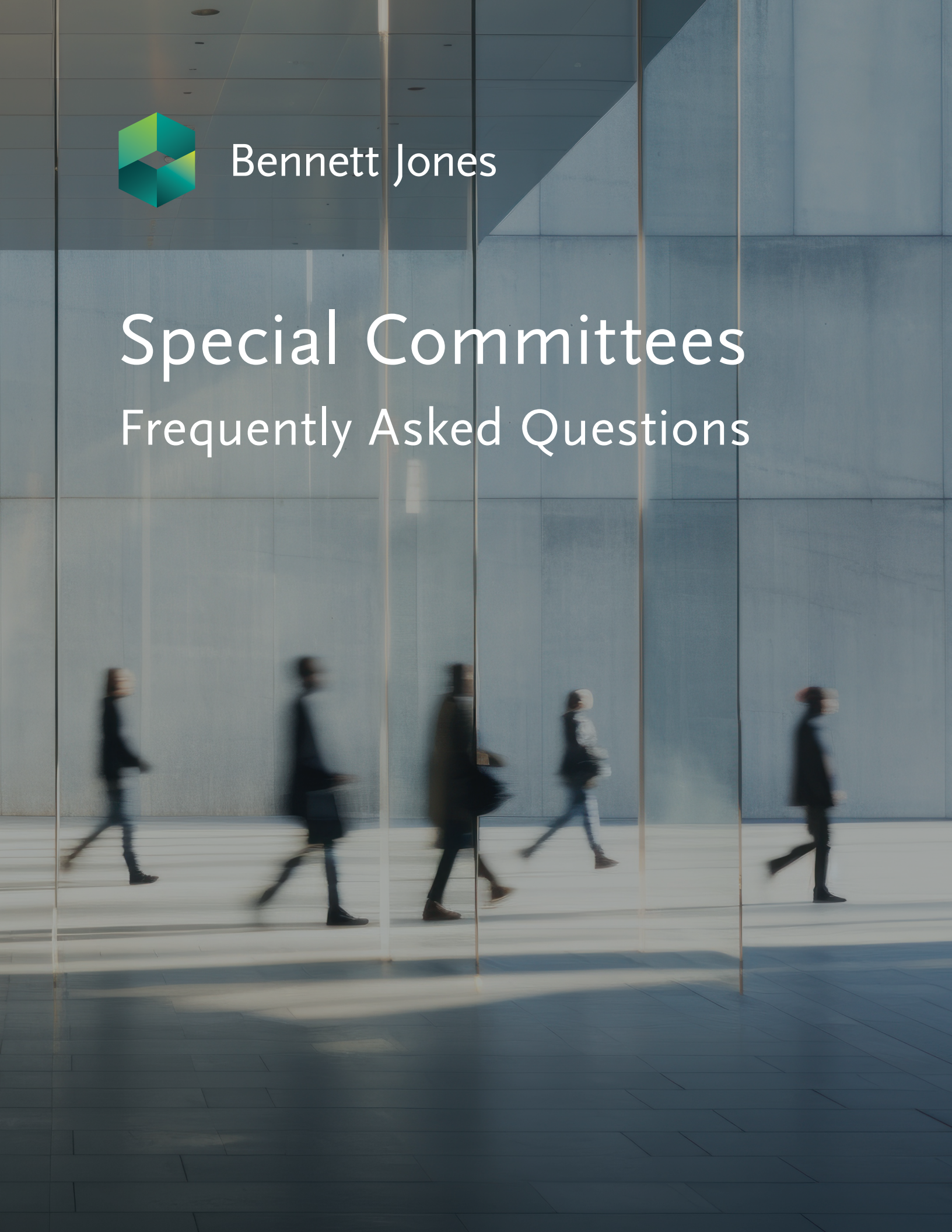

Bennett Jones

Special Committees

Frequently Asked Questions

Bennett Jones

Introduction

Special committees have evolved as a key corporate governance mechanism to assist boards of directors in discharging their fiduciary duties. Applicable securities laws mandate the use of special committees in connection with certain transactions and recommend the use of special committees for other transactions. Although the special committee mechanism is well known, corporations and directors often have limited exposure to transactions or investigations involving special committees. This guide addresses some of the frequently asked initial questions about special committees, their formation and administration.

It is critical to obtain legal advice early and before a special committee is formed. Although the initial stages of a transaction or an investigation may appear routine or straightforward, regulators or other stakeholders may test this perception, including through litigation. The initial decisions made by the board in establishing its process for reviewing a transaction or conducting an investigation may ultimately prove to be the most critical.

Please contact any member of the Bennett Jones Mergers & Acquisitions or Corporate Governance teams for assistance with forming or advising a special committee.

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A. Purpose and Formation

1.What is the role of a special committee and when should a board appoint a special committee?

A special committee is established by a board of directors to review the merits of a specific transaction or corporate governance issue. A special committee is sometimes called an ad hoc committee because it exists for a specific function and for a limited duration, unlike the standing committees of the board (e.g., an audit committee or a governance committee).

The most common reason for forming a special committee is to address situations where there is an actual or perceived conflict of interest between the corporation and specific stakeholders such as management or a significant shareholder.

Canadian corporate law allows boards to create committees with certain delegated powers. In some cases, forming a special committee is a legal requirement, such as insider bids, where a special committee must supervise the preparation of a formal valuation. Otherwise, forming a special committee is not usually a legal requirement but often represents good corporate governance and an effective means of insulating the board from one avenue of critique.

Special committees have been formed in the following situations:

- to review performance issues with management where independence is required;
- to supervise internal investigations addressing sensitive employment matters or potential or actual breaches of corporate and securities legislation;
- to lead investigations and make recommendations on potential litigation matters or to lead the corporation's response to external investigations; and
- in change of control transactions where there may be an actual or perceived conflict of interest, to ensure that directors satisfy their duty to act in the best interests of the corporation.

The role of a special committee is typically to guard against conflicts of interest by providing an objective and unbiased assessment of a transaction or other corporate governance issue and sharing its recommendations with the board.

If a special committee is formed in response to a potential material conflict of interest, it is preferable that the special committee is formed as soon as possible after the potential conflict is identified. Delays may lead to enhanced scrutiny from courts, regulators, other stakeholders and the public.

Canadian securities regulators have said that using a special committee is advisable for issuer bids, related party transactions and business combinations involving a material conflict of interest.[1] That said, if only a few directors are conflicted, the creation of a special committee may be unnecessary because conflicted directors can recuse themselves and the matter can be considered by the remaining members of the board, often under the leadership of an independent chair or lead director.[2]

The establishment of a special committee has cost implications to consider. Special committee members are compensated for their time, and a special committee is generally allocated a budget to retain professional advisors. See FAQ No. 20, "*How are members of a special committee typically compensated*?" below.

2. How should a special committee be composed?

A special committee should consist of directors who are independent and do not have a conflict of interest. Special committee members must not have a material interest in the outcome of a transaction or resolution of a governance issue and must not have any relationship which might compromise, or reasonably be perceived to compromise, the independence of the special committee or its ability to make an independent assessment. For transactions involving insider bids or related party transactions, directors serving on the special committee must also be independent of the director or shareholder proposing the transaction.[3]

In selecting special committee members, the expertise and experience of potential members should be considered. It is beneficial to have a mix of expertise and experience in the relevant area. Another key consideration is each member's ability to devote the necessary time to the special committee, as the work of a special committee may be significant. Other key considerations include the date the special committee is expected to present its final report to the board, the anticipated frequency and duration of special committee meetings, and the number of experts the special committee is likely to consult. Special committee members should also know that the committee's mandate may evolve or expand in response to ongoing developments.

All board discussions about the formation and composition of a special committee should be well documented to protect the board from criticism at a later stage. Boards should also consider obtaining legal advice in connection with forming a special committee to ensure the board has appropriately discharged its fiduciary duties.

One member of the special committee will typically be appointed as chair. The special committee chair may be appointed by the board of directors or by the special committee itself. When greater independence is required, it is advisable for the special committee to select its own chair rather than having the board make the selection. This ensures that the chair is not selected to advance a particular agenda or by individuals on the board with a conflict of interest. Although a single-person committee is possible, a multi-member special committee is preferable.

It has become common for boards to form special committees in connection with potential change of control transactions. In these cases, the board should consider conflicts of interest arising from the involvement of senior management. In *CW Shareholdings*[4], faced with a hostile takeover bid, the target procured a superior bid that was given deal protections including a break fee and an asset lockup. The original bidder challenged the superior bid in the courts. In challenging the superior bid, the original bidder noted that the Chief Executive Officer (CEO) was a member of the special committee of the target and was charged with the responsibility of leading its activities, including negotiating with third parties.

While the court in *CW Shareholdings* ultimately concluded that the directors had not breached their duties in procuring the superior bid and maximizing value, it stated that the CEO should not have been a member of the special committee, nor should the CEO have led the special committee's activities, including leading negotiations with third parties. The court noted that less reliance would be placed on the determinations of an improperly composed and structured special committee.

3. What criteria define independence?

Independence is fact-specific and depends on the relationships between directors, management, shareholders and other stakeholders of a corporation. Independence is essential for directors serving on a special committee and may be scrutinized by courts and regulators. The ultimate question is whether a committee member can determine the merits of the transaction or decision without being affected by a collateral interest or a relationship with a conflicted stakeholder. A director is not independent if they have a relationship that could, in the view of the board, be reasonably expected to interfere with the exercise of a member's independent judgment.[5]

Securities laws relating to audit committees and corporate governance list certain relationships where a director is not considered independent. These rules do not expressly apply to special committees, but it is common practice to apply these standards in considering the composition of a special committee. For example, a director who is or has been an employee or executive officer of the corporation over the previous three years, or whose immediate family member is or has been an employee or executive officer of the corporation over the previous three years, is not independent.[6]

In the context of issuer bids, insider bids, related party transactions and business combinations, Canadian securities law clarifies when a director will not be considered independent. A director is not independent if:[7]

- the director is an "interested party" in the transaction;
- the director is or has been an employee of an "interested party" over the previous 12 months;
- the director has acted as an advisor of an "interested party" over the previous 12 months;
- the director has a material financial interest in an "interested party"; or
- the director would reasonably be expected to receive a benefit as a result of the transaction that is not available on a *pro rata* basis to other security holders, including, without limitation, the opportunity to receive a financial interest in an "interested party", its affiliate, the corporation or any successor to the business of the corporation.

The definition of "interested party" is detailed and technical, but generally covers situations in which the director is related to a counterparty or is reasonably expected to receive a material benefit as a result of the closing of the transaction that is not received by the other shareholders of the corporation on a *pro rata* basis.[8]

Independence from management is often necessary but may not be the sole criterion for determining whether a committee member is independent depending on the nature of the committee and its mandate. In *YBM Magnex*[9] a securities regulator criticized the composition of an investigative committee because of the role of one committee member as both committee chair and an executive of the corporation's underwriter. The regulator found that the director's role as an executive of the corporation's underwriter ultimately compromised his independence.

Independence is ultimately assessed on a case-by-case basis. Courts have recognized that a standard of perfection is not required.[10] Mere allegations that directors are friendly with, travel in the same social circles or have a past business relationship with a counterparty are not enough to establish a lack of independence.[11] On the other hand, courts have held that close personal or business relationships (such as a 50-year friendship between management and a director) are enough to raise a reasonable doubt about independence.[12]

4. What steps should be taken if a special committee member becomes conflicted after being appointed to a special committee?

Any change affecting the independence or perceived independence of a committee member should be disclosed to the other members of the special committee as soon as possible. Depending on the type of conflict and role of the committee member, the steps to remedy the situation will vary. The resignation of the conflicted committee member should be considered. Discussions about a potential conflict should be well documented in the meeting minutes of the special committee to protect it from subsequent criticism.

5. How should a board establish a special committee?

A special committee should be established through a written mandate approved by the board. The scope and content of the mandate are important because the mandate determines the powers of the special committee and provides the benchmark against which it will be judged. The board must ensure that the mandate is sufficiently broad in terms of scope and powers to allow the committee to fulfill its function. The mandate should also allow for flexibility to account for unexpected needs and developments.

In general, a special committee mandate should address:[13]

- the purpose of the special committee;
- the responsibilities of the special committee and any ability to delegate these responsibilities;
- the authority to hire and compensate professional advisors, and obtain any required valuations or fairness opinions;
- the parameters for negotiation and/or communication with affected parties, including the authority to negotiate (or oversee the negotiation) of the terms of a transaction, the ability (and limits on the ability) to commit the board and the corporation, and control over public disclosure;

- the right of the special committee to access corporate records and confidential information and the ability to provide access to or control access by others to corporate records and confidential information;
- the terms of access to management and ability to direct management to assist the special committee;
- the expected product or decision, including whether the special committee is to make a recommendation to the board or make a final determination;
- special committee procedures and administrative support, such as record keeping, including the ability to keep its proceedings and records confidential;
- designation of the special committee chair;
- compensation of special committee members; and
- if appropriate, timelines and an objective measure to determine when the work of the special committee is complete.

The effectiveness of the special committee may be impaired if the mandate of the special committee is too restricted. For example, courts and regulators have criticized mandates that limit a special committee to considering proposals developed by management or a major shareholder.[14] The special committee mandate should not present the special committee with a *fait accompli*.

When there is a conflict of interest involving management or a major shareholder (such as a management buy-out, related party transaction or insider bid), a special committee should view itself as a bargaining agent for the other stakeholders. This authority should also be reflected in the special committee's mandate. Canadian securities regulators suggest that mandates for transactions involving a conflict of interest should authorize the special committee to:[15]

- either negotiate or supervise the negotiation of a proposed transaction, rather than simply review and consider it;
- consider alternatives to the proposed transaction, including maintaining the status quo or seeking other transactions that would enhance value;
- make a recommendation about the proposed transaction or give detailed reasons for why no recommendation is made; and
- hire independent legal and financial advisors without involvement or interference by other interested parties or their representatives.

Companies should resist the temptation to simply implement a standard form special committee mandate. While such templates exist, a mandate should be tailored to the circumstance at hand. In addition, the special committee's mandate is likely to be scrutinized if any litigation arises in connection with a challenge to the special committee's recommendation or the transaction.

Please contact any member of the Bennett Jones Mergers & Acquisitions or Corporate Governance teams for assistance in the formation of a special committee and the development of a tailored mandate.

6. How does a special committee help the board discharge its duties?

There are two main duties owed by directors.

First, directors owe a duty of loyalty to the corporation.[16] This duty requires directors to act honestly and in good faith and to avoid conflicts of interest.[17] Directors cannot profit at the expense of the corporation or reveal information learned in their capacity as directors.[18]

Second, directors have a duty to exercise the care, diligence, and skill of a reasonably prudent person in comparable circumstances.[19] To satisfy this duty, directors must be informed of all relevant facts before making decisions that affect the corporation. Directors must consider the reasonable expectations of stakeholders and the effect of potential decisions on them.[20] Directors owe their duties to the corporation rather than any individual stakeholder or group. Unlike in the United States, there is no general rule that directors must prioritize the interests of certain stakeholders (e.g., shareholders) above others.

The formation of a special committee helps directors to discharge their duties because it provides an independent and impartial review of all relevant facts relating to a transaction or decision. The advice of

a special committee can help the board to make an informed decision. A special committee can also help to avoid or manage conflicts of interest.

If a decision of the board is challenged, courts and regulators accord a high level of deference to business decisions taken in good faith that are reasonable, informed, and free from conflicts of interest.[21] This is known as the business judgment rule. To determine whether the business judgment rule applies, courts and regulators closely examine the process undertaken by the board to reach its decision. The establishment of a special committee provides a procedural safeguard in transactions involving real or perceived conflicts of interest and is one of the factors that courts will assess in determining whether the directors have exercised appropriate business judgment.

The board must retain a level of supervision over the activities of the special committee. This requires supervising, but not seeking to influence or interfere with, the operation of the special committee. This is generally achieved by having the special committee periodically provide updates on its activities to the board.

When the special committee concludes its mandate, it is appropriate for the special committee to prepare and present a report to the board. See "*16. How should the special committee report to the board?*" below.

7. When should a special committee engage professional advisors, and how should they be selected?

To better understand the implications of a decision, a special committee may engage professional advisors whether financial, legal, business or industry-specific. Professional and expert advice helps a special committee to discharge its mandate and increases the likelihood that the business judgment rule will apply to a final decision. Directors may rely in good faith on advice from experts such as accountants, lawyers, engineers or appraisers.[22] This helps ensure that the special committee and the board are properly informed.

The number and type of experts retained and the timing of their engagement depends on the circumstances. Generally, it is better to engage professional advisors early on in the process to ensure they have sufficient time and access to information to carry out their engagement. As the primary function of a special committee is to help the board discharge its legal duties, it is prudent to engage legal counsel at the onset of the process. Recommendations from professional advisors should be documented to establish a strong basis for relying on their advice.

Professional advisors should be independent and impartial. Directors should ensure that professional advisors disclose any relationships that may inhibit their ability to be impartial before they are retained. Courts will assess the experience, qualifications, credibility and reputation of professional advisors to determine whether it was reasonable to rely on their advice.

Selection criteria for professional advisors mirrors the criteria for the selection of special committee members.[23] In assessing independence, consideration should be given to whether the professional advisor can reasonably be expected to determine the merits of the issue without being influenced by a relationship with a conflicted stakeholder. Regulators have made positive comments on the special committee process when it involved experienced independent counsel and valuators.[24] In contrast, the heavily criticized special committee in *Netsmart* obtained advice from a long-standing, non-independent, financial advisor.[25]

A special committee may interview several professional advisors but care should be taken to ensure that confidentiality is not compromised during the interview process.

Fairness opinions from financial advisors are often obtained by a special committee in the context of a change of control transaction. Although not legally required, these opinions are commonly relied on by directors to assess whether a proposed transaction is in the best interest of the corporation and to show that they have discharged their fiduciary duties. In recent years, courts and regulators have raised concerns about certain aspects of fairness opinions.[26] Fairness opinions are often prepared by a financial advisor who receives fees contingent upon the completion of the proposed transaction. There is a risk that such fees may create an incentive for the financial advisor to recommend a transaction without exercising independent judgment.

There is ongoing debate among courts, regulators and professional advisors about the appropriate structure of compensation arrangements for fairness opinions. Some courts and regulators have suggested that it is preferable for a fairness opinion to be prepared by a financial advisor who only receives a fixed fee that does not depend on completion of the proposed transaction. Success fees are not prohibited, but committee members must ensure that compensation arrangements do not impact the impartiality of professional advisors.

Special committees should consider retaining a financial advisor on a fixed fee based, where the compensation received by the advisor does not depend on the successful completion of the transaction. This approach is particularly prudent in connection with a transaction that is perceived as contentious or is likely to attract significant scrutiny.

Securities regulators recommend that when a fairness opinion is obtained in a change of control transaction, the following information should be in the information circular provided to securityholders:[27]

- the structure of compensation arrangements, including whether the financial advisor is being paid a flat fee, a fee contingent on the delivery of the final opinion or a fee contingent upon the successful completion of the transaction;
- how the special committee considered compensation arrangements with the financial advisor when evaluating the fairness opinion;
- any relationship or arrangement between the financial advisor and the corporation or an interested party that could affect the independence of the financial advisor;
- a clear summary of the methodology, information and analysis (including financial metrics) underlying the fairness opinion that is sufficient to enable securityholders to understand the basis for the opinion; and
- the relevance and weight of the fairness opinion to the special committee in making its final decision or recommendation.

A special committee should consider whether to retain independent legal counsel. Depending on the circumstances, it may be appropriate for a special committee to rely on in-house counsel or the corporation's regular external counsel. That said, special committees are often formed to address conflicts of interest involving management or significant shareholders. If certain directors or management are conflicted, then it may be advisable for the special committee to obtain independent legal counsel, or for management or the significant shareholders to do so.

8. Is the establishment of a special committee or its activities required to be publicly disclosed?

In general, the existence and mandate of a special committee are not required to be publicly disclosed at the outset of the special committee process, although the answer is fact-dependent. Later in the process, securities law may require extensive disclosure of the special committee and its process. In the context of public M&A, securities law requires disclosure of the recommendations of the special committee and the risks and factors considered by the special committee in the information circular distributed to securityholders. A record of all materials considered by the special committee and minutes of all meetings should be created as a matter of good corporate governance and to assist with any potential disclosure requirements.

Issuer bids, insider bids, related party transactions and business combinations are subject to review by securities regulators. This review is generally triggered by the filing of a disclosure document relating to the proposed transaction. Regulators and applicable stock exchanges may review the proposed transaction and related disclosure for public interest concerns and compliance with securities laws. This review will focus on the following matters:[28]

- compliance with enhanced disclosure requirements that enable securityholders to make an informed decision;
- compliance with formal valuation requirements or with the conditions for exemptions from a formal valuation;
- minority approval requirements, including whether the corporation has excluded all parties that are not properly part of the minority; and

- the process conducted by the board and special committee.

The regulator's objective is to identify and resolve any issues prior to securityholder approval or the completion of the proposed transaction. If there are issues, a court or regulator may order a remedy that includes additional disclosure. An applicable stock exchange may also require additional disclosure as a condition of listing approval.

Apart from disclosure requirements, a special committee and board should consider strategic reasons in support of or against disclosing the existence of a special committee. On one hand, disclosure may reassure shareholders and other stakeholders that the matter is being independently assessed. On the other, disclosure could result in public criticism and lead to adverse reactions from employees, customers or other stakeholders.[29]

Disclosure of the compensation paid to directors is required in the annual filings of publicly traded companies, including any compensation paid to members of special committees. Legal counsel can assist with strategies for managing the confidentiality and timing of special committee fee disclosure.

B. Responsibilities and Liability

9. What are the duties of a member of a special committee?

Members of a special committee are generally subject to the same duties as other directors. Special committee members have a duty to act honestly and in good faith with a view to the best interests of the corporation.[30] Members will be judged against the level of skill and diligence that a reasonably prudent person would exercise in comparable circumstances. To satisfy these duties, special committee members must exercise independent judgment and should not use their position for personal gain. All information surrounding the special committee's activities should be kept confidential until members have agreed to disclose the information. Members of a special committee have a duty to avoid conflicts of interest. Any conflicts should be disclosed and discussions about conflicts should be recorded in the special committee.

10. Who bears the responsibility for a special committee's decisions?

Each member of the special committee must satisfy his or her duties as a director and is responsible for the recommendations and decisions of the special committee (unless he or she voted against a particular recommendation or decision).

The board generally retains responsibility for making a final decision after considering the recommendations of the special committee. The board may rely on the advice of the special committee as long as adequate systems and procedures were in place to ensure the special committee made an independent and informed recommendation.

11. Does a director assume new liability by serving on a special committee?

A director who serves on a special committee is subject to the same duties as other directors. That said, the actions of special committee members are likely to be scrutinized more closely by courts, regulators and other stakeholders, especially in the context of high-profile transactions or investigations.

Special committee members are required to exercise the care, diligence and skill of a reasonably prudent person in comparable circumstances. In general, a higher standard of care, diligence and skill will be expected from special committee members than from directors who are not serving on the special committee. All the same, directors who serve on a special committee will be protected by the business judgment rule if the special committee is duly established, independent and adheres to a reasonable process to evaluate relevant facts and consider the interests of affected stakeholders.

Directors who serve on a special committee may be subject to an increased risk of scrutiny from shareholders. For example, shareholders may alter their votes at subsequent annual meetings based on their views about the performance and recommendations of special committee members.

12. How can members of a special committee protect themselves against personal liability?

To protect against personal liability, special committee members should make sure they understand and carefully discharge their duties as directors. Special committee members should consider retaining independent professional advisors, as appropriate, and take time to consider the interests of all affected stakeholders. Procedures should be implemented to manage conflicts of interest. The special committee should be given sufficient autonomy and adequate resources to allow it to independently complete its objectives.

Special committee members should review the insurance policy the corporation offers to directors. Special committee members should confirm that their service on the special committee is covered by the insurance policy and, in particular, whether non-arm's length transactions (such as insider bids or related party transactions) are covered. If there are limits to the coverage offered by the corporation's insurance policy, special committee members may purchase additional insurance. Special committee members should also ensure that applicable indemnities that do not currently exist in favour of the corporation's directors are included in the special committee's mandate. If members of the special committee are directors of a subsidiary corporation, they should ensure that the parent corporation provides indemnification as well.

In connection with a change of control transaction, the special committee may also consider whether the definitive agreement should contain provisions to ensure that appropriate run-off insurance coverage is obtained and to limit the purchaser's ability to restrict or weaken indemnification arrangements in favour of the directors after closing.

C. Process Considerations

13. What steps can a special committee take to ensure the integrity of its process

The independence of special committee members is paramount to ensuring the integrity of the special committee process. Special committee members should be free from actual and potential conflicts of interest. Any conflicts issues should be brought to the attention of the special committee chair as soon as possible. To ensure independence and autonomy, the mandate of the special committee should provide the committee with control over its own processes including calling meetings, communicating with management and retaining professional advisors. The mandate of the special committee should be sufficiently broad and allocate adequate time and resources to allow the special committee to carry out its function in a meaningful way.

A special committee should meet regularly and prepare a record of all meetings. Minutes should be reviewed and approved after all meetings. The minutes should be clear and evidence informed and thorough discussions as the minutes may be scrutinized at a later stage should the special committee's process or recommendations be challenged. Minutes should document the advice provided by professional advisors and remain confidential until the special committee has reported to the board. Although some meetings will inevitably have non-committee members present (e.g., professional advisors or management), the special committee should ensure that it regularly meets independently and reserves a portion of each meeting for an *in camera* session.

The special committee should ensure that it has a detailed understanding of the relevant issues. The special committee should identify all stakeholders

affected by the decision and assess each stakeholder's reasonable expectations. The reasonable expectations of stakeholders depend on several factors, including, but not limited to, general commercial practice, the nature of the corporation, representations and agreements, actions that stakeholders could have taken to protect their interests, and the past practices of the corporation.[31]

It can be advantageous for special committees to retain professional advice to better understand the legal, business and financial implications of the matter at hand. The special committee should also communicate with management and the board to obtain institutional knowledge. Depending on the circumstances, the special committee may recommend that the corporation reach out to certain stakeholders.

Ultimately, the special committee needs to conduct itself in a manner that can withstand scrutiny. The special committee should examine all available alternatives, document its process, including the views of all stakeholders consulted, and the reasons for its final recommendation.

14. What is the relationship between a special committee, the board and management?

The board retains a general supervisory role over the affairs of the corporation and makes the final decision. The board cannot relinquish its duties by creating a special committee and must stay informed of relevant facts and alternatives before making a final decision. It is advisable for the special committee to share periodic updates with the board. Regular briefings should be given to the entire board rather than individual directors. Directors who are not on the special committee should be encouraged to share key information with the special committee.

Management has detailed knowledge of the daily operations of the corporation and is ultimately accountable to the board. The special committee should consult management to gain knowledge and perspective. Doing so requires striking a balance between preserving the special committee's independence and ensuring the special committee has access to the information it needs to make an informed recommendation.

In a review of strategic alternatives, auctions or change of control transactions, stakeholders may perceive management to favour a particular proposal or bidder because it increases the likelihood that members of management will maintain their roles with the corporation. Special committees need to guard against these potential or perceived conflicts. Input and participation by management are acceptable as long as the special committee remains in control of its process and is not directed by management. To ensure this occurs, a portion of each special committee meeting should occur without management present. When a special committee has been appointed to oversee a proposed transaction, management and directors who are not members of the special committee should not communicate with bidders without advance approval by the special committee

15. What are some examples of special committee processes that have been challenged?

Courts and securities regulators have been critical of management's presence or influence over special committees in several cases.

In *Magna*, management took the lead in negotiating a transaction with the controlling shareholder to unwind a dual class share structure. The transaction was presented to the special committee on a "take it or leave it" basis. The securities commission found that negotiations should have been supervised by the special committee from the outset, with management taking direction from the special committee.

Other pitfalls to avoid include:

- In *Netsmart*, management directed a due diligence process involving various private equity firms and negotiated with bidders without special committee oversight.
- In *Dole*,[32] the controlling shareholder and management interfered with the special committee by trying to restrict its mandate to negotiating with a particular bidder rather than considering other options. Management in *Dole* pushed the special committee to retain a financial advisor with a long-standing relationship with the CEO and arranged for

a due diligence session without informing the special committee.

- In *InterOil*, the court found that the special committee was passive and merely received reports on behalf of management who led the negotiations. The CEO stood to realize significant compensation through the change of control provision in his employment contract and the acceleration of his restricted share units. This conflict and the failure of the special committee to take a more active role in negotiations led the court to cast doubt on the independence of the special committee.

The key conclusion from the above cases is that while it is appropriate for management to be involved in a strategic process, including bidder negotiations, such involvement should take place under the supervision and direction of a special committee (on behalf of and reporting to the board) or another suitable representative, such as an independent member of the board.[33] Independent supervision should extend to determining which bidders participate in the process, the terms of their participation, and the oversight of negotiations with potential bidders, including inducements or deal protections.

16. How should the special committee report to the board?

A special committee should establish a system of interim reporting to assist the board in discharging its duty to supervise the special committee. The reporting protocol should be discussed at the outset and be set out in the mandate of the special committee. The frequency and nature of reporting will depend on the special committee's mandate.

Once the special committee has completed its work, it should provide a final report to the board. This report should include these elements:

- an overview of the mandate of the special committee;
- the steps and process followed by the special committee to discharge its mandate;
- the alternatives considered by the special committee and the strengths and weaknesses of each alternative;
- a summary of any professional advice received by the special committee;
- the recommendations of the special committee;
- the reasons for the recommendations of the special committee;
- risk factors and uncertainties considered by the special committee;
- copies of any formal opinions received by the special committee; and
- any qualifications or dissenting opinions from the recommendations of the special committee.

In some cases, it may be appropriate for the special committee to deliver a formal written report to the board. In other cases, the special committee's report can be delivered orally and reflected in the minutes of the board. The form of report will depend on the mandate of the special committee. In either case, directors should remember that the special committee's report may be subject to disclosure and judicial scrutiny if the board's decision is challenged.

17. Are communications between a special committee and its professional advisors protected against disclosure to third parties?

The extent of protection against disclosure to third parties depends on the type of professional advisor and the purpose of the advice. All communications between a client and legal counsel to obtain legal services and advice are protected by solicitor-client privilege. These communications are protected from disclosure and are not producible if a claim is brought by a third party. This protection ensures that clients can have honest conversations with their legal counsel and obtain the best advice.

Solicitor-client privilege may be waived by the client. Generally, the corporation is the client. The corporation, as represented by the board, has the power to waive solicitor-client privilege. Individual directors or board committees do not.

Communications with other professional advisors (such as accountants, investment bankers and engineers) are not generally protected by privilege. That said, solicitor-

client privilege may extend to communications involving other non-legal professional advisors when they help legal counsel provide advice. For this principle to apply, there must be a direct link between the advice of the non-legal professional advisor and the information that legal counsel required to provide legal advice.

Any communication or information compiled for the purpose of anticipated or active litigation is protected by litigation privilege. This type of privilege is more limited as it expires with the lawsuit and applies only against other parties in the litigation. Communications prepared to settle a legal dispute are also privileged.

18. Can a special committee's reports and conclusions be disclosed to third parties?

Reports prepared by a special committee should be kept confidential, at least until the end of the special committee's mandate. Special committee reports should not be shared with third parties other than as needed with the board, management and professional advisors.

Reports prepared by a special committee and communications between directors are generally not protected by privilege and are subject to discovery by third parties in litigation. That said, portions of a report which include legal opinions or advice are protected by solicitor-client privilege. If a report includes sensitive legal advice, the board should isolate and redact the legal advice to ensure that privileged information is not inadvertently waived if the board decides to disclose the report.

19. What is the board's role in reviewing the recommendations of the special committee?

The board cannot blindly rely on the recommendations of a special committee. Directors should ensure that they understand the recommendations and the reasons prepared by the special committee before following its advice. Directors should ask questions and review the facts and assumptions underlying the recommendations of the special committee. In general, if the board acts on the recommendations of the special committee, the business judgment rule will apply, as long as the special committee was independent and provided an informed and reasonable recommendation.

When the special committee is independent and has followed appropriate procedures, the board should be careful about making a decision that contradicts the special committee's recommendation. This is especially important if the special committee obtained professional advice. If applicable, the board's reasons for declining to follow the special committee's recommendations should be well supported and documented.

20. How are members of a special committee typically compensated?

The method and amount of compensation of committee members should be set out when the special committee is established.[34] Care should be taken to ensure that compensation does not affect, nor is perceived to affect, the independence or incentives of special committee members. Special committee members should not receive compensation that depends on the success of a proposed transaction or the committee making a particular finding.[35]

There are two primary methods of compensating committee members.

The first approach is a flat fee, such as a monthly retainer amount. The chair usually receives more compensation to reflect his or her added responsibilities.

The second approach is a per meeting fee, often based on the attendance fee paid to directors and committee chairs at regular board meetings.

Compensation arrangements are often structured as a hybrid of the above approaches, with special committee members receiving a retainer and per meeting fees.

Special committee compensation arrangements should reflect, as nearly as possible, the scope of the responsibilities of the special committee, including the expected number of meetings, the time commitment required of each special committee member and the importance and difficulty of the matters that the special committee has been tasked with considering.

In some cases, the mandate of the special committee may authorize the board to consider an increase in the committee's compensation at a later date should the committee's workload and responsibilities exceed the level that was originally anticipated.

Compensation should not be excessive compared to existing board compensation or management compensation. In determining the appropriate level of compensation, the amount paid to members of the audit committee is a helpful point of comparison.

The corporation should also reimburse special committee members for reasonable expenses incurred in connection with serving on the special committee.

For more information about special committee compensation, including market data, please contact any member of the Bennett Jones Mergers & Acquisitions or Corporate Governance teams.

21. Are nominee directors subject to different duties or special considerations?

Directors who are nominated or appointed by a significant shareholder are known as nominee directors. Public companies with a significant shareholder (such as an active investor or controlling family) will often have nominee directors. In many cases, the nominating shareholder will view the nominee director as its representative on the board.

Canadian corporate law seldom distinguishes between the duties of nominee directors and other directors.[36] All directors owe their duties to the corporation as a whole rather than the individual stakeholders responsible for their appointment. As a result, nominee directors cannot simply follow instructions from their nominating shareholder or put the interests of their nominating shareholder above all other considerations. Nominee directors must exercise independent judgment and consider the interests and reasonable expectations of all stakeholders.[37] A nominee director has an obligation to act in the best interests of the corporation, even if such action is not in the best interests of its nominating shareholder.

Although a nominating shareholder may regard a nominee director as its "eyes and ears" on the board, nominee directors are subject to a duty of confidentiality over information about the corporation they acquire in their capacity as a director. Nominee directors may not share confidential information with their nominating shareholder unless one of the following is in place:

- an express agreement (which can be oral) allowing the disclosure;
- an implied term in the ordinary course of business (e.g., sharing information with third parties as part of an M&A process); or
- an established custom.[38]

If a nominating shareholder wants access to confidential information, a written agreement that specifically permits the requested disclosure should be established between the nominating shareholder and the corporation. A nominating shareholder should also consider the potential impact of receiving confidential information. For example, access to undisclosed material information may restrict the nominating shareholder's ability to trade securities due to insider trading rules.

Like all directors, nominee directors must disclose to the corporation any business opportunities that come to their attention. Nominee directors must also disclose to the corporation any activities of the nominating shareholder which may affect an important aspect of the corporation's business, even if such disclosure conflicts with other duties owed by the nominee director to its nominating shareholder.[39] Given the potential issues that can arise around nominee directors, a nominating shareholder should carefully select the appropriate person to serve on a board and put in place procedures to mitigate conflicts.

Notes

1. Companion Policy 61-101CP to MI 61-101 ("CP 61-101"), s. 6.1(6); Multilateral CSA Staff Notice 61-302 – Staff Review and Commentary on Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions ("CSA Staff Notice 61-302").
2. *12178711 Canada Inc. v Wilks Brothers, LLC*, 2020 ABCA 430 at 53-56, leave to appeal to SCC refused, 2020 ABCA 438 ("*Calfrac*").
3. CP 61-101, s. 6.1(7).
4. *CW Shareholdings Inc. v WIC Western International Communications Inc.* (1998), 39 OR (3d) 755 (Ont Gen Div) ("*CW Shareholdings*").
5. National Instrument 52-110 – Audit Committees ("NI 52-110"), s. 1.4(2).
6. NI 52-110, s. 1.4(3).
7. MI 61-101, s. 7.1; MI 61-101CP, s. 6.1.
8. See MI 61-101, s. 1.1.
9. *Re YBM Magnex International Inc (2003)*, 26 OSCB 5285 ("*YBM Magnex*").
10. *Gazit (1997) Inc. v Centrefund Realty Corp.* (2000), 8 BLR (3d) 81 (Ont SCJ).
11. *In re MFW Shareholder Litigation*, CA No 6566-CS (2013) 67 A 3d 496 (Del Ch May 29, 2013).
12. *Delaware County Employees Retirement Fund v Sanchez*, 2015 WL 5766264 (Del Supr).
13. Barry Reiter, Directors' Duties in Canada, 7th ed (Toronto: LexisNexis Canada Inc, 2021) at §13.15.
14. *Re Magna International Inc.* (June 24, 2010), online: OSC https://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20110131_magna.pdf ("*Magna*"); *Pente Investments Management Ltd v Schneider Corp*, [1988] OJ No 4142, 42 OR (3d) 177, 44 BLR (2d) 115 (Ont CA) ("*Pente*").
15. Multilateral CSA Staff Notice 61-302 Staff Review and Commentary on Multilateral Instrument 61-101 *Protection of Minority Security Holders in Special Transactions* ("CSA Staff Notice 61-302").
16. ABCA, s. 122(1)(a); CBCA, s. 122(1)(a); OBCA, s. 134(1)(a); Business Corporations Act (British Columbia) ("BCBCA"), s. 142(1)(a).
17. *BCE Inc v 1976 Debentureholders*, [2008] 3 SCR 560 ("*BCE*").

18. *Canadian Aero Service Ltd v O'Malley*, [1973] SCJ No 97, [1974] SCR 592.

19. ABCA, s. 122(1)(b); CBCA, s. 122(1)(b); OBCA, s. 134(1)(b); BCBCA, s. 142(1)(b).

20. *BCE*.

21. *BCE*; *Pente* at para 36.

22. ABCA, s. 123(3); CBCA, s. 123(4); OBCA, s. 135(4); BCBCA, s. 157(2).

23. Reiter at §13.30.

24. *Re Sterling Centrecorp Inc.*(2007), 30 OSCB 6683.

25. *Re Netsmart Technologies, Inc Shareholders Litigation*, 924 A.2d 171 (Del Ch 2007) ("*Netsmart*").

26. *Re HudBay Minerals Inc* (2009), 32 OSCB 3733; *InterOil Corporation v Mulacek*, 2016 YKCA 14 ("*InterOil*").

27. CSA Staff Notice 61-302.

28. *Ibid*.

29. Reiter at §13.26.

30. CBCA, s. 122(1); *BCE*.

31. *BCE*.

32. *In re Dole Food Co, Inc Shareholder Litigation*, CA No 8701-VCL, 2015 WL 5052214 (Del Ch August 17, 2015) ("*Dole*").

33. *Calfrac*.

34. CP 61-101, s. 6.1(8).

35. MI 61-101, s. 7.1(3); CP 61-101, s. 6.1(8).

36. The exception is section 122(4) of the ABCA, which allows a nominee director to give special (but not exclusive) consideration to the interests of its nominating shareholder if the director is elected by the holders of a particular class or series of shares. This exception does not apply to Alberta corporations that have only one class of shares.

37. *Deluce Holdings Inc v Air Canada (1992)*, 12 OR (3d) 131 (Gen Div).

38. Reiter at §4.13.

39. *PWA Corp v Gemini Group Automated Distribution Systems Inc (1993)*, 103 DLR (4th) 609 (Ont CA).

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