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Toward a Distinctive Canadian Corporate Law Regime

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Note: At the time of publication, the author Ronald Daniels was affiliated with the University of Toronto. Currently, he is Provost of the University of Pennsylvania.

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Abstract

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Disciplines

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TOWARD A DISTINCTIVE CANADIAN CORPORATE LAW REGIME©

By Ronald J. Daniels* & Jeffrey G. MacIntosh**

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** Jeffrey G. MacIntosh, Associate Professor, Faculty of Law, University of Toronto. Extremely useful research for this article was provided by Gord Haskins, Janet Holmes, and Richard Naiburg. As always, Debra Forman, International Business and Trade Law Librarian, played an instrumental role in identifying sources of data for our work. Pia Bruni provided able secretarial assistance. Very helpful comments on earlier drafts of this article were provided by Jim Baillie, Roberta Romano, Michael Trebilcock, George Triantis, as well as the participants in a session of the Canadian Law and Economics Association held in Victoria, British Columbia (May 1990). We are, of course, responsible for all errors and omissions.

I. INTRODUCTION

During the last decade, the conventional vision of the corporation and of corporate and securities law has undergone radical transformation. Early privilege or concessionary paradigms of the corporation focused on the role of the corporation as a tool of state policy, and the corporation's core characteristics were analyzed in terms of how they furthered or hindered the achievement of the state's objectives.[1] More recently, the liberal contractarian paradigm has placed much greater emphasis on the formulation of suitable rules for the facilitation of private ordering arrangements, thereby relegating state objectives to a position of secondary or even trivial importance.[2] Accompanying this reconstruction of the vision of the corporation in society has been

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[1] See, *e.g.*, M.A. Eisenberg & W.L. Cary, *Cases and Materials on Corporations*, 6th ed. (Westbury, N.Y.: Foundation Press, 1988).

[2] For a thorough discussion of the different visions of the corporation and their roots in broader political theory, see R. Romano, "Metapolitics and Corporate Law Reform" (1984) 36 Stan. L. Rev. 923.

a recognition of the role that markets can play in controlling a wide range of problems that beset the modern corporation.[3] Moreover, acknowledgement of the role that markets play in disciplining opportunistic behaviour has effected a shift in the justificatory standards underlying corporate and securities law. Whereas in the past evidence of opportunistic behaviour by managers or shareholders was thought sufficient by itself to support legal intervention, today this evidence must be supplemented by arguments demonstrating the superiority of legal instruments to their market competitors.

The recognition that market forces can complement and, indeed, supplant legal rules, thus, has important implications for the design of an optimal corporate/securities law regime. Obviously, the more efficient underlying market mechanisms are in disciplining corporate conduct, the less the need for legal instruments to regulate it. And yet, despite the centrality of market efficiency in the design of appropriate rules, the structure and efficiency of Canadian markets has often been ignored both by academics and policy-makers. Do Canadian markets have distinctive properties that regulators should be sensitive to in formulating policy objectives? If so, what are these properties and how do they impact on Canadian corporate law and securities regulation? It is our belief that Canadian markets do possess distinctive characteristics, especially when compared to the United States, and that these characteristics have important implications for the nature of the optimal corporate and securities regime for Canada. Indeed, we argue that the failure to consider the distinctive features of Canadian markets may, especially when foreign approaches are emulated, result in statutory and judicial approaches to corporate regulation that only crudely fit the Canadian setting.

[3] D.W. Carlton & D.R. Fischel, "The Regulation of Insider Trading" (1983) 35 Stan. L. Rev. 857; F.H. Easterbrook & D.R. Fischel, "Voting in Corporate Law" (1983) 26 J. Law & Econ. 395; F.H. Easterbrook & D.R. Fischel, "Corporate Control Transactions" (1982) 91 Yale L.J. 698; D.R. Fischel, "The Corporate Governance Movement" (1982) 35 Vand. L. Rev. 1259; and R.K. Winter, Jr., "State Law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 J. Legal Stud. 251.

II. THE LIBERAL CONTRACTARIAN MODEL OF CORPORATE LAW

The liberal contractarian vision of corporate law is associated most powerfully with the law and economics movement. According to law and economics scholars, firms — of which corporations are a distinctive species — are best understood as the focal point for a series of contractual undertakings consummated between the shareholders, managers, creditors, employees, and suppliers of the corporation.[4] As the locus for these contracts, the corporation is nothing more than a "nexus of contracts." Through these contracts, the corporate form achieves its central purpose: enabling parties to obtain the benefits of task specialization by establishing a framework conducive to the maintenance of long run relations.

Given that the corporation is viewed as the by-product of a series of contractual, that is, voluntary and private arrangements, what is the role for corporate and securities law in this model? A purely enabling view is expressed by Easterbrook and Fischel, who argue that the role of courts and legislatures should be confined to reducing the transaction costs entailed in repeatedly negotiating, writing, and enforcing these contracts.[5] In this vein, legislatures should design corporate law statutes that embody the agreements that parties would have concluded in a world without transaction costs. Corporate statutes are merely the standard form contracts that the parties would have concluded in this idealized setting.

The keystone of the enabling view is the capital market, which is the instrumentality for detecting, analyzing, and impounding information respecting the behaviour of corporate insiders — the managers and controlling shareholders — into the prices of a corporation's shares. A well functioning market will allow investors to anticipate (in a probablistic way) the types and levels of "agency costs" that may affect their ultimate reward. Such anticipation will

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[4] The nexus of contracts theory is explicated in E.F. Fama & M.C. Jensen, "Separation of Ownership and Control" (1983) 26 J. Law & Econ. 301 and M. Jensen & W. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305.

[5] The most recent articulation of their position is contained in F.H. Easterbrook & D.R. Fischel, "The Corporate Contract" (1989) 89 Colum. L. Rev. 1416. See also *supra*, note 3.

be grounded in both the rational expectations of investors and historical experience with forms of opportunism generated by alternative governance structures. Armed with good foreknowledge of the probability distribution of potential returns, investors can then appropriately price the financial claims offered in initial public offering markets. Indeed, in a market that efficiently predicts all forms of opportunism engaged in by managers and controlling shareholders, we would expect that investors will pay no more, on average, than the claims they are purchasing are really worth *ex ante*. In the economist's lexicon, the market is then a "fair game."[6]

This has an important influence on the optimal legal regime through the mediating influence of the response of corporate issuers. Faced with a market that is a fair game, issuers will be unable to fool investors into paying more for securities than they are likely to be worth, given the probabilities of various forms of opportunism. In other words, all *anticipated* agency costs will be passed back to the issuer. This provides the issuer with a potent incentive to offer securities with characteristics that will tend to minimize the potential for future predatory acts either by managers or other investors. In an efficient market, all cost-justified agency cost reducing measures will normally be taken without regulatory intervention. For example, if a "majority of the minority" vote diminishes the probability of predatory behavior by majority shareholders more than it enhances the probability of opportunistic minority holdouts, then corporations will build a majority of the minority voting mechanism into the corporate charter without being forced to do so.[7]

This strong statement of the contractarian view is not without its critics.[8] Some have asserted that externalities and information asymmetries will impair the functioning of primary

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[6] It is important to note that this claim does not require all investors purchasing financial assets at the initial offering stage to be fully informed. Rather, only marginal purchasers need be fully informed, and, for infra-marginal investors, their errors in pricing need only be independent and unbiased.

[7] See Easterbrook & Fischel, *supra*, note 5.

[8] See, *e.g.*, V. Brudney, "Corporate Governance, Agency Costs, and the Rhetoric of Contract" (1985) 85 Colum. L. Rev. 1403 and R. Clark, "Agency Costs versus Fiduciary Duties" in J.W. Pratt & R.J. Zeckhauser, eds, *Principals and Agents: The Structure of Business* (Boston: Harvard Business School Press, 1985) 55.

markets.[9] In particular, it has been suggested that the determination of share values at the initial public offering ("IPO") stage is plagued by considerable indeterminacy and is characterized by the absence of negotiation between investors and issuer. The argument that IPO pricing is inaccurate is buttressed by empirical data showing that IPOs are generally underpriced and demonstrate considerable volatility during the period following the initial distribution.[10]

Other critics appear to have conceded the accuracy of market pricing at the IPO stage, but assert that corporate insiders will be able to exploit investors subsequent to the IPO, when the corporation's securities are trading in secondary markets. One basis upon which this critique can be constructed is the reputed failure of secondary markets to register events of opportunistic exploitation by causing appropriate adjustments in share prices. However, the more common criticism levelled against the ability of secondary markets to take care of themselves is the inability of shareholders to constrain such exploitation, due to the endemic problem of "collective action" that faces the shareholders of public corporations. As originally noted by Manne[11] and elaborated by Clark,[12] Easterbrook, Fischel,[13] and others, many shareholders will have small, transient interests and will take little interest in gathering information about prospective directors or proposed fundamental changes, or indeed in voting at all. While a pooling of interests might in theory alleviate the incentive problem, such coordination amongst investors is difficult and expensive and subject to the same

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[9] See, *e.g.*, M.A. Eisenberg, "The Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1461.

[10] See, *e.g.*, W. Rotenberg, "Pricing Initial Public Equity Offerings: Who Wins, Who Loses And Why?" (1990) 3(1) Can. Inv't Rev. 17; R.B. Beatty & J.R. Ritter, "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings" (1986) 15 J. Fin. Econ. 213; and K. Rock, "Why New Issues Are Underpriced" (1986) 15 J. Fin. Econ. 187.

[11] H.G. Manne, "Some Theoretical Aspects of Share Voting" (1964) 64 Colum. L. Rev. 1427.

[12] R.C. Clark, "Vote Buying and Corporate Law" (1979) 29 Case W. Res. 776.

[13] *Voting in Corporate Law*, *supra*, note 3.

incentive and free rider problems as individual action.[14] The proximate consequence of the collective action problem is that direct shareholder oversight of corporate insiders is attenuated. This leaves more room for insiders to spearhead corporate behaviour that redistributes wealth in favour of insiders and away from public investors. Share prices may quickly and accurately reflect the effect of such behavior on share prices, but this is cold comfort to investors who have lost part of their investment stake.

In our opinion, these criticisms miss the mark in relation to IPOs. While pricing of primary market offerings is not the product of direct investor/issuer contact, prices and terms of new issues will be determined by vigorous bilateral negotiations between the issuer and the underwriter. The underwriter has powerful incentives to ensure that the issue is not overpriced or (perhaps equivalently) issued with terms and conditions that turn out to be unfavourable to investors. Underwriters are typically large firms that are repeat players in capital markets. A reputation for overpricing new issues will quickly become known, causing investors to shun new offerings brought to market by the offending underwriter. This creates a strong incentive for the underwriter to ensure that the new issue is not overpriced.[15]

The participation of institutional investors in the IPO market will also assist in ensuring that new issues are not overpriced. Institutional investors typically purchase the lion's share of new offerings and are almost always canvassed by the underwriters in advance of the offering in order to determine the degree of institutional interest. Expressions of displeasure from institutional buyers will cause the underwriters to alter the terms of issue, or perhaps even withhold the issue from the market. In this way, the most sophisticated players in the market will play a very direct role in establishing the terms of a new issue, belieing the claim that

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[14] Both individual and collective action are plagued by the problem of "free riders." Since the efforts of an individual or of a coalition will be captured by all shareholders, this creates an incentive to let someone else do the work of policing management.

[15] On the role that reputation plays in bonding underwriter performance, see Rotenberg, *supra*, note 10; J. Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1549 at 1558-59; and R. Gilson & R.H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Va. L. Rev. 549 at 620.

investors are merely passive bystanders in the IPO process.[16] Although retail investors will not participate in this process, they will be able to free ride on the efforts of institutional investors, since the new issue is offered on the same terms to all buyers.

The fact that institutional players are the largest buyers of new issues will also enhance the reputational penalty associated with overpricing, since institutional traders are well placed to inflict damage on opportunistic underwriters by withdrawing lucrative brokerage and other business from the underwriter. If the reputation of underwriters is as important as we think it is, the underwriter may well have an incentive to set a price for new issues at a price *below* the true worth of the securities. Between the time of setting a price and bringing the issue to market, general market movements may result in the new issue being overpriced. Underpricing provides insurance against this eventuality. In addition, underwriters often take call options, at a strike price in excess of the offering price, as a part of their underwriting fee. Setting a low offering price is one way to ensure that these options will have value.

To the extent that underwriters will wish to avoid a bad reputation with firms seeking to go public, there will be some constraint on the degree of underpricing which they will be tempted to engage in. However, those in charge of businesses seeking to go public will not usually have had extensive experience (or indeed, any experience) with going public and will also have limited knowledge of the experience of others doing the same. They will also have a limited ability to penalize underwriters who fail to ensure that they receive an adequate price for their securities. Institutional buyers, on the other hand, are repeat players who frequently return to the market for new issues and will have ample opportunity to penalize misbehaving underwriters. Thus, the costs of underpricing a new

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16 We do not wish to concede, however, that direct negotiation is a prerequisite to efficient pricing. As long as buyers are repeat players with the ability to punish cheating sellers, an efficient contract will be the result even in a "take-it-or-leave-it" situation. See, *e.g.*, M.J. Trebilcock, "An Economic Approach to the Doctrine of Unconscionability" in B.J. Reiter & J. Swan, eds, *Studies in Contract Law* (Toronto: Butterworths, 1980) at 379.

issue are likely to pale in comparision to the costs of overpricing the issue.[17]

In the face of the incentives facing underwriters, it is therefore not surprising that, on average, new issues are indeed underpriced. Both this evidence and the considerations we have outlined above argue that if anyone is likely to be injured by inaccurate pricing of new issues, it is the issuers themselves and not the buyers of their securities. Indeed, we find it odd that critics of the contractarian paradigm would use evidence of underpricing to bolster their claim in favour of government intervention to protect investors. The need to protect investors who are profiting handsomely from new issues is, at the very least, not self-evident.

The participation of sophisticated institutional and block traders, as well as stock market analysts and brokers, will also tend to ensure accurate pricing of securities in secondary markets. As in primary markets, the retail investor will free ride on the efforts of sophisticated players to discover over- and under-priced securities.[18] This is not to say that we believe that Canadian secondary markets will always work with perfect efficiency. In the section that follows, we discuss the evidence bearing on the efficiency of secondary markets at greater length.

In any case, as we have noted, those who assert that investors are likely to be taken advantage of at some time subsequent to the initial offering do not usually focus on the inability of secondary markets to adequately record the effect of managerial or shareholder opportunism on share prices. Rather, the focus is on shareholder collective action problems. Two comments are in order. First, direct shareholder oversight is not the only mechanism for constraining opportunistic behavior. Managerial, product, and capital markets all play a role in disciplining market participants.[19] Second, the extent of the collective action problem

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17 See, generally, D. Barron, "A Model of the Demand for Investment Banking Advising and Distribution Services for New Issues" (1982) 27 J. Fin. 955 and D. Barron & B. Holmstrom, "The Investment Banking Contract for New Issues Under Asymmetric Information: Delegation and the Incentive Problem" (1986) 35 J. Fin. 115.

18 For a fuller description of these effects, see Gilson & Kraakman, *supra*, note 15.

19 See, *e.g.*, R.J. Gilson, "The Case Against Shark Repellant Amendments: Structural Limitations on the Enabling Concept" (1982) 34 Stan. L. Rev. 775.

will be greatly alleviated where institutional traders hold stock in the firm, since such traders will have much better incentives than smaller investors to monitor insiders and take appropriate action when harmful conduct is engaged in. Although we will not say much about Canadian managerial and product markets in this article, we comment below on how the unique features of Canadian markets impact on an optimal regime of rules to govern the transfer of corporate control. We also suggest that both mispricing and collective action problems will be much more severe for smaller public firms without institutional investors.

We also note that there is an embedded inconsistency in the position of those who accept that investors are not mistreated in primary markets but who assert that they are frequently mistreated subsequent to the initial offering. Part of what investors purchase at the primary stage are corporate governance mechanisms with varying degrees of constraints on insider opportunism. If investors are systematically exploited at the secondary stage, but primary markets are efficient, then systematic exploitation that will take place in the future must be reflected in the price that investors are willing to pay for their shares at the IPO stage. But this means that there can be no systematic exploitation. Either the prices at which new issues are offered will be adjusted by the underwriter or terms constraining opportunism will be incorporated into the corporation's charter or its terms of issue. In other words, an efficient primary market contains a self-correcting mechanism to reduce post-issue opportunism to the point where the marginal costs of reducing opportunism are equal to the marginal benefits obtained. Those who assert that primary markets work well, but secondary markets do not, bear an onus of explaining why primary markets should fail in this one crucial respect.

III. THE OPERATION OF CANADIAN CAPITAL MARKETS

A. *The Efficiency of Canadian Capital Markets*

Market efficiency is defined in relation to various information sets. A market is said to be efficient in relation to a particular set of information if market traders cannot realize positive abnormal returns from devising and executing trading strategies based on that data set. Empirical tests of market efficiency in the United States have uniformly found that markets are efficient in the "weak form." That is, abnormal returns cannot be made by trading on the basis of historical price movements. The vast majority of United States studies have also found that markets are efficient in the "semi-strong form," meaning that abnormal returns cannot be realized by trading on the basis of any information that is publicly available.[20] Not surprisingly, the evidence also demonstrates that American markets are not efficient in the "strong form." This means that market prices do not impound "inside" or non-public information into securities prices, and insiders can routinely make abnormal trading profits.

As in the United States, Canadian financial markets appear to efficiently impound information concerning historical price movements and thus appear to be weak form efficient.[21] Empirical tests have also demonstrated that Canadian insiders can systematically make abnormal trading profits on the basis of inside information.[22] However, the relatively less comprehensive empirical record confounds confident and sweeping generalization as to the

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[20] See, *e.g.*, R.A. Brealey & S.C. Myers, *Principles of Corporate Finance*, 2d ed. (New York: McGraw-Hill, 1984) c. 13; J. Gordon & L. Kornhauser, "Efficient Markets, Costly Information, and Securities Research" (1985) 60 N.Y.U.L. Rev. 761; and C.P. Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" (1977) 29 Stan. L. Rev. 1031.

[21] In respect of weak form efficiency, Rorke *et al.*, on the basis of a study sampling 133 stocks listed on the Toronto and Montreal stock exchanges, concluded that Canadian share prices were efficient in relation to historical price information. See C.H. Rorke *et al.*, "The Random Walk Hypothesis in the Canadian Equity Market" (1976) J. of Bus. Admin. 23.

[22] Baesel and Stein examined the trading patterns of two control groups, bank directors and conventional insiders, in the shares of 111 large industrial companies listed on the Toronto Stock Exchange over a four year period. They found that these groups were able to achieve consistently positive abnormal returns ranging from 3.8 per cent to 7.8 per cent, providing evidence that the market was not strong form efficient. See J.B. Baesel & G.R. Stein, "The Value of Information: Inferences from the Profitability of Insider Trading" (1979) 14 J. Fin. Quan. Anal. 553. Fowler and Rorke have reported similar results. After investigating over 33,000 inside trades over a ten year period, they found that insiders earned cumulative abnormal returns ranging from 2.9 per cent to 6.7 per cent. See D.J. Fowler & C.H. Rorke, "Insider Trading Profits on the Toronto Stock Exchange" (1988) 5(1) Can. J. Admin. Sci. 13. Most recently, these results have been replicated by J.-M. Suret & E. Cormier, "Insiders and the Stock Market" (1990) 3(2) Can. Inv't Rev. 87.

efficiency of Canadian capital markets in relation to information that is publicly available. A number of studies have found that Canadian mutual fund managers do not, on average, outperform market indices constructed from shares listed on the Toronto Stock Exchange.[23] On the assumption that professional mutual fund managers are well placed to uncover and exploit any public information that is not efficiently impounded in security prices, these studies supply good evidence that Canadian securities markets, like those of the United States, are efficient in the semi-strong form. Other investigations, however, appear to demonstrate semi-strong form inefficiencies. Studies have found that outsiders could earn abnormal trading returns by tracking the trading patterns of insiders as revealed in weekly reports filed with the Ontario Securities Commission (O.S.C.).[24] In two separate studies, Charest found that it was possible to make abnormal trading profits on the basis of public announcements concerning stock dividends and stock splits.[25] Other studies have found slow adjustments of stock prices to new information, which is also inconsistent with semi-strong form efficiency.[26]

In the end, it would be simplistic to declare that Canadian markets either are, or are not, efficient in the semi-strong form. It is much more likely that certain aspects of Canadian markets conform to semi-strong efficiency while others do not. In other words, the market is semi-strong form efficient in relation to some types of publicly available information but not others.

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[23] J. Williamson, "Performance of Canadian Mutual Funds, 1961-70" (1971) 36 Bus. Q. 94; D. Grant, "Investment Performance of Canadian Mutual Funds: 1960-74" (1976) 8 J. Bus. Admin. 1; A.L. Calvert & J. Lefoll, "The CAPM Under Inflation and the Performance of Canadian Mutual Funds" (1980) 12 J. Bus. Admin. 107; A.L. Calvert & J. Lefoll, "Performance and Systematic Risk Stability of Canadian Mutual Funds Under Inflation" (1981) 8 J. Bus. Admin. 279; and W.M. Lawson, "Market Efficiency: The Trading of Professionals on the Toronto Stock Exchange" (1980) 12 J. Bus. Admin. 41.

[24] Fowler & Rorke, *supra*, note 22 and Suret & Cormier, *supra*, note 22.

[25] G. Charest, "Returns to Dividend Changing Stocks on the Toronto Stock Exchange" (1980) 12 J. Bus. Admin. 1 and G. Charest, "Returns to Stock Splitting Stocks" (1980) 12 J. Bus. Admin. 19.

[26] See, *e.g.*, V.M. Jog & A.L. Riding, "Market Reactions of Return, Risk, and Liquidity to the Creation of Restricted Voting Shares" (1989) 6(1) Can. J. Admin. Sci. 62.

B. *The Implications of Uneven Informational Efficiency*

The uneven informational efficiency of Canadian capital markets yields important implications for the formulation of Canadian corporate and securities laws. An efficient market is a "fair game," in the sense that the odds of success and failure are well understood, and investors, on average, will earn what they expect to earn. In a market that is a fair game, financial claims will be priced appropriately, both in relation to the business risks they represent and the risks that minority holders will be opportunistically exploited by corporate controllers (whether managers or controlling shareholders). This creates a potent incentive for corporate issuers to offer securities on terms that tend to minimize the probability the controllers will engineer transactions that have the effect of confiscating all or part of the public investors' stake, obviating the need for state intervention to secure an efficient contract between firm and stakeholders.

The fact that capital markets have shown themselves to be responsive to some types of information and not to others means that regulators should be cautious about initiating policy on the basis of sweeping generalizations about the efficiency of Canadian capital markets. In some cases, markets will be efficient, attenuating the justification for regulatory interference. In other cases, markets will not be efficient, heightening the argument for intervention.

The existence of periodic inefficiencies in Canadian capital markets also raises the question of the extent to which the current institutional structure of the market and the regulation of financial intermediaries, institutional investors, and other capital market players advances or impedes the achievement of efficiency. For example, the *Income Tax Act*[27] limits retirement fund holdings in foreign assets to 10 per cent of the book value of the portfolio. This restriction may nurture a "hot-house effect," in which an excessive amount of capital chases too few investment opportunities. The result may well be that Canadian corporate

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27 S.C. 1970-71-72, c. 63, s. 206. The federal government has recently proposed a revision to the *Act* which will increase the ceiling on foreign assets to 20 per cent over a five year period. See Bill C-18, 3d Sess., 34th Parl., 1991.

issuers can foist inferior quality (for example, non-voting or restricted voting) securities on unwilling institutional investors. A related result may be the impairment of shareholder "exit" opportunities, by which institutional shareholders manifest their disapproval with current management by voting with their feet. If alternative investment opportunities offer little improvement, there seems to be little point in selling. The *Bank Act*,[28] in prohibiting any individual or group acting in concert from owning more than 10 per cent of a Schedule 1 chartered bank may impair the efficiency with which banks are operated, both by diminishing the incentives of large block holders to monitor management and by foreclosing the possibility of removing management by means of a hostile takeover. The resulting inefficiency may be manifest in part by deficient incentives for banks to monitor those corporations in which they hold interests.[29] The rule that prohibits banks from owning more than 10 per cent of a corporate issuer is also a source of inefficiency.[30] In limiting the size of bank holdings, both the incentive and the ability of bank managers to monitor corporate investments is attenuated. The result is virtual sterilization of a massive pool of investment capital that might be used with potent effect to ensure that corporate managers do not depart from the goal of pursuing shareholder wealth maximization. While we are aware that other considerations bear on the propriety of such policy initiatives, our point is that the effect of these constraints on the efficiency of Canadian markets has largely been ignored.

Finally, we note that although the evidence demonstrates that corporate takeovers are efficiency-enhancing, the existence of episodic semi-strong inefficiencies in Canadian capital markets raises the probability that mergers and acquisitions will be motivated more by a desire to exploit share price inefficiencies than by the realization of synergistic gains or the replacement of inefficient

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[28] R.S.C. 1985, c. B-1, s. 100(11).

[29] A recent and highly provocative account of the role that restrictions on the investment activities of various financial institutions have had on furthering corporate unaccountability may be found in M. Roe, "A Political Theory of American Corporate Finance" (Working Paper #36) (Columbia: The Centre for Law and Economic Studies, Columbia University School of Law, 15 November 1989).

[30] *Bank Act*, *supra*, note 28, s. 193(2).

management. Although transactions that seek to exploit hidden values for private gain are essentially redistributional in nature, they may generate efficiency gains to the extent that such transactions correct an initially inaccurate market price, thereby moving resources to their highest valued uses. Since corporate takeovers generate substantial transaction costs, takeovers motivated by underpricing may result in private gain while generating a net societal loss, measured by the opportunity cost of the resources devoted to effecting the transaction (less the benefit resulting from more accurate pricing of the corporation's securities). This emphasizes that the indirect costs of inaccurate security prices may be substantial and highlights the importance of tailoring market regulation in ways that contribute to, rather than detract from, market efficiency.

C. *The Second Market*

At the risk of oversimplification, Canadian capital markets are effectively divided into two segments. The first segment consists of public companies that typically trade in markets characterized by a large float of publicly traded securities, high liquidity, and high institutional shareholdings. The second consists of smaller public companies which exhibit a much smaller float of publicly traded securities, relatively low liquidity, and low institutional ownership. Even the Toronto Stock Exchange (TSE), Canada's largest and most liquid market, is dominated by the latter. A study by Fowler and Rorke, for example, found that only 5.3 per cent of the stocks traded on the TSE could be characterized as widely traded ("fat" stocks).[31] Of the remainder, 35.3 per cent were moderately traded and 59.4 per cent were infrequently or thinly traded. As the TSE exhibits the greatest depth of any public exchange in Canada, there is little doubt that other Canadian exchanges are dominated to an even greater degree by thinly traded stocks. Recognizing that some companies will fall in between these two polar types, we nonetheless

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[31] Fowler & Rorke, *supra*, note 22.

adopt the term "second market" to refer to relatively illiquid thinly traded securities with low institutional participation.

Financial economists (both in this country and elsewhere) have done remarkably little work, either theoretical or empirical, on the effects of thin trading on market efficiency. In theory, in an efficient market, a thinly traded security (like a fat security) should have a market equilibrium price that is, at any given point in time, the best estimate of the true worth of the security. However, a *datum* of key importance in the second market is the predominance of retail investors and a corresponding absence of institutional investors. Institutional funds are directed by sophisticated market professionals who have the time, training, and ability to monitor closely the fund's investments. Furthermore, since professionally managed funds will typically hold larger stakes than retail investors, the incentive of the managers to closely follow corporate developments and the performance of management is great compared to their retail counterparts. The higher level of monitoring of larger publicly traded companies with a professional following will tend to ensure more accurate pricing of their traded securities. New information will be quickly digested and impounded in the market price. Given the wealth of market experience and ongoing professional scrutiny of such companies, it is less likely that analysts will be able to uncover "overpriced" and "underpriced" securities. In short, the market for the securities of widely held public companies with institutional followings will tend to efficiently impound all publicly available information.

Corporations in the second market are far less likely to be well monitored. These companies are dominated by retail investors, who will mostly lack the sophistication, time, and investing savvy of the more experienced institutional investors. Such investors will find it more difficult to keep up with corporate developments. They will also frequently find themselves unable to interpret new corporate events and decide if what has happened (or is about to happen) bodes well or ill for the corporation. In short, retail investors are likely to be comparatively poor monitors of corporate and managerial performance. The price of securities in the second market is therefore more likely to diverge from semi-strong form efficiency.

The bifurcation of the market has potent implications for corporate governance. The presence of institutional investors serves as an important check on the freedom of corporate managers and controlling shareholders to redistribute corporate assets in their favour at the expense of minority investors. Large investors with economic clout will find the ear of management much more readily than retail investors and will possess powers of suasion that can be used to convince management not to proceed with unwise or opportunistic initiatives. Owing to their relatively small numbers, these powers of suasion can be greatly amplified by coordinated action.[32] Equally important, should push come to shove, institutional investors have both the incentive and the economic wherewithal to fund costly litigation that will benefit *all* shareholders.[33] The presence of an institutional clientele is therefore likely to lessen greatly the probability of unwise or opportunistic plays by corporate insiders.

In the second market, this significant source of oversight will be lacking. Retail investors with small, transient stakes and lacking a great deal of sophistication will not share the incentives of institutional investors to closely monitor corporate behaviour. They are also less likely to have access to the press, and their absence of economic power will mean that they will be able to exert little influence over management. Furthermore, small retail stakeholders will be both less willing and less able, either individually or collectively, to resort to judicial protection of legal entitlements. As a result, public investors in the second market will be exposed to a much higher risk of predatory conduct by corporate insiders.

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[32] For example, when Southam brought forward shark repellent proposals some years ago, institutional investors played a key role in convincing management to water down the proposals. See, *e.g.*, J. Partridge, "Foes of Southam-Torstar Deal to Get Day in Court" *The [Toronto] Globe and Mail* (27 October 1988) B5. Institutional players also played a role in convincing Crownx management to abandon a planned dual class recapitalization. See, *e.g.*, M. Mittelstaedt, "Chock One Up for CN Pension Fund" *The [Toronto] Globe and Mail* (12 April 1986) B2 and K. Howlett, "Crownx Drops Controversial Share Plan" *The [Toronto] Globe and Mail* (17 April 1986) B5.

[33] The Canadian Tire saga and the formation of the Class A Shareholders' Committee is ample testimony to both the power and motivation of institutional investors to protect their interests. See *Re Canadian Tire Corporation* (13 February 1987), 10 O.S.C.B. 858, 35 B.L.R. 56 (O.S.C.), aff'd 35 B.L.R. 117, 37 D.L.R. (4th) 94 (Div. Ct.), leave to appeal refused 35 B.L.R. (C.A.) [hereinafter *Canadian Tire*].

Thin trading also affects the availability of a variety of dissenters' rights available to the disgruntled shareholder. In connection with a variety of fundamental corporate changes, both federal and provincial corporations legislation allow shareholders to effectively "put" their shares to the corporation at a "fair value" to be determined by a court.[34] Where there is thin trading, Canadian courts have tended to completely disregard market price in assessing "fair value" and have based their determinations of value principally on a discounted cash flow analysis.[35] Because appraisal hearings usually proceed in an adversarial manner, with each side calling expert witnesses to establish fair value, this results in increased cost, delay, and uncertainty for the dissenting shareholder of a thinly traded corporation.

It will also be easier for insiders to manipulate the price of thinly traded securities, since the volume of buy and sell transactions necessary to move the market price will be far less than for large public companies. As a result, fraudulent insiders will find that they are able to finance market manipulation out of their own capital.

All of these factors combine to suggest that the nature of corporate governance issues facing corporations in the second market will differ in many respects from those facing corporations in the first market. There would appear to be a greater role in the second market for regulatory law that constrains the behaviour of corporate insiders, including both managers and controlling shareholders.

Despite this, the law currently treats all public corporations identically, whether they belong to the first or second market. We believe that the law makes too few distinctions between corporations in the first and second markets. The lesser degree of oversight, higher probability of insider predation, and less efficient stock

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[34] See, *e.g.*, *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, ss 190(3) and 206(3) [hereinafter *C.B.C.A.*] and *Ontario Business Corporations Act*, S.O. 1982, c. 4, ss 184, 187, and 188 [hereinafter *O.B.C.A.*].

[35] The fact that thinly traded stocks are more likely to deviate from a "true" or equilibrium value is good reason to *supplement* market price with other measures of value. However, completely disregarding market price in measuring the fair value of thinly traded stocks overlooks a rich source of information and is a practice which one of us has strongly criticized elsewhere. See J.G. MacIntosh, "The Shareholders' Appraisal Right in Canada: A Critical Reappraisal" (1986) 24 Osgoode Hall L.J. 201 at 286-88.

pricing in the second market suggest that stricter rules should attach in this context.

We also believe that some elements of the current regulatory environment contribute to the bifurcation of the market into first and second markets. Outstanding amongst these are "legal for life" restrictions that force fund managers to eschew investments in start-up or higher risk corporations that form a large part of the second market. Such restrictions are at odds with current financial theory that emphasizes that the relevant risk for a fund manager is the risk of the portfolio and not the riskiness of individual stocks in the portfolio. Indeed, focusing on the riskiness of individual securities, rather than of the portfolio as a whole, can lead managers to achieve sub-optimal diversification to the disadvantage of the fund's beneficial owners. We therefore applaud momentum in the direction of substituting legal for life restrictions with more general "prudent investor" standards. We also hope that the courts will have the wisdom to interpret the newer standard in light of state-of-the-art financial theory, which strongly suggests that a judicious mixture of safe and risky investments is the optimal way to achieve the highest return for a given level of portfolio risk.[36]

There are limits to the degree to which the law can be used as an instrument to improve informational efficiency in the second market. To an extent, the focus of media and market analysts on larger public corporations reflects a fascination with the large and powerful, rather than the small and unglamorous. It is no accident that the front pages of the financial press are populated with stories about comparatively large public companies with a high profile in the marketplace. These are the stories that attract public attention and help sell newspapers. Further, investment analysts will generally find retail investors more resistant to buying securities of companies

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[36] Although, where it has been adopted, the change to a "prudent investor" standard apparently has not yet resulted in an appreciable increase in demand for previously prohibited stocks, this may be attributable to the fact that there is a paucity of case law giving content to this somewhat vague test. As a consequence, it can be surmised that institutional investors, fearful of potential liability, will continue for a time to gravitate to the safe harbour of the relatively certain standards defined by legal for life tests. Perhaps, in time, as a body of precedent interpreting the content of the "prudent investor" test is amassed, institutional investors will feel more confident in deviating from the pattern of investment prescribed in legal for life rules.

they have never heard of. Coupled with the fact that many institutional clients will prefer to invest in "name" companies with healthy floats, investment professionals will find it rational to devote more (and perhaps even most) of their time to monitoring larger deeply traded concerns.

Thin trading also imposes an implicit and possibly unavoidable tax on the holding of large blocks. In theory, the purchase or sale of a large block of securities should have little or no impact on market price. Securities of equal risk and expected return are perfect substitutes and, absent new information about the risk or expected return of a given security, the volume of trading should not affect the price.[37] Indeed, empirical investigations in the United States of widely traded stocks show that large block trades have only a small effect on market price, and those fluctuations in market price are mostly attributable to cases in which the market suspects that the trader is motivated to trade by the possession of inside information.[38] However, as indicated, Canadian markets are dominated by thinly traded securities. Particularly in the second market, where public floats are small, the purchase or sale of a large block of securities may have a more substantial impact on both the acquisition and sale price for big buyers. This will cause institutional and fund investors to shy away from ownership of such securities in order to avoid the entry and exit "tax."[39]

Despite these natural limitations on the extent to which public policy can be used to unify first and second markets, we believe that the law may be able to play a larger role than at present in improving the informational efficiency of private markets,

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[37] The "substitution" effect should dominate the "price pressure" effect. See, *e.g.*, M.S. Scholes, "The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices" (1972) 45 J. Bus. 179. Frequently, heavy trading is associated with the arrival of new information and is thus often associated with large price movements. However, in such cases, it is the new information and not the heavy trading which causes the price movement.

[38] *Ibid.*

[39] So far as we know, there is but a single Canadian study on point. Close found price reactions to block trades similar to those in the United States. See N. Close, "Price Reaction to Large Transactions in the Canadian Equity Markets" (1975) 31(6) Fin. Anal. J. 50. However, the study did not focus on those corporations in the second market, for which we believe different results might have been achieved.

by centralizing information gathering in a readily accessible data pool available across the country at minimal cost. Although provincial governments currently collect and make available to the public a variety of information and documents, such as the identities of corporate directors and a copy of the articles of incorporation (indicating the terms of outstanding securities), obtaining this information may sometimes be difficult and time consuming. Depositing the terms of issue of securities, identities of directors and significant shareholders, the latest corporate balance sheet and earnings statement, and other pertinent information in an on-line computer system accessible by outsiders through telephone contact would avoid the need for costly duplication of information gathering services by investors and investment analysts. In our view, such a system would greatly lower the cost of obtaining important information about corporate issuers and would easily return its cost to the investing public. Such a service might indeed even be extended (at somewhat greater cost) to include press reports noting or commenting on corporate developments.

More generally, we suggest that it would be profitable to refocus regulatory attention on producing an empirical mapping of the marketplace, in order to substitute an empirically grounded identification of market inefficiencies for the sort of guess-making that all too often informs (or misinforms) current regulatory thinking. In particular, provincial regulators should make available funds for carrying out event studies indicating the consequences of a variety of corporate events (for example, the creation of restricted voting shares, corporate mergers and acquisitions, spin-offs, sell-offs, *et cetera*) on the value of stakeholder claims. An empirically grounded identification of market inefficiencies (or efficiencies) would improve the quality of public policy in the corporate and securities law domain.

In addition, we urge policy-makers to turn their attention to the perhaps unintended ways in which regulatory interventions (like legal for life rules) sometimes detract from, rather than enhance market efficiency. Regulatory interventions promulgated without a consideration of the full range of effects on market efficiency are like drugs with unanticipated side-effects. A failure to recognize the origins of market inefficiencies may result in treating the symptomatology of the illness, rather than the underlying disease.

D. *Concentrated Share Ownership*

One of the most distinctive features of Canadian capital markets is the high degree of concentration of share ownership. Only 14 per cent of the companies that make up the TSE 300 Composite Index are widely held. Of the remainder, 60.3 per cent are owned by a single shareholder with legal control (in excess of 50 per cent of the voting shares). 25.4 per cent are owned either by one shareholder with effective control (between 20 per cent and 49.9 per cent of the voting shares) or by two or three shareholders (each owning between 10 per cent and 20 per cent of the outstanding voting shares of the corporation) having the ability to combine and establish joint legal or effective control.[40] In contrast, American markets are characterized by a much greater preponderance of widely held companies. Approximately 63 per cent of the companies that make up the Fortune 500 companies are widely held, and 18 per cent are controlled by a shareholder or group of shareholders with effective control. Only about 12 per cent are controlled by a shareholder or group of shareholders with legal control.[41]

The predominance of shareholder controlled corporations in Canada changes the nature of conflicts that are likely to be important. Large block holders have better incentives than small investors to monitor management, since poor management affects the interests of a large stakeholder much more substantially than a small investor with a transient interest. Furthermore, the free rider problem that commonly makes coordinated shareholder action difficult is ameliorated, since a much more substantial portion of the benefits of monitoring is captured by the large block holder. The result will be more effective monitoring of hired managers. Moreover, since the controlling shareholder will effectively control the board of directors, which is legally empowered to hire and fire

[40] This data was derived from a variety of sources, including the *TSE 300 Composite Index* (April 1990) and from *Canadian Business* (June 1989).

[41] This data was based on the list of companies contained in the *1990 Fortune 500* (23 April 1990). Information on shareholdings was obtained from the Disclosure database (Micromedia). We were unable to classify 6.6 per cent of the companies on the *Fortune 500* list.

managers, underperforming (or cheating) managers can be displaced quickly and efficiently, without the need to requisition a shareholders' meeting.[42]

As a result, manager/shareholder conflicts are likely to be a less serious problem in Canada than in the United States, where widely held public corporations dominate. By the same token, however, the potential for inter-owner conflicts of interest is exacerbated. A controlling shareholder may abuse its power of control to engineer transactions that redistribute wealth to itself at the expense of minority shareholders. The controller might, for example, instruct the directors to deal with another controlled entity on non-commercial terms. Or the controller might spearhead a sale of corporate assets to another controlled entity, again at non-commercial prices. Controllers who are also managers may consume excessive salaries or other perquisites, or, without the fear of a hostile takeover bid to motivate them, may consume excessive leisure and manage poorly. There are many other possibilities for redistribution of corporate assets away from the minority (or from corporate creditors). Thus, although the power of control may be used beneficially – to monitor managers more closely – it may also be used injuriously to effect wealth transfers from one group of investors to another.

A concentration of share ownership will also blunt the effectiveness of oversight by institutional shareholders. As discussed further below, the Canadian market is characterized by the existence of many large webs of affiliated companies ultimately sharing a common controller. Institutional shareholders, like banks, insurance and trust companies, may justifiably fear loss of business or loss of access to preferential information flows should they oppose wealth-reducing management initiatives. Where the corporation in question is part of a larger empire, the economic threat to withdraw business,

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42 Where the manager is also a director, a shareholder vote will be necessary to remove the director in mid-stream. See, *e.g.*, *C.B.C.A.*, *supra*, note 34, s. 109(1) and *O.B.C.A.*, *supra*, note 34, s. 122(1). However, leaving fired officers on the board (and dropping them off the slate of directors at the next annual meeting) will be of little consequence if the shareholder controls a majority of appointments to the board, other than the manager(s) in question. In some cases, it may be necessary to requisition a shareholders' meeting to remove directors, but this is easier for a controlling shareholder to do than for a group of otherwise unconnected public shareholders. See *C.B.C.A.*, *ibid.* s. 143 and *O.B.C.A.*, *ibid.* s. 105.

whether explicit or implicit, can be a very potent one. In our view, the recent experience with poison pills in Canada furnishes anecdotal support for the claim that institutional voters are not immune from the effects of managerial pressure.

Recent empirical evidence from the United States confirms the role of ownership concentration in disciplining management. A study by Karen Wruck, for example, found that private sales of equity that had the effect of furthering the concentration of ownership interest resulted, on average, in increases in firm value.[43] The study also confirms, however, that increased concentration of firm ownership may result in some cases in a *reduction* in firm value. This is strongly suggestive of the pernicious influences to which firm control may be put. The results of the Wruck study are supported by another study that found that as managerial ownership increased, on average, firm value increased.[44] This study found, however, that the increase in value was not monotonic. Increases in managerial ownership below a 5 per cent ownership level appeared to increase firm value, while increases between 5 per cent and 25 per cent decreased firm value. Increases above the 25 per cent threshold again increased firm value. The second study hypothesizes that, over the intermediate range of managerial ownership, the negative effects of increased power of control dominate the positive influence resulting from a greater alignment of interest between controllers and shareholders.[45]

As compared to the United States, a jurisdiction with a predominance of widely held public corporations, the focal axis of agency problems in Canada is thus likely to be inter-investor conflicts, rather than investor-manager conflicts. This does not suggest that the appropriate substantive content of fiduciary norms dealing with inter-investor conflicts in Canada should be different than in the United States. It does, however, suggest that Canadian

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43 K.H. Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings" (1989) 23 J. Fin. Econ. 3.

44 R. Morck, A. Shleifer & R.W. Vishny, "Management Ownership and Market Valuation" (1988) 20 J. Fin. Econ. 293.

45 See also J. Pound, "Proxy Contests and the Efficiency of Shareholder Oversight" (1988) 20 J. Fin. Econ. 237 and J.A. Brickley, R.C. Lease, & C.W. Smith, Jr., "Ownership Structure and Voting on Antitakeover Amendments" (1988) 20 J. Fin. Econ. 267.

courts, regulators, and legislators ought to focus more attention than has been the case in the past on inter-shareholder relations and the ways in which shareholder powers of control may be used to effect purely redistributive and socially unproductive transactions. It is particularly odd, for example, that while controlling shareholders in the United States have been impressed with fiduciary duties for over half a century, it is still conventional wisdom in Anglo-Canadian law that shareholders – whether majority, controlling, or otherwise – owe no fiduciary duty, either to the company or to fellow investors.[46] We applaud judicial efforts to fashion a *de facto* fiduciary duty of shareholders through the statutory oppression remedy.[47] In addition, we are encouraged that Ontario regulators have recently made moves to regulate related party transactions by promulgating revised Ontario Securities Commission (o.s.c.) Policy 9.1.[48]

The predominance of shareholder controlled corporations in Canada also has implications for the focus of the debate over rules governing changes in corporate control. Changes of control in Canada are far more likely to be consummated as private sales of control blocks or negotiated transactions than as hostile takeover bids. Indeed, of the 1,148 merger and acquisition transactions tracked by Venture Economics in 1989, only 7 resulted in management resistance or more than one bidder entering the fray.[49] As a result, the rules governing private changes in control are of much greater importance in this country than in the United States, where the hostile takeover is a much more common means of effecting a transfer of control. Rules that tend to impede or discourage private changes of control will have serious consequences for the efficiency of Canadian enterprise. As cogently argued by

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[46] See J.G. MacIntosh, "Minority Shareholder Rights in Canada and England: 1860-1987" (1989) 27 Osgoode Hall L.J. 561 and J.G. MacIntosh, "Corporations" in *Law Society of Upper Canada Special Lectures, 1990* (Toronto: DeBoo, 1991) 189. For an attempt to explain this anomaly, see J.G. MacIntosh, J. Holmes & S. Thompson, "The Puzzle of Shareholder Fiduciary Duties" (1991) 19 Can. Bus. L.J. 86.

[47] *Corporations, ibid.*

[48] Discussed *infra*, notes 174-187 and accompanying text.

[49] The seven transactions involved Dickenson Mines, Falconbridge, Connaught Biosciences, Plastibec Ltée., Global Communications, Core-Mark International, and Steinberg Inc.

Easterbrook and Fischel, rules that either mandate equal sharing of a control premium or extension of a private offer to all shareholders on the same terms are very likely to reduce the number of corporate control transactions.[50]

E. *Highly Interconnected Corporate Relationships*

Another central characteristic of Canadian capital markets is the dominance of highly interconnected corporate empires. One measure of this interconnectedness can be derived from inter-corporate ownership patterns. Of the top one hundred most profitable companies in Canada in 1987, close to 45 per cent held 10 per cent or more of the voting shares of another company on the list.[51] The extensive holdings of Hees International Bancorp., Power Corporation of Canada, and Olympia and York are illustrative of the highly incestuous nature of the Canadian corporate community. These linkages are further buttressed by extensive cross appointments of Canadian directors. Of the top one hundred most profitable companies in Canada, we found that 296 of 1023 directors held two or more appointments. One director, Trevor Eyton, held nine. 71.1 per cent of these board appointments were held by directors with only one appointment, 17.5 per cent by directors with two appointments, and 11.4 per cent by directors with three or more appointments. In contrast, American data reveal corresponding figures of 81.8 per cent, 11.1 per cent, and 7.1 per cent.[52] The higher concentration in Canada is particularly significant when it is remembered that there are approximately one-tenth as many corporations in Canada as in the United States. Thus, even an identical proliferation of cross-appointments (in percentage terms) will, against the background of a much smaller economy, indicate a much more highly interconnected corporate sphere.

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50 *Corporate Control Transactions*, *supra*, note 3.

51 This figure was derived from a variety of research sources.

52 See J.M. Pennings, *Interlocking Directorates* (San Francisco: Jossey-Bass, 1980) figure 4 at 66. Pennings's data was derived from a 1977 study of 797 organizations.

The proliferation of corporate interconnectedness and interlocking directorships will have an impact on the efficacy of the oversight exercised by independent directors. The effectiveness of independent directorships in protecting minority investors has been subject to severe criticism even in the United States, where the corporate sector is much less concentrated and less dominated by controlling shareholders. Inside directors control the flow of information to outside directors and set agendas for board meetings. Although shareholders must elect directors, insiders (particularly the CEO) will control the nomination process and will effectively determine who sits on the board.[53] This clearly creates a disincentive for outside directors to question management policy, especially given the generous fees often paid to directors of public corporations. And, in fact, empirical investigations of the performance of independent directors have uniformly cast grave doubts on their effectiveness.[54] The pressures on outside directors to conform to the wishes of corporate insiders can only be exacerbated in Canada, where directors who are nominally "independent" may be employed by, or have business links to one or more of the corporations in an extended corporate empire. For example, a director employed by a related corporation under common control may have a legitimate fear that loss of employment will be the proximate result of opposing management. Even directors who have no employment ties with any corporation in a web of companies may be employed by a company that does or hopes to do business with one or more companies in the affiliated group. The conflict of interest will be particularly potent for investment bankers whose employers do a vast amount of business with sprawling corporate empires containing numerous companies. It will often be difficult, we suggest, for such directors to keep their

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[53] See V. Brudney, "The Independent Director: Heavenly City or Potemkin Village?" (1982) 95 Harv. L. Rev. 597 and M.L. Mace, *Directors: Myth and Reality* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1971).

[54] See, *e.g.*, Mace, *ibid.*; T.H. White, *Directors: Power or Pawns?* (Don Mills, Ont.: CCH, 1978); and B.D. Baysinger & H.N. Butler, "Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director" (1984) 52 Geo. Wash. L. Rev. 557. Most recently, see J.W. Lorsch & E. MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Boston: Harvard Business School Press, 1989).

gaze fixed steadfastly on the welfare of the firm and minority investors and to forget the potential consequences of piquing management's ire.

For similar reasons, we have doubts about the serviceability of "independent" fairness opinions and valuations rendered by investment bankers. Corporate management will select an investment banker to render a fairness opinion. The same managers will select the firm's underwriters and, depending on the nature of the business carried on by the firm, may also be in a position to parcel out lucrative brokerage business to investment bankers. An investment banker anxious to protect or secure future business with an issuer will find it difficult – though not impossible – to deliver a fairness opinion or valuation at odds with management's declared view. These pressures are intensified by the small size of the Canadian financial community, where conflicts of interest will be virtually unavoidable. Recent linkages between banks and securities dealers magnify these potential conflicts.[55] The large banks that dominate the Canadian economic landscape will frequently be large lenders to (or deposit takers from) the issuer commissioning the fairness opinion or valuation. Like the underwriting and brokerage business carried on by the investment banker, this business will in a very real sense be held hostage by the issuer pending a favourable opinion or valuation.

These pressures will be magnified where the issuer is part of an extended empire. In such a case, the investment banker (and perhaps its associated banking parent) may rightly fear loss of the business not only of the particular issuer, but some or all of the business of a large group of affiliated corporations.

In addition to having a strong incentive to deliver a biased fairness report or valuation, the investment banker will have ample opportunity to do so. The fairness report or valuation will depend critically on the values attributed to a variety of highly uncertain parameters, like the discount rate, time horizon, and expected cash flows. Relatively small adjustments in some or all of these parameters can easily produce the result desired by management.

[55] For example, Nesbitt Thomson Deacon Inc., RBC Dominion Securities Inc., ScotiaMcLeod Inc., and Toronto Dominion Securities Inc., all have links with major Canadian banks.

Precisely because valuation is such an uncertain science, producing a broad range of possible answers, a valuation can be "cooked" without the results appearing patently unreasonable.

Therefore, both the "downside" to delivering an unfavourable report to management (losing business) and the "upside" to delivering a favorable one (gaining business) are potentially enormous. By comparison, the downside to delivering a report generously skewed in management's favour seems trivial, given the very slim likelihood that legal liability or other untoward consequences will attach.

Indeed, we would argue that management can play a generous role in ensuring that the valuer produces the "appropriate" valuation, even aside from exerting overt or covert pressure on the valuer or using its economic clout to create an apprehension that an undesirable result (from management's view) will create a loss of business. Valuation in the face of uncertainty depends keenly on intimate knowledge of the unique problems and prospects of the particular business venture. An accurate valuation conducted by even a truly independent outside party depends on the ability and willingness of management to communicate intangible as well as tangible factors to the valuer. It seems clear to us that management has a sharp informational advantage over any outside party. For one thing, the managers will be experts in the particular business in question, while the valuer will not. For another, the managers will be intimately involved in the enterprise on a day-to-day basis, giving them a peculiarly favourable perspective from which to evaluate the business and its prospects. It also seems clear that managers have incentives to withhold information that is damaging to their asserted position. In saying this, we do not mean to suggest that managers are routinely guilty of conscious wrongdoing in such situations, but merely that, when self-interest intervenes, it is bound to alter the colouration of facts presented to the valuer, whether consciously or not. For this reason, even a fairness opinion or valuation conducted by a genuinely disinterested third party must be regarded with caution. It is not surprising that fairness opinions and valuations obtained by management are almost always consistent with management's views.

F. *Conclusion*

We have traced out some of the most important characteristics of Canadian capital markets, particularly those features that distinguish our markets from those south of the border. These characteristics have important implications, not only for market efficiency, but for the appropriate content of rules governing the operation of Canadian markets. Our conclusions on matters of substantive law are admittedly both sketchy and tentative. However, the main point that we wish to make is that the substantive content of market regulation must be carefully informed by a keen understanding of the empirics of the market. It is our contention that this understanding has heretofore largely been absent. In our view, the time has arrived for those who construct the rules to base public policy on facts and not merely enlightened guesstimates of "what's broke" and how to fix it.

IV. THE OPERATION OF THE CANADIAN CORPORATE AND SECURITIES LAW MARKET

One of the purposes of this paper is to direct attention to the linkage between the institutional structure of Canadian markets and the achievement of regulatory objectives in the corporate domain. In this section, we focus on the relationship between the regulatory structure of the Canadian corporate and securities law market and the achievement of regulatory objectives. More particularly, we look at how power is distributed between the securities regulators and the courts and how this impacts on the substance of regulatory outcomes.

A. *Differences in Corporate and Securities Law in Canada*

The two primary instrumentalities for regulating corporate conduct and securities markets are the courts and the securities regulators. For example, a matter involving an alleged breach of fiduciary duty can be resolved by means of private litigation in the courts or by administrative action to sanction the putative wrongdoers. There are a great many differences between these two forms of oversight. The formulation of regulatory policy by securities regulators, whether expressed in statutory amendments, regulations, or the issuance of policy statements, frequently involves the invited participation of the financial community, often through the device of holding public hearings to assess proposed regulatory changes. Where hearings are held, whether in respect of general policy initiatives or particular instances of alleged wrongdoing, they are almost always conducted in an informal manner, with little attention paid to procedural niceties or rules of evidence. This often means that securities regulators can intervene much more expeditiously than can a court. The cease trade and denial of exemptions powers, moreover, give Canadian securities regulators a very wide discretion to act "in the public interest."[56] This introduces a high degree of flexibility and adaptability into administrative proceedings before securities regulators, a flexibility which is heightened by virtue of the fact that securities regulators do not consider themselves bound by the doctrine of *stare decisis*, nor by adherence to judicial standards of proof. Furthermore, an administrative proceeding can be commenced at the instance of the Commission itself, rather than at the instance of aggrieved private parties.[57]

This differs markedly from the manner in which adjudication occurs in the courts. Judicial policy is formed in the crucible of a particular dispute brought to court by private litigants.[58] As a consequence, whatever policy arguments are put forward will be presented with a view to buttressing the case of one or other of the

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[56] See, *e.g.*, Ontario *Securities Act*, R.S.O. 1980, c. 466, ss 123 and 124 [hereinafter *O.S.A.*].

[57] Under both the *C.B.C.A.* and the *O.B.C.A.*, the Director (and sometimes the O.S.C. under the Ontario legislation) may in some circumstances commence an action on behalf of minority interests as *parens patriae*. See, generally, P. Anisman, "The Commission as Protector of Minority Shareholders" in *Special Lectures of the Law Society of Upper Canada, 1989: Securities Law in the Modern Financial Marketplace* (Toronto: De Boo, 1989) 451 at 490-93 [hereinafter *Special Lectures of the Law Society of Upper Canada, 1989*] (discussing the Ontario legislation only). These powers have indeed been used. See, *e.g.*, *Sparling* v. *Royal Trustco* (1984), 24 D.L.R. 245 (Ont. C.A.). However, this form of action is still the exception, and most cases that arrive in court do so at the behest of private litigants claiming injury.

[58] *Ibid.*

private parties. The public interest will not necessarily be represented. Furthermore, the argumentation will tend to be much more closely focused on the content of past precedent and the application of such precedent to the facts at hand. Although policy arguments may be presented, they will usually assume a considerably less important role in a judicial than an administrative proceeding. Added to this is the fact that judicial proceedings are highly formalized, with rules of procedure and evidence rigidly adhered to. This will restrict the range of facts that achieve legal relevance and will further diminish the importance of broad ranging policy or empirically based arguments. Finally, court rulings will tend not to lend themselves to broad statements of policy as well as Commission adjudications do, and the precedent which emerges is often more highly fact specific.

It is our contention that the choice of regulatory instrument and the division of power between the courts and securities administrators have a potentially far-reaching impact on the number and range of disputes that are brought forward for adjudication. The selection of disputes brought before the courts by private litigants is subject to collective action problems. Particularly in the second market, where many or most shareholdings are small and transient, it will not pay for any shareholder to be the mouse who bells the cat.[59] By comparision, securities regulators may select for hearings those disputes which they feel most implicate the public interest, and collective action problems do not interfere with this selection. For this reason, the number and choice of matters that will be adjudicated if courts are the only regulatory forum will differ from those adjudicated where only the administrative option is available.

For a number of reasons, we further hypothesize that the substantive outcomes of these disputes will be influenced by the forum in which the matter is heard. As indicated, administrators pay minimal attention to either rules of procedure or evidence. By contrast, the courts follow a rigidly formal procedure: for example, pre-trial pleadings, discoveries, and a highly stylized adjudication process. Strict rules of evidence apply. These procedural and

[59] Collective action problems are discussed *supra*, notes 11-14 and accompanying text.

evidentiary strictures will greatly influence both the choice of facts that achieve legal relevance and the manner in which these facts are presented. Some facts which are admitted to administrative proceedings will be excluded in a court hearing. This cannot help but influence the substantive outcomes of cases.[60]

In addition, the differences in available sanctions can obviously generate different substantive outcomes. For one thing, a court has the full range of legal and equitable remedies at its disposal (and indeed, has an even wider selection of remedies under the statutory oppression remedy), and might, for example, award damages, a sanction not open to securities regulators. However, the administrators have their own advantages. As indicated, the powers to cease trading a transaction or deny trading exemptions in the "public interest" are extremely flexible tools that can be used quickly to respond to novel forms of transactions or abuse. Particularly because many complex transactions are difficult to unwind (and interlocutory relief is not always available in the courts), the ability to respond quickly and flexibly may be a key factor in determining the outcome of the case. Moreover, the open-ended nature of the regulators' discretionary sanctions allows for substantively different outcomes than those in the courts. The malleability of these tools has, for example, enabled the O.S.C. to recognize the existence of shareholder fiduciary duties, when the courts have not yet clearly done so.[61] More generally, the O.S.C. has indicated that it will consider imposing a cease trade or denial of exemptions order even though there is no breach of a legal requirement found in any statute, regulation, or even policy statement.[62]

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[60] See J.R.S. Prichard, "A Systematic Approach to Comparative Law: The Effect of Cost, Fee and Financing Rules on the Development of the Substantive Law" (1988) 17 J. Legal Stud. 451.

[61] See *Canadian Tire*, *supra*, note 33. See, generally, Anisman, *supra*, note 57 at 463-475; *Corporations*, *supra*, note 46; and *Minority Shareholder Rights in Canada and England: 1860-1987*, *supra*, note 46.

[62] Anisman, *ibid.* The open-ended texture of the statutory oppression remedy has also enabled courts to cast aside many of the common law limitations confronting corporate plaintiffs. However, even with a mandate as broad as that furnished by the oppression remedy, the courts have not yet explicitly recognized the existence of shareholder fiduciary duties. This is good evidence that there are still likely to be occasional differences in substantive outcomes as between courts and securities regulators. See also *First City Financial*

Of course, decisions of securities regulators are generally appealable to the courts,[63] and in theory this power of appeal should ensure that substantive outcomes in administrative *fora* do not differ markedly from those that would be achieved in a court. However, this theory fails in practice. By and large, the courts have deferred to the presumed superior expertise of the administrators and have exercised their power of review with surprising timidity. It is a rare case indeed when Commission action is enjoined by the courts.[64]

B. *The Different Balance of Corporate and Securities Law in Canada and the United States*

Both through the issuance of policy statements and their wide ranging discretionary powers, Canadian securities regulators are encroaching on the domain of corporate law at an ever more rapid rate. For example, before Part XIX of the Ontario *Securities Act*

Corp. v. *Genstar Corp.* (1981), 125 D.L.R. (3d) 303 (Ont. H.C.) [hereinafter *First City Financial*], in which the court refused to grant an injunction where the matter was also before the O.S.C., on the ground that the Commission's ability to use the threat of invoking the cease trade power enabled it to find a "middle ground" not available to a court. See *infra*, note 64.

[63] See, *e.g.*, *O.S.A.*, *supra*, note 56, s. 9(1).

[64] See H.N. Janisch, "Reregulating the Regulator: Administrative Structure of Securities Commissions and Ministerial Responsibility" in *Special Lectures of the Law Society of Upper Canada, 1989*, *supra*, note 57 at 97. The deference shown securities regulators by the courts is plain in *First City Financial*, *supra*, note 62. In an application for an injunction to restrain the completion of a competing takeover bid, Reid J., in denying the application, indicated a preference to defer to the superior expertise of the Securities Commission, commenting at 316:

> It appears to me that the Commission has adequate jurisdiction and power to deal with the issue of non-disclosure in the circumstances of this case. If that is not found under s. 123 of the Act, then other sections may well be available, both to create jurisdiction and to authorize action.

The Court noted that, by using the cease trade power, or by *threatening* to use the power, the Commission could use its powers of "persuasion and suggestion" to fashion an appropriate remedy – a "middle ground" not available to a court asked to grant an interim injunction. In choosing to defer to the Commission, the Court also pointed to the speed, relative informality, and superior expertise of the Commission. As a matter of practice, corporate and securities practitioners will tend to go to the Commission before going to the courts, for precisely the reasons indicated by Reid J. (in addition, of course to the fact that this may be the cheapest way to secure redress).

(dealing with takeover bids) was amended to include takeover bids for non-voting classes of shares,[65] the Commission purported to achieve the same result through Commission Policy Statement 1.3, which, like other O.S.C. policies, entirely lacks juridical force.[66] The same policy statement purports to extend to holders of non-voting (and restricted voting) shares the rights of voting shareholders to receive notice of, to attend, and be heard at, company meetings, although there is no such requirement in any applicable corporate law.[67] For over a decade, the Commission has also indicated in Policy Statement 9.1 that it will require an independent valuation and majority of the minority voting approval in order for a corporation under its jurisdiction to consummate a going private transaction, again even where there is no such requirement in relevant corporate law.[68] Most recently, the Commission has extended the requirements of this policy statement to a variety of other types of transactions.[69] These are merely illustrative examples of the manner in which securities regulators have recently moved into the domain of corporate law.

The picture is somewhat different in the United States. Although like its Canadian counterparts, the federal Securities and Exchange Commission (S.E.C.) has been given a wide variety of discretionary powers,[70] its power to order that trading in the securities of an issuer shall cease is much more circumscribed than the power given to Canadian regulators.[71] Moreover, the S.E.C.

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65 R.S.O. 1980, c. 466, as am. S.O. 1987, c. 7, s. 8.

66 See O.S.C. Policy 1.3, para. V.1.

67 *Ibid.* Part IV.

68 See O.S.C. Policy 9.1. Although a similar requirement may be found in the *O.B.C.A.*, *supra*, note 34, s. 189, the jurisdiction of the securities regulators extends to companies incorporated in other provinces, if those companies have significant numbers of shareholders in Ontario.

69 The proposed revisions to Policy 9.1 were adopted on 5 July 1991. See "Policy Statement 9.1 – Disclosure, Valuation, Review and Approval Requirements and Recommendations for Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions" (1991) 14 O.S.C.B. 3345. See *infra*, notes 174-87.

70 See *The Puzzle of Shareholder Fiduciary Duties*, *supra*, note 46.

71 *Ibid.*

possesses no counterpart to the power to deny trading exemptions.[72] As a consequence, the discretionary power of federal regulators to shape the market is much more limited than in Canada.

The fact that securities regulation in Canada is a provincial matter, while it is largely a federal matter in the United States, may be an important factor in explaining why Canadian securities regulators generally wield a wider ambit of discretionary authority than their American counterparts. Conflict of law rules dictate that the corporation carries its charter with it wherever it goes, so that disputes relating to the governing corporate law are determined under the law of the chartering jurisdiction. Securities laws, however, apply to all corporations with a material number of shareholders in the regulating jurisdiction, wherever incorporated. Securities law is thus the instrument of choice for provincial policymakers bent on expanding their control over corporate behaviour, since all corporations that wish to play in the local jurisdiction's backyard must abide by its home-grown rules.[73] Indeed, because securities regulators commonly take the view that out-of-province transactions have a reflexive effect on local investors, they have shown few qualms about purporting to extend their jurisdiction to transactions taking place entirely in another jurisdiction.[74]

One of the most important consequences of the extent to which Canadian securities regulators have begun to intrude on matters that have traditionally fallen in the domain of corporation law is that competitive corporate law innovation is likely to be greatly stifled (if it has not been already). As the American literature indicates, law can be thought of as a "product," with corporations as "buyers" of the product.[75] In the United States, it

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[72] *Ibid.*

[73] See, *e.g.*, M.J. Trebilcock *et al.*, *The Choice of Governing Instrument* (Ottawa: Ministry of Supply & Services, 1982).

[74] See, *e.g.*, P.J. Dey, *Opening Statement for Panel on Extraterritorial Application of Securities Laws* (Los Angeles: Law Institute of the Pacific Rim, 21 October 1983); *In re Connor* (1976), O.S.C.B. 149; and *In re Kaiser Resources Ltd* (10 April 1981), 1 O.S.C.B. 13C.

[75] See R. Romano, "Law as a Product: Some Pieces of the Incorporation Puzzle" (1985) 1 J. Law Econ. & Org. 225.

is clear that states compete for incorporation business, which brings in franchise fees and taxation revenues.

Although some have suggested that the competition for chartering business operates to the disadvantage of the corporation's shareholders and in favour of its managers,[76] the evidence now suggests that this is not usually the case.[77] The competition for chartering business, in fact, appears to have produced superior corporation laws. In Canada, although there has been some recent chartering competition, it has failed to produce the elaborate institutional regime that can be observed in the United States.[78] Although there may be a variety of factors responsible for less vigorous competition (that is, the role of the Supreme Court, inability to realize minimum efficient scale of production, enhanced prospect of coordinated behaviour, legal market failures, and geographic monopoly by central Canadian governments), the ability of securities regulators to effectively nullify corporate law reforms by imposing their own standards may be the most important factor.[79]

The diversion of the function of corporate and securities law adjudication to the administrators has another side-effect. Since Canadian judges see relatively few corporate or securities law disputes, few have acquired any degree of expertise in these areas. The result is a generally low quality of judicial crafting of corporate and securities law. This is in marked contrast to many of the state courts. The Delaware courts in particular have evolved mechanisms for expedited hearings, circulation of judgments for comment before release, and a high level of judicial competence in cases involving corporate litigants.

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[76] See, *e.g.*, W.L. Cary, "Federal and Corporate Law: Reflections Upon Delaware" (1974) 83 Yale L.J. 663.

[77] Romano, *supra*, note 75.

[78] R.J. Daniels, "Should Provinces Compete: The Case for a Competitive Corporate Law Market" (1991) 36 McGill L.J. 130.

[79] *Ibid.*

C. *Summary*

The regulatory parameters applicable in Canada differ somewhat from those in the United States. More particularly, securities regulators have a broader range of discretionary powers, and have used these powers to move into the domain of corporate law to a degree not witnessed in the United States. One consequence of this development is that the success of provincial (or federal) corporate law reforms is rendered problematic, given the ability and demonstrated inclination of securities regulators to make their own corporate law. These institutional parameters supply both an important context and an important constraint against which proposals for corporate law reform must be measured. Increasingly, the attention of corporate law reformers must be focused on the securities regulators, and their use of policy statements and discretionary sanctions, rather than simply the corporation codes.

V. THE IMPACT OF DISTINCTIVENESS: THREE CASE STUDIES

In this part, we apply the insights culled from the previous discussion to three case studies: (1) the private agreement exemption; (2) poison pills; and (3) a non-arms length transaction between controlled corporations of the Bronfman group of companies. Each of these will be examined in turn.

A. *The Private Agreement Exemption in Canada*

The role that the distinctive features of the structure of Canadian markets and institutions can play in influencing the content of the corporate and securities law regime is vividly illustrated by the longstanding debate over the appropriate role of the private agreement exemption from the requirements of the takeover bid legislation. This issue, which has been addressed by a number of governmental and non-governmental task forces over the last two and a half decades, has once again been brought to the fore by the recent proposal of the Canadian Securities Administrators to tighten the ambit of the exemption.[80] In our opinion, the decision whether to tighten or, indeed, relax the private agreement exemption should be based on a firm understanding of the costs and benefits of the exemption in a Canadian setting. Although a number of the analyses furnished to support changes to the exemption have articulated a similar commitment, it is our opinion that this commitment has been honoured more in its breach than in its observance.

The private agreement exemption is simply a statutory safe-harbour that, in the case of the Ontario *Securities Act*, exempts offers to purchase shares from five or fewer shareholders at a price not exceeding 115 per cent of a benchmark market price from the rigours of the takeover rules.[81] These rules prescribe certain minimum conditions for the consummation of a statutorily defined takeover bid, that is, an offer to acquire voting or equity shares of any class that would result in the offeror owning more than 20 per cent of that class of shares. These conditions include: minimum bid periods,[82] early warning requirements that force acquirors to disclose the acquisition of securities of a given class of shares once certain ownership thresholds are reached,[83] mandated disclosure of material information respecting a takeover bid,[84] *pro rata* take up of shares when the number of securities tendered into a bid is greater

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[80] The C.S.A. proposal suggests a tightening of the existing regime by limiting to one the number of times that the exemption can be relied on by a shareholder in respect of a given class of securities and by imposing constraints on the length of time during which purchases under the exemption can occur. According to the C.S.A., the tightening is needed so that inequalities in the treatment accorded institutional and individual security holders can be mitigated. See Canadian Securities Administrators Take-over Bid Subcommittee, "Proposed Changes to Provincial Securities Legislation – Take-Over Bids" (1990) 13 O.S.C.B. 2295.

[81] The private agreement exemption may be found in *O.S.A.*, *supra*, note 56, s. 92(1)(c).

[82] The minimum bid period under the Ontario *Securities Act* is twenty-one days. *Ibid.* s. 94(2).

[83] The *Act* requires that acquisition of 10 per cent of the voting or equity securities of a company must be accompanied by the issuance of a press release, and within two business days, a report to the Commission. *Ibid.* s. 100(1). Each additional acquisition of 2 per cent must be accompanied by the issue of a press release, a copy of which must be filed with the Commission. *Ibid.* s. 100(a)(2).

[84] *Ibid.* s. 97(1).

than the number sought by an acquiror,[85] and withdrawal rights.[86] Since these "rules of the road" have the effect of substantially fettering the flexibility of both the purchasing and selling shareholders in effecting control transfers, the ability to avoid their application is of considerable economic value.

The current form of the private agreement exemption reflects no single underlying rationale, but rather is a compromise between those expressing contrary views about the ownership of any premium paid to acquire control of the company. To some commentators, of whom Berle and Means are the most prominent, the ability to control the corporation is merely an incident of the voting process.[87] Under this theory, control is a corporate asset and any premium paid for control must therefore be shared amongst all shareholders. Other commentators who have objected to the disproportionate sharing of the control premium have grounded their arguments more directly in a simple principle of equality:[88] that is, whether a shareholder holds or participates in control or not, equality of treatment must govern in any transfer of control.

Others, notably Easterbrook and Fischel, have championed the view that unequal treatment of controlling and non-controlling shareholders is unobjectionable and may indeed be a *desideratum.*[89] Easterbrook and Fischel argue that shareholders will, *ex ante*, choose the rule that maximizes their expectation of future gain, and that a rule that allows controlling shareholders to receive a disproportionate share of any premium paid for parting with control will accomplish this end. A fundamental assumption in the argument is that transfers of control are generally beneficial to the

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85 *Ibid.* s. 94.7.

86 *Ibid.* s. 94.4.

87 A.A. Berle & G.C. Means, *The Modern Corporation and Private Property*, rev'd ed. (New York: Harcourt, Brace & World, 1967). Other commentators arguing for the sharing of a control premium on this ground include D.C. Bayne, "Corporate Control as a Strict Trustee" (1965) 53 Geo. L.J. 543; D.C. Bayne, "The Sale of Corporate Control" (1965) 33 Fordham L. Rev. 583; and R.W. Jennings, "Trading in Corporate Control" (1965) 44 Calif. L. Rev. 1.

88 W.D. Andrews, "The Stockholder's Right to Equal Opportunity in the Sale of Shares" (1965) 78 Harv. L. Rev. 505.

89 *Corporate Control Transactions, supra*, note 3.

corporation, in that they tend to eliminate inefficient management and move corporate assets to the hands of those who can direct them most efficiently. Thus, even though shareholders may not participate directly in a control premium (or may receive less than a *pro rata* share of the premium) they will benefit *indirectly* to the extent that the corporation is better run. In addition, allowing controllers to keep a disproportionate share of the control premium will increase the probability that a control transfer will occur. Because controllers can reap a higher reward for selling control, they will be more inclined to do so. Similarly, because the buyer need not pay a premium to all shareholders, its cost of acquisition will be lowered, and it will be more inclined to make the acquisition.[90]

The argument in favour of allowing controllers to keep any control premium may be buttressed by noting that, in the absence of government intervention, control blocks of shares typically trade in the market at a premium to the market price. This premium may reflect in part the psychic benefit of being able to direct the operations of the corporation. Some, like the late Harold Ballard, clearly derive pleasure from the ability to control over and above any financial reward that might result from ownership of a control block. Others may derive advantage from being able to arrange the manner in which profits are returned to shareholders in a manner that minimizes their personal income taxes. So long as the source of the control premium is non-objectionable, the ability of the seller to capture a premium for sale of control reflects both the fact that controlling and non-controlling shares are *not* in fact fungible, and the fact that the controller itself will have paid a premium to acquire control.[91] The imposition of a level price rule in these

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[90] As against this, one might argue that in cases in which the law mandates that the premium be split between all shareholders equally, or in cases where the law requires that an offer be made to all shareholders on equal terms, the seller might simply divide the control premium that it had anticipated paying between all shareholders, resulting in no increase in acquisition cost. However, while this might indeed be the case, in such cases the controlling seller will be less likely to sell, diminishing the probability that a takeover bid will succeed.

[91] In perhaps a more sinister vein, controllers may sometimes derive benefit from diverting corporate assets to their own use, whether through excessive managerial salaries, consumption of perquisites, arranging interested transactions, or other means. If this is the case, then the argument for allowing holders of control to capture a premium for its sale is

circumstances would confer windfall gains on non-controlling shareholders, without any ethical support or efficiency gains.

To a large extent, the evolution of the private agreement exemption is a consequence of the different weight that policy-makers have accorded to each of these arguments. Initially, in Ontario, the greatest weight appears to have been attached to the view that corporate control is a personal and not a corporate asset. This view is implicit in the report of the Kimber Committee,[92] whose recommendations resulted in the *The Securities Act, 1966* and the first comprehensive set of takeover rules in Ontario. The Committee recommended that transfers of control effected by way of private agreement be exempted from the ambit of the proposed takeover legislation.[93] Strictly speaking, the Committee's exclusion of privately effected control transfers from the takeover legislation was not meant to be an endorsement of any of the competing visions of the status of the control premium. Rather, the Committee felt that the duty to share a control premium was essentially a fiduciary duty, whose evolution was best left to the courts.[94]

Barely five years after the report of the Kimber Committee, the appropriate distribution of the control premium was examined once again in the Ontario Securities Commission's Merger Study.[95] Although the Merger Committee was sensitive to the plight of minority shareholders who "find themselves at a loss, because of the competing claims or atmosphere of uncertainty, to know the best

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clearly weakened.

[92] Ontario, *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Government of Ontario, 1965) (Chair: J.R. Kimber) [hereinafter *Kimber Report*].

[93] *Ibid.* para. 3.12.

[94] *Ibid.* In the words of the Committee:

> We are of the opinion that the evolution of a legal doctrine which may impose upon directors or other insiders of a company who constitute a control group a fiduciary duty toward other shareholders of such company in cases of control is, apart from insider trading aspects, a matter to be left to development by the judicial process.

[95] Ontario Securities Commission, *Report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements* (Toronto: The Commission, 1970).

course to follow" during the course of a takeover bid,[96] it refrained from recommending "the easiest and least flexible solution, to prohibit all 'exempt offers,' requiring all acquisitions to be made through circulars and all offers to be made *pro rata* to all shareholders."[97] The basis for the Merger Committee's reluctance was rooted in the efficiency concerns standing at the heart of the Chicago School's enthusiasm for unequal sharing. In the view of the Committee, subjecting private transfers of control to the takeover bid regime would

> reduce incentive to a common denominator, including the incentive to control, manage, build and then divest to take the benefit of those efforts. The solution providing equality is simple. The result of the solution would be profound.[98]

The Committee also noted that there was no evidence that control persons had so abused their positions as to require special treatment and echoed the Kimber Committee's recommendation that the issue of fairness as between shareholders be remitted to the courts. Accordingly, in their view, the private agreement exemption should be left undisturbed.

By the time that the Select Committee of the Ontario Legislature addressed the issue three years later,[99] momentum in favour of a more confined role for the private agreement exemption appeared to be gathering force. Despite this and over the strong reservations of the minority and a change of heart by the O.S.C., the Select Committee continued to support a wide ambit for the private agreement exemption. While the majority reiterated the efficiency concerns expressed by Merger Committee, the minority report called for the introduction of a requirement that a private purchase of control would be followed up by an offer on the same terms to all other shareholders. In stark contrast to the views of the majority, the minority wholeheartedly embraced the notion of control as a

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96 *Ibid.* para. 7.03.

97 *Ibid.* para. 7.04.

98 *Ibid.*

99 Select Committee on Company Law, *1973 Report on Mergers, Amalgamations and Certain Related Matters* (Toronto: Queen's Printer, 1973) (Chair: William Hodgson).

corporate asset and the fungibility of shares of the same class.[100] With respect to the majority's argument that an equal price regime would endanger entrepreneurial incentives, the minority simply asserted that this argument was "not as strong as it appears."[101]

At the end of the day, however, it was the minority, and not the majority that prevailed. Following the Select Committee's report, a number of bills were introduced in the legislature that sought to modify the private agreement exemption. One of the earliest of these initiatives, Bill 98 (which would have resulted in *The Securities Act, 1975*) envisaged the removal of the private agreement exemption by requiring all offers to be made to all Ontario security holders on the same terms, irrespective of whether or not the acquiror sought to pay a control premium to a controlling shareholder.[102] After this Bill failed, the legislature ultimately adopted a compromise position which permitted the retention of the private agreement exemption, subject to an obligation to make a "follow-up" offer to non-controlling shareholders, as the minority of the Select Committee had recommended.[103] Under this provision[104]

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[100] As the minority report put it:

> Conceptually, at least, each share in the capital of a company is the same as every other share of the same class and entitles the holder to an aliquot interest in the company. When a controlling shareholder sells control, the thing he is really selling is corporate assets and the right to control the use of those assets and those assets belong to all of the shareholders, not merely the controller.

Ibid. at 31.

[101] *Ibid.*

[102] This prompted Peter Dey to suggest that the

> Government has been almost too rigorous in its attempt to eliminate the payment of control premiums ... Under Bill 98, the acquisition of a company by way of a share offer will be a very expensive proposition. Fewer companies will be able to master the resources to undertake the payment of a premium for control and the extension of an offer upon similar terms to the balance of target company shareholders.

See P. Dey, "Securities Reform in Ontario: The Securities Act, 1975" (1975-76) 1 Can. Bus. L.J. 20 at 38. For an excellent chronology and discussion of the various stages of legislation introduced respecting the private agreement exemption, see B. Bailey & P. Crawford, "The Takeover Bid by Private Agreement: The Follow Up Offer Obligation" (1983) 7 Dal. L.J. 93.

[103] As indicated by Bailey & Crawford, *ibid.* at 116, the legislation was a

> compromise between those advocating minority shareholder protection and those advocating an improvement of the integrity of the capital markets without placing undue restrictions on the entrepreneur when dealing in the public marketplace.

(as modified by the regulations[105]), control might be purchased from fewer than fifteen persons at a premium to market of less than 115 per cent without triggering a follow up obligation. Any private purchase of control from fifteen or more persons or in excess of the stated premium triggered an obligation to make an offer for equivalent consideration to other shareholders within a year.

The follow-up offer provision was relatively short-lived. In the wake of sustained criticism, members of the corporate bar (the Practitioner Committee[106]) and the securities industry (the Industry Committee[107]) were invited to comment to the O.S.C. on possible amendment of the provision. Apart from the similarity of their recommendations, one of the most striking features of the two reports is their rejection of efficiency concerns in favour of an unqualified adoption of the concept of substantive equality among all shareholders of the corporation, irrespective of controlling or non-controlling status. The *Practitioner Report*, for example, stated:

> we believe that shareholders of an offeree issuer and public investors generally should be confident that transactions which may affect the *de facto* control of public security issuers will be made, as a matter of principle, on a basis which requires identical treatment of holders of the same class of securities and that all such shareholders will have an equal opportunity to participate in the benefits which may accompany a change of effective control of issuers.[108]

Embracing what it viewed as changing commerical mores, the *Industry Report* also recommended the adoption of an equal price rule, rejecting the notion that the control premium was private property. What was a minority view, just a decade earlier, had now become the received wisdom in the financial community.

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[104] See *The Securities Act, 1978*, S.O. 1978, c. 47, s. 91(1).

[105] Formerly R.R.O. 1980, Reg. 910, s. 163(3).

[106] Ontario Securities Commission, *Report of the Committee to Review the Provisions of The Securities Act (Ontario) Relating to Take-Over Bids and Issuer Bids* (Toronto: The Commission, 1983) [hereinafter *Practitioner Report*].

[107] Securities Industry Committee on Take-over Bids, *The Regulation of Take-Over Bids in Canada: Premium Private Agreement Transactions: Report of the Securities Industry Committee on Take-over Bids* (Ottawa: The Committee, 1983) (Chair: P. Lortie) [hereinafter *Industry Report*].

[108] *Practitioner Report, supra*, note 106 at 1.

The two committees also noted that the follow-up offer as then structured frequently required the Commission to make the difficult determination of whether a follow-up offer was for "equivalent" consideration. Further, as the follow-up offer could take place up to a year after the initial exempt purchase of control, market conditions may have changed dramatically, possibly making it difficult for the offeror to comply with its obligation.[109]

Despite these criticisms, the committees did not recommend the complete abandonment of the private agreement exemption. Rather, the committees recommended that the follow up offer obligation be jettisoned in favour of an approach derived from Quebec securities legislation, under which an offer made to more than five persons or in excess of a 115 per cent premium to market would be a non-exempt "takeover bid," requiring full and immediate compliance with the provisions of the *Act* relating to takeover bids.[110] This recommendation eventually became law.[111]

In a review of the evolution of the private agreement exemption, the absence of facts is astonishing. The fundamental purpose of securities regulation is the promotion of the interests of investors. Many of the theoretical arguments either in favour of or against the narrowing private agreement exemption have empirically testable implications for the welfare of investors. And yet, in the history that we have reviewed, no attempt has been made to seek out or commission any empirical investigations of the effect of narrowing the scope of the private agreement exemption on Canadian capital markets.

Those who have participated in the policy process have made reference to the various theoretical arguments that we have canvassed above, though much of the debate has proceeded without a keen sensitivity to what is, in fact, distinctive about the Canadian context and how this might impact on policy. Virtually every report, from that of the Kimber Committee to those of the corporate bar and securities industry, has grappled at an abstract level with the

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[109] Both of these difficulties are apparent in *In re Turbo Resources Ltd and Bankeno Mines Ltd* (5 November 1982), 4 O.S.C.B. 403C.

[110] *Securities Act*, S.Q. 1982, c. 48, s. 116, as am. S.Q. 1984, c. 41, s. 40.

[111] In the current legislation, see *O.S.A.*, *supra*, note 56, s. 92(1)(c).

possibility that the structure of the Canadian economy could render solutions transported from other contexts less applicable to Canada.[112] Nevertheless, this recognition has seldom (if ever) been followed up by a concrete analysis of the nature of Canadian distinctiveness and its consequences, rendering the appeal to Canadian distinctiveness more rhetorical than real.

The *Industry Report*, for example, blithely dismissed the efficiency concerns implicated by an equal price regime in the following terms:

> The Easterbrook-Fischel proposition is that the fiduciary obligation is not *per se* to ensure that benefits arising from transactions are all shared equally or 'fairly'. Rather, the fiduciary should maximize wealth and then follow the agreed rules for distribution of benefits ... They justify their approach with their assumption that shareholders unanimously prefer legal rules under which the amount of gains is maximized, regardless of how gains are distributed. *Evidence in the Canadian capital market invalidates this assumption.*[113]

Unfortunately, the evidence relied on by the authors of the *Industry Report* is not presented.

Not all of the theoretical arguments regarding the disposition of a control premium are empirically testable. For example, the view that all shareholders have an ethical or moral entitlement to share equally in any premium is obviously not subject to empirical verification. However, even for those who prefer a moral argument (based, for example, on the principle of "equality" as an end in itself) to an efficiency argument, the *economic costs* of imposing a particular regime of rules must surely be relevant. And there are indeed a variety of ways in which the comparative costs of different regimes of rules may be illuminated. To begin, it is important to know *how many* private transfers of control have taken place both before and after changes in the regulatory regime restricting private transfers of control. Equally, it is important to know how target

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[112] For instance, the *Kimber Report*, *supra*, note 92 at 20, para. 3.03 noted that the existing structure of the financial community in Ontario and in Canada at large differs from that of other jurisdictions, such as the United Kingdom ... While the legislation and studies in other jurisdictions have been examined by the Committee, we have remained cognizant of the fact that any recommendations which we make should related to the commercial and financial circumstances which prevail in Canada and not elsewhere.

[113] *Industry Report*, *supra*, note 107 at 29 (emphasis added).

shareholders (and acquiror shareholders[114]) fare when there is a private agreement transferring control of the corporation. Well recognized statistical and econometric techniques can help determine if any changes in the frequency of, or gains resulting from such transactions, are a product of changes in the regulatory environment. The results of investigations of this nature would take policy-making out of a vacuum and situate it in a factual environment against which the costs and benefits of different forms of regulatory interventions could be measured. For example, evidence that private changes in control generate net gains for acquiror and target shareholders or that the frequency of private changes in control has decreased dramatically since the introduction of the restrictions on private changes in control, might do much to strengthen the case against restricting the private sale of control.

There is other evidence which might help illuminate the utility of the private agreement exemption. For example, if the progressive tightening of the exemption has resulted in fewer private changes of control, has it also resulted in proportionately more changes of control being effected by offers made to shareholders generally? How do the gains of shareholders of both target and acquiror companies in takeover bids compare to the gains to shareholders where there are private changes in control?

More generally, what are the sources of gains in acquisition activity? Private gains of shareholders might be funded, for example, by transfers of wealth from bondholders or employees to shareholders, from increasing monopolization of the markets in which the acquiror and target sell their products or sharply reduced tax burden. If so, then private gains may mask net social costs. This might have a profound effect on takeover policy (and not merely the private agreement exemption). On the other hand, private gains may arise from elimination of inefficient management, from transaction synergies, or from other sources of efficiency improvements, and result in net increases in societal wealth.

Restricting the scope of the exemption is likely to force acquirors seeking control to resort more frequently to general offers

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114 And indeed, the other constituents of both acquiror and target corporations, like bond holders, employees, *et cetera*.

to shareholders. This, in turn, is likely in many cases to increase the capital needed to effectuate a takeover bid. Thus, it would be useful to know how efficiently Canadian debt markets work in funding acquisition activity. Evidence of a weakness in funding acquisition programmes might be further evidence against a narrow private agreement exemption, while evidence of robust debt markets might cut in the other direction.

A further issue that invites empirical investigation (and one that has been largely neglected by Canadian commentators) is the extent to which Canadian takeover policy has been diverted toward the pursuit of the wrong target. From the Kimber Committee onwards, the primary goal of takeover policy has been the protection of the interests of target shareholders.[115] And yet, to the extent that target shareholders are enriched by the takeover rules, acquiring shareholders are impoverished. This pure redistribution of wealth has no efficiency consequences and seems rather pointless. But let us suppose that for some reason target shareholders are to be seen as more deserving than acquiror shareholders. Are the same people in fact systematically likely to be target shareholders? Or might they sometimes be target shareholders and sometimes acquiror shareholders? The question is important. Most shareholders hold portfolios of securities, either by constructing such portfolios themselves or investing their funds through financial intermediaries (banks, insurance and trust companies, mutual funds, *et cetera*) which hold large portfolios. If these shareholders are just as likely to be acquiror shareholders as target shareholders in respect of a given acquisition, then the argument that target shareholders are more deserving than acquiror shareholders seems to fall to the ground. After all, those who are target shareholders in one acquisition are likely to be acquiror shareholders in the next. Over the long haul, the policy of favouring target shareholders will therefore have *no* distributional impact.

One might argue that in these circumstances the policy of favouring target shareholders at least does no harm. But this is not quite accurate. First, the restrictive takeover rules reduce the number of takeover bids and therefore the level of management

115 *Kimber Report*, *supra*, note 92 at 22, para. 3.10.

discipline, decreasing the overall efficiency of Canadian enterprise. Second, compliance with the rules creates large legal, accounting, and planning costs. If the distributional goal of favouring target shareholders is illusory, the underlying rationale for our current takeover rules is in serious jeopardy.

The empirical issue for verification is therefore the extent to which there is a discrete class of "target" shareholders who are not also likely to be acquiror shareholders. Does the typical Canadian portfolio contain representatives of both classes of corporation or more of one class than another? Many of the largest Canadian companies are owned by public upstream holding companies — like B.C.E., Canadian Pacific, Hees, Edper Enterprises, and Power Financial — that afford institutional and retail investors alike the opportunity to directly participate in the benefits arising from a control transfer (to the extent that these flow to the acquiror).

B. *The Case of Poison Pills*

Since late 1988, when Inco first introduced the poison pill to Canadian capital markets, approximately twenty-four Canadian companies have adopted or have announced their intention to adopt poison pills.[116] Most of these companies are "management controlled" public companies lacking a controlling shareholder.

The introduction of the poison pill by widely held public companies is a disturbing development. Although there is as yet almost no systematic empirical evidence that would shed light on how shareholders of Canadian poison pill companies fare, there is a large body of empirical evidence from the United States (where poison pills made their debut in late 1982) that suggests that poison pills are not in the best interests of shareholders, but serve to protect managers against loss of employment as a result of a hostile takeover bid. Three American studies conclude that, on average, share prices decline on the announcement of the intended adoption

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[116] See J.G. MacIntosh, "Poison Pills in Canada: A Reply to Dey and Yalden" (1991) 17 Can. Bus. L.J. 323.

of a poison pill.[117] Companies that adopt poison pills appear to be more poorly run than their industry cohorts.[118] Moreover, judicial decisions upholding a managerial decision *not* to redeem a poison pill – that is, a decision to defeat a hostile bid – result on average in share price declines for target companies, while decisions ordering poison pill redemption cause share prices, on average, to rise.[119] Other evidence suggests that poison pills are not in the best interests of shareholders.[120] There is only a single Canadian study[121] which, though ambiguous in its result, it is not materially inconsistent with the American studies.[122]

In the United States, neither corporate nor securites law require that a poison pill be approved by shareholders.[123] In fact, poison pills appear to have become popular with widely held public corporations in the United States for precisely this reason. Other "shark repellent" techniques, like fair price charter amendments, staggered boards, managerial authority to issue blank cheque preferred shares, and similar devices require shareholder approval. In the face of increasing inability to convince institutional shareholders to vote in favour of shark repellent amendments, American managers have opted for a technique that by-passes shareholder approval entirely. Thus, in the United States, the poison pill has become a potent tool for circumventing institutional shareholder oversight of management.[124]

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[117] P.H. Malatesta & R.A. Walkling, "Poison Pill Securities: Stockholder Wealth, Profitability and Ownership Structure" (1988) 20 J. Fin. Econ. 347; M. Ryngaert, "The Effect of Poison Pill Securities on Shareholder Wealth" (1988) 20 J. Fin. Econ. 377; and Office of the Chief Economist, Securities and Exchange Commission, *The Effects of Poison Pills on the Wealth of Target Shareholders* (Washington: Securities and Exchange Commission, 1986).

[118] See J.G. MacIntosh, "The Poison Pill: A Noxious Nostrum for Canadian Shareholders" (1989) 18 Can. Bus. L.J. 276 at 288-89.

[119] *Ibid.* at 287-88.

[120] *Ibid.* See also MacIntosh, *supra*, note 116.

[121] P. Halpern, "Poison Pills: Whose Interests Do They Serve?" (1990) 3(1) Can. Inv't Rev. 57.

[122] See MacIntosh, *supra*, note 116, n. 13-14 and accompanying text.

[123] See MacIntosh, *supra*, note 118 at 277.

[124] *Ibid.*

In Canada, securities regulators and stock exchanges now require shareholder approval of poison pills as a matter of course.[125] Moreover, the "permitted bid" form of poison pill is crafted to nominally leave the decision of whether to approve a permitted bid in the hands of shareholders.[126] On the face of it, Canadian poison pills thus appear to do little violence to the principle that shareholders are the ultimate arbiters of the fate of the corporation. And indeed, no majority of Canadian shareholders has yet turned down management's request to approve a poison pill.

The fact that Canadian shareholders routinely approve measures that operate against their best interests is a puzzle with important implications for the analysis of corporate governance in Canada. Many of the corporations that have adopted poison pills have significant institutional shareholdings.[127] We believe that the case of poison pills is a cautionary tale that emphasizes both the strengths and weaknesses of the capital market discipline exercised by institutional shareholders in Canada.

Looking first to the strengths of institutional involvement in the marketplace, institutional shareholders and their advisors have been the primary source of criticism of management, bringing to bear a degree of experience, expertise, and market acumen not shared by the average retail investor. Amongst institutional shareholders, the *Caisse de Dépôt et Placement du Québec* has been particularly active in campaigning against poison pills.[128] The Allenvest Group Inc., an advisor to institutional shareholders, has also been vigorous in its opposition to the poison pill.[129]

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125 However, such approval requirements have not yet been formalized.

126 See Allenvest Group Limited, "Summary of Current Poison Pill Plans" (1990) 2(3) Corp. Gov. Rev. 2 [hereinafter *Summary*]; P. Anisman, "An Acceptable Poison Pill Rights Plan?" (1990) 2(2) Corp. Gov. Rev. 2 [hereinafter *An Acceptable Plan?*]; and P. Anisman, "Poison Pill Rights Plans: A Checklist of Issues" (1990) 2(3) Corp. Gov. Rev. 4 [hereinafter *Checklist*].

127 We do not have figures on institutional shareholdings in pill adopting firms and must therefore rely on anecdotal accounts in the press. See, *e.g.*, MacIntosh, *supra*, note 118 at 305-11 (adoption of a poison pill by Inco Ltd).

128 The *Caisse* was particularly involved in the Inco compaign. *Ibid.*

129 See *Summary*, *supra*, note 126; *Checklist*, *supra*, note 126; and *An Acceptable Plan?*, *supra*, note 126.

Representations made by Allenvest Group Inc. have been pivotal in convincing some Canadian companies to alter some of the provisions of their poison pills.[130] As a result of institutional opposition, many shareholder votes approving poison pills have been perilously close to failing, in sharp contrast to the usual nearly unanimous endorsement of management initiatives.[131] Thus, institutional shareholders have played a key role in shaping the debate about poison pills.

Equally important in emphasizing the vanguard role of institutional shareholders is the fact that retail investors have been characteristically mute on the issue of poison pills. This is not surprising. Retail investors are not protected by any organization that represents their interests. They have no spokespersons. Indeed, by nature, the retail investor is something of a wallflower, watching the action from a distance and hoping for good fortune. This simply emphasizes the point that we made earlier: collective action problems prevent small investors from protecting their own interests. Larger block holders, like institutional shareholders, play a vital role in disciplining corporate management and keeping capital markets on track. This is a role that cannot be replicated by small shareholders.

And yet, despite the institutional opposition that has emerged to poison pills, the fact remains that no poison pill has yet been defeated. In our view, this highlights the weaknesses of institional oversight of the market. In the face of potent evidence from the United States that poison pills do not operate in the best interests of shareholders, institutional shareholders have voted in favour of poison pills in sufficient numbers to ensure that all

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130 See W.S. Allen, "Post Pillage" (1990) 2(5) Corp. Gov. Rev. 1.

131 The total percentage of shareholders voting on the resolution to adopt a poison pill and the percentage of those shareholders voting against the resolution are shown in brackets (for those companies that, at the date of writing, have taken a vote): Pegasus Gold (50 per cent, 16 per cent); Moore Corp. (66 per cent, 42 per cent); Sherrit Gordon (42 per cent, 47 per cent); Alcan Canada (68 per cent, 46 per cent); Ipsco (46 per cent, 16 per cent); Dofasco (68 per cent, 31 per cent); Nowsco (43 per cent, 2 per cent); Finning (42 per cent, 3 per cent); Canadian Pacific (53 per cent, 42 per cent); Southam (87 per cent, 37 per cent); Federal Ind. (68 per cent, 36 per cent); Placer Dome (56 per cent, 43 per cent); Computalog (58 per cent, 16 per cent); Loewen Group (56 per cent, 6 per cent); Franco Nevada (64 per cent, 7 per cent); United Coin (53 per cent, 13 per cent); and CAE (40 per cent, 8 per cent). See Allen, *ibid.*

Canadian pills presented to shareholders have been adopted.[132] Why have some institutions voted in favour of the adoption of poison pills?

One answer, of course, is that some percentage of institutional investors simply believe management's representations that the poison pill will operate in the best interests of shareholders. Although we believe that the evidence is robust in suggesting that poison pills are not in the best interests of shareholders, we do not suggest that no rational person could adopt a different view.[133] Our experience, however, convinces us that many institutional shareholders voting in favour of poison pills were simply ignorant of the United States evidence showing that shareholders, on average, suffer when a poison pill is adopted. This demonstrates the first limitation to institutional shareholder oversight of capital markets. Institutional oversight is effective only to the extent that institutional shareholders adequately inform themselves on matters that bear upon their decision of how to vote. Although institutional investors possess greater expertise than the average retail investor, an uninformed institutional decision is not much more effective than the uninformed decision of a relatively unsophisticated retail investor.

We conjecture that it is easier for corporate management in Canada to secure adoption of wealth-decreasing measures in part because Canadian institutional investors are less likely to be well informed than their American counterparts. This is a consequence of the fact that our relatively small capital market does not generate the depth of experience that a larger market necessarily will. In a large market, fund managers will have greater access to both anecdotal and systematic evidence about the likely effects of the adoption of measures like poison pills. In relation to the former, managers of institutional funds in a large market will have a wealth of collective experience to draw upon in evaluating management initiatives. In relation to the latter, a large market begets large data

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[132] We do not have a precise breakdown showing how institutional shareholders voted. However, it seems clear, in at least some cases (for example, Inco) that had institutional shareholders all voted against the poison pill, it would have failed.

[133] See MacIntosh, *supra*, note 118 at 312-21.

samples, which furnish generous raw material with which to conduct statistical studies. A large data sample reduces statistical "noise" and generates a meaningful picture of what happens to share prices on the adoption of various management initiatives. The American experience is illustrative. In the United States, there is a rich empirical academic literature which fund managers may consult in the interests of better informing their decisions as to how to vote on various management initiatives. And, whether as a consequence of fund managers' own experiences in the market, or the availability of systematic empirical evidence, or both, there is evidence that American institutional shareholders have played an important role in opposing wealth-decreasing corporate initiatives.[134]

By contrast, the collective experience of Canadian institutional investors with various forms of management initiatives is likely to be impoverished, given the much smaller size of our market and the relative infrequency of many types of corporate events. Similarly, there is a paucity of systematic empirical evidence bearing on the consequences for investors of various types of corporate transactions. One looks in vain, for example, for Canadian studies on the effects on share prices of managerial resistance to a hostile takeover bid.[135] To a large extent, this is due to the unavailability of basic data sets in Canada. While data for conducting American research is readily available from a number of commercial sources,[136] data sets in Canada are rudimentary or non-existent.[137]

Despite the unavailability of Canadian empirical evidence, we are surprised at the degree to which Canadian institutional shareholders and fund managers are unencumbered by even a

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[134] See, *e.g.*, Brickley, Lease, & Smith, Jr., *supra*, note 45.

[135] The paucity of Canadian evidence, in contrast to the richness of the American literature, is illustrated by the discussion in MacIntosh, *supra*, note 116, n. 13 and accompanying text.

[136] For example, the Center for Research on Securities Prices (C.R.S.P.) at the University of Chicago.

[137] Data collected for commercial sale is subject to substantial economies of scale, since marginal sale costs are trivial compared to the fixed cost of initial data collection. This makes data collection for commercial dissemination much more attractive in the large American market than in the much smaller Canadian market.

passing familiarity with the American literature. Similarities between the two countries are sufficient that tilling this fertile ground would greatly enhance the quality of decisions made by Canadian institutional investors and fund managers and result in more effective policing of corporate management. In particular, we suggest that a greater familiarity with the corpus of American evidence would result in the defeat by shareholders of not a few poison pill plans.

A less easily remedied defect in the mechanism of institutional shareholder oversight of capital markets is institutional shareholder co-option by corporate management. Sometimes institutional shareholders will conduct business with a corporation seeking to adopt a poison pill or will be seeking future business from such a corporation. Where this is the case, corporate management can threaten to direct present or future business away from a shareholder who votes against the poison pill or other management sponsored initiatives. In fact, it is probable that no explicit threat is necessary particularly where present or possible future business ties are highly lucrative, institutional investors will not be anxious to bite the hand that feeds them. Profits from a direct trading relationship might easily exceed losses sustained by the adoption of a wealth-reducing management initiative, the burden of which is shared by all shareholders. One can imagine that this creates a potent inducement for institutional investors to vote routinely with management.

Many, or perhaps even most, institutional shareholders may fear reprisals from voting against management. Banks may fear loss of deposit or lending business. Trust companies may fear loss of pension or fund management fees, or the withdrawal of the personal trust plans of senior management. Insurance companies may fear the cancellation of lucrative insurance coverage, whether it be corporate asset or liability coverage, D & O insurance, or other forms of insurance underwriting.

The problem of institutional co-option is more serious in Canada than in the United States. Where the corporation is a link in a larger corporate empire, an institutional investor opposing a management initiative may fear the loss of business from all of the corporations in the affiliated group. The fact that many corporations in such affiliated groups will have a controlling shareholder may appear to render institutional activism irrelevant in any case.[138] However, even in such cases, institututions have a vital role to play both as critics of management, and, in more extreme cases, as plaintiffs. Management pressure may prevent them from effectively serving either of these roles.

These disturbing influences were present in the contest ultimately leading to the adoption of the first poison pill in Canada by Inco Ltd. Although institutional investors understandably were reluctant to air their grievances, newspaper accounts at the time indicated that at least some institutions felt unduly pressured by management to vote in favour of the proposed poison pill.[139] The reluctance that some industry participants felt to let their views on the poison pill be publicly known are amply illustrated by an account in the *Globe and Mail* of a meeting of the Mining Analysts Association of Ontario.[140] When the time came to take a vote on whether or not to support the Inco poison pill, it was reported that the analysts were unanimously against adoption. However, one analyst in attendance was persuaded to vote in favour of the poison pill, and only the final tally of votes reported. This was allegedly done so that each analyst in attendance could claim to have been the one who supported the poison pill.

One way to greatly ameliorate the problem of institutional co-option is to mandate confidential voting. Where management cannot determine how institutional or other shareholders have voted on a resolution, shareholders need not fear reprisals from management should they vote against a management initiative.[141] Allenvest Group Inc. has recently sponsored the first shareholder

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[138] Where there is a "controller," institutional shareholders may nonetheless possess a power of "negative control" if they are collectively able to defeat a special resolution requiring the approval of two-thirds of those shareholders voting. Thus, the existence of *de facto* or even *de jure* controlling shareholder does not automatically mean that the votes of institutional shareholders or other large blockholders are meaningless.

[139] See MacIntosh, *supra*, note 118 at 305-11, especially n. 151.

[140] J. McNish, "Analysts Fire Shot at Inco Proposal" *The [Toronto] Globe and Mail* (20 October 1988) B1.

[141] Where there are a very few large blockholders, management may be able to infer from the vote count how particular investors voted. However, this will likely be an exceptional case.

initiative in Canada in favour of confidential voting, in asking Inco shareholders to approve such a measure.[142] Although an affirmative vote on this proposal cannot as easily be interpreted as a repudiation of management as a vote against a specific management initiative, we anticipate that much management pressure will be brought to bear on institutional shareholders to vote against this proposal. In all likelihood, it will fail.

The provincial legislatures ought to give very serious consideration to the passage of legislation that mandates confidential voting for public corporations. Such legislation may be a crucial step towards ensuring that institutional oversight of the market is truly effective and would redound to the benefit of all shareholders. As indicated earlier, consideration ought also to be given to removing constraints that impede the ability of institutional investors to police corporate management. For example, allowing banks to own a controlling equity position would enable bank managers to play an active, rather than merely a passive role in overseeing bank investments.[143] This would convert a huge pool of now passive investment capital into active capital, bumping up a notch the degree of discipline exerted over corporate managers.

In sum, the events surrounding the introduction of poison pills in Canada demonstrate both the value and limitations of institutional involvement in the marketplace. Institutional investors play an invaluable role in policing corporate managers, but one that is currently subject to both market and legal constraints. We are convinced that there are changes in the legal environment that will make institutional shareholders more active and more effective players in Canadian capital markets. These are changes that can be easily and quickly implemented, and we urge legislators and

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[142] See Allenvest Group Limited, "Confidential Voting" (1990) 2(4) Corp. Gov. Rev. 1.

[143] Section 193(2) of the *Bank Act*, *supra*, note 28 prohibits a bank from owning a Canadian corporation's shares whose attached voting rights would permit the bank to vote more than 10 per cent of the total votes attached to all issued and outstanding shares. In addition, section 110(11) of the *Act*, prohibits any person or group of associated persons from legally owning or beneficially owning more than 10 per cent of the issued and outstanding shares of any particular class of the bank's shares. This latter limitation ought also to be removed, in order that the bank managers are themselves held accountable both by large blockholders and by the threat of a hostile takeover.

securities regulators to give their serious attention to the role of institutional players and how to enhance this role.

C. *The Westfield Minerals Saga and O.S.C. Policy 9.1*

The Westfield Minerals saga is illustrative both of the conflicts of interest that can be generated in a market dominated by extended corporate empires and the dangers such conflicts pose for minority interests. It also illustrates the consequences of the absence of institutional interests in the "second market," as well as the uses and limits of independent valuations and approval by an independent committee of directors.

Prior to the end of February 1989, Westfield Minerals Ltd. was controlled by an Australian mining concern.[144] At the end of February, the Australian company agreed to sell its interest in Westfield to American Resource Corp. Ltd. of Bermuda. American Resource was a 96 per cent owned subsidiary of Canadian Express Ltd., which itself was a wholly owned subsidiary of International Pagurian Corp.[145] Pagurian Corp. was, in turn, controlled jointly by Christopher Ondaatje and Hees International Bancorp Inc., the merchant banking arm of the Edward and Peter Bronfman empire. By this circuitous route, the sale thus effectively transferred control of Westfield into the hands of the Bronfman empire of companies.

Westfield's "crown jewel" was a 35 per cent interest in a Chilean gold and silver mine known as Choquelimpie.[146] By mid-1989, the mine was fully on-stream and producing gold at an annual rate of about 100,000 ounces and silver at an annual rate of about 500,000 ounces.[147] Ore reserves in the main deposit were 7.7

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[144] Reveltek controlled Westfield by virtue of a 45.6 per cent shareholding interest. Reveltek, in turn, was controlled by Whim Creek Consolidated of Australia. See "Northgate/Westfield Sells 15% Stake in Whimcreek" *Northern Miner* (27 February 1989) 15.

[145] *Ibid.*

[146] The other partners in the venture were Shell Chile (42 per cent) and Citibank N.A. (23 percent). See "Hees Group to Keep Westfield Busy" *Northern Miner* (29 May 1989) 13. The *Northern Miner* also indicated the extent of Westfield's other assets.

[147] "Westfield Progressing With Choquelimpie Mine in Chile" *Northern Miner* (28 August 1989) 6 [hereinafter *Choquelimpie*].

million tons, producing 0.058 ounces of gold per ton and 1.75 ounces of silver at the end of May 1989. It was expected that exploratory drilling would uncover further reserves.[148]

The Westfield controversy stemmed from a decision of the Westfield board, announced on 3 November 1989, to sell all of Westfield's mining assets, including the interest in the Choquelimpie mine, to another company in the Hees/Bronfman empire, Northgate Exploration Ltd. [149] The mining interests were sold for $24.8 million, leaving Westfield essentially a holding company with $25 million in cash and $15 million in securities of other mining concerns.[150]

The sale was not effected at arm's length, since both the seller and buyer of the assets, which both had minority shareholding interests, were ultimately controlled by the Bronfmans.[151]

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148 *Ibid.*

149 Northgate was controlled by Great Lakes Group Inc., another company in the Hees/Bronfman empire and was thus itself a Bronfman controlled company. The deal in question was actually a complex transaction involving three companies: Westfield, Northgate, and Norwest Holdings Inc. Before the transaction occurred, Westfield owned 10 per cent of Northgate and 51 per cent of Norwest. The other 49 per cent of Norwest was owned by Northgate. Reduced to its simplest terms, the deal between the three companies involved Westfield selling all of its mining properties to Norwest and its 51 per cent stake in Norwest to Northgate. Thus, when the dust settled, Northgate held 100 per cent of the shares of Norwest and thus indirectly owned the mining assets formerly owned by Westfield (including the Choquelimpie mine property). After the transaction, Westfield retained its 10 per cent interest in Northgate. See "Control of Westfield Sold to Bronfman Group Outpost" *Northern Miner* (27 February 1989) 15; "Hees Group to Keep Westfield Busy" *Northern Miner* (29 May 1989) 13; "Northgate Buys Stake in Chilean Mine" *The [Toronto] Globe and Mail* (11 November 1989) B6; P. Kennedy, "Westfield's Sale of Chilean Mine Draws Criticism" *Northern Miner* (13 November 1989) 1; D. Francis, "Westfield Deal Shows Need for Minority Rights" *Financial Post* (25 January 1990) 3; D. Francis, "Shareholders to Fight Agreement by Peter Bronfman Companies" *Financial Post* (4 April 1990) 6; "Westfield Minerals" *The [Toronto] Globe and Mail* (27 April 1990) B13; "Bronfman Company Stock Swap Comes Under Official Scrutiny" *Financial Post* (27 April 1990) 6; K. Noble, "New Rules Would Have Helped" *The [Toronto] Globe and Mail* (24 May 1990) B4; J. Heinzl, "Westfield Shareholders Win Mining Valuation" *The [Toronto] Globe and Mail* (26 May 1990) B7; G. Scotton, "Westfield Agrees to Have Northgate Deal Valuation" *Financial Post* (28 May 1990) 17; "Westfield Minerals" *The [Toronto] Globe and Mail* (26 June 1990) B21; A. Robinson, "Westfield Investors Question Valuation" *The [Toronto] Globe and Mail* (29 June 1990) B11; G. Gransden, "Westfield Minority Airs Gripes" *The [Toronto] Globe and Mail* (30 June 1990) B5; and G. Scotton, "Westfield Grilled on Share Swap" *Financial Post* (2 July 1990) 18.

150 *Ibid.*

151 *Ibid.*

Nonetheless, the Westfield directors elected to proceed with the sale of assets without a shareholder vote[152] and without an independent valuation of the mining properties.[153]

The non-arm's length sale of Westfield assets precipitated complaints from minority shareholders alleging that the consideration received for the assets was inadequate.[154] Although these complaints were reported in the financial press,[155] Westfield directors refused to review the transaction or to put it to an independent valuation or a shareholder vote, asserting that the transaction was fair and had been approved by a committee of independent directors.[156] After some months of inaction, a group of minority shareholders complained to the Director of the *Canada Business Corporations Act* and to the O.S.C.[157] A second group of shareholders, under the banner of the Committee of Dissident Westfield Shareholders, solicited donations from other shareholders

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152 *Ibid.*

153 The decision to proceed without a shareholder vote may well have violated section 189(3) of the *C.B.C.A.*, *supra*, note 34 which requires an approving shareholder vote in the case of a decision to sell "all of substantially all the property of a corporation other than in the ordinary course of business." The courts have found this provision to be triggered by sales which effect a qualitative change in the nature of the business carried on, even where the assets sold constitute less than 50 percent of the total assets of the company. See, *e.g.*, *Re 85956 Holdings Ltd and Fayerman Brothers Ltd* (1986), 25 D.L.R. (4th) 119 (Sask. C.A.). The directors of Westfield are reported to have stated that "the delay and expense of a meeting of shareholders would not be justified as holders of a majority of the shares were in favor." See *Westfield Deal Shows Need For Minority Rights*, *supra*, note 149 at 3. It is difficult to understand why delay and expense would dispense Westfield from a mandatory statutory requirement.

154 See, *e.g.*, Kennedy, *supra*, note 149; *Shareholders to Fight Agreement by Peter Bronfman*, *supra*, note 149; and Gransden, *supra*, note 149.

155 See *supra*, note 149.

156 The *Northern Miner* reported that "according to Northgate President John Kearney, the deal was approved unanimously by an independent committee of directors, consisting of Westfield directors who are not officially associated with Northgate." See Kennedy, *supra*, note 149 at 2.

157 The Director, Frederick Sparling, announced that the transaction would be investigated by the federal Department of Consumer and Corporate Affairs. See *Bronfman Company Stocks Comes Under Official Scrutiny*, *supra*, note 149. The O.S.C. appears to have been approached some months earlier.

and hired a lawyer.[158] Nonetheless, a full year after the announcement of the sale, no action had been taken either by Westfield, the C.B.C.A. Director, or by the O.S.C.

Ultimately, however, at the end of May 1990, Westfield relented and agreed to commission an "independent" valuation of the mining interests by Burns Fry.[159] The results of the valuation supported Westfield's position and suggested that Norwest had paid too much for Westfield's mining assets.[160] The valuation and approval of the transaction by "independent directors" were apparently enough to convince the O.S.C. and the Director of the C.B.C.A. to take no further action, and indeed none has been taken at the time of writing.

The key reasons for an absence of regulatory intervention appear to be both the independent valuation and approval of the transaction by independent directors, and indeed these are central features of the new Policy 9.1,[161] crafted in the wake of the Westfield drama. In our view, both of these shareholder protections are likely to improve the quality and efficiency of corporate decision-making, but the Westfield saga is a cautionary tale that demonstrates the dangers of relying entirely on such procedural protections to ensure appropriate treatment of minority interests.

The efficacy of an "independent" valuation commissioned by any company in a vast corporate empire like the Bronfman group of companies can easily be questioned. Even where the company commissioning a valuation is a truly independent entity, a valuer either currently doing business with the corporation or anticipating

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[158] *Shareholders to Fight Agreement by Peter Bronfman*, *supra*, note 149.

[159] The announcement to commission an independent valuation was made at Westfield's annual meeting on 25 May 1990. See Heinzl, *supra*, note 149. The *Financial Post* quoted Northgate President and CEO John Kearney as saying "we were absolutely conscious of the situation and we blew it. We didn't handle it well ... In retrospect, we should have had a valuation at the time, but hindsight is always 20/20." See *Westfield Agrees to Have Northgate Deal Valuation*, *supra*, note 149 at 17. The *Financial Post* also later quoted Westfield President Danesh Varma as saying that an independent valuation of the transferred assets should have been performed at the time of the sale, but was not done because of the cost. See *Westfield Grilled on Share Swap*, *supra*, note 149 at 18.

[160] See *infra*, notes 162-63 and accompanying text.

[161] See *supra*, note 68. See also *infra*, notes 174-87 and accompanying text.

possible future business will have an incentive to arrive at a result congenial to management, who will decide the disposition of future business. Since companies performing valuations also frequently will offer underwriting, brokerage, merchant banking, and other services to corporate clients, the cost of arousing management's ire may be large. When the client is a corporation in an extended empire of companies with a common controller, the cost of raising management's dander may be overwhelming. In such a case, "management" is no longer the management of a single entity, but the controllers of the vast panoply of related companies with the power to distribute an enormous volume of lucrative securities related business. In these circumstances, there are pressures on the valuer to deliver a report acceptable to management. It is perhaps for this reason that it is virtually unheard of for an investment banker or other valuer to deliver a fairness opinion or valuation that does not reflect management's view.

Although we do not purport to pass judgment on the accuracy of the valuation performed by Burns Fry, we do note that the result was congenial to management. The report showed the value of Westfield's mining interests (sold for $24.8 million) as between $15.7 and $18.8 million, and thus purported to show that Westfield received *too much* for the mining assets sold to Northgate.[162] It is also worth pointing out how sensitive this valuation was to a variety of rather indeterminate parameters. These included the ore reserves, the prices of gold and silver on world markets, and an appropriate discount rate which must reflect, amongst other things, the political risks of doing business in Chile. A change in assumptions about any one of these parameters could result in a very different result. For example, while the Burns Fry valuation assumed that ore reserves would last until 1992, Westfield's own 1988 year-end report suggested that production might extend to

[162] See "Bronfman Asset Deal" *Financial Post* (27 June 1990) 19; Robinson, *supra*, note 149; and *Westfield Grilled on Share Swap*, *supra*, note 149. The *Financial Post* had earlier quoted Northgate President John Kearney as saying: "If anybody got screwed it wasn't who you think it was," intimating that Northgate had paid too much for the assets." See *Westfield Grilled on Share Swap*, *supra*, note 149 at 18.

1995-96.[163] Furthermore, press reports indicated the distinct possibility that further exploratory drilling would result in expansion of proven ore reserves.[164] In addition, there was a large measure of disagreement between Westfield and its minority shareholders over the applicable discount rate. The Burns Fry valuation applied an 18 per cent rate, while minority shareholders asserted that a three per cent rate was appropriate.[165] Finally, as we noted above, management generally has an incentive (whether consciously or unconsciously) to colour the information given to the valuer to ensure an appropriate result. While we cannot say if this happened in the Westfield case, there was at least a real possibility that this was so.

Our point is not that the valuation commissioned by Westfield was necessarily in error, but rather that there was ample room for a valuer to produce a result sympathetic to management by making small adjustments in any of these key parameters. Because such a result is likely to generate repeat business for the valuer, there are obvious incentives for a putatively "independent" valuer to favour management's view.

In defending the sale of assets, Westfield put much stock on the fact that the sale had been approved by a committee of "independent" directors otherwise unaffiliated with either Westfield or Northgate.[166] But, as we have indicated, there are a number of grounds for questioning the efficacy of this type of shareholder protection. One is that the directors may not in fact be sufficiently distanced from the corporation to be truly disinterested and

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163 See *Westfield Grilled on Share Swap*, *supra*, note 149, reporting remarks of Bill Haney, a minority shareholder, to a Westfield shareholders' meeting. Mr. Haney is also reported to have said that the reserves "seem to have dropped a considerable amount in a very short time." *Ibid.* at 18. The day before, *The [Toronto] Globe and Mail* reported that the Burns Fry valuation showed a shorter mine life because of a decision to expand capacity and production. See Robinson, *supra*, note 149.

164 See, *e.g.*, *Choquelimpie*, *supra*, note 147 and Robinson, *supra*, note 149. The Committee of Dissident Shareholders argued that "[v]ital to the evaluation of these mining assets, and especially the ... Choquelimpie property, is not a simplistic arithmetic computation of proven ore reserves and related tonnage, but, of 'potential' – the iceberg whose tip is merely showing at this point in time." Robinson, *ibid.* at B11.

165 Robinson, *ibid.*

166 See, *e.g.*, Kennedy, *supra*, note 149.

dispassionate decision-makers. The Westfield saga is a case in point. At least two of the reputedly independent directors were in fact officers or directors of other corporations in the Hees/Bronfman group of companies.[167] Moreover, setting the power and economic penetration of an elaborate corporate empire like the Bronfman's against the background of a relatively small economic stage highlights the difficulty of securing objectivity. From a business perspective, the client served by an independent director in a case like Westfield is not Westfield alone, but the Hees/Bronfman group of companies which control Westfield. Given the relatively small pool of directorial talent in Canada, it will often be difficult to find directors who are not connected either by business or social links to important players in the corporate group.

Even those without present connections to key players may well anticipate or seek out future linkages, so that their judgment also will be shaded. Furthermore, although shareholders elect directors, it is the inside managers who decide who shall be nominated to serve as directors.[168] Outside directors therefore owe their continued tenure to the consent of insiders, which undeniably raises the cost of opposition to management initiatives. The psychological advantage possessed by insiders is cemented by their obvious informational advantage. Insiders who devote all of their energies to the corporation will be much more familiar with its workings than will outsiders whose attention is intermittent and who receive all of their information from insiders.[169] It is thus not surprising that empirical studies both in the United States and Canada have concluded that outside directors feel beholden to management and play a very limited role in protecting shareholder interests.[170]

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[167] These were Brian Lawson, an officer of Canadian Express, and C.J. Cunningham-Dunlop, a director of Orofino Resources Ltd, a company controlled by Northgate. See *Westfield Deal Shows Need for Minority Rights*, *supra*, note 149.

[168] Of course, the degree of control exercised by insiders over outsiders is greater where the inside managers closely represent the interests of the controlling shareholder, as in the Westfield case.

[169] See *supra*, note 53 and accompanying text.

[170] See *supra*, note 54 and accompanying text.

Where the inside directors present a monolithic front and strongly urge the propriety of an action which the outside directors have been asked to pass upon, it will be that much more costly, both psychologically and otherwise, for the outsiders to oppose management. In the Westfield case, six of thirteen Westfield directors were also Northgate executives.[171] Moreover, the President of Westfield, Danesh Varma, was also a director of Canadian Express, Pagurian Corp., and American Resource, all of the companies in the control hierarchy that connected Westfield to Hees International, and was a director of Hees International as well.[172] It must have been clear to the outside directors that, in opposing the sale of Westfield assets, they would be opposing, not only the unanimous view of Westfield's insiders, but in fact the will of the Hees/Bronfman empire. In the result, approval of the transaction by a putatively independent committee of directors cannot be regarded as dispositive of its propriety.

Institutional shareholders were conspicuously absent from the Westfield drama. This was no accident. Westfield is a second market company without material institutional holdings. Although shareholders were able to organize themselves and ultimately achieved some measure of success by securing a third party valuation, the presence of large institutional holders undoubtedly would have led to increased pressure on management and ultimately might have secured a result more satisfactory to the minority shareholders. Institutional shareholders generally have larger stakes, better incentives to police management, more resources to oppose managerial initiatives, better access to the press, regulators, and management, and lower costs of collective action.[173] The cost and difficulty of organizing minority interests in companies like Westfield

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[171] Kennedy, *supra*, note 149. Somewhat inconsistently, *The [Toronto] Globe and Mail* reported that there were *four* Westfield directors who were also directors and officers of Northgate or its subsidiaries. It reported that these directors were John Kearney, Patrick Downey, Sylvester Boland, and C.J. Cunningham-Dunlop. See Gransden, *supra*, note 149.

[172] Gransden, *ibid.*

[173] The Westfield saga need only be compared to the attempted takeover of Canadian Tire by its dealers to illustrate what a difference the presence of institutional shareholdings makes.

and securing access to the press and to regulators typically will mean a lower level of protection for these interests.

Although the O.S.C. was slow to react to the complaints of minority Westfield shareholders, the proximate result of the Westfield saga was the release for comment on 23 May 1990 of draft revisions to O.S.C. Policy 9.1, the final version of which was adopted on 5 July 1991.[174] The policy, which previously dealt only with issuer bids, insider bids, and going private transactions, now includes in addition any "related party transaction," which includes any transaction between the corporation and a party in a position to exercise influence over the control of the corporation.[175] Had the policy been in place when the Westfield transaction took place, Westfield would have been obligated to put the transaction to a shareholder vote, excluding all control votes and all votes directed by an "interested party."[176] In addition, an outside valuation would have been required.[177] However, the policy would not have required approval of the Westfield transaction by a committee of independent directors. Rather, the policy merely states that "issuers involved in a related party transaction should consider and if reasonable to do so" have the transaction reviewed and approved by a 'special committee' of outside directors.[178]

The revisions to the policy leave in place the previous requirements for extended disclosure and an independent valuation accompanying issuer bids, insider bids, and going private transactions and extend these requirements to related party transactions. An attempt has been made to make the valuation requirement more meaningful in a number of ways. First, the valuer must be "qualified" and "independent."[179] Second, an attempt is made to articulate acceptable valuation methods and to ensure that the

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[174] See *supra*, note 69.

[175] *Ibid.* Part I, para. 2.2(15).

[176] *Ibid.* Part I, para. 2.2(7) and 2.2(10); Part V, para. 18 and 20; and Part VI, para. 23.1.

[177] *Ibid.*

[178] *Ibid.* Part V, para. 19 and Part VII, para. 27.

[179] *Ibid.* Part VI, para. 23.1. See, generally, para. 23.

valuer has adequate access to information necessary to make the valuation.[180] Third, the valuer must present a reasonably detailed report showing not only the result of the valuation, but the valuer's credentials, the terms of compensation, assumptions made, methods used, and other factors.[181] In addition, a number of exceptions to the valuation requirement are outlined, some of which were not present in the former Policy 9.1.[182] As before, a summary of the valuation must be sent to shareholders, and the results of prior valuations must be disclosed.[183]

As indicated above, the minority approval requirement is made applicable both to going private transactions and significant asset transactions, and the definition of minority approval is changed to ensure exclusion of votes controlled by interested parties.[184] Although approval by a committee of independent directors is not made mandatory, guidelines for the establishment of an independent committee are set out.[185]

Policy 9.1 recognizes the dangers inherent in related party transactions. However, we have some reservations about the policy. More particularly, we have noted the limits of independent

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[180] *Ibid.* Part VI, para. 24.

[181] *Ibid.* Part VI, para. 24.4(1) states:

> The formal valuation report must disclose the identity and credentials of the firm performing the formal valuation, the identity and credentials of any individuals who were principally responsible for the report's preparation, the date the valuer was first contacted in respect of the transaction, the date on which the valuer was retained, the financial terms of the retainer, the subject matter of the formal valuation, the date of the formal valuation, the scope and purpose of the formal valuation, the meaning of the word "value" in the circumstances, a description of the type of information and sources upon which the valuer relied, a description of the type of any information the valuer requested but was denied, the valuation approaches considered, the key assumptions made, the relative importance attached to assumptions made and factors considered, any other experts relied upon and the valuation conclusion reached. The source of any fact which is material to the formal valuation must be clearly stated, including sufficient detail so that the significance of the fact can be reasonably assessed by a user of the report.

See, generally, para. 24.4.

[182] *Ibid.* Part V, para. 18.2 and Part VI, para. 26.

[183] *Ibid.* Part VI, para. 24.5 and 24.6.

[184] *Ibid.* Part I, para. 2.2(10).

[185] *Ibid.* Part VII, para. 27.

valuations and approval by a committee of independent directors. There is some danger that the procedural protections of Policy 9.1 will be interpreted as a complete certification of the propriety of a related party transaction. In other words, Policy 9.1 may provide a procedural safe harbour for related party transactions that insulates some suspect transactions from regulatory or judicial review. While securing an approval by independent directors and/or an independent valuation may "freshen the atmosphere,"[186] courts and administrators must be sensitive to the difficulties of securing genuinely "independent" oversight by outside directors or valuers in Canada.

The requirement to secure approval of a majority of the disinterested shareholders is probably a more effective shareholder protection, provided that shareholders are provided with the necessary facts upon which to base a meaningful judgment. There is little reason to believe that minority interests will be influenced by the fear of management retaliation for voting against a management proposal. Where the corporation has secured minority approval only after obtaining an approval of the independent directors and/or an independent valuation, the minority approval would carry some added weight. However, even in the face of such an approval, courts and administrators would do well to remember that, while the votes of minority shareholders may not be corrupted by the sorts of pressures that might divert the minds of outside directors or valuers, there are other reasons to believe that minority approval should not be regarded as a complete certification of fairness. In particular, management control of the proxy machinery combined with shareholder collective action problems are bound to inhibit the expression of shareholder dissent. This will be particularly true in the second market, where there are few institutional investors, the majority of the company's shareholders will hold small and transient stakes in the company, and the problem of "free riders" will be severe. In these circumstances, there may not be many shareholders who take the time to inform themselves adequately to wield their votes effectively: many simply will return their proxies to

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[186] We borrow this phrase, in slightly altered form, from *Gottlieb* v. *Heyden Chemical Corp.*, 91 A.2d 57 at 59 (Del. S.C., 1952), which held that upon ratification of an alleged wrong by a majority of the minority of shareholders "the entire atmosphere is freshened."

management without reviewing the proxy material or will fail to return their proxies at all.

Finally, we add that courts and administrators must not lose sight of the fact that the requirement to secure the approval of a majority of disinterested shareholders creates dangers of opportunism by a *minority* of shareholders, who may use their power of veto in an extortionate manner to secure a larger share of the "take" than that to which they are truly entitled. The danger will be particularly severe where there is a single shareholder or coalition of shareholders, who hold a majority of the minority shares. Just as it is impossible to delve into the minds of directors (whether insiders or outsiders) and ascertain their motives for acting, it is impossible to directly ascertain the motives of minority shareholders. Courts and administrators must be sensitive to this danger and be prepared to dispense with the minority approval requirement where appropriate.[187]

VI. CONCLUSION

Our goal in writing this article has been to establish some tentative guideposts to assist Canadian policy-makers in addressing many of the challenges that they will confront in the next decade. Focusing attention on the distinctive features of Canadian markets will, we believe, give greater precision and clarity to the policy-making process in the corporate and securities area.

In framing much of our discussion, we readily acknowledge that many of our observations are qualified and tentative. Yet, given the relative paucity of data that exists in many areas, we felt duty bound to be somewhat modest in formulating ambitious policy initiatives. To do otherwise would, we believe, fall prey to the temptation of speculative policy-making which is only too often the manner in which Canadian policy is formed.

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[187] Policy 9.1, *supra*, note 69 does in fact recognize this danger. See Part I, para. 1.4. See, however, *In re M.Loeb, Limited*, (December 1978), O.S.C.B. 333, in which the Commission declined to waive the requirement for a majority of the minority approval of a going private transaction where a single shareholder maneuvered itself into a hold-out position.

There is, however, one clear proposal that we wish to advance. It comes in the form of a plea for greater support for and understanding of the rigorous mode of empirical analysis that we have argued for in this article. Given the opportunity to generate an empirical mapping of the marketplace that will highlight the nature and sources of market imperfections, we believe that legislators and administrators who formulate policy bear an increasingly heavy burden of demonstrating market inefficiency before regulatory interventions can be justified.

Thus far, this onus has largely gone undischarged. This is unfortunate, for we feel that the time is well past when regulatory interventions could be justified by simple declaratory assertions about the achievement of market efficiency, completely unsupported by hard evidence or even a clear understanding of what efficiency entails.