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THE VALUATION LAW REVIEW

Corporate / Securities Decisions and Regulatory Developments

The Valuation Law Review summarizes corporate and securities decisions and recent regulatory developments of interest to business valuators and is a joint publication of The Canadian Institute of Chartered Business Valuators and Stikeman Elliott LLP. The Valuation Law Review is not intended to provide legal advice and readers should not act on information in the publication without seeking particular advice on matters that are of concern to them. Readers are cautioned against relying upon the decision abstracts contained herein, which are edited and in outline form only, and are directed to the full report of the reasons of the Court or Securities Regulator, as applicable.

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I. CANADIAN DECISIONS

Kerr v. Danier Leather, Irving Wortsman, Jeffrey Wortsman and Bryan Tatoff

(2004), Unreported O.J. No. 1916

Ontario Superior Court of Justice

May 7, 2004

In this recent high profile class action decision from Ontario, a company and two of its officers were found liable for misleading statements in a prospectus where financial forecasts were not revised in light of disappointing intra-quarter results. The class members were awarded damages based upon the civil right of action for misrepresentation in the *Ontario Securities Act*.

This was a successful class action by Danier shareholders against Danier and two officers of Danier who signed the certificate in the prospectus stating that it contained "full true, and plain disclosure of all material facts relating to the securities being offered". The class members got judgment for damages based on the civil action for misrepresentation under the *Ontario Securities Act* (OSA). The alleged misrepresentation related to future-oriented financial information; namely, financial forecasts, contained in the prospectus for an initial public offering (IPO) of Danier Leather shares that closed on May 20, 1998. Prior to that date, Danier had filed preliminary prospectuses that included financial forecasts for the last quarter of the financial year ending June 30, 1998. However, as of May 20, 1998, the actual results for that last quarter were substantially below the monthly targets upon which the forecasts were based because the unseasonably warm May weather that year had a dramatic effect on sales. A few days after the IPO closed, Danier prepared and disclosed revised forecasts based on these intra-quarter results, resulting in a decline in its share price. Eventually, the actual unaudited results were published which showed better performance than the revised forecasts and the share price recovered to some extent. As it turned out, the initial forecast was not far off the actual results. The share price, however, did not fully recover.

Justice Lederman found Danier and the two officers who signed the prospectus certificate liable for the misleading forecast. He held that the actual intra-quarter results were material facts that should have been disclosed because their omission rendered misleading or false the factual statement implied by the forecast; namely, that management had a reasonable basis for believing the forecast.

The case will no doubt cause issuers and underwriters to analyse much more carefully the impact of new information on their prior public disclosure of predictions and opinions. Even if predictions or opinions are stated in the disclosure to be opinions held on or predictions as of a particular date, a failure to update them or disclose changed information about the assumptions underlying those opinions or predictions may possibly give rise to liability.

Misrepresentation

Section 130(1) of the OSA deems a purchaser of a security offered under a prospectus to have relied on any misrepresentation in a prospectus at the time of its purchase and confers a right to recover damages. Given the definition of "misrepresentation" in the Act, civil liability can arise where a prospectus together with any amendments to it: (i) contains an untrue statement of material fact, or (ii) omits to state a material fact that is required to be stated, or (iii) omits to state a material fact that is necessary to make a statement not misleading in the light of the circumstances in which it was made.

With respect to the question as to whether a forecast can be a fact for securities law purposes, the Court in the Danier decision held that a forecast is not a fact in the absolute sense. However, a forecast includes the following factual assertions: (i) the forecast represents the forecaster's best judgement of the most probable set of economic conditions and the company's planned course of action, (ii) the forecast is sound and reliable in the sense that the forecaster made it with reasonable care and skill, and (iii) the forecaster generally believes the forecast, the forecaster's belief is reasonable and the forecaster is not aware of any undisclosed facts tending to seriously undermine the accuracy of the forecast.

The Court went on to say that a forecast is not an untrue statement of material fact if the results were not achieved, but rather if any of the factual assertions implied in the forecast are untrue. Namely, if the forecast does not represent management's best judgement because: (i) the forecast was not prepared using reasonable care and skill, or (ii) management does not generally believe the forecast, or (iii) management's belief in the forecast is not reasonable, or (iv) management is aware of facts that would seriously undermine the forecast.

Concerning the question of materiality, the Court held that if the implied factual statements significantly affect or would reasonably be expected to have a significant effect on the market price or value of securities, they could be "material".

With respect to the first prong of the definition of misrepresentation, Justice Lederman found that there was no misstatement of fact because management believed in the forecast as of the date it was made and based it on reasonable assumptions. Similarly, Justice Lederman concluded that there was insufficient evidence that Danier omitted material facts from the prospectus. In this regard,

he noted that although the actual financial results that pre-dated the prospectus (representing approximately one-third of the quarter in question) were below the IPO forecast, these results alone would not reasonably be expected to have a significant effect on the market price or value of the securities.

However, the plaintiffs did succeed in proving that Danier failed to state material facts necessary to make a statement not misleading in light of the circumstances in which it was made, on the basis that the omission of the actual intra-quarter financial results rendered the forecasts misleading statements.

After reviewing the Ontario policy on financial forecasts, the Court concluded that certain facts may be material facts because of the statement to which they relate, even if they are not material on a stand-alone basis. Information such as financial results may not be material standing alone but, because the market had an expectation as to the company's results due to the statements in the prospectus, the actual results became material. If the forecast is a statement of material fact in that it significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of Danier's shares, then intra-quarter results which seriously put in question the accuracy of the forecast would have or would reasonably be expected to have the same effect and would therefore be material as well. Disclosure is necessary in order to make the forecast not misleading when intra-quarter results represent a marked departure from forecast expectations and it is probable that this departure will continue to the end of the quarter.

Also, the forecast would be an *untrue statement of material fact* due to the intra-quarter results if the forecast no longer represents management's best judgment because management no longer subjectively believes the forecast, or management's subjective belief in the forecast is no longer objectively reasonable or the results tend to seriously undermine the accuracy of the forecast. In addition, if the intra-quarter results, when disclosed, significantly affect the market price or value of the securities, then this is evidence that they are likely material.

In determining whether management had a subjective belief in the forecast or a reasonable belief in it, the Court focused on a financial analysis prepared on May 18 (but as of May 16) that compared actual revenue for the quarter against the forecast. The analysis showed that actual revenue was significantly below that which was the basis of the forecast but concluded that the forecast could still be met. The two defendant officers who had reviewed this May 16 analysis argued that it was not a material fact because they were not required to undertake this

comparative analysis, there was no planned due diligence session as of May 20 and they had prepared it on their own initiative. The officers provided various reasons why they believed that the forecast could still be achieved, including the two sales promotions planned for the last part of the quarter.

The Court accepted that the officers did have a subjective belief that they would meet the forecast. However, that subjective belief was held not to be based on an objectively reasonable analysis. The information in management's possession prior to closing demonstrated a marked departure from the results that had been expected and the Court found that there was a sufficient probability that this marked departure would continue to the end of the quarter.

In considering the materiality of the information, the Court looked at the actual effect of the subsequent disclosure on its actual results and stated that "materiality can be measured under the OSA on a *post hoc* basis by observing the movement of shares following disclosure." Since the disclosure occurred shortly after closing and the information disclosed was basically the same as that known to management before May 20, this was held to be particularly appropriate.

In the end, the forecast was substantially achieved. The Court held that this was not relevant to the analysis because it was the truth of the factual assertions at the time of the investor's purchase that mattered. Hindsight obtained from the fact that a misrepresentation at the time of purchase later becomes true because the forecast is substantially achieved does not make it any the less a misrepresentation at the operative date, namely the time of purchase.

The defendants argued that the cautionary language and risk factor disclosure in the prospectus with respect to the forecast negated the materiality of those forecasts. However, the cautionary language and risk factors did not qualify the particular implied factual statements in the forecast that it represents management's best judgment. The cautionary language used was the standard language required by the rules on financial forecasts. Given that the forecast was made in the context of an IPO prospectus, the Court held that the risk of misleading the reader is increased as it was the only source of publicly available information regarding the potential value of the shares.

The Court noted that there were a number of ways that this misrepresentation could have been addressed by Danier before closing depending on the view that it took regarding its ability to achieve the forecast, namely: (i) issuing a revised

forecast, (ii) disclosing the actual intra-Q4 results together with an expression of continued confidence in the forecast, and (iii) delaying the closing of the IPO.

The Due Diligence Defence

The officer defendants argued that they were personally protected by the due diligence defence in the OSA. To do so, they had to show that they conducted a reasonable investigation so as to provide reasonable grounds for a belief that there had been no misrepresentation. The Court concluded that they had not acted reasonably. Viewed on an objective basis, their failure to make any kind of adequate analysis of the poor financial results experienced as of May 20 and what was causing them was found not to be a reasonable investigation required of a prudent person in the circumstances of the case. This failure was held not to support any reasonable belief that the forecast remained achievable. Moreover, their failure to consult with any of their professional advisors regarding the impact of the information on the forecast and its potential impact on the price of the shares was held not to reflect a standard of conduct expected of senior management. The Court relied on evidence from the underwriters that they would have expected to be consulted about the results and the May 16 analysis.

Damages

Price or Value. The Court held that *prima facie*, the damages are the differential between the price paid and the post-misrepresentation price. This amount may then be adjusted if the defendant proves that all or part of the depreciation in price is attributable to factors other than the misrepresentation; an example of which is a general decline in the stock market before disclosure. The defendant may also prove that the post-misrepresentation price is affected by factors other than value and does not represent value. The market price may not represent value when it is affected by factors unrelated to value, such as market manipulation or when the market is ill-informed or uninformed about important factors relating to the value of the securities.

Date for Measuring Price or Value. The Court said that the OSA by its silence confers discretion to determine damages contextually. The goal is to determine the real value of the shares at the time of purchase free of the misrepresentation. The market reaction is important because it shows what the consensus of buying and selling opinion of the value of the securities is free of the misrepresentation. The trading price was not free of the misrepresentation until June 4, the date of

the disclosure. The market reaction as of this date and following is the best evidence of the real value of the shares.

Sustaining Actual Loss. The plaintiffs were entitled to recover damages even if they had not sold and crystallized their loss. However, if the plaintiff makes what is essentially a second investment decision upon learning of the misrepresentation and continues to hold the securities after the disclosure, then subsequent movements in the market price of the securities will be for the account of the plaintiff whether positive or negative. (Investors who both bought and sold before the June 4 disclosure would not suffer any damage – they were not included in the class).

Measure of Damages. The purchase price of Danier shares was $11.25. The closing price on June 4, the date of disclosure, was $10.25, suggesting damages of $1.00/share. However, the Court felt that the post-misrepresentation price should be adjusted to eliminate the effects of price stabilization activities undertaken by the underwriters and any abnormal price movements to eliminate the effects of panic selling. The plaintiff's expert convinced the Court that the market did not fully absorb the effect of the forecast revision and the market price was no longer affected by price stabilization activities until June 10, on which date the closing price was $8.90. This meant damages of $2.35 /share.

Under the proposed amendments to the OSA included in Ontario Bill 198, which would create a statutory right of action for investors in the secondary market against companies and other responsible persons for misrepresentations in continuous disclosure documents or a failure to make timely disclosure, the legislation provides detailed rules with respect to the quantification of damages. While Justice Lederman did not make any reference to Bill 198 in the Danier decision, the analysis he followed with respect to the calculation of damages is largely consistent with the detailed provisions contemplated in Bill 198.

The Danier decision is being appealed.

Re Cartaway Resources Corp.
(2004), SCC 26
Supreme Court of Canada
April 22, 2004

In this Supreme Court of Canada decision, the Court restored a British Columbia Securities Commission Order showing deference to provincial securities commissions and their expertise in regulating financial markets. The Supreme Court also confirmed general deterrence as an appropriate, and sometimes necessary, consideration in making Orders that are both prospective and preventative.

In October 1994, Robert Hartvikson and Blayne Johnson (the Brokers), together with a group of other securities brokers at First Marathon Securities Limited (First Marathon), acquired Cartaway Resources Corp. (Cartaway), which was then a small company in the business of licensing garbage containers in British Columbia. The purpose of the acquisition was to purchase a company that traded on the Vancouver Stock Exchange, which could then be used to vend in other businesses and thereby facilitate access to the capital markets without having to go through the process of an initial public offering.

In the spring of 1995, the Brokers were presented with an opportunity to purchase some mining claims in Voisey's Bay, Labrador, an area of considerable nickel, cobalt and copper deposits. The vendor wanted a combination of cash and free-trading securities of Cartaway in exchange for the mining claims. On April 5, 1995, an oral agreement to purchase the claims was reached and the Brokers used a numbered shell company for the purpose of "warehousing" the mining claims. Without disclosing to the market the acquisition of the mining claims and the material change in Cartaway's business to a mining exploration firm, the Brokers raised money to finance the acquisition of the mining claims through a private placement on May 5, 1995 priced at $0.125 per unit. Over 82% of the offering was placed with the Brokers, other First Marathon brokers or their friends. When Cartaway announced the completion of the transaction, the use of proceeds was cited as "undetermined future acquisitions".

In June 1995, Cartaway completed the purchase of the mining claims through the acquisition of all of the outstanding shares of the shell company and became the sole owner of the mining claims. On June 29, 1995, Cartaway announced the change in its business to a mining exploration firm and that it was making an "arm's length" acquisition of the mining claims. Cartaway then proceeded with another private placement for $1.00 per share purchase warrant, which closed on July 11, 1995. The offering memorandum for this second private placement did not disclose the Brokers' acquisition of the mining claims, the extent of the holdings by other First Marathon brokers or any conflicts of interest.

The British Columbia Securities Commission's (the BCSC's) investigation into Cartaway was triggered one year later when, in May 1996, Cartaway announced that it had found significant mineralization on the Voisey's Bay mining claims based on visual inspections of drilling samples. Cartaway's share price jumped

dramatically to $23 then fell to $1 when sample analyses failed to confirm the initial findings. The Brokers made $5.1 million in total profits by trading Cartaway shares.

The BCSC found, among other things, that the Brokers had breached the prospectus requirements of the British Columbia *Securities Act* (the Act) by splitting the purchase of the securities in the first private placement with other First Marathon brokers who did not individually qualify for the $97,000 prospectus exemption. By acquiring control of Cartaway and then continuing to act as brokers and principals in the sale of Cartaway's securities, the BCSC also found that the Brokers put themselves in a conflict of interest with their duties to their clients and Cartaway, and that they did nothing to resolve these conflicts.

The BCSC found that it was in the public interest to fine the Brokers the maximum administrative penalty of $100,000 under the Act. However, on appeal by the Brokers to the British Columbia Court of Appeal (the BCCA), the majority of the BCCA found that the maximum penalty was too severe and unreasonable in all the circumstances. It therefore substituted a penalty of $10,000 for each of the Brokers. Considering the decision of the Supreme Court of Canada (the SCC) in *Committee for Equal Treatment of Asbestos Minority Shareholders v. Ontario Securities Commission* ([2001] 2 S.C.R. 132) (*Asbestos*), the BCCA felt that the SCC's opinion of the Ontario Securities Commission's public interest jurisdiction as prospective and preventative, rather than remedial or punitive, restricted the BCSC's public interest jurisdiction to restraining the future conduct of the Brokers that would likely prejudice the public interest. It further held that the BCSC did not have the authority to consider general deterrence, and that only the specific conduct in relation to the breach of the Act could be considered.

The decision of the BCCA was then appealed to the SCC. The SCC disagreed with the BCCA's interpretation of *Asbestos*, reinstated the BCSC's original order and held that nothing inherent in the BCSC's public interest jurisdiction prevents the BCSC from considering general deterrence in making an order. To the contrary, the SCC held that it is reasonable to view general deterrence as an appropriate, and perhaps necessary, consideration in making orders that are both prospective and preventative.

The SCC noted that Courts have less expertise relative to securities commissions in determining what is in the public interest in the regulation of

financial markets, and in interpreting their constituent statutes given the broad policy context within which securities commissions operate. As a result of this and other factors, the appropriate standard of review was held to be one of reasonableness, not correctness, which required the Court to determine whether there was a rational basis for the decision of the BCSC in light of the statutory framework and the circumstances of the case. Following a review of the relevant factors, the Court found that the BCSC's Order was reasonable and that the Brokers' conduct justified the imposition of the maximum penalty as a deterrent.

Ford Motor Co. of Canada Ltd. v.
Ontario Municipal Employees Retirement Board

(2004) 41 B.L.R. (3d) 74.
Ontario Superior Court of Justice
January 22, 2004

In a novel oppression claim, minority shareholders succeeded in arguing that the Ford Motor Company's transfer pricing arrangements with its Canadian subsidiary unfairly prejudiced the minority.

The Ford case dealt with complex proceedings and issues in respect of the valuation of shares and the alleged oppression of minority shareholders in the context of a going-private transaction. More particularly, Ford Motor Company (Ford U.S.), as the controlling shareholder of Ford Motor Company of Canada (Ford Canada), decided to buy the 6% stake in Ford Canada that it did not already own by way of a continuance and amalgamation followed by a second-step "squeeze out" of the minority. Ford Canada's board of directors appointed a special committee to consider the transaction proposed by Ford U.S. and it retained an investment dealer to perform an independent valuation.

Ford U.S. initially offered the Ford Canada minority $150 per share, but increased its offer to $185 after the special committee's independent valuator set the valuation range at between $160 to $200 per share. Significantly, the independent valuation was based on projections of future earnings and cash flows of Ford Canada, which were themselves premised on the Ford U.S. – Ford Canada transfer pricing system. The special committee recommended acceptance of the $185 offer and Ford Canada called a shareholders' meeting to have the proposed transaction approved, although the meeting was really just a formality since Ford U.S. owned more than 90% of the outstanding shares. Because of Ford U.S.'s ownership level, there was no requirement under Ontario Securities Commission Rule 61-501 for "majority of the minority" approval, and Ford U.S. did not volunteer to submit the transaction to this higher standard of approval.

As a result, the transaction was easily approved, but 53.3% of the minority shareholders dissented from the continuance and the amalgamation (as was their right under applicable corporate law) so that Ford Canada was forced to apply to the Court to have it determine the "fair value" of the Ford Canada shares.

There was significant disagreement on this issue. Ford U.S. and Ford Canada, supported by the independent valuation, argued for the original offer price of $185 per share. The dissenting shareholders counterclaimed, asking for $642.50 per share, on the basis that their interests had been oppressed and that the fair value of their shares had been significantly understated by Ford Canada. The essence of the dissenting shareholders' position was that Ford Canada's minority shareholders were unlawfully oppressed through the inter-corporate transfer pricing system between Ford Canada and Ford U.S. Thus, the claim of the dissenting shareholders encompassed two elements: firstly, a claim for alleged past oppression and secondly, a "go-forward" element to be taken into account in considering the value of their shares.

In light of the inter-related issues, the Court stated that the quantification of overall fair value would differ markedly depending upon whether or not it found historical oppression with consequential compensation owed to the dissenting shareholders. The marked discrepancy in fair value assessment between the parties stemmed directly from the inter-corporate transfer pricing system. This particular matter was directly related to the allegation of oppression.

Agreements between Ford Canada and Ford U.S. formed the basis for the transfer pricing system, and the two were found not to be dealing in at arm's length. The question to be posed was therefore as follows: was the transfer pricing system employed in a manner similar to what would have been in place in an arm's length scenario? In determining this, Ford Canada argued that the regime did not offend the relevant tax authorities, and therefore was not unlawful. The Court, however, determined that it was insufficient for a taxpayer to have a transfer pricing system that does not violate tax laws. The system must also not result in unfairness to minority shareholders such as to constitute oppression within the ambit of the *Canada Business Corporations Act*. The term "transfer pricing system" was used by the Court in its broader sense. That is, it was not considered as simply a tax regulatory issue, but also referred to the overall inter-corporate pricing structure employed between Ford Canada and Ford U.S.

In the end, the Court found that the transfer pricing system was (and had been) unfair and detrimental to the minority shareholders. The Canadian operation had not been profitable during the 10-year period in question in great part because of the transfer pricing regime in place and could reasonably have seen a profit, but the transfer pricing system did not allow for it. The Court agreed with the dissenting shareholders that external economic events could not be used by themselves to justify 19 years of losses in Ford Canada's sales operations. A truly independent, arm's length entity in the position of Ford Canada would have demanded a reformulation of the inter-corporate transfer pricing system in 1984 due to Canadian-U.S. exchange rates. No arm's length purchaser would have agreed to a pricing arrangement that left it with staggering losses.

Since the Court found the transfer pricing structure to be unfair and oppressive, it ordered Ford Canada to notionally revise its transfer pricing structure with Ford U.S. to calculate the entitlement of the dissenting minority shareholders. Such compensation encompassed two elements. Firstly, the "historical oppression" component looked back to the period from 1985 to September 11, 1995 (the valuation date). However, since a limitation period applied as to the oppression claim, the period of time for which the Court made an adjustment was significantly shorter than that claimed by the dissenting shareholders. Specifically, historical oppression recovery was permitted only for the number of days within the period from January 11, 1994 to September 11, 1995 that a shareholder owned the relevant shares in Ford Canada. Secondly, the Court ordered that the necessary notional changes to the transfer pricing structure be made to determine the fair value of the dissenting minority's shares as of September 11, 1995, noting that it would be unfair to dissenting minority shareholders not to include such notional changes to the transfer pricing structure in determining the "go forward" component of value in respect of their shares. In this regard, the Court was very specific in awarding enhanced value to only the minority shareholders, as the majority shareholder, Ford U.S., was capturing the lost value indirectly through the operation of the unfair transfer pricing system.

Montreal Trust Company of Canada v. Call-Net Enterprises

(2004), O.J. No. 631 (Ontario C.A.)

Ontario Court of Appeal

February 20, 2004

In August 1999, Call-Net Enterprises Inc. (Call-Net) was experiencing financial difficulties and shareholders were upset and critical of the performance of senior executives. Call-Net received notice from a shareholder, Crescendo Partners L.P. (Crescendo), that they had obtained sufficient share ownership to requisition a meeting of shareholders. The purpose of the meeting was to replace six of the nine members of the Call-Net board of directors. Prior to the meeting and in response to Crescendo's efforts, Call-Net entered into agreements (Change of Control Agreements) providing its senior executives with generous benefits in the event it experienced a change of control. Under the terms of the Change of Control Agreements, a change of control was deemed to have occurred if any person acquired the "right to control or direct 35 per cent or more of the combined voting power of the corporation in any manner whatsoever". Call-Net also entered into a trust agreement with Montreal Trust Company of Canada (Montreal Trust), pursuant to which approximately $30 million was deposited with Montreal Trust to pay out benefits to executives in the event that a change of control occurred and the executives elected to invoke the relevant provisions in the Change of Control Agreements.

The Ontario Court of Appeal considered whether the accumulation of proxies constituted a "change of control" within the meaning of executives' Change of Control Agreements. The Court concluded that a proxyholder who accumulates proxies does not control or direct the voting power of the corporation and therefore no actual change of control occurred. The Court emphasized that while the purpose of Change of Control Agreements are to protect senior executives, this protection must occur within the context of retaining their loyalty to the company at a time of turmoil and uncertainty.

In advance of the requisitioned meeting, Crescendo solicited proxies from other shareholders and accumulated proxies relating to more than 35 per cent of Call-Net's shares. On the eve of the meeting, Call-Net and Crescendo agreed that it was in the best interests of both parties to reach a compromise and adjourn the meeting, as Call-Net was concerned that it may be taken over by a corporate raider who would choose to sell its assets and Crescendo had a concern relating to a change of control provision in Call-Net's bond indenture which would require the company to repurchase the bonds for $2.2 billion if it was triggered. Under the compromise reached, Crescendo was permitted to nominate three directors to an expanded ten-member board and the meeting was adjourned.

Nonetheless, ten senior executives alleged that there had been a "change of control" within the meaning of the Change of Control Agreements and sought to collect the payouts they claimed to be entitled to thereunder. The executives argued that the accumulation of proxies by Crescendo triggered the relevant provision of the Change of Control Agreements because Crescendo, as the proxyholder, had the ability to control or direct the voting power of Call-Net.

In the comprehensive decision of Justice Lax of the Superior Court of Justice released on January 28, 2002, the Court looked somewhat askance at this opportunistic reading of the provision by the former executives and held that they were not entitled to receive payments from the trust since Cresendo's accumulation of proxies did not amount to a change of control within the meaning of the Change of Control Agreements. In this regard, Justice Lax reasoned that the language in the Change of Control Agreements was meant to deal with an "actual take-over bid or other transaction, under which control is actually assumed, and not the mere accumulation of proxies", since this is "the only interpretation that gives effect to all of the provisions of the agreement, is consistent with the meaning of control or direct in corporate law, reflects accurately the nature of the power conferred by a proxy and addresses the commercial purpose of the Change of Control Agreement".

The Ontario Court of Appeal agreed with the lower court decision that the mere accumulation of proxies was not sufficient foundation to trigger a change in control within the meaning of the Change of Control Agreements. In reaching this conclusion, the Court of Appeal sanctioned the lower Court's characterization of a change of control agreement as a protective mechanism for both the executive and the corporation and noted that this latter purpose is fulfilled if the key executives "remain at their posts, loyally serving the best interests of the corporation, until the outcome of the siege is determined, one way or another". The Court of Appeal further emphasized that the purpose of the change of the Change of Control Agreement would be completely undercut if the former executives' interpretation of the Change of Control Agreement was adopted, since the result would be that senior executives would have an incentive to leave the company at a moment turmoil and fragility in the company and reap huge financial rewards for doing so. Accordingly, the appeal was dismissed.

Casurina Limited Partnership v. Rio Algom Limited

(2004), O.J. No. 631 (Ontario C.A.)
Ontario Court of Appeal
February 20, 2004

In Volume 9, Issue 1, January 2003, we reported that holders of Rio Algom convertible debentures claimed they were oppressed when Billiton plc made a successful bid for all the shares of Rio Algom, which were then delisted, rendering the debentures' conversion feature unattractive.

The Ontario Court of Appeal agreed that a "no action clause" barred an oppression action against an issuer and a third party brought by debentureholders and rejected an argument that the trust indenture was a "contract of adhesion".

The oppression application failed on the narrow grounds that a "no action" clause in the debenture trust indenture prevented the debentureholders from bringing any legal proceedings (except in certain specified circumstances) in respect of the debentures – and could be relied upon not only by Rio Algom but also by Billiton, a third party.

This decision of Justice Spence has been upheld by the Ontario Court of Appeal, which also rejected the debentureholders' argument that the trust indenture was a contract of adhesion and so, in the event of any ambiguity, should be interpreted against Rio Algom. The Court of Appeal also agreed with Justice Spence that the take-over and resulting delisting of Rio Algom shares did not constitute oppression by either target Rio Algom or acquirer Billiton. (In assessing the debentureholder's reasonable expectations both Justice Spence and the Court of Appeal noted that the trust indenture provided a remedy – redemption at par – in the event of a delisting; the trust indenture did not, however, provide for special compensation in the event of a takeover, although it could have).

Justice Spence did say that a transfer of assets from Rio Algom to Billiton subsidiaries after the takeover was oppressive (since it did away with whatever value the conversion right might have retained after Rio Algom shares were delisted) and he suggested redemption at 25% over par as a possible remedy if the no-action clause had not applied. Given its agreement that the no-action clause barred the debentureholder's claim for oppression, the Court of Appeal declined to address either of these issues.

Garfinkle v. NCR Corporation et al.

No. 500-11-022785-048

Quebec Superior Court (Commercial Division)

April 6, 2004

The Quebec Superior Court granted an Order under Section 144 of the *Canada Business Corporations Act* that permitted Optimal Robotics Corp. to avoid cancelling and rescheduling a shareholders' meeting, and to proceed to consider a superior transaction with another entity utilizing the proxy materials delivered in respect of the prior proposal. The Order further declared that all proxies delivered by Optimal shareholders to vote in favour of or against the original transaction at the meeting would count in respect of the superior transaction.

Optimal Robotics Corp. (Optimal) is a Canadian company that developed self-checkout technology for use in the retail industry. In February 2004, Optimal and NCR Corporation (NCR) entered into an asset purchase agreement pursuant to which NCR was to acquire Optimal's self-checkout business for US$30 million. The agreement contained a "fiduciary out" provision that enabled Optimal to terminate the agreement upon the payment of a US$3 million break fee.

The day after signing the agreement with NCR, Optimal mailed a management information circular in connection with a shareholders' meeting to be held on April 6, 2004 to approve the sale to NCR. After mailing the information circular, Optimal received an unsolicited offer from Fujitsu Transactions Solutions Inc. (Fujitsu) who offered to acquire Optimal's self-checkout business for US$35 million. The other terms of the Fujitsu transaction were essentially the same as those of the NCR transaction.

On April 5, 2004 (i.e., only one day before the scheduled shareholders' meeting), Optimal announced that it had entered into a definitive agreement with Fujitsu and provided notice to NCR of the termination of the agreement between Optimal and NCR. On the same day, a director and shareholder of Optimal applied to the Quebec Superior Court seeking an Order under Section 144 of the *Canada Business Corporations Act* (CBCA) that would authorize Optimal to amend the special resolution of Optimal shareholders relating to the NCR transaction to provide for the approval of the Fujitsu transaction (utilizing the same information circular previously sent to Optimal shareholders) and permit Optimal to provide notice of the new resolution to shareholders via news release. The Order would further declare that all proxies delivered by Optimal shareholders to vote in favour of or against the NCR transaction at the meeting would count in respect of the Fujitsu transaction. The effect of the Order would be to substitute the vote on the Fujitsu transaction for the vote on the NCR transaction and maintain a shareholders' meeting and vote that would have otherwise required a fresh proxy circular, along with certain ensuing delays and added costs to Optimal.

The Quebec Superior Court granted the Order which provoked a two-pronged reaction from NCR. Firstly, it informed Optimal that it was willing to increase the price of its offer to US$38. Secondly, prior to the commencement of the meeting the next day, NCR sought a modification of the Order that would prevent the vote on the special resolution from proceeding until a later date.

Justice Chaput dismissed the NCR motion. He held that under Section 144 of the CBCA, the time and place of calling a shareholders' meeting is a matter that is internal to the company. Accordingly, no outside third party has any standing to intervene and seek to have changes made. However, Justice Chaput cautioned the directors of Optimal and the Chairperson at the shareholders' meeting that they would be well advised to inform the voting shareholders of NCR's willingness to counter the Fujitsu offer.

The Optimal decision highlights an innovative use of Section 144 of the CBCA and the ability of M&A transaction participants to seek flexible rulings from a Court in the context of evolving circumstances. It also begs certain questions concerning the legitimacy of such relief in the context of a competitive bidding situation, as a result of the narrow window of time that Optimal shareholders were left with to consider NCR's more lucrative counter offer.

II. U.S. CASES

Hollinger International Inc. v. Conrad M. Black, Hollinger Inc. & Others

(2004), C.A. No. 183-N

Court of Chancery, State of Delaware

February 26, 2004

The Delaware Court of Chancery considered the fiduciary and contractual responsibilities of Conrad Black, as well as the statutory and equitable limitations with respect to stockholder-adopted by-laws and the permissibility of a corporation adopting a rights plan to prohibit the stockholders of the corporation's controlling shareholder from selling the controlling shareholder to a third party. The Court concluded that Conrad Black breached his fiduciary and contractual duties and acted without restraint. Because his actions posed "grave injury" to Hollinger International Inc. and its stockholders, the Court issued an injunction against the sale, held that the rights plan was a legitimate defensive mechanism and deemed the by-law amendments ineffective.

As Vice-Chancellor Strine remarked at the beginning of his judgment, an understanding of the relationship between certain relevant corporate entities and Conrad M. Black (Black) was critical to the resolution of the dispute. At the bottom of the corporate family is Hollinger International Inc. (International), which owned various newspapers, including (at the time of the judgment) the *Chicago Sun-Times*, the *Daily Telegraph* in the UK and the *Jerusalem Post*. International has a controlling shareholder, Hollinger Inc. (Inc.), whose shares trade on the TSX. Inc. owns approximately 30% of the equity of International but by virtue of International's dual-class capital structure controls approximately 73% of the voting rights. Ravelston Corporation Limited owns approximately 78% of Inc.'s common stock and Black owns over 65% of Ravelston. Thus, there is a large discrepancy between the voting power Black practically wielded (which was nearly absolute) and his personal economic stake in International, which was about 15%.

The background to the dispute can be traced back to May 2003 when Tweedy Browne, one of International's largest shareholders, demanded that the Board investigate the payment of over US$70 million in "non-competition" payments. In November 2003, a Special Committee formed by the Board of International concluded that over US$38 million of the "non-competition" payments had been made by International to three of International's inside directors (plus one other senior manager), but was unable to find any evidence of the payments having been authorized by either the Board or by International's audit committee. As a result, the two committees jointly wrote a letter to the executives asking them to provide evidence of proper approval. Black responded via his attorney explaining why the payments were justified and that the lack of any formal approval "must have been an oversight".

Notably, the Vice-Chancellor concluded that by this time, Black was reeling from both the threat of an investigation by the U.S. Securities and Exchange Commission (the SEC) and the Special Committee, and wanted to "head-off" actions by the independent directors that would elicit SEC scrutiny and take the steam out of the Special Committee process by focusing the independent directors on a strategic process involving International. Under this pressure, Black "reached out" to the Barclay brothers on November 11 to resume

discussions about the sale of Inc. (which included control of *The Daily Telegraph*) which he had previously terminated. Shortly afterwards on November 15, Black also entered into a Restructuring Agreement with International's Directors. This entailed Black stepping down as Chief Executive Officer but continuing as Chairman, the continuation of the work of the Special Committee and the re-payment of the non-compete payments by the three inside directors and the senior manager with 10% due at the end of the year. Two inside directors were also removed from the Board leaving an independent majority. Importantly, the Restructuring Agreement also included two paragraphs (6 and 7) which read, in part, as follows:

> " 6. The full Board of Directors will engage Lazard as financial advisor to pursue a range of alternative strategic transactions ("Strategic Process"). *The Chairman of the Company will devote his principal time and energy to pursuing the Strategic Process with the advice and consent of the Executive Committee and overall control by the Board ...*
>
> 7. *During the pendency of the Strategic Process, in his capacity as the majority stockholder of [Inc.], Lord Black will not support a transaction involving ownership interests in [Inc.] if such transaction would negatively affect the Company's ability to consummate a transaction resulting from the Strategic Process unless the [Inc.] transaction is necessary to enable [Inc.] to avoid a material default or insolvency. In any such event, Lord Black shall give the Company as much advance notice as reasonably possible of any such proposed [Inc.] transaction."* (emphasis added by Court)

According to Vice-Chancellor Strine, Black, conscious that the Strategic Process would likely last until June 2004, immediately began breaching the agreement by letting the Barclays know that if they wanted to take control of the *Telegraph* in the near future without facing competition from other bidders they had to deal with him personally and outside of the Strategic Process. Specifically, Black used confidential information given to him in his official capacity at International to negotiate behind the Board's back, all the time while he was meant to be devoting his energy to directing the Strategic Process to maximize the value of International's assets.

In late December, Black was questioned by the SEC about the non-competes but invoked the Fifth amendment and refused to co-operate. Alone of the inside

directors, he also failed to repay the 10% of the sum he owed International and thus literally breached the Restructuring Proposal. This, together with Black's behind the scenes maneuvering with the Barclays, caused the Board to consider their options, one of which was the adoption of a shareholders' rights plan to thwart a deal with the Barclays who, by early January, had settled on a purchase of Inc. with Black. On January 20, the International Board formed a Corporate Review Committee (CRC) which was given a broad remit to act for the company and adopt defensive measures such as the shareholders rights plan. Black promptly caused Inc. to file a written consent designed to give him personal veto over the Strategic Process by enacting by-law amendments requiring unanimous action by the International board for any significant decision, abolishing the CRC and stripping the Special Committee of the authority it had just received from the Board.

Vice-Chancellor Strine held that Black violated his fiduciary duty in a number off ways. Firstly, he denied the International Board the right to consider the sale of the *Telegraph* – the primary interest of the Barclays – as part of the Strategic Process and diverted that opportunity to himself through Inc. Even as controlling shareholder of International and Inc. and even in the absence of the Restructuring Proposal, the judge believed that Black was obliged to inform the International board of the opportunity to sell the *Telegraph*. Secondly, Black misled his fellow directors by failing to disclose his dealings with the Barclays. Thirdly, he improperly used confidential information belonging to International to advance his own personal interests. Lastly, he urged the Barclays to put improper pressure on Lazard (International's financial advisor) to betray their client and secure the Board's agreement to the sale. In sum, the judge found that Black "intentionally subverted the International Strategic Process he had pledged to support through a course of conduct involving misleading and deceptive conduct towards his fellow directors" and therefore dramatically breached his duty of loyalty.

The Vice-Chancellor then turned to consider the contractual issues surrounding the Restructuring Proposal. He concluded that Black breached the terms of the agreement in four ways by: (i) failing to repay the 10% of the non-compete payments by December 31, 2003, (ii) failing to devote his time and energy as required to the Strategic Proposal, (iii) agreeing to a deal with the Barclays which had a negative effect on International's ability to complete a transaction arising out of the Strategic Proposal (the Barclays would be reluctant to sell the assets of International soon after having purchased them because, in their own words,

acquiring the Telegraph was a "once in a lifetime opportunity"), and (iv) finally, failing to give "as much advance notice as reasonably possible" of the Barclays deal as required by paragraph 7 (Black knew about the deal in mid-November and had reached an agreement in principal by early January).

Black raised two principal arguments in defence of any breach of the Restructuring Proposal, both of which were firmly rejected by the Vice-Chancellor. His first argument, that he was fraudulently induced to enter the Restructuring Proposal by the Special Committee's claim that the non-competes were not properly authorized, was firmly rejected by the Vice-Chancellor largely because he believed that Black chose to sign the agreement to "save face and more severe action" by the International Board and ... "head off an investigation" such as an official inquiry by the SEC. The Vice-Chancellor also found that Black conducted and relied on his own investigation into the Special Committee's allegations and that there was no evidence that the non-competes were approved. The Vice-Chancellor also gave short shrift to Black's second main attempt to justify his support for the Barclays transaction on the basis that Inc. faced a "material default" or "insolvency" within the meaning of paragraph 7 of the Restructuring Proposal. The evidence was apparently entirely to the contrary as Inc. was estimated to have an asset to liability coverage ratio of 3 to 1.

Although the by-law amendments were found to be statutorily permissible under Delaware Corporation General Law (DGCL), the Vice-Chancellor held that they were inconsistent with the DGCL, largely because they were clearly adopted "for an inequitable process and [had] an inequitable effect". In this regard, he noted that their purpose was to disable the International board and prevent it from completing the Strategic Process "utilizing the tools available to the board under the DGCL". While noting the significance of striking down by-law amendments adopted by a controlling shareholder, the Court concluded that "action is required here because those amendments complete a course of contractual and fiduciary improprieties ... to end-run the Strategic Process [Black] had agreed to lead and support."

The defendants were equally unsuccessful in arguing the last key issue on whether the CRC had satisfied its *Unocal* duties in adopting the shareholders' rights plan. The Vice-Chancellor noted that in general, there are good reasons why principles of fiduciary duties ought to take into account the expectations of controlling stockholders in evaluating directors' use of a rights plan, but said that the permissibility of the rights plan depended on the equities of the situation.

Under *Unocal*, defensive measures such as a rights plan can only be adopted if the board has "reasonably identified a threat to the corporation to which the rights plan is a proportionate response". The first prong of the test required the Board to identify a threat to the corporation's best interests after a reasonable investigation. The CRC easily passed that test as the proposed transaction with the Barclays would prevent International from conducting the full market evaluation contemplated by the Restructuring Proposal. The second test was to consider whether the plan was disproportionate to this threat. The judge said that in the ordinary course of events, it might be perverse for a subsidiary's board to use a poison pill to prevent its parent corporation from selling itself. However, this was clearly not such a situation and the rights plan - which was to be for a limited duration – gave the board "breathing room" to maximize the realizable value for its assets.

Given the tenor of the entire judgment, it was hardly surprising that the Vice-Chancellor granted International a preliminary injunction against the Barclays transaction. Clearly, he was satisfied that International had shown a sufficient threat of irreparable harm and that the balance of hardships supported the grant of the injunction since the threat to Inc.'s public stockholders was "mild". The judge did, however, attach one condition to the injunction, namely that International offer short-term financing to Inc. to help it cover an upcoming note payment.

The Hollinger decision suggests that where the Delaware Court of Chancery determines that a controlling stockholder has engaged in inequitable conduct with a subsidiary corporation involving contractual and fiduciary breaches, the Court may use its equitable discretion to prohibit otherwise valid action by the controlling stockholder and permit the subsidiary corporation to employ defensive mechanisms to protect its interests. The decision also raises interesting questions concerning dual-class capital structures since despite the fact that Black only owned approximately 15% of the equity of International, he was able to control over 70% of its voting power. The case further highlights the distinction between legal and equitable corporate law claims and serves as a reminder that inequitable action does not become permissible simply because it is possible. The case finally serves as an example of how the Delaware Courts will sanction the use of a rights plan to prevent a sale of a controlling interest in a parent company and how shareholders can regulate the powers of the Board by using effective by-laws.

In Re. MONY Group Shareholder Litigation

(2004), C.A. No. 20554

Court of Chancery, State of Delaware

February 17, 2004

This case was heard in the Delaware Court of Chancery about a week earlier than *Hollinger*. The plaintiffs in the MONY Group, Inc. (MONY) action requested an injunction against a stockholder vote on a proposed merger between two companies engaged in the insurance industry. They alleged that the defendant Board failed in their fiduciary duty by deciding to forego a pre-agreement auction in favour of a single bidder and challenged the board's decision that the merger proposal was the best proposal reasonably available.

The Delaware Court of Chancery applied the *Revlon* test in assessing MONY's decision not to hold an auction. The Court concluded that directors can satisfy these duties by entering into a merger agreement with a single bidder, establishing a "floor" for the transaction and then testing the transaction with a post-agreement market check. However, the Court granted a limited injunction to allow stockholders to assess the cost of certain change-in-control agreements which were unusually high by industry standards.

MONY is a publicly traded Delaware company involved in the business of selling life insurance to high-income individuals. The defendant AXA Financial Inc. (AXA) is a Delaware company also engaged in selling insurance and is a wholly-owned subsidiary of the French insurance giant. MONY's problems stemmed back to the company's demutualization in 1998. By 2002, the board had met to discuss what to do and engaged the services of Credit Suisse First Boston (CSFB). CSFB suggested various potential acquirors including AXA, but the board rejected the idea of a public auction because: (i) there had been a disastrous attempt to do so by a competitor, and (ii) they were concerned about a potential adverse effect on MONY's sales force and the gleaning of information by competitors in the due diligence phase and instructed the CEO to explore merger opportunities. The CEO met with his AXA counterpart in January 2003 who offered an initial purchase price of about US$26 per MONY share.

MONY's senior management held Change-in Control agreements (CICs) which contained golden parachute provisions which AXA estimated were worth up to US$163 million. The Board rejected AXA's original offer, believing that the offer price would have been higher were it not for the CICs. An independent analysis of the CICs carried out by a consulting firm during the summer of 2003 reported that the CICs were worth about US$205 million or approximately 15% of the value of the proposed merger with AXA. It was further noted that CICs are typically in the 1% to 3% range, and sometimes up to 5% of a transaction's value. Based upon the advice of the consultant, the board of MONY decided to forbid the CEO from engaging in further negotiations with AXA until new CICs were in place. Further, under threat that the existing CICs would not be renewed when they expired in December 2003, the board offered senior management new CICs

(which they all accepted) lowering the payout provisions to between 5% and 7% of the purchase price or the sum of US$79 million.

With the issue of the CICs seemingly out of the way, MONY and AXA announced a merger agreement on September 17, 2003 providing for the payment of $31 cash for each share of MONY. The agreement contained a non-solicitation provision with a broad fiduciary-out, as well as a termination fee that represented about 3.3% of MONY's equity value and 2.4% of the transaction value in the event of the termination of the transaction as a result of a superior proposal. Although one other financial group did express an interest in talking with MONY if the AXA deal failed, no one made a competing offer during the five-month period between the announcement of the agreement and the start of the litigation. On January 16, 2004, MONY filed a final proxy statement that included a description of the background of the transaction, the fairness analysis from CSFB and the board's recommendation to the stockholders to approve the merger.

The plaintiffs brought a motion to enjoin the merger, claiming that the MONY board had breached its fiduciary duties under *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.* (1986) (*Revlon*) by not procuring the best possible price for MONY. In this regard, the plaintiffs alleged that rather than negotiating with AXA directly or establishing a special committee for such task, the board had effectively delegated to its CEO the responsibility for the transaction.

In rejecting the plaintiffs claim, the Vice-Chancellor noted that in a change of control situation, a board has the duty of showing they were adequately informed and acted *reasonably*. However, this reasonableness test did not require evidence that they made a perfect decision. The Court also rejected the plaintiff's "lone wolf" theory for a number of reasons, including the fact that the board itself and not the CEO had made the decision to initiate the strategic process, the fact that the board had actively supervised the CEO's activities and had demonstrated its control over the negotiations and the fact that the CEO had acted faithfully and diligently during the negotiation process. With respect to *Revlon* duties and the board's decision to forego an auction, the Court concluded that the directors can satisfy their fiduciary duties by entering into a merger agreement with a single bidder, establishing a "floor" for the transaction and then testing the transaction with a post-agreement market check. The Court noted, in this regard, that the board had taken into consideration a number of factors in deciding not to pursue

a public auction. The Court approved the dictum of Vice-Chancellor Strine from the *Revlon* case:

> While one would not commend ... the board's actions as a business model of value maximization, the process the directors used to sell the company cannot be characterized as unreasonable.

The Court further noted that the MONY board was comprised of financially savvy members, who were adequately informed about the industry and the potential suitors available to MONY, and who had retained CSFB for advice and had explored alternatives to a transaction. The board had also obtained a fairness opinion from CSFB, and AXA appeared to be a "perfect fit" with MONY, thus positioning it to make a strong offer.

A second claim advanced by the plaintiffs was that MONY's disclosure in the proxy statement regarding the CICs was materially misleading. In relation to this claim, the Court applied the test in *Arnold v. Society for Savings Bankcorp.* (Court of Chancery, State of Delaware, 1994) that once a board has traveled down the road of partial disclosure of the history of the merger, it has an obligation to provide the stakeholders with "an accurate, full, and fair characterization of those historic events". The Court felt the proxy statement was misleading in that it emphasized the reduction of payments under the CICs and the correlation between the reduction and the AXA offer, but did not mention the comparative analysis which indicated that the CICs were still more lucrative than was normal. The Court also felt that this disclosure created an impression that the CICs were in line with those in comparable transactions, which was not the case. The Court therefore granted a limited injunction requiring the defendants to prepare supplemental disclosure to remedy the wrong caused to the stockholders' right to cast a full vote after full and fair disclosure of all material facts as the comparative analysis of the CICs might alter the total "mix" of information available for a reasonable stockholder.

In so doing, the Court adopted the test for materiality established in *Rosenblatt v. Getty Oil Co.* (493 A. 2d 929 (Del. 1985)), wherein it was held that "an omitted fact is material if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote". The Court also sanctioned the full disclosure of independent reports approved in In *Re. Pure Resources Shareholders' Litigation* (808 A.2d 421 (Del.Ch. 2001)) which established that stockholders of Delaware corporations "are entitled to a fair summary of the

substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely."

By way of postscript, in April 2004, the Delaware Chancery Court held in a separate decision that a decision by MONY's board of directors to postpone a shareholder meeting at which a vote on the company's proposed merger with AXA was to take place and to re-set the record date did not constitute a breach of the board's fiduciary duty to stockholders, and that proxies submitted by MONY stockholders in connection with the original meeting could be counted in connection with the re-scheduled meeting, notwithstanding the change in the record date.

III. REGULATORY DEVELOPMENTS

Amendments to Ontario Securities Commission Rule 61-501

On June 29, 2004, extensive amendments to Rule *61-501 – Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions*, which has been renamed *Rule 61-501 – Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions* (Rule 61-501 or the Rule), came into force. Rule 61-501 provides securityholders of issuers involved in specified types of transactions – generally, those that are "non-arm's length" in nature, – with the benefits of enhanced disclosure requirements and, in certain cases, independent valuations and "majority of minority" securityholder approval. The Ontario Securities Commission (OSC) has stated that the amendments are primarily intended to "clarify grey areas, reduce the necessity for applications for exemptive relief and generally make the Rule more user-friendly". The amendments are a significant re-write of Rule 61-501, with a number of substantive and drafting changes.

Some of the more significant changes to Rule 61-501 are summarized below:

Business Combinations

The term "going-private transaction" is no longer used in Rule 61-501. Instead, the term in the new Rule is "business combination," which is defined in essence as:

> "an amalgamation, arrangement, consolidation, amendment to the terms of a class of equity securities or any other transaction of the issuer, as a consequence of which the interest of a holder of an equity security of the issuer may be terminated without the holder's consent, regardless of whether the equity security is replaced with another security…"

This change in terminology is designed to more accurately reflect the intended scope of the Rule (which, for example, is intended to regulate amalgamations where holders of equity securities become securityholders of an amalgamated entity, unless an exemption is available).

The exceptions to the definition are similar to those available under the old Rule, including exemptions for compulsory acquisitions under applicable corporate law, stock consolidations whose "securityholder elimination effect" is only nominal,

The Ontario Securities Commission has implemented numerous amendments to *Rule 61-501 – Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions*, which it has renamed *Rule 61-501 – Insider Bids, Issuer Bids, Business Combinations and Related Party Transactions.* The stated intention of the amendments are to clarify grey areas, reduce the necessity for exemptive relief and generally make the Rule more "user friendly". Key changes include: (i) the term "going-private transaction" has been replaced with the term "business combination" in order to more accurately reflect the intended scope of the Rule, the "equal treatment" exemption has been constrained by additional restrictions and changes have been made to the circumstances in which a formal independent valuation will be required, (ii) the Rule defines "collateral benefit" very broadly to capture (with certain narrow exceptions) pre-existing entitlements without taking into account the existence of offsetting costs, (iii) the "insider bid" definition has been tightened to deter avoidance strategies and a requirement has been added that the independent committee of the target issuer's board use its best efforts to ensure that the formal valuation for an insider bid be completed and provided to the offeror in a timely manner, (iv) additional exemptions

from the valuation and minority approval requirements in the context of "related-party transactions" have been added, and (v) an express statement has been added to the Rule that shareholders are not seen to be acting in concert with a related party merely by agreeing to support the transaction.

certain transactions with "downstream" entities, and transactions where all related parties are treated equally with other securityholders. However, this latter "equal treatment" exemption will now be constrained by additional restrictions, namely;

(i) that no related party may acquire (or combine with) the target or its business (this limitation, formerly implicit, is now express),

(ii) that no related party be a party to any "connected transaction" (see next page),

(iii) that no related party receive a non-exempt "collateral benefit" (see below), and

(iv) to deal with subordinate voting share and similar situations, if the issuer has more than one class of equity securities outstanding, that no related party may receive consideration greater than that received by all Canadian holders of any other class of equity securities "in relation to the voting and financial participating interests" represented by them; this wording is interpreted in the Companion Policy by the OSC in a manner that makes it very clear that one would probably be better off to buy subordinate voting shares at a lower price in the market, since equal treatment with the likely more costly superior voting shares is then mandated.

An important difference from the old regime is that not all business combinations that are otherwise caught by the Rule have to be accompanied by an independent valuation. A valuation is now required only in two scenarios: first, where an "interested party" would, as a consequence of the transaction, acquire the issuer or combine with the issuer; and second, in the case of a "connected transaction" with a related party that itself requires a separate valuation as a substantial related-party transaction (in which case there are two distinct valuations required). Even then, an exemption may be available. Thus, the mere presence of a collateral benefit, while enough to make a transaction subject to the Rule, and while affecting voting, does not necessarily require an independent valuation to be completed.

The definition of a "connected transaction" has also been extended to include transactions having at least one party in common, directly or indirectly, that are

negotiated or completed at approximately the same time or are inter-conditional (other than transactions related solely to an individual's services as an employee, director or consultant). This is a new concept. It is also clarified that a lock-up agreement is not a connected transaction in and of itself.

Collateral Benefits

Canadian take-over bid rules require that identical consideration be offered to all holders, and explicitly prohibit, absent discretionary relief, agreements, commitments or understandings that have the effect of providing consideration of "greater value" to one or more securityholders. In the context of a voting transaction, rather than a take-over bid, a collateral benefit may (instead of preventing a transaction entirely) have the effect of altering the voting in respect of a transaction and making it subject to minority approval (and, on occasion, independent formal valuation) requirements.

The Rule defines collateral benefits very broadly and generally does not take into account the existence of any offsetting costs to the related party that received the benefit. Collateral benefits now also expressly include increases in salary, lump sum payments, payments for surrendering securities (e.g. stock options) and employment-related or directorship-related enhancements in benefits that a related party (including, among others, directors, officers and 10% shareholders) is entitled to receive directly or indirectly as a consequence of a transaction or bid.

There are carve-outs for:

(i) enhanced employee benefits received under a non-incentive group plan that are generally provided by the buyer to similarly situated employees, and

(ii) employment-related or directorship-related benefits provided that (a) they are not granted for the purpose of increasing the value to the recipient for his or her securities, (b) they are not by their terms conditional on the recipient's support for the transaction, (c) they are fully disclosed, and (d) either (A) a situation of de minimus individual ownership exists (if the recipient and his or her associated entities own or control less than 1% of any class of equity securities of the target), or (B) the benefit is not considered material to the individual (an

independent board committee must determine, and publicly disclose, that the value of the benefits – here, interestingly, net of offsetting costs- to the recipient is less than 5% of the value he or she will receive for his or her securities).

The OSC has also indicated that the collateral benefit provisions of Rule 61-501 will apply to pre-existing rights, such as golden parachutes (i.e., "triggering" such a parachute is sufficient to constitute a collateral benefit). As a result, the Rule will likely require that many more arrangements than prior to its implementation, including both pre-existing rights and employment-related and director-related matters, have to be considered from a collateral benefit perspective, which may complicate merger and acquisition transactions and increase the likelihood of needing an independent committee.

Notably, the Companion Policy suggests that giving a securityholder preferential treatment to obtain its support will "not normally be considered justifiable," and that "differential treatment is only justified if its benefits to the general body of securityholders outweigh the principle of equal treatment". The policy indicates that while the OSC will "generally rely on an issuer's review and approval process," it may intervene "if it appears that differential treatment is not reasonably justified". The intention behind this provision is unclear, but suggests that certain transactions involving unequal treatment may not be permitted, even though approved by minority shareholders.

Insider Bids

An "insider bid" now extends to, among other things, situations where a bidder was (or is acting in concert with a person who was) an insider at any time within the twelve months preceding the commencement of a take-over bid. This provision is designed to deter avoidance strategies such as resigning from the target board shortly before launching a bid.

Insider Bids - Obligations of Independent Committee

Addressing concerns that have been expressed by offerors carrying out unfriendly insider bids, the Rule adds a requirement that the independent committee of the target issuer's board must use its "best efforts" to ensure that the formal valuation for an insider bid is completed and provided to the offeror in a timely manner.

Related Party Transactions

While removing the old small-transaction valuation exemption for transactions under $500,000, the new Rule offers a broader valuation exemption for issuances of treasury securities to a related party for cash where neither party is aware of any undisclosed material information, subject to certain disclosure requirements. A minority approval exemption also exists for, among other things, issuances of securities to related parties in an amount of up to $2.5 million (including the value of connected transactions), provided they are approved by at least 2/3 of the independent (and non-employee) directors. This exemption is only available to issuers not listed on the TSX, the NYSE, the Amex, NASDAQ (including both the National and SmallCap markets) or an exchange outside both Canada and the U.S.

As is the case with business combinations, as a technical matter, not all related party transactions would be subject to valuation requirements.

Negotiations with Major Shareholders

The OSC has indicated that, in order to rely on the valuation exemption for previous (or contemporaneous) arm's-length negotiations, all negotiations with the selling securityholder must be carried out by persons and companies who are at arm's-length from it. This means that negotiators must be selected with care.

Also, the Rule states that shareholders are not considered to be acting in concert with a related party merely by agreeing to support the transaction. This position was previously articulated in a companion policy statement, which the B.C. courts refused to apply in the *Sepps* decision (see Volume 8, Issue 1, July 2002 of the *Valuation Law Review*), an occurrence that should ideally not happen again as a result of this change to the Rule.

Acquisitions by Controlling Shareholders

A shareholder who already controls the company may not always be willing to offer "intrinsic value," thus in effect paying a control premium to minority shareholders. The valuation requirements, however, do not permit a downward adjustment to reflect the prior ownership of control. This is the case notwithstanding the fact that a controlling shareholder can rely on a valuation

exemption if another equally treated major shareholder agrees to support the transaction, and that in such situations experience demonstrates that the agreed price is unlikely to include a full control premium and will thus be less than the intrinsic value.

As a result, when providing fairness opinions, valuators have often felt uncomfortable describing a price at less than intrinsic value as "fair." The OSC has indicated that a board and valuator can provide supplemental information (provided that it is clearly distinguished from the valuation information) regarding appropriate downward adjustments. Asked to confirm that intrinsic value does not necessarily equate to fairness, the OSC said that directors and securityholders should decide for themselves the weight they wish to attach to the results of valuations, thus implicitly recognizing a divergence between fairness and intrinsic value. This may well be seen to facilitate, in appropriate circumstances, the provision of a fairness opinion for a transaction in which less than intrinsic value is being offered by a controlling shareholder, with careful disclosure, of course.

Discussions with Valuators

Finally, the OSC has suggested that any actual or attempted exercise of influence over a valuator by a related party is improper, and that even "reasoned discussion" may be inappropriate, proposing instead that reasons for disagreement should be publicly disclosed.

A copy of Rule 61-501, as amended, can be obtained from the OSC's website at www.osc.gov.on.ca.