

Corporate Securities

SEPTEMBER 16, 2002

The Repap Decision: The Importance of Process to the Business Judgment Rule

The “business judgment rule” has long stood for the proposition that courts should not seek to second-guess the business decisions of directors, who are assumed to be in a better position to understand the business of the corporation and to guide its affairs. The limits of this protection of corporate decision-making have been explored in a decision of the Ontario Superior Court of Justice.

Background

The decision in *UPM-Kymmene Corporation v. UPM-Kymmene Miramichi Inc.* was recently released. In that decision, Madame Justice Lax set aside an employment contract between a successor corporation to Repap Enterprises Ltd. (“Repap”) and Steven Berg, Repap’s former Senior Executive Officer and the Chairman of its board of directors.

Repap was a listed, Canadian forest products company. In 1999, Steven Berg, an American lawyer and businessman, introduced Repap to an U.S.-based investment fund, which subsequently became Repap’s largest shareholder. Concurrently with the fund’s investment, Berg was made a director of Repap and Chairman of its board of directors. Shortly after his appointment, Berg sought to become Repap’s “Senior Executive Officer” and entered into an employment agreement with Repap. The evidence in the trial suggested that Repap did not require a Senior Executive Officer and, even if it had, that Berg was not the appropriate candidate. Nevertheless, the proposed employment agreement with Berg provided for generous payments, benefits and perquisites, including a five-year employment term with renewals, a signing bonus of 25 million Repap shares, a stock option for an additional 75 million shares, a market capitalization bonus, immediate pension credit of eight years, executive employee benefits and liberal change of control and termination provisions.

The proposed compensation package was considered at two meetings of Repap’s board of directors. At the first meeting, the contract was “contentious” and was not approved. The directors determined to retain an independent executive compensation consultant to provide advice and instructed the Compensation Committee to consider the matter further and report back to the board. Following the first meeting, two directors (one of them being the Chairman of the Compensation Committee) resigned.

By the time of the second meeting, two new directors recruited by Berg had joined the Repap board. At the meeting, the board of directors approved Berg’s employment agreement, relying in part on the advice provided by the independent consultant on the day of the meeting. The board was not made aware that the consultant had not been permitted to conduct the research, benchmarking or other analysis that would typically be undertaken. Moreover, neither the independent consultant nor the new members of the Compensation Committee were made aware that the agreement had met with resistance at the first directors’ meeting, that the Chair of the Compensation Committee had resigned or that management of Repap was opposed to the agreement and questioned its propriety.

The Decision

In rescinding the contract, the Court held that Berg had breached his fiduciary duty to Repap as a result of the manner in which he negotiated

THE UPDATE

and presented his agreement for approval. The court also held that the board of directors had breached its duty of care by failing to make its decision on an informed and reasoned basis.

The Court found that Berg had breached his duty on two grounds. First, he had failed to fully inform the board of directors, including with respect to management's disapproval of the agreement and the shortcomings of the independent opinion. Additionally, Berg had failed to act honestly and in good faith with a view to the best interests of the corporation. Here, the Court relied on Berg's failure to implement a reasonable process for independent review of the agreement, as well as his request for "types and amounts of compensation that he knew or ought to have known were not in the best interests of Repap...".

The Court also found that the directors of Repap had breached their duty of care by not having made any of the inquiries or investigations that would have enabled them to engage in a proper analysis of the matter and form a reasonable judgment about whether to approve the agreement. The court then considered whether the business judgment rule applied to shield the board's decision from judicial scrutiny and intervention. The court acknowledged that, generally, deference should be given to decisions of a board of directors in recognition of the autonomy of a corporation and the expertise of its directors. However, the Court clearly stated that this should be the case only to the extent that directors are scrupulous and demonstrate diligence in arriving at their decisions. In the present case, the court found that the conduct of the Repap directors (including their failure to establish a proper process for independent review of the agreement, their failure to review the consultant's advice properly and their failure to ask questions of Berg, the consultant and management of Repap) fell short of this standard.

Implications

Courts generally afford, and likely are to continue to afford, corporate directors a significant degree of deference. However, the Repap decision reaffirms that this protection will not apply where directors, in exercising their decision-making power, fail to act diligently and on an informed and reasoned basis. Decisions that are made in such circumstances will continue to be susceptible to judicial interference. Accordingly, boards of directors should ensure that they have appropriate

processes to ensure that, in deciding matters that affect the welfare of stakeholders, they have the information, resources and time necessary to properly evaluate alternatives and reach informed conclusions.

We invite you to contact any member of the Goodmans securities team to discuss your corporate governance policies and procedures.

Toronto

Allan Goodman 416.597.4243

agoodman@goodmans.ca

Stephen Halperin 416.597.4115

shalperin@goodmans.ca

Tim Heeney 416.597.4195

theeney@goodmans.ca

Jonathan Lampe 416.597.4128

jlampe@goodmans.ca

Dale Lastman 416.597.4129

dlastman@goodmans.ca

David Matlow 416.597.4147

dmatlow@goodmans.ca

Neill May 416.597.4187

nmay@goodmans.ca

Stephen Pincus 416.597.4104

spincus@goodmans.ca

William Rosenfeld 416.597.4145

wrosenfeld@goodmans.ca

Neil Sheehy 416.597.4229

nsheehy@goodmans.ca

Jeffrey Singer 416.597.4283

jsinger@goodmans.ca

Kenneth Wiener 416.597.4106

kwiener@goodmans.ca

Vancouver

Paul Goldman 604.608.4550

pgoldman@goodmans.ca

Steven Robertson 604.608.4552

srobertson@goodmans.ca

Bruce Wright 604.608.4551

bwright@goodmans.ca

Hong Kong

Leo Seewald 852.2522.1061

lseewald@goodmans.ca