Corporate Governance for Municipally-Owned Local Electricity Distribution Utilities

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EXECUTIVE SUMMARY

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Local distribution electricity utilities ("**LDCs**") have been a source of stable and predictable income for their municipal owners. That is in large measure a result of the fact that LDCs are providing a monopoly service overseen by a regulator charged with the obligation, among other things, to ensure the stability of the LDCs.

One result of these circumstances is that municipalities have in many cases played a limited role in the governance of their LDCs. In addition, the directors of LDCs, including in some cases members of municipal councils, have likewise played a limited role in governance. They have elected, instead, to rely largely, if not entirely on the expertise of management. This is in part because of the complexity of the electricity distribution business, in part because the fact of regulatory oversight, and in part because the range of business decisions was limited by the absence of competitive pressures.

Several new factors are combining to make the focus on the governance of LDCs more important. Technological changes pose a potentially significant challenge to the traditional distribution model, creating the prospect of having to develop new business models with an attendant increase in business risk. At the same time, legislative changes expose LDC governance to regulatory oversight. Finally, the prospect of mergers and consolidations creates a new set of governance obligations and challenges, particularly in circumstances where municipalities, as a result of a merger or consolidation, hold only a minority interest in the LDC.

The governance obligations of directors are based, in the first instance, on compliance with the statutory obligations to act honestly and in good faith, with a view to the best interests of the corporation and to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Directors are obligated to serve a corporation selflessly, honestly and loyally, and to exercise independent judgment.

Directors are obligated to avoid conflicts of interest, which in most cases will involve circumstances where a director obtains, directly or indirectly, a monetary gain as a result of his or her decisions. However, municipal councillors may encounter circumstances where monetary gain is not at issue, but where there may be a conflict between his or her obligations to the municipal owner and his or her obligations to the LDC.

In the circumstances of a merger or consolidation, a municipality may go from being a majority, or sole, owner of the LDC to holding only a minority interest. To protect its interests in those circumstances, the municipality must first ensure that the transaction processes, including the transaction documents, are designed and structured in ways which protect its interests. Once

the transaction is completed, the resulting governance structure must include mechanisms, whether in the form of a unanimous shareholder's agreement or a shareholder declaration, that provide, to the extent possible, the municipality holding a minority interest with the appropriate degree of control or influence over, and awareness of, the operations of the LDC.

The governance challenges for directors, and for municipalities, most often arise in the following circumstances:

1. Resolving conflicts in the respective roles of a director as a member of the municipal council and of the board of directors of the LDC;

2. Determining whether, or to what extent, regulatory oversight relieves directors, and indeed municipalities, of their governance obligations;

3. Ensuring that the board of directors, and the governance structure, are properly equipped to deal with the challenges of an evolving distribution sector; and

4. Ensuring that the proper transaction governance mechanisms are in place in circumstances where, as a result of a merger or consolidation, a municipality holds only a minority interest in the LDC.

I Introduction

Several factors have recently converged to place an increased focus on the governance of municipally-owned local electricity distribution utilities. ("**LDCs**").

While there is a risk in generalizing, it has often been the case, particularly for smaller LDCs, that directors have played a largely passive role in the governance of LDCs. Several factors have contributed to that phenomenon. One is that electricity distribution is a highly technical operation, with the result that directors without specialized knowledge have deferred to the expertise of management. A second is that the business of LDCs, governed as it is by the seemingly opaque rules of regulatory economics, can reinforce the need to rely on the expertise of management. Finally, the fact that LDCs are regulated, something which has offered a substantial measure of stability to the business of the LDCs, has allowed many directors to adopt a "hands off" approach to the performance of director obligations. The directors of LDCs, and in particular, the municipal councillors who are directors, have in many cases been able to rely on a reasonably-predictable stream of income from LDCs without having to engage too deeply in the oversight of the LDCs.

A parallel, and related, phenomenon is that the municipal shareholders of LDCs in many instances have taken a passive, or non-interventionist, approach to the business and affairs of LDCs, for the same reasons. Staff and politicians at the municipal shareholder level, faced with the technical complexity of LDC operations, and secure in the knowledge that the regulator will both protect the interests of ratepayers and assure a predictable and steady stream of dividends, have in large measure left management to run the LDCs as they see fit.

One unfortunate result is that the management of LDCs have in some instances come to resent what they regard as intrusive oversight by municipal owners, and to resist the necessary changes in governance.

However, there is now the prospect of material changes in both the business and regulatory environments for LDCs, arising in part from the deployment of distributed energy resources, combined with increased consumer choice, both of which may threaten the stability of the traditional LDC business model. Pressure to adapt to those changes, which bring with them increased business risk, puts increasing pressure on LDCs to enlarge the scope of their businesses and adopt new business models, with increasing levels of risk. At the same time, recent amendments to the *Ontario Energy Board Act, 1998* ("**OEB Act**")[1] expose officers and directors to the risk of prosecution, or at least an increased measure of oversight and accountability, for the failure to adhere to governance obligations.

These factors, together with the encouragement of the provincial government, have prompted a number of municipalities to consolidate or merge with other LDCs to form larger LDCs. These

1 *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sched. B.

consolidations and mergers create new governance concerns, particularly as municipalities move from being the sole or majority shareholder to a minority position. The consequent changes in equity interests and dividend streams must be properly addressed, first in the merger transaction processes and documents, and then in the governance framework. The roles, responsibilities, rights, obligations and accountabilities among management, directors and shareholders, in the development of the documents effecting the merger/consolidation, and in the governance framework for the post-merger entity, must be carefully considered.

All of these developments prompt the need to review the governance practices of LDCs and, in particular, the governance obligations of their officers and directors. These developments also prompt the need to review the roles of municipal shareholders in the governance of the LDCs. Unless, and until, there are changes in the tax rules which currently limit private sector involvement in the electricity distribution sector, municipalities will remain the principal owners of LDCs.

In this paper we seek to accomplish three basic objectives, as follows:

1. To describe the basic governance obligations, and to a more limited extent, good governance practices, of the officers and directors of LDCs;

2. To examine how recent developments in the electricity sector and changes to the OEB Act may affect those obligations and practices; and

3. To examine governance roles and responsibilities of a municipal shareholder in the circumstances of a merger or consolidation, particularly where the shareholder holds a minority interest in a merged LDC.

To provide a practical focus for the discussion, we examine a number of circumstances where the issues of how to fulfil governance obligations are particularly complex. They include the following:

1. Resolving potential conflicts in the obligations of directors who are also members of municipal councils;

2. Balancing of the obligations of directors to their LDC, and to their shareholder municipality, and to the LDC's ratepayers;

3. Assessing the impact of regulatory oversight on the obligations of officers and directors;

4. Balancing the obligations of officers and directors, to the LDC and to the municipal shareholder, in the context of a possible sale of the LDC, or the purchase of another LDC;

5. Assessing the impact on officers and directors of recent changes to the OEB Act; and

6. Mitigating the risks, particularly for municipal shareholders, posed by potential consolidations and mergers.

Two qualifications should be placed on the discussion which follows. The first relates to a distinction between (1) governance obligations which are, by and large, legal in their nature and arise primarily from statutes, and (2) good governance practices. Adhering to the latter would include adhering to the former, primarily to mitigate any risk which the failure to follow legal obligations might entail, but would not be limited to following those obligations. The focus of much of the discussion in this paper is on governance obligations rather than governance practices and on identifying where and when appropriate governance practices need to be developed, rather than on attempting to prescribe specific governance practices.

The second qualification is that much of the focus of the discussion which follows is on private corporations. The governance obligations of publicly-traded corporations are more detailed, and more complex, than are the obligations for private corporations. That said, however, while the governance obligations and governance practices of publicly-traded corporations may not apply to private corporations, they can in many respects provide a useful guide to how officers and directors of private corporations, particularly LDCs, should conduct themselves.

In a private corporation, particularly one with only one shareholder, that shareholder can exercise a substantial measure of control. It can, for example, remove officers and directors who fail to perform their governance obligations. The irony is that many municipal shareholders of LDCs do not exercise that authority, and have played a limited role in the governance of the LDC.

Finally, and by way of an overview observation that should inform any consideration of governance, we note the following statement of the Supreme Court of Canada:

> The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care.[2]

[2] *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, 2004 SCC 68, at para 64 (“***Peoples***”).

II Governance Obligations

Corporate governance has been defined as follows:

> The processes and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes ensuring the financial viability of the business. 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 stakeholders, such as employees, customers, suppliers and communities.[3]

The focus of the discussion on governance is largely, and appropriately, on the roles of officers and directors. But the breadth of the definition cited in the previous paragraph is such that shareholders, particularly in closely-held corporations, play an essential role in establishing the governance framework and in overseeing its operation. As we will discuss below, the role of municipal shareholders comes into sharp focus in circumstances of a merger or consolidation.

The sources of governance obligations are, roughly speaking, twofold. They are, first, the obligations which exist at common law, and in corporate statutes. Second, they are the obligations which arise from a variety of other statutes, and in particular from the statutes which regulate LDCs.

a) Statutory and Fiduciary Obligations

1. The Ontario Business Corporations Act

At common law, the officers and directors of a corporation owe duties of loyalty and care to a corporation. Those duties have now been set out in corporate statutes, in the case of Ontario LDCs, in the *Ontario Business Corporations Act* ("**OBCA**").[4]

Subsection 115(1) of the OBCA provides that "Subject to any unanimous shareholder agreement, the directors shall manage or supervise the management of the business and affairs of a corporation".

Subsection 134(1) of the OBCA provides:

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

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3 Toronto Stock Exchange Committee, Report of the Toronto Stock Exchange Commission on Corporate Governance in Canada (Toronto, TSX, 1994) at 7.

4 *Business Corporations Act*, R.S.O. 1990, c. B.16.

> (a) act honestly and in good faith with a view to the best interests of the corporation; and
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> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Point (a) above is commonly referred to as the duty of loyalty. That duty includes the duty to avoid conflicts of interest, the duty not to use a director's position for personal gain, the duty to serve a corporation selflessly, honestly and loyally, and the duty to exercise independent judgement.

The Supreme Court of Canada, in the Peoples decision, described the content of the directors' fiduciary duty in the following words:

> The statutory fiduciary duty requires directors and officers to act honestly and in good faith vis-à-vis the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. Directors and officers must serve the corporation selflessly, honestly and loyally.[5]

As a general proposition, the courts will defer to decisions of directors if they can be seen as reasonable business decisions, ones that are based on a consideration of reasonable alternatives and reflect the application of an "appropriate degree of prudence and diligence"[6].

The decisions by officers and directors must be based on an assessment of the best interests of the corporation. At its most basic, the best interests of the corporation are economic interests, particularly the interests of the shareholders. But they may also include the interests of employees, suppliers, and consumers. They may also include broader societal concerns, for example, the impact of the corporation's activities on the environment.

Recent decisions of the Supreme Court of Canada have extended the obligations of officers and directors to the duty to treat stakeholders affected by corporate actions equitably and fairly[7]. For LDCs, those stakeholders would include, principally, ratepayers. One issue for the officers and directors of LDCs, which we will explore later in this paper, is how the duty of care to one of the

[5] Peoples, supra, at para 35.
[6] *Ibid.,* at para 67.
[7] See, for example, *Peoples* at para 42.

stakeholder groups, the ratepayers of the LDC, may be affected by the regulatory oversight of the Ontario Energy Board ("**OEB**").

Section 132 of the OBCA deals with conflicts of interests for officers and directors. Subsection 132(1) provides:

> A director or officer of a corporation who,
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> (a) is a party to a material contract or transaction or proposed material contract or transaction with the corporation; or
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> (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,
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> 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.

Subsection 132(5) provides that a director who has given that notice shall not attend any part of a meeting of directors during which the contract or transaction is discussed and shall not vote on any resolution to approve the contract or transaction, except in limited circumstances.

The striking feature of section 132 is that it contemplates a relatively narrow band of essentially pecuniary interests and not the kinds of conflicts that, for example, a member of municipal council who is also a director might encounter. This is a subject which we explore further in this paper.

Subsection 134(2) of the OBCA provides that "Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement".

Subsection 135(4) of the OBCA provides that a director has complied with his or her duties under subsection 134(2) if he or she has "exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances".

That subsection further provides, among other things, that the officer and director is entitled to rely in good faith on the report of "a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by any such person".

b) The Regulatory Statutes

In addition to the obligations imposed on officers and directors under the OBCA, there are obligations set out in a number of what might be described as regulatory statutes. They would include, for example, the *Occupational Health and Safety Act*[8], the *Employment Standards Act*[9], and the *Environmental Protection Act*[10]. There is a substantial body of law on how these obligations must be fulfilled, centred on the concept of "due diligence".

The court decisions on what constitutes "due diligence" for officers and directors indicate that they should, as a matter of good governance practices, and in order to mitigate these statutory risks which the corporation faces, do the following:

1. Be aware of the statutory obligations and risks which the corporation's activities may create if there is a breach of those obligations;

2. Be aware of the steps which the corporation must take to comply with those obligations;

3. Be advised immediately of any breaches of those obligations by the corporation;

4. Be advised immediately of how those breaches have been addressed;

5. Be aware of developing industry standards on best practices in fulfilling the statutory obligations; and

6. Require regular reports from management on the corporation's risk management and compliance practices.

LDCs are subject, in particular, to obligations imposed by the *Electricity Act, 1998*[11] and by the OEB Act. The *Electricity Act, 1998* requires LDCs to provide non-discriminatory access to distribution services, imposes an obligation to connect to any building that requires service, and imposes an obligation to sell electricity. The OEB Act authorizes the OEB to issue licences, codes and market rules, all of which must be complied with by the LDC. Of particular

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8 *Occupational Health and Safety Act*, R.S.O. 1990, c. O.1.

9 *Employment Standards Act, 2000*, S.O. 2000, c. 41.

10 *Environmental Protection Act*, R.S.O. 1990, c. E.19.

11 *Electricity Act, 1990*, S.O. 1998, c. 15, Sched. A, sections 26, 28 and 29.

importance are the provisions of the Affiliate Relationships Code, which sets out the rules governing the relationship between an LDC and its affiliates.

Complying with all of those various obligations is a matter of good corporate governance. In addition, the content of OEB policies, while not necessarily binding, and the content of OEB decisions on, for example, rate applications, are matters that officers and directors should be aware of and, if applicable, with which they should ensure the LDC complies.

In addition to complying with these obligations, LDCs must comply with an over-arching obligation arising from the so-called "regulatory compact". An LDC has a monopoly on the distribution of electricity in its licenced territory. In return for enjoying the benefits of that monopoly, the LDC must not only fulfill its statutory and regulatory obligations, it must act in the best interests of its ratepayers. The existence of the regulatory compact, and its attendant obligations, distinguish LDCs from other OBCA corporations. The difference was expressed, by the Ontario Court of Appeal, in the following terms:

> 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.[12]

That statement by the Ontario Court of Appeal suggests that the obligation of the officers and directors of an LDC, to balance the interests of its shareholders against those of its ratepayers, exists regardless of the role of the OEB. That said, however, the fact that the OEB has an obligation to "strike this balance and protect the interests of the ratepayers" raises the question of whether, or to what extent, the officers and directors may rely on the OEB to, in effect, fulfil their obligations in circumstances where they have failed to do so. This question is examined further below.

III Governance Practices

It is beyond the scope of this paper, and indeed beyond the scope of the expertise of its authors, to discuss in detail what are regarded as good governance practices. The literature on what constitutes good governance practices is large. In addition, there are training programs in corporate governance, for example, those offered by the Institute of Corporate Directors.

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[12] *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 ONCA 284 at para 50 ("**THESL Decision**").

We can identify what are now commonly-accepted measures of good governance practices. These would include the following:

1. The establishment of rigorous risk management policies and practices, together with a regular review to ensure that those policies and practices are consistent with best industry practices;

2. Appointment as directors people who have the skills and knowledge appropriate to the operation of an LDC and to the oversight functions of the board. The required expertise might include legal, accounting, financial, human resources, as well as regulatory and technical. This will be particularly important in the event that an LDC adopts, for example, a new business model entailing a greater degree of risk;

3. Appointment of independent directors, that is directors who have no financial interest in the LDC and who are not otherwise connected to the LDC or the municipal shareholder(s);

4. Implementing training programs for officers and directors, particularly training in the specific technical and economic characteristics of a regulated distribution utility;

5. Ensuring compliance with the particular regulatory obligations imposed by the *Electricity Act, 1998* and the OEB Act; and

6. Ensuring that officers and directors take continuing professional development programs.

Finally, and as noted above, good governance practices would include an awareness of all of the statutory obligations which the corporation and its directors must fulfill, as well as an awareness of how those obligations are being fulfilled, and how any breaches of those obligations have arisen, and how the breaches are being addressed.

IV Particular Issues

Discussions of the obligations of officers and directors, and of good governance practices, while important, can seem theoretical if taken out of the context of the lived experience of LDCs. In the sections below, we discuss governance obligations and practices in the context of a number of particular issues LDCs now face, or are likely to face, in the near future.

a) Challenges to the Traditional LDC Business Model

It is by now commonly understood, and widely discussed, that improvements in technology have, for the first time, put consumers, large and small, in the position of being able to reduce their reliance on the existing distribution system and, perhaps, leave that system altogether. This combination of technological change and consumer choice is often referred to as the "death spiral" for distribution utilities. Even if the most dire of the "death spiral" warnings do not materialize, these developments may well mean that it will no longer be possible for officers and directors to sit by, essentially passively, while the regulated entity produces a predictable stream of income for its municipal owners. These developments will also require the municipal shareholder to pay greater attention to the protection of its interests in the LDC.

There is a broad range of possible options for responding to this challenge to LDCs. It is beyond the scope of this paper to discuss the nature and extent of the challenges and about the possible responses to it. For purposes of this paper, the point is that these challenges may take LDCs out of their traditional "comfort zone" by requiring them to engage in new, and potentially more risky, forms of business. When that happens, the officers and directors of LDCs will have to pay even greater attention to their governance practices. That will include, among other things, ensuring that the officers and directors have the skills and training required to engage in, and benefit from, new forms of business activities.

The prospect of fundamental changes in the existing LDC business model is not theoretical. A number of the larger LDCs have already expanded the range of their business activities by, for example, engaging in joint ventures to develop smart grids. Recent amendments to the OEB Act, which will be discussed in detail below, give the OEB the power to authorize LDCs to engage in businesses other than the distribution of electricity. Those amendments will also eliminate the constraints on the nature of the businesses that LDC affiliates can engage in, something which also increases the risk, not just for the affiliates, but for the LDC itself.

b) Conflicts of Interest

As we discussed above, the provisions of the OBCA dealing with conflicts of interest are focused entirely on pecuniary concerns related to material contracts or transactions. In like fashion, the *Municipal Conflict of Interest Act*[13] provides that pecuniary interest, direct or indirect, acts as a bar to a councillor participating in a decision.

Municipal councillors have an obligation to act in the best interest of their municipality. It is possible to conceive of circumstances where this obligation to act in the best interests of a municipality would give rise to a non-pecuniary conflict with the obligation of the councillor who is a director of an LDC to act in the best interests of the LDC. Where, for example, a municipal councillor/director asks, on behalf of his or her constituents, that an LDC not build a transformer

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[13] *Municipal Conflict of Interest Act*, R.S.O. 1990, c. M.50, section 5.

or a sub-station in a particular neighbourhood, a decision which, if acted on would increase the LDC's costs, does that constitute a conflict of interest? Under the OBCA, and the *Municipal Conflict of Interest Act*, it would not. But it would seem, to a reasonably objective observer, to be a conflict of interest nonetheless. At the very least, it would appear to pose a challenge to the other duties owed by the director, for example, the duty to act in the best interests of the corporation, to be loyal, and to exercise independent judgment.

The types of non-pecuniary conflicts of interest we are referring to do not always have what might be described as a visible solution. They would not, for example, always, or even very often, involve a municipal councillor recusing himself or herself from voting on a decision which might affect the LDC. What is required, in these circumstances, is a sensitivity to the existence of conflict and a decision to take the steps necessary to avoid it.

c) The Impact on Governance of Regulation

Ours is a highly-regulated economy. Virtually all business operations must comply with some form of regulatory obligation. However, LDCs are subject to a greater degree of regulatory supervision, arising from the fact that they are monopolies providing an essential service. The essential components of an LDC's operations, including the range of businesses they may engage in, the rates they may charge, their return on equity, and their ability to sell their businesses, are subject to regulatory control. What this section of our paper discusses is the impact of that regulatory control on governance.

Earlier in this paper we referred to the statement of the Ontario Court of Appeal, in the THESL Decision, about the obligation of a regulated utility to operate in a manner that balances the interests of the utility shareholders against those of its ratepayers. That statement also refers to the obligation of the OEB to intervene in order the strike the balance and protect the interests of ratepayers. The question we want to explore now is whether, and if so to what extent, the role of the OEB may affect the way officers and directors carry out their governance obligations.

Two examples present themselves. The first relates to the rates which LDCs propose to charge their ratepayers. Included in the obligations of officers and directors is the obligation to have regard to the stakeholders of a corporation. Those stakeholders would include, in the case of LDCs, the ratepayers. Should the officers and directors try to ensure that rates are kept as low as possible, in the interests of ratepayers, even if doing so reduces the dividend payable by the LDC to the shareholder municipality? Or can officers and directors seek to maximize the revenue obtained from the LDC for the shareholder, secure in the knowledge that the OEB will protect the interests of ratepayers?

The second example is the case of a sale of the LDC. On the surface, the officers and directors should, in the interests of the shareholder, and in the interests of the residents of the municipality, seek to maximize the return they get for the sale. However, the circumstances of the purchaser, including the purchase price paid, may in the long term result in an increase in rates for the ratepayers of the seller. If, as the Supreme Court of Canada has indicated, the officers and directors of a corporation, in this case the selling LDC, must have regard to, among others, the stakeholders of the LDC, which would include its ratepayers, should they then ensure that the purchase price paid for the LDC is one that will not adversely affect ratepayers in the long term?

The answer to the question is complicated by the fact that the sale must be approved by the OEB. In doing so, the OEB will apply the so-called “no harm” test, one component of which is ensuring that the rates paid by the ratepayers of the selling LDC will be no higher than they were prior to the sale. Given that the OEB will be applying that test, is the obligation of the officers and directors of the selling LDC to have regard to the impact of the sale on its ratepayers relieved and, if so, to what extent?

We do not believe that the OEB’s regulatory oversight relieves officers and directors of their governance obligations. The officers and directors cannot make decisions which violate or ignore their governance obligations secure in the knowledge that the OEB will correct them. That said, fulfilling those governance obligations may well require officers and directors to challenge the nature and extent of that oversight, for example, where they believe that the OEB has exceeded its jurisdiction. At the same time, willfully ignoring the constraints imposed by that oversight might constitute a breach of governance obligations and not reflect good governance practices. The important thing is to be aware of the possible tension between good governance and regulatory oversight, and to be certain that that tension has been fully addressed and appropriately resolved in all governance activities.

d) The Impact on Governance of Changes to the OEB Act

Three recent amendments to the OEB Act have important implications for the governance of LDCs.

The first is the creation of a new provision, under the hearing “Duties of Officers and Directors of a Corporation”. The new provision is in section 125.2, and reads:

> Where a transmitter, distributor, retailer of electricity, gas marketer or unit sub-meter provider is a corporation, every director and officer of the corporation shall,
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> (a) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances; and
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> (b) take such measures as necessary to ensure that the corporation complies with all applicable requirements under this Act, the *Electricity Act, 1998* and the *Energy Consumer Protection Act, 2010*.

This new provision is something of an anomaly. To begin with, the obligations created by subsection (a) are identical to those set out in section 134 of the OBCA. However, unlike the

OBCA, the officers and directors of an LDC can be prosecuted for a breach of section 125.2 of the OEB Act. While the OEB Act does not contain a section comparable to subsection 135(4) of the OBCA, it must be presumed that the director and officer who could show that he or she exercised the “care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances” would constitute a defence of due diligence.

The obligations described in subsection(b) of section 125.2 are those which any LDC, in the ordinary course of its business, would fulfill. The reporting requirements imposed on LDC by the OEB are extensive and, when combined with the filing requirements in rate application, would make compliance virtually impossible to avoid. Given that, it is unclear why subsection 125.2 was thought to be necessary.

What section 125.2 does do is authorize the OEB to investigate governance practices of LDCs and, where appropriate, prosecute the officers and directors of LDCs for a violation of the stated obligations. Accordingly, while the substantive requirements of compliance with section 125.2 may be neither new nor particularly onerous, given the existing OBCA obligations, the threat of OEB oversight makes the development of, and adherence to, good governance practices more important.

The second amendment to the OEB Act is found in a new subsection 71(4), which reads:

> Despite subsection (1) the Board may, if in its opinion special circumstances of a particular case so require, authorize a transmitter or distributor to carry on a business activity other than transmitting or distributing electricity other than through one or more affiliates, in accordance with an order of the Board.

This new authority would seem, on the surface, to be a response to the challenges, described above, facing LDCs. The subsection would authorize the OEB to permit an LDC to expand the range of its businesses or to develop a new business model. It is unclear how the section would be interpreted (for example, what constitutes “special circumstances”) and whether the new business would continue to be regulated. For the purpose of this paper, we simply observe that a decision by an LDC to ask the OEB to exercise this new authority would require the officers and directors of an LDC to exercise skills, and bring to bear judgements, that might not be required in the existing circumstances.

The third is the deletion of the constraints on the businesses on which LDC affiliates may engage. Prior to the amendment, the affiliates of LDCs were limited to a narrow range of what might be described as “energy services” businesses. By eliminating that limitation, the affiliates are now permitted to engage in any form of business, something which may, depending on the nature of the business, entail significantly greater risk for the affiliates, and for the LDC.

e) The Risks and Challenges Presented by Consolidations and Mergers

The growing number of consolidations and mergers among LDCs is a product of a number of factors. They include the provincial government's embrace of the recommendations of the Clark working group, and the concern, particularly among smaller LDCs, that only by being part of a larger entity can they effectively respond to the challenges they face.

Merger/consolidation transactions pose a number of risks to LDCs and to their municipal shareholders as the ultimate owners of the equity interests in the LDCs and the entities entitled to their dividend streams. Merger/consolidation transactions also create a fundamental reorganization of the roles, responsibilities, rights and obligations among the participating LDCs and their shareholders, boards and management. It is, in our view, essential that these risks and fundamental changes be identified and addressed through good governance structures developed proactively at the outset of any merger/consolidation transaction. This requires a collaboration among the management of the LDC, the directors of the LDC, municipal staff and municipal politicians.

The legal documentation implementing the merger, acquisition and consolidation of a number of small LDCs into a larger merged LDC entity will invariably include significant representations and warranties being given by the direct shareholder of each merging entity on behalf of itself and its merging LDC participant. The terms of these representations and warranties and the accuracy and comprehensiveness of the disclosures made in connection with these representations and warranties bear directly on the liabilities and risks to the equity interests of the municipal shareholder in the LDC. If representations and warranties are inappropriately onerous or disclosures are incorrect, the municipal shareholder's interests in the LDC are at risk by virtue of potential liability under the representations and warranties. Further, each merging participant and its ultimate municipal shareholder is relying on the representations, warranties and disclosures of the other merging entities and their shareholders being appropriate, accurate and comprehensive. Numerous other terms of the documentation bear direct consequences to the interests of the municipal shareholder of the merging entities, including: (1) closing calculations and adjustments giving rise to the ultimate percentage ownership of shareholders in the merged entity; (2) the nature and number of closing conditions; and (3) limitations, exclusions and time limits of indemnification obligations.

We outlined at the beginning of this paper the various forces at play which have led to shareholders and directors placing a large degree of reliance upon management of the LDCs in the governance and operations of the LDCs. In the context of these circumstances and the interests of the municipal shareholders in the implementation and outcome of the merger process, it is our view that one of the fundamental governance issues to be addressed in the circumstances of LDC mergers and consolidation is the development of appropriate governance procedures to ensure the appropriate level of municipal shareholder engagement and oversight in the merger process and in the development of the documents which give effect to the merger/consolidation.

The development of appropriate governance practices to address LDC merger and consolidation transactions requires a proactive and cooperative approach between the municipal shareholder and LDC management. LDC management must recognize and respect that it is the municipal shareholder's equity interests and dividend streams (as well as a host of local political and policy issues) that are being directly affected by the transaction, and they must willingly and openly offer up governance protocols and procedures that recognize and accommodate the municipal shareholder's interests in these matters. LDC management must acknowledge that the municipal shareholder is not an expert in the business and regulatory framework LDCs work in, and they must be aware of and address the potential conflicts of interests pressures placed upon LDC management in these types of transactions. On the other hand, municipal staff and politicians must recognize that requiring a governance process that adequately protects the interests of the ultimate municipal shareholder necessitates an appropriate response and engagement by them, and they must acknowledge that they are responsible for communicating their requirements and providing the resources and commitment to actively participating and being accountable for their role in the governance process and in the development of the merger/consolidation transaction and the documents which effect the transaction.

An appropriate governance process for protecting the interests of the ultimate municipal shareholder in an LDC merger/consolidation transaction must address, among other things, the following in relation to the negotiation and finalization of the documents effecting the merger/consolidation and in proceeding to the closing of the transaction:

1. The role of municipal shareholder staff and advisors in the negotiation of the representations, warranties, covenants, conditions and terms of the merger documents;

2. The role of municipal shareholder staff and advisors in the population and review of data rooms concerning disclosures of the merger participants and their shareholders;

3. The role of municipal shareholder staff and advisors in the preparation, review and consideration of due diligence reports concerning their LDC participant (for the purposes of assessing the municipality's risks concerning the representations, warranties and disclosures of its LDC) and concerning the other LDC participants (for the purposes of its reliance on the liabilities, obligations and risks of combining with other LDC participants);

4. The role of the municipal shareholder in the retaining of legal, financial, tax, environmental, asset condition, and regulatory experts and advisors and in

determining the scope, qualifications and ambit of due diligence and expert reports and opinions and the municipality's ability to rely on such reports and professional opinions; and

5. The creation of appropriate lines of authority and decision making powers and of appropriate lines of accountability, and the creation of appropriate reporting protocols on the risks and benefits of the transaction and concerning the progress of the transactions.

Given the complexity of these transactions, the various pressures and interests of each participant within each LDC and the various areas of interest and required expertise, there are no easy or "one size fits all" resolution to these issues. While we cannot offer any standard governance protocols to address these issues suitable for every case, we can confidently express the view that a proactive and timely consideration and resolution of these governance issues is critical to the interests of all participants and stakeholders within an LDC and among all merger participants. If these issues are not determined with certainty before the process begins, it may be too late to effectively implement them partway through the transaction. Confusion and gaps in lines of accountability and decision making authority, and in the ability to take the benefit of the protections of professional opinions, may ensue in the absence of timely and proactive consideration of these issues. False assumptions may arise that each shareholder's interests are being fully and property protected.

The merger transaction not only creates a number of governance issues in the implementation of the merger, it fundamentally alters the governance structure to which the LDC, its board, its management and its municipal shareholders are subject. This shift in paradigm occurs simply by virtue of the municipal shareholder moving in the course of the merger transaction from a sole or super majority shareholder in a merging LDC to, in all likelihood, a minority shareholder in a larger merged entity.

It is arguable that this change is as fundamental and material a change, from a corporate governance perspective, to the interests of a shareholder as a shareholder can experience in the context of a privately held corporation.

In the pre-merger LDC, the municipal shareholder is either a sole or majority shareholder who can rely on its dominant shareholder voting powers to ensure its interests are, and always will be, appropriately protected. If the board of the LDC ignores its interests as shareholder, it can simply replace the board with members who will be more responsive to its demands and requirements. Often the sole or super majority shareholder will have in place (and, even if not, it always has the option of putting in place) a unanimous shareholder declaration under section 108 of the OBCA which can vest upon the municipality as shareholder any powers of the directors with respect to the management of the business and affairs of the Corporation that the municipal shareholder chooses. Accordingly, the municipal shareholder in the pre-merger LDC has the opportunity to take and keep such controls as it wishes and to insist on reporting structures, decision making authorities and governance arrangements as it from time to time sees fit in relation to any or all aspects of the business and affairs of the LDC.

In the vast majority of circumstances a merger/consolidation transaction will mean that controlling shareholders of pre-merger LDCs are converted into minority shareholders of the larger post-merger LDC. They move from a position where they have absolute control to one where, absent a shareholders' agreement, they may have no control and, at best, limited influence. They need to consider what measures they require to protect their minority position and to establish the governance structures to accomplish that. They need to identify those aspects of the business and affairs of the merged/consolidated LDC over which they want to retain control.

This imposes the obligation on all merger participants to consider the form of shareholders agreement that will be required for the merged/consolidated LDC to serve as the foundation for corporate governance from the closing of the merger transaction going forward. Each municipal shareholder must cross the bridge from being in complete control (in the sense of being able to cause those things it desires to occur or prevent things to which it objects from occurring) to a minority position that does not have control of anything other than what is provided in the shareholders agreement. A shareholders agreement for the merged LDC may identify and address matters that each municipal shareholder may have limited control over (in the sense of being able to prevent them from occurring without its consent), matters which may fall within its influence (because they require shareholder or director approvals which it or its nominee director(s) may vote for or against), matters for which it has no control or influence and is simply made aware of, and, finally, matters over which the LDC can act without control, influence or knowledge of the municipal shareholders.

A shareholders agreement must address, from a governance perspective, among other things, the following:

1. Shareholder nominee representation on the board;

2. Governance for shareholders and board meetings;

3. Matters requiring unanimous shareholder approval (matters which cannot take place unless the municipal shareholder approves, providing "control" for the shareholder in this limited sense);

4. The identification of corporate actions and decisions requiring identified percentages of shareholder approval and the setting of the threshold percentage of shareholder votes required for such corporate actions and decisions (matters

over which a municipal shareholder may have varying degrees of influence depending on its proportionate ownership of shares in the merged LDC, its position on the issue under consideration and the ultimate outcome of the vote);

5. Reporting procedures for financial statements, budgets, strategic plans and dividends, including reporting procedures for applications for rate and other regulatory approvals;

6. Dividend policies and strategic plan and amendments to dividend policies and strategic plans, particularly where changes in strategic plans may have an impact on local employment and service levels;

7. Restrictions on transfers of shares;

8. Permitted transfers of shares;

9. Rights of first offer or refusal on transfers of shares;

10. Restrictions on treasury issuances and anti-dilution and pre-emptive right provisions;

11. Buy-sell/shotgun/put/call share transfer provisions;

12. Permitted reorganization transactions; and

13. Restrictive covenants/non-competition/confidentiality provisions.

As discussed above, recent amendments to the OEB Act permit an LDC to seek OEB approval to engage in businesses other than the distribution of electricity. Such a change might entail a fundamental shift in the business model and in the risk profile of the LDC. Municipalities holding minority interests may want control over the decision to engage in a new business and, therefore, in the decision to apply to the OEB for approval to do so.

In addition, municipalities holding a minority interest may wish to ensure that the shareholder agreement includes some measure of control over the content of rate applications, including capital spending plans.

Settling on an appropriate governance regime through an appropriate shareholders agreement governing the merged LDC requires, itself, an appropriate governance regime being implemented by each merging LDC to govern the negotiation and settling of the shareholders agreement as part of the merger documents.

Once again, the management of each LDC and its municipal shareholder have to proactively recognize the importance of this undertaking and build in governance protocols at the early stages of the merger transaction to determine, among other things: (1) how the municipal shareholder's requirements for a go forward shareholders agreement are going to be determined and communicated; (2) how the negotiations are to proceed; (3) confirmation of direct lines of authority and accountability in the negotiation of these important terms; and (4) confirmation of the roles and accountabilities of the various professional advisors in the negotiations.

V Conclusion

The governance of LDCs is a topic which has been ignored for a long time, largely due to the particular context within which the LDCs operate. The importance of good governance is now coming into sharper focus. It is essential that LDCs review their governance structures and practices to ensure not only that these meet the highest industry standard, but are appropriate for changing business and regulatory conditions.

At the same time, the role of municipal shareholders requires re-examination, particularly in the context of mergers and acquisitions. Municipal shareholders must ensure that there are mechanisms in place to protect their interests, particularly in circumstances where, as a result of a merger or acquisition, they hold only a minority interest.

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