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Governance Issues for Municipalities and their LDCs

Robert B. Warren, WeirFoulds LLP
Daniel P. Ferguson, WeirFoulds LLP

A presentation for the Council for Clean and Reliable Electricity Conference
“To Own or Not to Own: Ownership and Governance Issues for Municipally-Owned Electricity Distribution Utilities”
Hilton Suites Conference Centre, Markham, Ontario
February 27, 2014



Overview

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- what is corporate governance
- why is it important
- what are the sources of governance obligations
- what are the unique elements of corporate governance for municipally-owned LDCs
- are the requirements of governance different for members of municipal council who are directors of an LDC
 - is there a potential conflict of interest
 - what is the nature of the conflict
 - how is it resolved
- how do governance obligations apply in making the decision to own, sell or merge an LDC



What is corporate governance

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““Corporate governance” means the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes insuring the financial viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The direction and management of the business should take into account the impact on other stakeholder such as employees, customer, suppliers and communities.”

- Toronto Stock Exchange Committee on Corporate Governance in Canada, Where Were the Directors? (Toronto: TSX, 1994) at 7.



What is corporate governance

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- matters of process and structure
examples:
 - ensuring board members have the requisite expertise
 - ensuring board members are independent
 - ensuring processes are in place to ensure compliance with law
- this presentation focuses primarily on the formal legal obligations of governance



Why is good governance important

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- protecting and advancing the best interests of the corporation and its stakeholders
- mitigating the risk of liability for corporate acts
 - derivative actions
 - sections 245-247 of the OBCA
 - oppression remedy
 - section 248 of the OBCA



Why is good governance important

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- mitigating the risk of personal liability for officers and directors
 - examples:
 - section 194 of the *Environmental Protection Act*
 - sections 81 and 82 of the *Employment Standards Act*
 - sections 25 and 26 of the *Occupational Health and Safety Act*
- mitigating the risk of OEB decisions reversing LDC decisions



Sources of governance obligations

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- A. Common law
 - Fiduciary obligations and conflict of interest
- B. Statutes
 - *Ontario Business Corporations Act*
- C. Constating and organizational documents of the Corporation
 - Articles, by-laws, shareholder agreements or directions
- D. Regulatory obligations unique to LDCs



Sources of governance obligations

A. Common law

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- fiduciary obligations of officers and directors
- must ensure corporation's interests are paramount
- conflicts of interest
 - historically, common law generally prohibited directors from doing business with the corporation that it served



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- bears repeating that the legislature requires all municipally-owned LDCs to be incorporated as OBCA corporations
 - they are not line departments of municipalities, required to be responsible to every request or direction from municipal councillors or staff
- statutes essentially codify the common law obligations



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- duty of loyalty and duty of care

S. 134(1) of the OBCA

Every director and officer of a corporation in exercising his or her powers and discharging his or her duties to the corporation shall,

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- what does the duty of loyalty entail
 - duty to avoid conflicts of interest
 - duty not to use director's position for personal gain
 - duty to serve the corporation selflessly, honestly and loyally
 - duty to exercise independent judgment



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

- BCE Decision in the SCC:

“Where conflicting interests arise, it falls to the directors of the corporation to resolve them in accordance with their fiduciary duty to act in the best interests of the corporation. The cases on oppression, taken as a whole, confirm that this duty comprehends a duty to treat individual stakeholders affected by corporate actions equitably and fairly. There are no absolute rules and no principle that one set of interests should prevail over another. In each case, the question is whether, in all the circumstances, the directors acted in the best interests of the corporation, having regard to all relevant considerations, including — but not confined to — the need to treat affected stakeholders in a fair manner, commensurate with the corporation’s duties as a responsible corporate citizen. Where it is impossible to please all stakeholders, it will be irrelevant that the directors rejected alternative transactions that were no more beneficial than the chosen one.”



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- duty to treat stakeholders affected by corporate actions equitably and fairly
- who are the stakeholders of the LDC
 - examples:
 - ratepayers
 - residents
 - local environment
 - employees of the LDC
 - debt holders



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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Conflicts of interest

S. 132(1) of the OBCA

A director or officer of a corporation who,

(a) is a party to a material contract or transaction or proposed material contract or transaction with the corporation; or

(b) is a director or an officer of, or has a material interest in, any person who is a party to a material contract or transaction or proposed material contract or transaction with the corporation,

shall disclose in writing to the corporation or request to have entered in the minutes of meetings of directors the nature and extent of his or her interest

- requires a director to have a pecuniary interest or a connection to a contracting party



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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Municipal Conflict of Interest Act

5. (1) Where a member, either on his or her own behalf or while acting for, by, with or through another, has any pecuniary interest, direct or indirect, in any matter and is present at a meeting of the council or local board at which the matter is the subject of consideration, the member,
- (a) shall, prior to any consideration of the matter at the meeting, disclose the interest and the general nature thereof;
 - (b) shall not take part in the discussion of, or vote on any question in respect of the matter; and
 - (c) shall not attempt in any way whether before, during or after the meeting to influence the voting on any such question

–requires a pecuniary interest, direct or indirect



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- what are the obligations of councillors to their municipality
 - section 224 of the *Municipal Act* lists the following obligations of council:
 - (a) to represent the public and to consider the well-being and interests of the municipality;
 - (b) to develop and evaluate the policies and programs of the municipality;
 - (c) to determine which services the municipality provides;
 - (d) to ensure that administrative policies, practices and procedures and controllership policies, practices and procedures are in place to implement the decisions of council;
 - (d.1) to ensure the accountability and transparency of the operations of the municipality, including the activities of the senior management of the municipality;
 - (e) to maintain the financial integrity of the municipality; and
 - (f) to carry out the duties of council under this or any other Act. 2001, c. 25



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- is there an inherent conflict of interest for municipal councillors who are also directors of the LDC
 - do their obligations to their municipality and to their LDC conflict



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- there is no conflict *per se* arising from the different roles of a member of council and a director of an LDC
 - section 132 of the OBCA is breached only if there is a pecuniary interest or a connection to a contracting party



Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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- the concern is with less obvious conflicts

example:

- council wants the LDC to move a transformer to accommodate municipal planning considerations, but doing so would add unnecessarily to the costs of the LDC



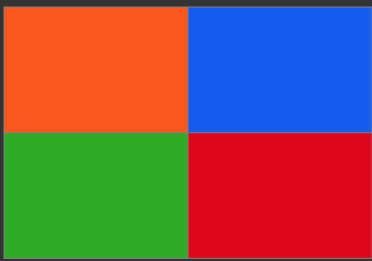
Sources of governance obligations

B. Statutes

Ontario *Business Corporations Act*

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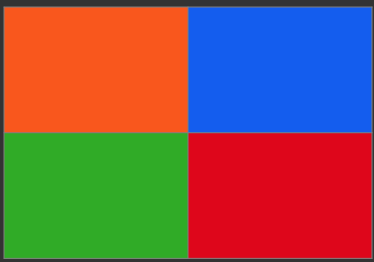
- how are such conflicts resolved
 - avoiding conflicts before they arise
 - respecting the different obligations of municipal councillors and the directors of the LDC
 - if conflicts cannot be resolved, the municipal councillor must not participate in the LDC's decision-making on the matter in issue



Sources of governance obligations

C. Constating and organizational documents of the LDC

- articles
- bylaws
- shareholder directions
 - Subsections 108(2) and (3) of the OBCA
 - (2) A written agreement among all the shareholders of a corporation or among all the shareholders and one or more persons who are not shareholders may restrict in whole or in part the powers of the directors to manage or supervise the management of the business and affairs of the corporation.
 - (3) Where a person who is the registered holder of all the issued shares of a corporation makes a written declaration that restricts in whole or in part the powers of the directors to manage or supervise the management of the business and affairs of a corporation, the declaration shall be deemed to be a unanimous shareholder agreement.




Sources of governance obligations

C. Constating and organizational documents of the LDC

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examples:

- OBCA provides that certain actions require shareholder approval
 - amalgamation
 - sale of all or substantially all of the assets or undertaking
- provisions taking away the power of the directors to hire a CEO or to enter into agreements above a specified threshold



Sources of governance obligations

C. Constatting and organizational documents of the LDC

- what is their effect in law
 - transfer to the shareholder the rights, powers, duties and liabilities that would otherwise lie on the directors
 - subsection 108(5) of the OBCA
- how do they affect the governance obligations of officers and directors
 - transfer the governance obligations to the shareholder
 - may do so in whole or in part



Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- LDC subject to requirements of *OEB Act* and *Electricity Act*
 - examples:
 - Section 29 of the *Electricity Act*
 - Section 78 of the *OEB Act*
 - requirements of OEB rules and orders
 - eg *Affiliate Relationships Code*
 - terms of distribution licence
 - decisions of the OEB

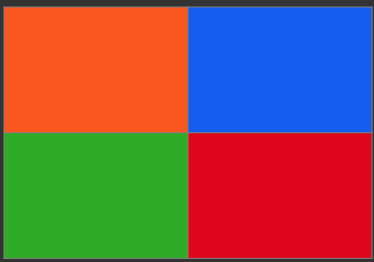


Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- “regulatory compact”
 - monopoly for the distribution of electricity
 - corresponding obligations
 - acting in the best interests of ratepayers
 - rate regulation



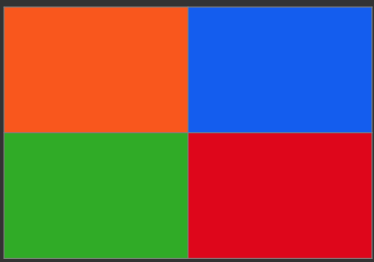
Sources of governance obligations

D. Regulatory obligations unique to LDCs

- the regulatory compact and its attendant obligations distinguish the LDC from other OBCA corporations

"[50] The principles that govern a regulated utility that operates as a monopoly differ from those that apply to private sector companies, which operate in a competitive market. The directors and officers of unregulated companies have a fiduciary obligation to act in the best interests of the company (which is often interpreted to mean in the best interests of the shareholders) while a regulated utility must operate in a manner that balances the interests of the utility's shareholders against those of its ratepayers. If a utility fails to operate in this way, it is incumbent on the OEB to intervene in order to strike this balance and protect the interests of the ratepayers."

Toronto Hydro-Electric System Limited v. Ontario (Energy Board), (2010) 99 O.R. 3d 481. at 484

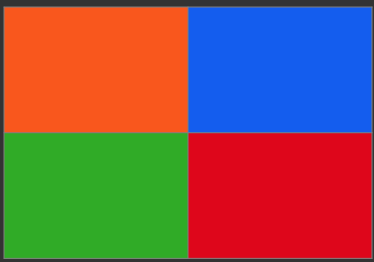


Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- the role of the OEB in regulating matters of good governance
 - imposes rules, codes, etc. ex ante
 - approves rates ex ante but based in part on an ex post review of LDC decision-making
 - approves transfers and mergers ex ante
- what is the effect of the OEB on the governance obligations of the directors and officers of LDCs
 - generally
 - with respect to mergers and acquisitions



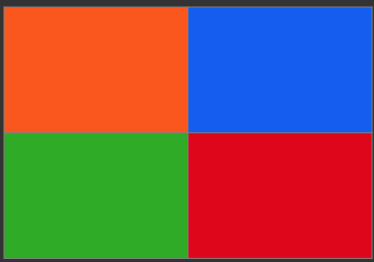
Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- “no harm test”¹
 - whether the transaction will have an adverse effect relative to the status quo in terms of the OEB’s statutory objectives
 - does not include a determination of whether another transaction, real or potential, can have a more positive effect than the one that has been negotiated to completion by the parties

¹ EB-2005-0234/0254/0257 (the “Combined Decision”) dated August 31, 2005

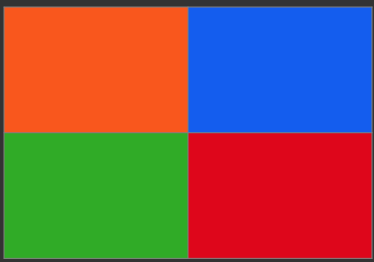


Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- “no harm test”
 - selling price relevant only if the price paid is so high as to create a financial burden on the acquiring company
 - whether future revenue requirements will unduly burden ratepayers
 - fact that purchase price too low is not relevant

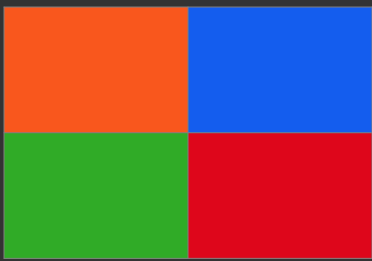


Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- “no harm test”
 - conduct of seller, including the extent of due diligence or degree of public consultation, not an issue for the OEB
 - no harm test is not a process test that addresses the rationale for or the process underlying the transaction
 - customers of LDCs and residents have rights under the OBCA



Sources of governance obligations

D. Regulatory obligations unique to LDCs

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- the role of the OEB's statutory objectives in the application of the "no harm test"

"1.(1) The Board, in carrying out its responsibilities under this or any other Act in relation to electricity, shall be guided by the following objectives:

1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service
2. To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry."



Governance and the decision to own, sell or merge the LDC

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- considerations
 - the LDC as a source of revenue for the municipality
 - an ongoing benefit to the shareholder and its residents
 - if continued ownership reflects inefficiencies that drive up rates, then the obligation to protect the interests of ratepayers may be breached by continuing to own



Governance and the decision to own, sell or merge the LDC

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- if a sale or merger would result in efficiencies that would improve service or reduce rates, it would be in the best interests of ratepayers
 - how is that balanced against the impact on the municipality and its residents of a loss of ongoing revenue



Governance and the decision to own, sell or merge the LDC

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- considerations where the price offered is above market value or book value of assets
 - benefit to shareholder and residents
 - does it benefit ratepayers if rates increase in the longer term
 - is public policy a relevant consideration
 - if so, in what way
 - example, impact on debt level of HONI



Governance and the decision to own, sell or merge the LDC

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- what financial and other calculations must the officers and directors make to support the decision to own, sell, or merge
- what is the relationship, if any, between the governance obligations and the role of the OEB
 - does the oversight role of the OEB affect the governance obligations with respect to acquisitions and mergers
 - do officers and directors have an obligation to consider factors beyond the limits of the “no harm test”



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WeirFoulds LLP
4100 – 66 Wellington Street West
PO Box 35, Toronto-Dominion Centre
Toronto, ON M5K 1B7
www.weirfoulds.com

Robert B. Warren
Phone: 416-947-5075
rwarren@weirfoulds.com

Daniel P. Ferguson
Phone: 416-947-5029
dferguson@weirfoulds.com