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Intercorporate transactions may be oppressive

Ford Canada shareholders oppressed by unfair transfer pricing

BY W. MICHAEL G. OSBORNE, AFFLECK GREENE ORR LLP.

An unfair intercorporate transfer price system in place between Ford Motor Company of Canada and its US parent, Ford Motor Company, oppressed Ford Canada's minority shareholders, the Ontario Court of Appeal ruled in early 2006.[1] However, because there was no evidence as to when these shareholders owned their shares, they were each entitled to only one day's damages.

The court's decision is replete with lessons for parent companies of non-wholly-owned subsidiaries, including:

Treating a partly-owned subsidiary as though it were wholly-owned may be oppressive toward minority shareholders of the subsidiary.

Intercorporate transactions should be on the same basis as the subsidiary would negotiate if it were a truly independent entity.

Disparity in profitability between a parent and a subsidiary can lead to a finding that intercorporate transactions are unfair, and thus oppressive, toward minority shareholders of the subsidiary.

The subsidiary's managers have a duty to apply business judgment to, and negotiate, intercorporate transactions; they cannot simply take the terms imposed by the parent.

It may even be oppressive *not to change* the way in which a parent and a subsidiary do business with one another in response to changing economic circumstances.

As well, this decision establishes potentially far-reaching principles relevant to oppression claims involving any public company:

The court will presume that shareholders of public companies have certain reasonable expectations about how the business of the company will be carried out.

Statements in financial statements and annual reports can give rise to reasonable expectations by shareholders and, if untrue, found an action in oppression.

A public company that does not meet general "shared expectations about the way in which a public company should be run" may be liable for oppression.

A shareholder cannot obtain a remedy for oppression that occurred before the shareholder became a shareholder.

The court will not adjust a valuation to account for historical oppression. However, the valuation will include a going forward component (that is, increase) reflecting improvements in performance caused by cessation of the oppressive conduct.

Ford takes Ford Canada private

In 1995 Ford Motor Company ("Ford") decided to take its Canadian subsidiary, Ford Motor Company of Canada ("Ford Canada"), private. Ford was entitled under the relevant corporate statutes[2] to buy out the minority shareholders without obtaining their approval, because Ford owned 94% of Ford Canada, and the minority shareholders, only 6%. Ford offered the minority shareholders $185; some minority shareholders, including the giant pension fund, Ontario Municipal Employees Retirement Board ("OMERS"), dissented. Ford Canada then commenced an action for a valuation of the shares.

In 1999, OMERS and some of the minority shareholders amended their defence to include a counterclaim for oppression that had occurred between 1985 and 1995.

In 2004, Cumming J. valued the Ford Canada shares at $207, and, having found that Ford Canada oppressed its minority shareholders, made an additional award that depended on how long a particular shareholder owned shares. He directed a reference to a master to determine long each shareholder had owned their shares.[3] Both Ford and OMERS appealed.

The Court of Appeal upheld most aspects of the trial judge's decision. Rosenberg J.A., writing for the panel, agreed with the trial judge that the transfer pricing system imposed on Ford Canada by Ford was oppressive, but disagreed with ordering a reference to determine how long each minority shareholder had owned their shares. He also agreed with the trial judge's conclusion as to the value of the shares.

Oppressive transfer pricing

Transfer pricing, that is, the prices Ford and Ford Canada paid each other for vehicles, parts, development, and other costs, in intercorporate transactions, was at the heart of the case. The transfer pricing system that Ford imposed led to a decline in profitability of Ford Canada beginning in 1977, and losses in Ford Canada's Canadian Vehicle Division ("CVD"). Since the transfer pricing system operated in US dollars, the decline of the Canadian dollar was a major contributing factor to the decline in Ford Canada's performance. Ford Canada's poor performance was one of the reasons Ford decided to take it private.

The Court of Appeal agreed with the trial judge that the question was: what pricing would Ford Canada have been able to negotiate had it been a truly independent entity? Here, Ford and Ford Canada should have changed the transfer pricing system they used because the decline in the Canadian dollar led to the CVD paying more for vehicles than it could ever recover from dealers. Ford and Ford Canada should have adopted a "profit-split" approach to transfer pricing. There was evidence that Ford used this approach when dealing with arms' length suppliers such as Mazda and Kia.[4]

Experts retained by OMERS found that if the profit-split approach had been used by Ford and Ford Canada, Ford Canada's profits would have been $2.6 - 3 billion higher over the period 1985-1995.[5]

No business judgment

Ford Canada relied on the business judgment rule in its appeal: courts will not impose liability for mistaken but good faith business judgments. However, there was no evidence that Ford Canada had applied any business judgment; it never attempted to negotiate or considered the reasonableness of the transfer pricing. It simply accepted prices imposed by its parent. The business judgement rule thus did not apply.[6]

Shareholders' reasonable expectations

It is difficult to obtain evidence about reasonable expectations of a widely-held company. However, a court can "infer reasonable expectations from a public company's statements and the shared expectations about the way in which a public company should be run", Rosenberg J.A. held.[7] Here, Ford Canada's shareholders had an expectation that prices would be negotiated at arm's length between Ford and Ford Canada (not just dictated by Ford), and that Ford Canada's management would act in the best interests of Ford Canada and make best efforts to earn a reasonable profit.[8]

This expectation arose from Ford Canada's financial statements. Until 1985, they expressly claimed (incorrectly) that transfer prices were negotiated on an arm's length basis. After 1985, they simply said that prices were "calculated to approximate levels charged by competitive sources for similar goods". Although the beginning of the oppression period corresponded with this change in wording, and Ford Canada's financial statements did point out the negative impact of the decline in the value of the Canadian dollar on its profitability, the change did not help Ford Canada. A Ford Canada executive admitted that the new wording expressed an "arm's length concept".[9]

Treating a partially-owned subsidiary as though wholly-owned

The trial judge held that Ford treated Ford Canada as a wholly-owned subsidiary. Ford benefited by

shifting losses to Ford Canada and profits to Ford through transfer pricing, because it received 100% of the benefits of such transfers, while suffering only 94% of the corresponding loss.[10] Nevertheless, the trial judge found that because Ford Canada had not tried to renegotiate transfer pricing, Ford had not committed oppression.[11]

This finding is inconsistent with finding that Ford treated Ford Canada as a wholly-owned subsidiary and imposed an unfair transfer pricing system on it, Rosenberg J.A. held. Ford's treatment of Ford Canada unfairly disregarded the interests of Ford Canada's minority shareholders and was thus oppressive.[12]

Rosenberg J.A. emphasized, however, that it was not imposing a fiduciary duty on parent corporations toward their subsidiaries or the minority shareholders of the subsidiary.[13]

No remedy for past oppression

Shareholders cannot be compensated for oppression that occurs before they become shareholders, the court held. While the oppression remedy can involve both personal and derivative remedies, it is based on a wrong done to a shareholder or identifiable group of shareholders.[14] The effect of past oppression would normally be reflected in the market price the shareholder pays for the shares.[15] Consequently, "to award a shareholder for past oppression would not be compensation but a windfall".[16]

This conclusion is valid if the share price at the time of purchase reflects the effect of past oppression. This, in turn, depends on the assumption that capital markets are efficient, and that sufficient information is available for the price to reflect the past oppression. Here, while Ford Canada's overall poor performance was known, the court also found that Ford Canada's financial statements "masked the true state of affairs".[17] It is possible, therefore, that the market price did not fully reflect the cost of the oppression.

No adjustment to value for historical unfairness

The Court of Appeal agreed with the trial judge that the fair value of the shares should not be adjusted to account for a notional increase in value of the company had the oppression not occurred. Valuations are prospective. However, a reasonable, unrelated purchaser would renegotiate transfer pricing and would calculate Ford Canada's value accordingly. Consequently, it is appropriate to add a going forward component based on the rise in share price caused by ending the oppressive conduct.[18]

No evidence of time of shareholding

OMERS and the other dissenting shareholders did not lead any evidence about when they were shareholders. Because a shareholder cannot be compensated for past oppression, establishing when each shareholder owned their shares was an essential part of the case. To deal with this problem, the trial judge directed a reference.

The Court of Appeal held that a reference was not appropriate, and awarded one day's damages for oppression instead. Rosenberg J.A. wrote:

I can see no compelling reason to give the OMERS shareholders the opportunity after the trial has concluded to prove a fundamental element of their case. There is no suggestion that the OMERS shareholders were caught by surprise. The issue was squarely raised at trial as an aspect of the question of whether the oppression remedy or fair value included an historical element and entitlement to that historical component.[19]

Conclusion

Although Ford Canada's minority shareholders won a pyrrhic victory, the Court of Appeal's decision contains several important lessons, both for companies with non-wholly-owned subsidiaries and public companies generally. The court has made it clear that a parent company cannot manage a non-wholly-owned subsidiary as though it were wholly-owned. Intercorporate transactions must be on the same basis as the subsidiary would achieve if it were an independent entity. Directors and officers of the subsidiary must thus truly negotiate intercorporate transactions with the parent company. Although the case was not decided on fiduciary principles, it implicitly reaffirms the principles that directors and officer of subsidiaries have fiduciary duties to the company they manage, not to the parent company.

The imposition of liability on Ford Canada to shareholders in the secondary market for what

amounts to an implied representation in its financial statements, is perhaps this case's most wide reaching finding. Public companies will need to scrutinize their annual reports and financial statements even more carefully as a result. As well, this decision raises the possibility for liability for failing to meet "shared expectations about the way in which a public company should be run" – a potentially very wide field of liability.

This decision, together with recent amendments to Ontario's *Securities Act* facilitating shareholder class actions for corporate misrepresentations on the secondary market,[20] results in an environment where public companies face much greater risk of liability for their public statements.

For more information contact:

W. Michael G. Osborne, Affleck Greene Orr LLP
Tel: 416-360-5919
Email: mosborne@agolaw.com

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[1] *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board*, [2006] O.J. No. 27 (C.A.)

[2] The transaction involved both the *Canada Business Corporations Act* and the *Ontario Business Corporations Act* because Ford exported Ford Canada from the CBCA to the OBCA, then took it private under the OBCA. Regardless, both statutes provide that Ford could force the transaction on the minority, provided that the minority was entitled to be paid fair value for its shares.

[3] *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board*, [2004] O.J. No. 191 (S.C.J.)

[4] C.A. at ¶41-54.

[5] S.C.J. at ¶406-418.

[6] C.A. at ¶55-59

[7] C.A. at ¶66

[8] C.A. at ¶61, 70-77.

[9] C.A. at ¶71-74.

[10] S.C.J. at ¶349, 365.

[11] S.C.J. at ¶374

[12] C.A. at ¶97.

[13] C.A. at ¶98-99.

[14] C.A. at ¶108-112

[15] C.A. at ¶114; S.C.J. ¶ 252-254.

[16] C.A. at ¶115.

[17] C.A. at ¶167.

[18] C.A. at ¶128-135

[19] C.A. at ¶158

[20] *Securities Act*, R.S.O. c. S-, ss. 138.1-138.14; see Kenneth Dekker, "The future of shareholder class actions in Ontario", *The Litigator*, June 26, 2005, http://www.agolaw.com/litigatorca.asp?file=litigator/jun05/page1

a g o Affleck Greene Orr LLP
365 Bay Street, Suite 200, P.O. Box 489, Toronto, Ontario, Canada M5H 2V1
Telephone: 416 360 2800 Fax: 416 360 5960
www.agolaw.com