure in Issuers’ Annual and Interim Filings* (“NI 52-109”) to include additional annual certifications (the “Proposed Certifications”) by an issuer’s CEO and CFO (or persons performing similar functions) that (i) they have evaluated the effectiveness of the issuer’s internal control over financial reporting as of the end of the issuer’s financial year and (ii) caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year based on such evaluation.

The Proposed Certifications will mirror the certifications CEOs and CFOs have been required to file for financial years ending after March 30, 2005 regarding disclosure controls and procedures, and will be required for all reporting issuers (including issuers listed on the TSX Venture Exchange) other than investment funds. It is currently contemplated that the Proposed Certifications will apply for financial years ending on or after December 31, 2007.

The Proposed Certifications will not affect the current

¹ CSA Notice 52-313, March 10, 2006

² Proposed MI 52-111 was substantially similar to Section 404 of the *Sarbanes-Oxley Act of 2002* (the “Sox 404 Rules”). The CSA has decided not to implement Proposed MI 52-111 “after extensive review and consultation and in view of the delays and the debate underway in the US over the rules implementing [the Sox 404 Rules].”

requirements of NI 52-109. In that regard, for financial years ending after June 29, 2006, an issuer’s CEO and CFO will be required to acknowledge that, in addition to being responsible for establishing and maintaining disclosure controls and procedures (and making certifications with respect to the design and effectiveness of those controls and procedures), they are also responsible for establishing and maintaining the issuer’s internal control over financial reporting and that they have:

- designed such internal control over financial reporting, or caused it to be designed, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer’s GAAP; and
- caused the issuer to disclose in its annual and interim MD&A any change in the issuer’s internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the issuer’s internal control over financial reporting.

Canadian Securities Administrators’ Audit Committee Compliance Review

Early this year, the CSA announced the results of its review of compliance with Multilateral Instrument 52-110 *Audit Committees* (“MI 52-110”).³

The review, using a nationwide sample of 95 issuers, focused on compliance by issuers with the requirements prescribed by MI 52-110 relating to audit committee composition and responsibilities.

With respect to audit committee charters, it was found that only 64% of the charters reviewed set out the audit committee responsibilities prescribed by MI 52-110.

The CSA staff notice regarding the MI 52-110 review concluded as follows:

“In our view, the level of compliance by issuers with the provisions of [MI 52-110] was unacceptable. We were particularly concerned to learn that even the largest issuers, exempt TSX issuers, were not fully compliant.

We expect issuers to fully comply with [MI 52-110].

We intend to conduct additional reviews of compliance by issuers with [MI 52-110] in the

³ CSA Notice 52-312, January 13, 2006

near future. We will actively follow up on deficiencies identified in those reviews and will pursue appropriate remedies where we deem it appropriate.”

Issuers should take careful notice of CSA Notice 52-312 because unlike the recommended corporate governance guidelines for boards, board committees and codes of conduct in National Policy 58-201 *Corporate Governance Guidelines* (“NP 58-201”), the requirements of MI 52-110 are mandatory. The OSC could, for example, utilize its broad powers under the *Securities Act* (Ontario) (the “OSA”) to mandate compliance with MI 52-110 and impose sanctions for any failure to do so.

The CSA review of issuer compliance with MI 52-110 could also be a harbinger of a much more broad review of the corporate governance practices of issuers by securities regulators. In particular, we would note that the OSA was recently amended to include, among other provisions, new section 121.3, “Governance of reporting issuers”. Pursuant to section 121.3, an issuer must comply with such requirements as may be prescribed with respect to the governance of issuers, including requirements relating to:

- the composition of the issuer’s board of directors and qualifications for membership on the board, including matters respecting the independence of directors;
- the establishment of specified types of committees of the board of directors, the mandate, functioning and responsibilities of each committee, the composition of each committee and the qualifications for membership on the committee;
- the establishment and enforcement of a code of business conduct and ethics applicable to its directors, officers, employees and persons or companies that are in a special relationship with the issuer, including the minimum requirements for such a code; and
- procedures to regulate conflicts of interest between the interests of the issuer and those of a director or officer of the issuer.

It is possible that a number of the corporate governance guidelines of NP 58-201 will at some stage, through OSA section 121.3, become mandatory for issuers.

Business Judgement Rule

Since the Supreme Court of Canada’s October 2004 decision in *Peoples Department Stores Inc. (Trustee of) v. Wise*, which affirmed the place of the “Business Judgement Rule” in Canadian law, the Business Judgement Rule has been considered and applied in a number of high profile court decisions. The Business Judgement Rule is important

to directors and officers of public and private businesses because it has been developed and applied by courts to protect those individuals from liability in connection with decisions made honestly, prudently, in good faith and on a reasonable, informed basis.

The Business Judgement Rule has been articulated as follows:

“The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board’s determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board’s decision. This formulation of deference to the decision of the Board is known as the ‘business judgement rule’.”⁴

“The Business Judgement Rule protects boards and directors from those that might second-guess their decisions. The court looks to see that the directors made a reasonable decision, not a perfect decision. This approach recognizes the autonomy and integrity of a corporation and the expertise of its directors. They are in the advantageous position of investigating and considering first-hand the circumstances that come before it and are in a far better position than a court to understand the affairs of the corporation and to guide its operation.

However, directors are only protected to the extent that their actions actually evidence their business judgement. The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions.”⁵

⁴ *MapleLeaf Foods Inc. v. Schneider Corp.* (1998)

⁵ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* (2002) (“*Repap*”). In *Repap*, a large compensation package for the chairman of the company was reportedly approved at a compensation committee meeting that lasted approximately five minutes and at a following board meeting where the compensation package was discussed for approximately 30 minutes. The trial evidence was unclear whether the directors reviewed the final version of the compensation agreement, but it was clear that the appointed compensation expert had not opined on the final agreement. The compensation package was set aside as a result of a shareholder oppression action.

A different result was reached in *In re The Walt Disney Company*

Recently, in *Kerr v. Danier Leather Inc.* (December 2005), the Ontario Court of Appeal held that the Business Judgement Rule made it appropriate to give deference to the views of an issuer's management as to the achievability of a forecast contained in a prospectus for an initial public offering.⁶ This decision may have significant implications for issuers if the *Danier* decision is interpreted by courts to mean that the Business Judgement Rule protects directors and officers in matters related to the issuer's continuous disclosure obligations, as well as in public offerings. If this is the case, potential liability under the new OSA secondary market civil liability rules⁷ may be mitigated if directors and officers can show they acted within a "range of reasonableness" when making decisions with respect to disclosure.

More recently, the Ontario Court of Appeal held in *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board* (January 2006) that the board of Ford Canada could not avail itself of the protection of the Business Judgement Rule in defence of an oppression action because the board had not given the required attention to the allegedly oppressive arrangement at issue, the transfer pricing system between Ford Canada and Ford US.

The scheduling of a shareholders meeting requested by a shareholder, taking into account the need for full disclosure and the clarification of important matters relevant to the shareholders meeting, was found to be properly left to the business judgement of the issuer's directors in *Paulson & Co. Inc. v. Algoma Steel Inc.* (January 2006).

The Business Judgement Rule was also cited in granting the final order approving a plan of arrangement in *Scion Capital v. Bolivar Gold Corp.* (February 2006).

It is important to note that *Peoples* balanced the protection provided by the Business Judgement Rule to directors and officers in two important ways. First, the decision extended

Derivative Litigation (2005) because the judge found that the plaintiffs had failed to demonstrate that the directors had acted in a "grossly negligent manner or that they had failed to inform themselves of all material information reasonably available when making a decision" and that the directors "did not intentionally shirk or ignore their duty, but acted in good faith, believing they were acting in the best interests of the Company."

⁶ *Danier* is also important because it confirms that issuers will not be subject to liability under the OSA if they fail to disclose a "material fact" arising after the date of a final prospectus but prior to the closing of the offering of securities under that prospectus, as long as that material fact does not amount to a "material change". A material fact is defined in the OSA to mean a fact that would reasonably be expected to have a significant effect on the market price or value of a security. A "material change" is defined to mean a change in the business, operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer.

⁷ For a description of these rules, see Wildeboer Dellelce LLP Securities Law Update, Sept. 2005 (available at www.wildlaw.ca/docs/sep05.pdf).

the potential range of beneficiaries for whom directors and officers owe a statutory "duty of care".⁸ In *Peoples*, the court said it was "obvious" that the beneficiaries of this duty included creditors. If creditors are beneficiaries of the duty, it is equally "obvious" that shareholders must be as well. It has long been assumed that directors and officers owe their duty of care solely to the corporation. Second, the court prescribed a standard of care which is objective; traditionally at common law, this standard was subjective, reflective of the individual's particular capabilities. In the words of the court: "To say that the standard is objective makes it clear that the factual circumstances surrounding the actions of the director or officer are important in the case of the ... duty of care, as opposed to the subjective motivation of the director or officer..."⁹ In articulating the duty of care for directors and officers with these important clarifications, the court has balanced the role of the Business Judgement Rule with the possibilities of the statutory oppression remedy.

Board Special Committees

The utilization of a special (or independent) committee of a board of directors has long been accepted as a method for the proper exercise of a board's responsibilities. OSC Rule 61-501 *Insider Bids, Issuer bids, Business Combination and Related Party Transactions* ("OSC Rule 61-501") recognizes the use of such committees in certain circumstances.¹⁰ In its simplest iteration, a special committee is an *ad hoc* committee of directors formed to make recommendations to the board in regard to a particular matter, each director member of the committee being free of a conflict of interest with respect to the matter.

⁸ Both the *Canada Business Corporations Act* and the *Business Corporations Act (Ontario)* express the duty of care as the exercise of "care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".

⁹ The Ontario Securities Commission cited an objective standard of review for each director based on the director's knowledge and background in *YBM Magnex International Inc. (Re)* (2003).

¹⁰ Part 6 of the Companion Policy to OSC Rule 61-501 includes the following:

"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."

A case early this year from Delaware, *In Re Tele-Communications Inc.* (January 2006), has given guidance concerning important issues involved in the proper functioning of special committees. The case involved a class action regarding the merger of AT&T with Tele-Communications Inc. ("TCI"). Holders of multiple voting shares ("B Shares") received 10% more for their shares than the holders of non multiple voting shares ("A Shares") under the merger. Other than the number of votes entitled for each share, the attributes of the A Shares and B Shares were the same. The B Shares were primarily held by certain board members. The TCI board established a special committee of two directors (one of whom held a significant number of B Shares) in connection with the merger. Holders of A Shares brought a class action alleging breaches of fiduciary duties by the directors of TCI. The defendant directors brought a motion to dismiss the claim.

In refusing to dismiss certain claims at a preliminary stage and allowing those claims to proceed to trial, the court identified certain issues with respect to the operation of the TCI special committee, including:¹¹

- The non disclosure of and nature of the compensation to the two directors on the committee: "... the uncertain, contingent, and potentially large nature of the payments, without any objective benchmarks or other measures, could have given [the directors] additional undisclosed financial interests in the transaction that might have affected their judgements. Compensation of Special Committee members that is contingent, ambiguous, or otherwise uncertain raises a triable issue of material fact as to what each member anticipated in the event the Special Committee approved the transaction, and whether such anticipated reward was significant to the reasonable shareholder."
- The insufficient diligence the committee performed in accepting the premium of the price of the B Shares over that of the A Shares, the committee having inadequately informed itself of relevant precedent transactions.
- The mandate of the committee being differently understood by each member, which caused "a structural flaw that fissured throughout the process that followed."
- The "ambiguous or misunderstood" mandate of the committee probabing causing "a choice of directors not ideally aligned" with the holders of A Shares.
- The failure by the committee to engage its own legal and financial advisors, instead using those already advising TCI: "This alone raises questions regarding the quality and independence of the counsel and advice received."

- The appropriateness of the financial advisor's contingent compensation: "A special committee does have an interest in bearing the upfront cost of an independent and objective financial advisor. A contingently paid and possibly interested financial advisor might be more convenient and cheaper absent a deal, but its potentially misguided recommendations could result in even higher costs to the special committee's shareholder constituency in the event a deal was consummated."

Although *Tele-Communications* is a Delaware case, Delaware corporate law often shapes Canadian corporate law and the issues examined in *Tele-Communications* are also relevant for Canadian boards.

Proxy Solicitation by Dissidents

The OSA requires that management send a form of proxy to voting security holders for use at a meeting of those security holders. The OSA also permits other persons or companies ("dissidents") to send proxies to voting security holders. Importantly, neither management nor dissidents may "solicit" proxies unless the proxy is accompanied by an information circular that contains prescribed, and detailed, information.

The proxy solicitation rules have favoured management because they have been broadly interpreted to apply to a range of communications to or among shareholders that might lead to the obtaining, withholding or revocation of proxies from shareholders. As a result, shareholder communications before shareholder meetings were required to be effected through the expensive and time-consuming medium of a dissident circular, unless undertaken in certain permitted and limited circumstances.

The *Canada Business Corporations Act* (the "CBCA") was amended in 2001 to clarify that the following activities do not constitute "solicitation", and therefore do not require the preparation of a dissident circular:

- A public announcement (such as a speech in a public forum or press release) by a shareholder of how the shareholder intends to vote at the shareholder meeting and the reasons for that decision.¹²
- A communication for the purposes of obtaining the number of shares required for a shareholder proposal.
- A communication, other than a solicitation by or on behalf of management, that is made to shareholders in any prescribed circumstances. An example of a

¹¹ Claims were allowed to proceed, despite the fact that 98.9% of the votes cast by TCI's shareholders were in favour of the merger.

¹²To illustrate, institutional investors issued press releases regarding their concerns with the Molson-Coors merger.

prescribed, or permitted circumstance, is when a shareholder communicates with other shareholders concerning the business and affairs of an issuer but does not accompany that communication with a proxy.¹³

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us at:

In its 2003 report, the Five Year Review Committee Reviewing the OSA (the "Committee") recommended changes to the solicitation rules in the OSA to bring the OSA in line with the CBCA. Recent amendments to the OSA appear to have begun the harmonization of these rules. The OSA has now been amended so that (i) the definition of "solicit" and "solicitation" does not include "such activities as may be prescribed in the regulations [to the OSA] and (ii) the requirement to provide an information circular does not apply, among other circumstances, to "any solicitation, otherwise than by or on behalf of the management of a reporting issuer, in such other circumstances as may be prescribed in the regulations [to the OSA]." ¹⁴ If the Committee's recommendations are followed, the regulation to the OSA will be amended to reflect the circumstances now identified in the CBCA which do not constitute proxy solicitation requiring the preparation of a dissident circular.

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There have been a number of proxy contests in the past two years, on matters ranging from the election of non-management nominated directors (Creo Inc., YMG Capital Management Inc., Environmental Management Solutions Inc., Wi-LAN Inc., AnorMED Inc.) to proposed corporate reorganizations (MI Developments Inc.) to opposition to mergers and acquisitions (Bolivar Gold Corp., IAMGold Corporation, Wheaton River Minerals Ltd.). The amendment of the OSA rules regarding the ability of shareholders to broadly communicate amongst themselves should add momentum to this shareholder activism.

¹³ The CBCA amendments were consistent with rules adopted by the US Securities and Exchange Commission in 1992 regarding proxy solicitation.

¹⁴ OSA, s. 84 and s. 86 (2) (a.1)