THE VALUATION LAW REVIEW

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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. 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

LSI Logic Corp. of Canada, Inc. v. Logani et al

(2001), 204 D.L.R. (4th) 443

Alberta Court of Queen's Bench

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In connection with a going private transaction, the Court rejected the plaintiffs' "back door" approach to establishing oppressive conduct on the part of a company's management. The Court found that disclosures made by the company to the plaintiffs in discovery for a fair value hearing could not be used to support a subsequent oppression claim. The disclosures were protected by both an implied undertaking that the information obtained in discovery could not be used for a collateral purpose, and in this case, an express contractual undertaking to the same effect that the Court refused to waive.

In 1995, LSI Logic Corp. of Canada, Inc. ("**LSI**"), a TSE-listed company, was the subject of a going private transaction led by its US-based parent ("**LSI US**"). The transaction was to be completed in two steps: a take-over bid by LSI US, followed by a share consolidation that resulted in the squeeze-out of the minority. The share consolidation left the minority shareholders holding fractional shares that were cancelled by LSI in exchange for a cash payment equivalent to the consideration offered under the take-over bid.

The proceedings arose out of the exercise by certain minority shareholders (the **"Dissenting Holders"**) of their dissent rights under the *Canada Business Corporations Act* (**"CBCA"**). The CBCA permits shareholders to dissent from certain fundamental changes to a corporation – including share consolidations – and apply to a court to fix fair value for their shares. Over the course of a three-year period, the Dissenting Holders made numerous court appearances related to the fair value proceedings, even going so far as to accept an interim payment in satisfaction of part of their claim.

After participating in the fair value proceedings throughout this period, the Dissenting Holders' hired new counsel and advanced a new theory. Their new theory was that the going private transaction was *ultra vires* LSI and therefore void, and that the Alberta Queens Bench, the court before which the proceedings were brought, did not have jurisdiction to hear the fair value petition. They brought a motion to strike LSI's original fair value petition and advanced the entirely new claim of oppression against LSI and its directors and officers. In response, LSI moved to strike the Dissenting Holders' motion to strike and the Dissenting Holders' oppression claim, and applied for an injunction to prevent the Dissenting Holders from using confidential information obtained during the earlier fair value proceedings to support the oppression claim.

The Court easily dismissed the *ultra vires* argument. The Court noted that a corporation used to have to expressly outline its powers in its articles and by-laws and that any action taken that conflicted with those powers was considered beyond the power of the corporation and void. However, the Court noted that the doctrine of *ultra vires* was done away with in the early 1970s when the CBCA

granted corporations full legal capacity. The Court noted that a corporation now has the power to do whatever a natural person can do, subject to any restrictions imposed by the law generally, or the corporation's articles and by-laws. Contrary to the Dissenting Holders' position, the Court found that it is well established that this ability includes entering into going private transactions. In a related argument, the Dissenting Holders argued that the CBCA does not permit the cancellation of fractional shares, a claim that was dismissed by the Court as being clearly contradicted by a plain reading of the relevant sections of the Act, which provide for, among other things, the ability to restrict the ownership of shares.

The Dissenting Holders were equally unsuccessful in convincing the Court that it had no jurisdiction to hear a fair value petition. The Court noted that not only does the CBCA explicitly provide that shareholders entitled to dissent from a transaction are entitled to apply to a Court for an order fixing fair value, the Court's ability to do so is not limited to the specific circumstances outlined in the Act. The right to dissent may, for example, be granted voluntarily by the party proposing the relevant transaction and incorporated into the transaction documents.

Throughout the process of the dissent and fair value determination, the Dissenting Holders and LSI cooperated in providing each other information to allow their expert valuators to prepare for the fair value hearing. In doing so, with the advice of counsel, they agreed to procedures for an interviewing protocol and expanded oral and document disclosure. This disclosure included all documents that were in the working files of Prudential Securities and ScotiaMcleod, the two financial advisors retained by LSI and LSI US, and approximately 1,000 documents from LSI itself.

LSI and the Dissenting Holders reached an agreement on confidentiality and on the use of the information provided by LSI and its advisors through this expanded discovery process. That agreement included an express undertaking on the part of the Dissenting Holders which stated that the documents provided to them during discovery were "proprietary and confidential" and were not to be used except for the purposes of "this litigation".

In 1999, about three years after beginning the fair value litigation, the Dissenting Holders began an oppression claim against LSI and its directors and officers. The claim arose from facts relating to, among other things, the disposition of certain of LSI's Korean assets and the negotiation of a technology license agreement. LSI

argued for an injunction preventing the Dissenting Holders from bringing the oppression action because it was allegedly based entirely on confidential information obtained from LSI under the terms of the discovery arrangement. They argued that the use of the information amounted to a breach of an implied undertaking under Alberta law and the express undertaking described above. The Dissenting Holders responded by moving for a declaration that they were not in breach of an express or implied undertaking, or alternatively, that they be granted relief from any such undertakings.

The Court responded by recognizing that in Alberta, there is an implied undertaking that "information acquired through the discovery process shall not be used for any purpose which is ulterior or collateral to the lawsuit" in relation to which it was obtained. It found that the new action for oppression was such a collateral purpose and that the information obtained by the Dissenting Holders in discovery for the fair value proceedings could not be used to support that claim.

The Dissenting Holders were also unsuccessful with their argument that the express undertaking did not apply. They argued that their use of the words "this litigation" could not be interpreted to mean that they were restricted from commencing a new action arising out of events that took place within the same time frame as the going private transaction generally. The Court disagreed with that interpretation, stating that a plain reading of the term indicated that the materials were restricted for use in the fair value proceedings.

Finally, the Dissenting Holders argued that notwithstanding the fact that they may be in breach of the express and implied undertakings, they should nevertheless be relieved from compliance. The Court found this request unusual for several reasons, including the fact that the Dissenting Holders were requesting relief from undertakings that they had already broken and the fact that the request for relief was from an express contractual undertaking.

The Dissenting Holders argued that their discovery of the information supporting the oppression claim fell into one of the very narrow circumstances in which a court should grant relief from an undertaking on confidentiality granted during discovery. However, the Dissenting Holders' only argument was that they had found out about the existence (but not the details) of the technology transfer agreement and the disposition of the Korean assets from publicly available sources.

They argued that since the existence of these transactions was in the public domain, they were entitled to use the additional detail obtained in discovery to support the oppression claim. The Court rejected this argument, concluding that to come to such a finding would mean that no publicly traded company could ever rely on the implied undertaking not to disclose. The Court found that "disclosure in fair value proceedings does not give shareholders a license to troll for evidence of oppressive conduct".

National Trust Co. v. H&R Block Canada, Inc.
(2001), 56 O.R. (3d) 188
Ontario Court of Appeal
(October 26, 2001)

The Ontario Court of Appeal found a purchaser of assets in bulk for fair value who did not comply with the *Bulk Sales Act* (Ontario) liable for the value of the assets purchased, even though the seller had used the entire sale proceeds to pay part of the amounts owing to two prior ranking secured creditors, on the basis that the unlawful bulk sale had deprived creditors of their statutory right to contest the sale.

This matter involved the appeal and cross-appeal of an application: (i) to declare a bulk sale from Tax Time Services Ltd. ("**Tax Time**") to H & R Block Canada, Inc. ("**H&R**") void, and (ii) for an order requiring H&R to account to National Trust Co. ("**National Trust**") for Tax Time's debt. The case raised the issue of the extent of damages a bulk sale purchaser may be liable to the creditor of the bulk sale seller if the *Bulk Sales Act* (Ontario) (the "**Act**") was not complied with at the time of the sale.

Subsection 16(2) of the Act holds a buyer of a bulk sale liable to account to the creditors of the seller if the sale is set aside or declared void. The Court found H&R liable for the debt that Tax Time owed to National Trust at the time of the sale plus interest, but did not find H&R liable for the cost and interest of the subsequent litigation between Tax Time and National Trust. The Court essentially required a buyer (*i.e.* H&R) to account to an unsecured creditor (*i.e.* National Trust) for the value of that creditor's claim even though the findings were that (i) H&R had paid fair value for the assets, and (ii) Tax Time had used all of the proceeds of sale to pay two prior ranking secured creditors. In other words, even if the Act had been complied with, National Trust would probably have received nothing. The indemnity given by Tax Time to H&R as a part of the sale was worthless in this case because Tax Time was no longer in business.

The reasoning of the two majority judges was as follows: The purpose of the Act is to protect all creditors, including unsecured creditors. That is achieved in one of two ways, either full payment to all creditors (section 3 of the Act) or less than full payment, but coupled with a detailed procedure for giving creditors, including unsecured creditors, an opportunity to state their position on the proposed sale (sections 4, 7, 8, 9, 10, 11 and 12 of the Act). By not complying with the Act, H&R deprived the creditors of their statutory right to contest the sale. The Court said

that it was speculation to say that the judge hearing the application would have approved the sale.

Subsection 16(2) of the Act is the remedy provision. To paraphrase, it states that if a sale has been set aside or declared void and the buyer has received or taken possession of the assets, the buyer is personally liable to account to the creditors of the seller for the value of the assets purchased. The Court was basically saying that in taking that "account," H&R would not get any credit for the proceeds of sale actually paid to creditors even if those proceeds were paid to exactly the creditors who would have been paid had the Act been complied with and the sale approved.

The majority of judges made a few other points about the Act:

- The buyer has to account for the amount owed to the complaining creditor up to the value of the assets. So, if the assets had a greater value at the time of the sale than the amount owing to the creditors, the buyer would not have to account for the full value of the assets.
- In assessing the amount owing to the creditors, the court looks to the amount owing at the time of the sale plus interest. In this particular case, at the time of sale, litigation had been commenced for the amount owing (pursuant to a financing arrangement). Judgment was obtained many years later. The Court did not allow National Trust to include the costs and expenses of obtaining the judgment and defending the appeal of the judgment, as these were not amounts owing at the time of the sale.

There was a very strong dissent from one of the judges who believed that the amount paid to secured creditors should be taken into account in the accounting and, therefore, H&R would not have to account for anything, given that it had paid fair value for the assets. He did recognize that H&R would have the burden of showing that had the Act been complied with, it would not have produced any recovery for National Trust. In other words, if Tax Time had not applied the proceeds rateably, H&R would have to account for that portion not applied rateably. The dissenting Judge thought that any other result would be draconian as H&R would have to pay for the assets twice, and the creditors would receive a windfall. That, however, is exactly what the majority decision of the Court permitted to happen.

Leave to appeal to the Supreme Court of Canada has been sought (See (2001), S.C.C.A. No. 231).

McAteer v. Devoncroft Developments Ltd.
[2001] A.J. No. 1481
Alberta Court of Queen's Bench
(November 7, 2001)

This matter involved a number of consolidated actions, counterclaims, third party claims and had, according to the Court:

> … all the trappings of a great novel – a loving family corporation developing a golf course and residential project, the introduction of a wealthy female investor, a family broken apart by an affair between the investor and the husband/father, a marriage proposal and cohabitation of the ex-husband and the investor, a divorce, high finance, empire building, corporate intrigue, lack of business and personal faith, termination of the personal relationship and engagement, insolvency, receivership/bankruptcy, and ultimately litigation.

The relevant valuation issues were, however, more narrow and concerned different approaches to determining fair market value.

Devoncroft Development Ltd. (**"DDL"**) was a closely-held family company principally involved in the development of a private golf course and surrounding residential development near Winnipeg. In 1990, in need of financing, DDL approached Martha Billes, who invested $750,000 in return for a 50% stake. The other shareholders of DDL were McAteer (10%) and his wife Mason (40%, held in trust for their children). Subsequent to her investment, Billes became a director of DDL. McAteer was the only other director of DDL.

Mason (since divorced from McAteer) alleged that Billes failed to disclose her interest in certain loans made to DDL subsequent to her becoming a director of the company. In so doing, Mason argued, Billes violated the conflict of interest provisions of both the *Business Corporations Act* (Alberta) (**"ABCA"**) and the relevant Unanimous Shareholders' Agreement (**"USA"**). Mason also implicated McAteer for allegedly giving assurances to Billes that Mason was aware of Billes' interest in those loans. McAteer had also executed an Officer's Certificate implying there was no impediment to the loans even though this was clearly untrue. Mason therefore asked for remedies under the shareholder oppression provisions of the ABCA.

Two directors of a closely-held company, who were also shareholders of the company, were found to have acted in an oppressive manner with respect to the interests of a third shareholder. The Court held that a single sale of shares occurring ten months prior to the oppressive act provided a sufficient basis for determining the fair value of the third shareholder's shares. The Court rejected the argument that in the absence of multiple sales of the shares, a "market comparable" approach should be adopted.

The relevant conflict of interest provisions of the ABCA and the USA both required a DDL director who was a director of a second corporation that was a party, or who had a material interest in any person that was a party, to a material contract with DDL to disclose the nature and extent of her interest. Such a director of DDL was also disqualified from voting on any resolution to approve the material contract. The USA further required the material contract to be approved by shareholder resolution where 50% (or more) of the directors were disqualified. The Court found the impugned loans to be material contracts. One of the impugned loans to DDL was from a trust for Billes' son, of which Billes was one of three trustees. The Court held that because the other two trustees were her accountant and a Canadian Tire dealer – Billes being from the founding family of Canadian Tire – she must therefore be held to have exercised "de facto control" over the trust because of her "business authority" over her fellow trustees. Therefore, the Court held that Billes had a "material interest" in her son's trust (despite the fact that she did not have a personal financial interest in the trust) and was a "party" to the trust loan by virtue of being one of the three legal entities (*i.e.* the trustees) constituting the trust. The Court held that Billes breached the conflict of interest provisions of the ABCA and the USA when she failed to disclose to Mason her material interest in the trust loan.

Similarly, with respect to the second impugned loan, the Court also found Billes in breach of the conflict of interest provisions of the ABCA and the USA because she failed to disclose to Mason that she was a director (as well as a 49% shareholder) of the corporation that loaned money to DDL. The second loan was also increased by $200,000 to allow DDL to retire McAteer's non-interest bearing shareholder loan. The Court also found this act not to be in the best interests of DDL.

The Court held that Billes could not excuse conduct that favoured lenders in which she had a material interest on the basis that, once DDL became "hopelessly insolvent" she owed a fiduciary duty to the company's creditors. The director's duty to creditors in near-insolvency situation "is not a principle that seems to be well developed in Canada", the Court stated. The important 1998 *Re Peoples Department Stores* decision, which suggests otherwise, does not appear to have been considered.

The Court found Mason was injured because she was deprived of the choice, as a shareholder, to decide (through a shareholder resolution) whether she wanted to participate in the loans which ultimately led to the loss of her entire investment.

After deciding in favour of Mason, and against Billes and McAteer, the Court proceeded to consider some interesting valuation issues. Since DDL was bankrupt, Mason's damages were set at the value of her shares in 1991, at the time of the first oppressive conduct (specifically, the date of the misleading Officer's Certificate signed by McAteer upon closing of the trust loan). The two sides took very different approaches to the valuation of these shares. The Mason valuation purportedly adopted a "market comparable" approach, while the Billes valuation adopted an "appraisal-based" or "net assets" approach. Essentially, the two valuations differed in their valuation of DDL both at the time of Billes' $750,000 investment and at the time of the Court's valuation date. The Court ultimately preferred the Mason valuation.

The key point was that there had only been one sale of shares in DDL, namely to Billes in return for her $750,000 investment. Moreover, that sale took place nearly a year before the Court's valuation date. The Court adopted the following definition of "fair market value" cited by Mason's expert (but also pointed out that, for the purpose of the oppression remedy, the operative consideration is "fair value" and not "fair market value"):

> …the highest price available in an open and unrestricted market between informed and prudent parties, acting at arms length and under no compulsion to transact, expressed in terms of monies [sic] worth.

Mason's valuation looked at other transactions that took place at or around the Billes investment and concluded they supported the view that DDL had some value. Mason's valuation maintained that the best evidence for DDL's value was the Billes investment. Mason's expert then concluded that there would not have been any significant or material change in the value of DDL by the time of the Court's valuation date, because DDL's business and financial position had not changed significantly during this period.

Billes' valuation agreed there was no significant change in the value of DDL between Billes' investment and the Court's valuation date. However, Billes' valuation concluded DDL had a value of nil on a net assets basis, both at the time of Billes' investment and at the time of the Court's valuation date. The Billes valuation concluded that the various transactions considered by the Mason valuation required adjustments. In support, the Billes valuation cited the commentary of Ian Campbell on business valuation to the effect that:

> …in a market comparable approach…there must be a sufficient number of transactions and the details of the transactions must be sufficiently known, in order for one to come to a reasoned decision as to whether the prices of the transactions are comparable and can be used to yield a value.

The Court generally accepted this principle, but held that it applies only in the absence of an "actual sale":

> While the details of the transaction need to be known, as is the case here, the theory requiring a "sufficient number of transactions" applies when there are no "actual sales" of the subject shares and one must look at other sales surrogates to provide a notional market value opinion. When there is an "actual sale", as in the sale of shares to Billes, and it is a valid indicator, and I accept that it is, I am of the view that numerous transactions are not required. Only one is required if it meets the definition and is an "actual sale".

The Court also accepted that value and price are not the same concepts, that prices arise from recent sales, and that the value of comparable interests can be estimated from analyzing those sale prices. However, the Court held that a comparative analysis of unrelated sales is unnecessary if there is a "valid actual market value sale of the subject asset". While more than one sale of the subject assets would provide greater confidence, even one "actual sale" – *i.e.* one that was a "true indication of fair market value" – was enough in the Court's opinion. The Court illustrated its reasoning with the following example:

> …if buyer A comes within the definition of "fair market value" and pays $x for an asset on day y, and buyer B wants to obtain an opinion on the value of the asset as at day y, one would rightly conclude that the value was $x, without enquiring as to the value others paid for different, but similar, assets at other times.

The Court also held that while fair market value may include "an assessment in the notional marketplace", it need not be tied to a notional market when there is an actual sale of the asset in question at the subject time. In other words, the Court held that where parties are informed and prudent, and acting freely at arm's length, the price they arrive at represents (or, at least, is a "very strong indicator") of the "fair market value" of the thing purchased. The Court also adamantly rejected the suggestion in the Billes valuation that the words "equally informed" be substituted

for "informed" in the definition of "fair market value" that it had accepted (see above). The Court held that purchasers can never be as "equally informed" as vendors. Even the purchaser's due diligence is required only to produce a "reasonable and informed" view based on available information, not a perfect understanding.

The Court may have been moved to adopt this conclusion because the Billes valuation concluded that DDL shares were worthless (this was presumably one of the reasons that the loans were required). The Court evidently considered it unlikely that Billes, a sophisticated business person with professional advice, would invest $750,000 to buy 50% of a company that was worth nothing. (Incidentally, the Court rejected out of hand Billes' argument that part of the $750,000 was for the management services of McAteer rather than a payment in consideration of the shares that Billes had received.)

As noted above, the Court recognized that the Mason valuation might not have reflected the "market comparable approach" because it was based on one actual transaction rather than on a number of comparable sales. Nevertheless, the Court considered it to be expert evidence of fair market value, which it accepted.

The Court made two additional valuation-related points. First, the Court did not consider the fact that the Billes valuator, unlike the Mason valuator, was Manitoba-based to be relevant to the credibility of their respective valuations. Second, although the due diligence for Billes' purchase of her 50% stake in DDL was conducted by her accountant and not by a chartered valuator, that fact by itself did not detract from the "investment price being a very strong indicator of fair market value".

The Court thus accepted Mason's valuation of $1.5 million as the value of the DDL at the 1990 date of Billes' purchase of DDL shares. This would indicate a value of $600,000 for Mason's 40% stake, but the Court focussed on a statement in Mason's valuation that the value had declined to $440,000 over the ten months between the Billes' purchase and the first oppressive act, which seems odd as Mason's valuator had elsewhere agreed with Billes' valuator that there had been no material change in the value of DDL in the period preceeding the Court's valuation date. The Court stated that it would have allowed a minority discount as well, had one been quantified and argued for. Thus the $440,000 judgment stood against Billes and McAteer personally, although the Court allowed Billes' third party claim for indemnification by McAteer.

Highfields Capital I LP v. Telesystem International Wireless Inc.

(2002), 31 B.L.R. (3d) 133

Ontario Superior Court of Justice

(February 6, 2002)

An issuer bid as a part of a recapitalization was determined to be oppressive because the bidder offered collateral benefits to certain unitholders to lock up their units and take advantage of the deemed exchange provision of the units, which made the bid coercive against other unitholders. The Court permitted the bid to be revised by declaring the deemed exchange provision void and by offering the collateral benefits to all unitholders.

This matter involved an application by Highfields Capital I LP, Highfields Capital II LP, and Highfields Capital Limited (collectively "**Highfields**") to restrain an issuer bid made by the respondent Telesystem International Wireless Inc. ("**TIW**") pursuant to the oppression remedy provisions of s. 241 of the *Canada Business Corporations Act* ("**CBCA**").

The applicants Highfields were owners of units which related to the equity of TIW's subsidiary, Clear Wave N.V. (**"CW"**). TIW made an issuer bid as part of its recapitalization plan. Under the bid, unitholders who tendered would receive TIW shares at the ratio of 5.46 TIW shares for each unit. Highfields alleged that the consideration under the issuer bid was inadequate, that certain unitholders were being offered collateral benefits and inducements not available to all unitholders, and that the issuer bid was coercive by reason of the deemed exchange provision in the terms governing the units.

TIW made an agreement with Telesystem Ltd. (**"Telesystem"**) and the Caisse de dépôt et placement du Québec (**"Caisse"**) (both unitholders of CW), and J.P Morgan Partners (BHCA), L.P (**"JPM"**) and U.F. Investments (Barbados) (**"UFI"**) (neither unitholders of CW), offering the four parties the right to purchase special warrants exercisable for TIW securities, and in the case of JPM and UFI, the opportunity to purchase TIW shares through the exercise of share purchase warrants.

The recitals to the offer stated that the offer was made to JPM and UFI "in consideration for the conversion of the subordinated voting shares" and to Telesystem and the Caisse "as a consideration for [their] agreement to tender their Units and, in the case of Telesystem, to convert its Multiple Voting Shares". The special warrants were offered at US$0.61. Each warrant entitled the holder to purchase a share of TIW for no additional consideration. A subsequent amendment provided purchase warrants in place of certain of the special warrants which carried the right to purchase shares at U.S. $1.00 per share. The shares that Telesystem and the Caisse would acquire through the exercise of their warrants would be post-recapitalization shares.

TIW contended that the warrant sale to Telesystem and the Caisse was not a "collateral benefit" in contravention of subsection 97(2) of the *Securities Act* (Ontario) ("Act") because the warrants did not provide a greater consideration than that offered to other holders of units. The evidence they provided was that when the warrants were negotiated in November 2001, the price of TIW shares was only about US$0.30. On November 28, 2001, the day the agreement with the four parties was signed, TIW shares traded at between Cdn.$1.90 and Cdn. $2.18.

The Court stated that pre-recapitalization trading prices were not a reliable indicator of the value of the post-recapitalization shares, or of the value on November 28, 2001 of the warrants to acquire such shares. Although there was no reliable evidence as to the value of the warrants on November 28, 2001, the Court held that by entering into the agreement to acquire the warrants, Telesystem and the Caisse gave up rights they otherwise would have had not to tender their units. They also gave up rights they would have had under the issuer bid to withdraw the units they tendered. In giving up these rights, Telesystem and the Caisse received valuable consideration.

On this basis, the Court held that by providing these rights to Telesystem and the Caisse, TIW had provided to them, by way of a collateral agreement relating to the units, "a consideration of greater value than that offered to the other holders" of the units, which was in contravention of the Act. The Court concluded that to the extent that Telesystem and the Caisse enhanced their participation in the recapitalization, they had obtained an enhanced participation in the control and ownership of the combined business entities, or at least in such ownership.

In addition, by operation of a deemed exchange provision in the unit indenture, unitholders who failed to tender to the bid (and its offer of 5.46 TIW shares for each unit) could be potentially forced to receive only 0.2 TIW shares per unit, if insufficient units remained outstanding upon termination of the bid.

A valuation analysis for the Independent Committee of the Board of Directors of TIW was prepared by TD Securities (**"TD"**). It was concluded that under the majority of scenarios examined, there would be a negative net impact to unitholders from tendering to the bid. TD advised that acceptance of TIW shares in place of the interest represented by the units in the equity of CW would mean the holders would rank after TIW creditors rather than ahead of them. There was

also no assurance that TIW would have or be able to obtain sufficient funds to meet its debt obligations. The Court concluded that TD's analysis provided an investor with reasonable grounds to conclude that the consideration being offered was inadequate.

The Court concluded that the issuer bid was oppressive because TIW offered illegal collateral benefits to some unitholders to lock up their units, and that TIW had structured the bid to take advantage of the deemed exchange provision of the indenture to make the bid coercive against other unitholders.

Having determined that Highfields had established its complaint, the Court considered the remedy proposed by J.P. Morgan Partners, LLC and Hutchison Whampoa Limited (both as intervenors) to award damages in the amount of the difference in value between the CW shares represented by the units and the TIW shares issuable under the bid. However, it was determined that such remedy would be inadequate since it would allow a taking of the property interest of the complainant security holders. The Court ultimately concluded that an order to restrain the bid would not be excessive, even though it would restrain the take up of the units of those unitholders who wanted their units to be exchanged for TIW shares.

Following the Court's decision, TIW proposed an amendment to certain terms of the issuer bid and sought a Court order that would allow the issuer bid to proceed on the revised terms. The Court agreed that the bid could be revised so that it would no longer breach subsection 97(2) of the Act, nor constitute oppressive conduct under the CBCA. The Court declared the deemed exchange provision void, presumably on the basis that it was oppressive, and gave all unitholders the right to take up a pro rata share of the special warrants and the purchase warrants previously offered to the Caisse and Telesystem in accordance with applicable securities laws.

The original bid was oppressive on account of three factors: (i) a consideration which unitholders might reasonably consider to be inadequate, (ii) special consideration being made available to only two of the unitholders, and (iii) the coercive effect of the deemed exchange provision. With the elimination of the latter two factors, the Court believed that each unitholder could decide for itself whether it wished to accept the bid or to continue to hold the units.

Sepp's Gourmet Foods Ltd. v. Lembit Janes et al

(2002), 98 B.C.L.R. (3d) 217

B.C. Court of Appeal

(February 14, 2002)

In February 2002, the British Columbia Court of Appeal released a decision in which it interpreted the minority approval requirements of Ontario Securities Commission ("**OSC**") Rule 61-501 in a manner contrary to the published policies of the OSC (which were adopted after much discussion and analysis) and the established practice among securities law practitioners. The Court of Appeal held that a person who enters into an agreement with a control group to support a proposed transaction will be acting jointly or in concert with that group - resulting in that person, even if otherwise at arm's length from the control group, being excluded from voting as part of the minority in respect of the transaction. This decision may create difficulties in merger transactions, and potentially lead to dramatically different results between merger transactions and take-over bids.

The British Columbia Court of Appeal has continued its troubling interpretation of the effect of "lock-up" agreements in the context of public company mergers. The Court ruled that a minority shareholder who entered into a lock-up agreement to tender his shares in a proposed transaction should be considered to be acting jointly or in concert with the control group and should therefore be excluded from voting in the minority approval process. This decision goes against current practice among securities law practitioners and the published policies of the Ontario Securities Commission.

The case involved the proposed "going private" acquisition of Sepp's Gourmet Foods Ltd. by a group of shareholders, directors and management employees of Sepp's (the **"Acquisition Group"**). Led by Sepp's chairman, the Acquisition Group controlled approximately 50% of the Sepp's shares. Prior to the announcement of the proposed transaction, the Acquisition Group obtained the support of Rosenberg, a significant shareholder controlling approximately 12.5% of Sepp's shares. Under the proposed transaction, all of Sepp's shareholders other than members of the Acquisition Group were to transfer their shares in exchange for a cash payment of $0.71 per share.

The proposed transaction was to occur by way of a plan of arrangement under the British Columbia Company Act (**"BCCA"**), and as a result had to be approved by a special resolution (requiring 75% approval) of Sepp's shareholders, as well as by a "majority of the minority" (*i.e.* generally speaking, a majority of shares held by holders that were not part of the Acquisition Group) under certain special provisions, commonly known as the "Loewen Amendments," of the BCCA. OSC Rule 61-501 also imposed certain requirements in connection with the proposed transaction, including somewhat different minority approval requirements. As a result, in drafting the interim order sought from the Court, which was to provide the procedural basis for the transaction, Sepp's specified that the transaction required the approval of a special minority of Sepp's shareholders. The classes of persons excluded from comprising the special minority were based on the provisions of the BCCA and also the provisions of OSC Rule 61-501.

Janes Family Foods Ltd., a competitor of Sepp's, opposed the transaction. Upon learning of the proposal, Janes began buying Sepp's shares on the open market and, by the record date for the shareholders' meeting in early August, held approximately 13% of Sepp's shares and, by the date of the shareholders' meeting in late September, approximately 18%. Although Janes publicly announced its intention to make a take-over bid for all of Sepp's shares at a price of $0.84 per share in early September, it was unable to successfully negotiate the terms of that transaction with Sepp's and, by the time of the shareholders' meeting, had announced the withdrawal of its bid.

At the shareholders' meeting, the proposed transaction received the approval of 80.5% of the votes cast by all shareholders, as well as the approval of 64% of the votes cast by the special minority. At the fairness hearing in which Sepp's sought its final order in respect of the proposed transaction, Janes opposed the granting of the final order on a variety of grounds, including the argument that a number of shareholders who voted in favour of the proposed transaction were wrongly allowed to vote as part of the special minority.

As a result of Rosenberg's substantial holdings, Janes focused its arguments in this respect on the exclusion of Rosenberg from the special minority. The trial Court found that in order to be excluded under the wording of the BCCA or under OSC Rule 61-501, Rosenberg would have to both (a) have reached an understanding to support the transaction, and (b) have been acting jointly or in concert with the Acquisition Group. The trial Court found that, while an understanding with Rosenberg was reached, since Rosenberg did not otherwise act jointly or in concert with the Acquisition Group, he should not be excluded from the special minority. This is the narrow point which was the subject of the appeal. Janes successfully advanced a secondary associated argument relating to certain shares registered in "street form" (registered in the name of a broker). The trial Court held that such shares could not be voted as part of the special minority since there was no reliable way of determining whether the holders properly formed part of the special minority.

While the Court of Appeal provided some useful advice regarding the application of the majority of the minority provisions of the BCCA, the appeal was decided strictly on the basis of that portion of the wording of the interim order, which related to OSC Rule 61-501.

In interpreting this wording of the interim order, the Court of Appeal dismissed such obvious aids to interpretation as are found in the companion policy to OSC Rule 61-501 and seems not to have considered other aids to interpretation such as industry practice. Instead, the Court of Appeal looked only to the words themselves, their "grammatical and ordinary sense" and, despite ignoring the

interpretive policy of the OSC, claims to have read the words "harmoniously with the scheme and object of the legislation." On this basis, the Court of Appeal held that "a person who has entered into an agreement with a control group to support a proposed corporate action must be said to be acting jointly or in concert with that group." As Rosenberg had agreed to vote his shares in favour of the proposed transaction, he was excluded from the special minority with the result that Janes' dissenting vote carried the day and the proposed transaction failed.

This decision is troubling, as it goes against the published policies of the OSC, industry practice and, some might even say, common sense - deeming a "seller" to be acting jointly or in concert with a "buyer," for no other reason than having, in effect, agreed to sell shares via the proposed transaction. Also of concern is the continuation of a trend, started in the recent British Columbia Court of Appeal decision in *Pacifica*, in which the Court of Appeal questions the enforceability of support agreements (see Volume 7, Issue I, November 2001 of the Valuation Law Review for a discussion of the *Pacifica* case). The impact of this latest decision on future transactions is not clear at this time. It is also unclear how the OSC will react (although they may make amendments to OSC Rule 61-501 to make it more clear) and whether courts in other jurisdictions will follow this decision. However, by leaving the requirements of OSC Rule 61-501 outside the scope of interim orders, it may be possible to leave the interpretation of OSC Rule 61-501 to the OSC, rather than the courts. This approach would be consistent with standard practice with respect to other regulatory approvals, such as those required under the Investment Canada Act or the Competition Act, which are enforced by the regulatory bodies in question rather than the courts. Alternatively, a party concerned with the effect of this case on a particular transaction could seek exemptive relief from the OSC.

Leave to appeal to the Supreme Court of Canada has been sought. (See (2002), S.C.C.A. No 4).

II. U.S. DECISION

Kerry P. Gray v. Cytokine Pharmasciences, Inc.
2002 Del. Ch. LEXIS 48
Court of Chancery of Delaware, New Castle
(April 25, 2002)

A dispute about the fair value of common shares of a corporation, and the Court's subsequent rejection of valuations completed by non-arm's length experts, resulted in the Court's reliance on a combination of findings of an independent valuation, subject to additional discounts and adjustments.

This case involved an appraisal action pursuant to s. 262 of the *Delaware General Corporation Law* ("**DGCL**"). The Court was asked to determine the fair value of the common shares of PharmaSciences, Inc. ("**PSI**" or "**Company**"), a Delaware company, as of the date that it merged with Cytokine Networks, Inc. ("**CNI**"). The merged company subsequently changed its name to Cytokine Pharmasciences, Inc. ("**CPSI**"). Pursuant to the merger which occurred in 1999, each PSI common share ("**PSI Share**") was converted into the right to receive approximately 59.4 CPSI common shares. The petitioner Kerry P. Gray ("**Gray**") owned 592 of the 47,800 PSI Shares at the time of the merger. Gray contended that PSI's fair equity value at the time of the merger was U.S. $192.5 million, or U.S. $3,330 per common share. The respondent CPSI contended that the fair market value of PSI at the time of the merger was U.S. $26.5 million, or U.S. $458 per common share, considerably less than that argued by Gray.

PSI, founded by Gray and several of his business partners in 1992, was a closely held company primarily engaged in the business of developing drug delivery products. In 1996, the Company rejected an offer of U.S. $27 million from Forest Laboratories because PSI's board of directors (the **"Board"**) believed that the offer did not consider any value for the Company's new products. PSI also considered a proposal by Volpe Welty & Co., which advised that the sale price of PSI should range between U.S. $35 and U.S. $45 million, although a higher price could be obtained if an active bidding auction occurred. However, the Board believed that PSI should be valued somewhere in the range of U.S. $60 million.

In 1997, Access Pharmaceuticals (**"Access"**), a company operated by Gray, offered U.S. $45 million for PSI, which was later increased to U.S. $51 million. In correspondence between Gray and PSI, Gray maintained that investment bankers for Access considered the U.S. $51 million offer to be a premium price based on a discounted cash flow (**"DCF"**) model and payback analysis. While the Access offer was pending, PSI also explored a merger with CNI, which was controlled by Jeffrey Picower, who was also the majority shareholder of PSI.

Lehman Brothers Holdings Inc. (**"Lehman Brothers")** was retained to provide a valuation of PSI in April 1997. They valued the Company at U.S. $64 million using financial projections prepared by PSI that did not quantify new business opportunities. One of the exercises performed by Lehman Brothers was a DCF analysis of the projected stream of earnings attributable to PSI's cervical ripening product, which produced a valuation range with a midpoint of U.S. $83 million.

In mid-1998, PSI estimated that its value was U.S. $49.4 million without new products, and U.S. $129.6 million with new products. CPSI argued that those valuations were not management's best estimate of the future performance of the Company because they did not take into account the probability that some or all of PSI's new products would fail.

In 1999, PSI decided to merge on a stock-for-stock basis with CNI. Montgomery Medical Ventures (**"MMV"**), a substantial PSI shareholder, opposed the merger because it was about to liquidate and could not distribute unregistered securities to its investors. PSI repurchased MMV's interest at a price of U.S. $266 per share (for a total purchase price of about U.S. $9.9 million), a price that PSI later described as a "steal". After negotiating a 60:40 ratio (PSI to CNI) for the merger, the parties jointly asked Merrill Lynch & Co. Inc. (**"Merrill Lynch"**) to value the stock of the companies without opining as to fairness. The Merrill Lynch valuation derived the following equity range values for PSI:

Approach	Equity Range Value	Midpoint
Discounted Cash Flow	U.S. $66.5 - U.S. $126.6 million	U.S. $96.5 million
Public Market	U.S. $65.6 - U.S.$79.3 million	U.S. $72.5 million
M&A Transactions	U.S. $75.6 - U.S.$100.5 million	U.S. $88.1 million

In its DCF analysis, Merrill Lynch applied a blended discount rate of 40-50% on PSI's projected cash flows. At the time of the valuation, PSI's management took issue with the discount rate used by Merrill Lynch and contended they should be significantly lower. Merrill Lynch did not agree.

Both parties retained their own experts in this appraisal action. Gray's trial expert was Jeffrey B. Davis, president of Small Caps Online Group, LLC, a boutique communications and investment banking firm which provides financial services to small-cap health care and information technology companies. Davis had never served as an expert in any judicial proceeding and relied entirely on a DCF analysis to value PSI. His analysis of PSI resulted in a valuation range with a mid-point of U.S. $192.5 million, or U.S. $3,330 per share.

CPSI's trial expert was J. Mark Penny of Hempstead & Company, an accredited senior appraiser in the American Society of Appraisers with a specialty discipline in business valuation. Penny had conducted about 1,000 business valuations,

including 10 in the pharmaceutical industry and two in the drug delivery business. Penny used a DCF analysis and a guideline company analysis (subsequently referred to as the **"Comparable Companies Approach")**. Based on the DCF analysis, Penny determined the fair equity value of PSI at U.S. $36.7 million, and based on the guideline company analysis, he determined the fair equity value at U.S. $35.9 million. Weighing these results equally, Penny determined that the fair value of PSI Shares at the time of the merger was U.S. $36.4 million, or U.S. $383 per share. He then adjusted this valuation to reflect the fact that MMV shares were not outstanding at the time of the merger (having been repurchased by PSI for about U.S. $9.9 million in cash). Penny concluded that the fair equity value of PSI was U.S. $26.5 million, or U.S. $458 per share.

The Court first commented on the considerably different valuations of PSI. With regards to Davis's valuation, the Court doubted its reliability for several reasons. First, a year before the merger, Gray had retained Davis to serve as financial consultant and advisor to Access. For these services, Davis received substantial monthly cash payments and warrants to purchase Access stock. Furthermore, Davis had admitted that he agreed to serve as an expert on account of his relationship with Gray. Second, Davis's DCF analysis included interest income in his projection of free cash flows and applied an inappropriately low discount rate to PSI's future cash flows. Davis incorrectly assumed that interest income would be retained by the Company and not distributed to shareholders. Third, the Court concluded Davis's valuation was so high that that it questioned both his qualifications and his independence. It was noted that Davis's valuation was "off the charts" as compared to the valuations conducted by Merrill Lynch and Lehman Brothers, and was four times higher than any offer PSI received when attempting to sell the Company. The Court essentially concluded that Davis's valuation was too high to be reliable. Gray and Davis had also failed to explain the extreme variation from the other valuations that were conducted. As such, the Court decided not to rely on Davis's valuation.

The Court also found Penny's valuation to be unreliable. More specifically, Penny's cash flow analysis disregarded the cash flow projections that were prepared by PSI's management and relied upon by Merrill Lynch. Penny instead made his own projections by assuming a constant rate of growth over PSI's 1998 revenues (10% in one case and 20% in another) and eliminating all projected earnings from new products. Penny endorsed CSPI's argument that management's prior forecasts were merely "what if" scenarios. The Court disagreed and determined that due to the inherent difficulty involved in predicting when a

pipeline product would gain regulatory approval, management projections would inevitably contain "what if" scenarios. PSI presented these forecasts to Merrill Lynch to determine the fair market value of PSI and CNI for the proposed merger and presented no evidence that suggested Merrill Lynch was told the forescasts were mere "management tools" which did not accurately reflect PSI's future cash flows. Penny also ignored management projections in several other respects, and did not provide valid reasons to warrant all adjustments applied. The Court could not accept that Penny, with his limited experience with PSI, was better equipped to make future financial projections than PSI's management. The Court thus found Penny's projections to be unreliable, because "to do otherwise would condone a company's management or board of directors to disavow their own data in order to justify a lower valuation in an appraisal proceeding". The Court also found Penny's DCF to be so heavily dependent on the determination of PSI's terminal value that the entire exercise amounted to little more than a special case of the Comparable Companies Approach to value, and thus had little or no independent validity. For such reasons, the Court found Penny's DCF analysis to be unreliable.

The Court found Penny's Comparable Companies Approach to be unreliable because the comparable companies used by Penny were much larger than PSI in terms of revenue and market capitalization (e.g., the median revenue and market capitalization of the comparable companies chosen were 12 and 24 times higher than PSI). Furthermore, of the 10 comparable companies utilized by Penny, only one was in the drug delivery business.

Having determined that both of the expert valuations were unreliable, the Court relied on Merrill Lynch's valuation as a reliable depiction of PSI's fair value at the time of the merger. The Court considered that Merrill Lynch was a disinterested party at the time it prepared its valuation with no reason to artificially inflate or shrink what it considered to be PSI's value. CPSI argued that Merrill Lynch's valuation should be set aside since it did not represent PSI's value as a going concern on a stand-alone basis. CPSI emphasized the deposition testimony by the lead Merrill Lynch analyst that its valuation did not account for the risk that a certain PSI product would never be approved. The analyst testified that had he valued PSI as a going concern on a stand-alone basis, he would have adjusted management's projections to reflect that risk. The Court, however, found the analyst's testimony to contradict Merrill Lynch's own valuation report, which discussed the discount rate applied to management's projected cash flows as follows:

- Discount rates for development stage companies in the biopharmaceutical/biotechnology industry typically range from 35% to 70%. The discount rate appropriate for a particular company depends upon factors including:

  - Stage of development of the company's product pipeline (*i.e.*, Pre-clinical, Phase I, Phase II, Phase III) and the probability of developing these products successfully;

  - Diversification of the company's product pipeline/portfolio;

  - Level of competition within the company's targeted market(s);

  - Existence of collaborations and/or partnerships between the company and larger drug companies;

  - Outlook for and existence of commercially launched products by the company; and

  - Depth of the company's management team and other qualitative factors.

The Court found that the large discount rate applied by Merrill Lynch to PSI's projected cash flows took into consideration the possibility that PSI's pipeline products would never reach the market. The Court also interpreted the analyst's testimony that his valuation method would be the same if the merger were a stock-for-cash transaction to imply that Merrill Lynch did not just perform a comparative valuation, but instead applied normal valuation techniques as they would in any valuation assignment.

In addition to its DCF analysis, which had applied a blended discount rate of 40-50% on PSI's projected cash flows, Merrill Lynch also placed a value on PSI beyond the forecast period by applying a range of multiples of revenue to projected revenues in 2008. Based on market valuations for companies similar to PSI, a range of revenue multiples from four to six times was selected. The terminal value was then discounted to the present and added to the present value of projected cash flows from 1999 to 2008. The Court found that PSI's projected future cash flows should be discounted by 50% because at the time of Merrill Lynch's valuation, the discouraging results from the meetings about the

regulatory approval of a certain PSI product were not yet available. The results decreased, but did not eliminate, the likelihood that such product would successfully enter the market. The Court thus accounted for the discouraging results by using the high range of the discount rates applied by Merrill Lynch.

The Court also found that a revenue multiple of four times should be applied to PSI's projected revenues in 2008 to most accurately determine PSI's terminal value. PSI was in a strong financial situation at the time of the merger, had no long-term debt and had captured 85% of the U.S. market, in addition to scheduled launches in numerous other markets. However, the Court found that a substantial part of PSI's revenues hinged on the success of a specific PSI product, and therefore applied a low revenue multiple of four times to take into consideration certain negative regulatory developments relating to such product.

The Court applied a 50% discount rate to PSI's projected cash flows together with a terminal multiple of four times, resulting in an enterprise value of about U.S. $66.5 million. This value was then adjusted because Merrill Lynch's DCF analysis did not include interest income, cash equivalents or interest expenses on any debt. The Court added the U.S. $8.7 million PSI had in cash and investments, resulting in a going concern value of PSI at the time of the merger of about U.S. $75.2 million.

The Court also found that Merrill Lynch's Comparable Companies Approach reliably depicted PSI's fair value at the time of the merger. Merrill Lynch excluded companies with revenues greater than U.S. $150 million and companies with no commercially launched products on the market. Merrill Lynch compared PSI with five other companies that focused on drug delivery, were of similar size and had products in similar stages to that of PSI. Based on multiples derived from the comparable companies, Merrill Lynch determined that PSI's enterprise value ranged from U.S. $57.8 million to U.S. $71.5 million. The Court selected the midpoint value of this range and added U.S. $8.7 million to reflect PSI's cash and investments, resulting in a value of U.S. $73.4 million.

The Court averaged the values from the DCF and comparable companies analyses and arrived at a going concern value of U.S. $74.3 million. After adjusting for PSI's repurchase of MMV's holdings of PSI Shares, a value of U.S. $64.4 million, and a per share value of U.S. $1,114, was determined. The Court also indicated that interest on the fair value of the PSI Shares should be compounded monthly based on several previous decisions of the same Court and the fact that PSI had loaned funds to CNI a few months prior to the merger with interest to be compounded monthly.

Accounting standards recently developed by the Accounting Standards Board in Canada and its U.S. counterpart, the Financial Accounting Standards Board, may require valuations to be prepared from time to time in connection with the testing for impairment on an annual basis of goodwill and intangible assets with an indefinite life. Such valuations may be discloseable under Canadian securities law (including under Ontario Securities Commission Rule 61-501, Quebec Securities Commission Policy Q-27 and the normal course issuer bid rules of The Toronto Stock Exchange).

III. REGULATORY DEVELOPMENTS

Valuations Prepared in Connection with New Accounting Standards May Be Discloseable

Recent accounting standards developed by the Accounting Standards Board ("**AcSB**") in Canada (See AcSB Handbook Section 3062, *Goodwill and Other Intangible Assets*) and its U.S. counterpart, the Financial Accounting Standards Board, have come into effect that require goodwill and intangible assets with an indefinite life to be tested for impairment on an annual basis. Goodwill and indefinite life intangibles are no longer amortized. Intangible assets with a definite life continue to be amortized over their useful life.

The procedures prescribed for making transitions to, and for complying with, the new accounting standards may require that issuers prepare valuations from time to time. It should be noted that any such valuations may be discloseable under Canadian securities law.

Specifically, Ontario Securities Commission Rule 61-501 and Quebec Securities Commission Policy Q-27 require disclosure of any prior valuation in the event of subsequent insider bids, substantial issuer bids, going-private transaction or related-party transactions (if minority approval is required). "Prior valuation" is defined for the purposes of Ontario Securities Commission Rule 61-501 and Quebec Securities Commission Policy Q-27 to mean "a valuation or appraisal of an issuer or its securities or material assets, *whether or not prepared by an independent valuator*, that, if disclosed, would reasonably be expected to affect the decision of a beneficial owner to vote for or against a transaction ... " (emphasis added).

In addition, the normal course issuer bid rules of The Toronto Stock Exchange (the **"TSX"**) require an issuer to include in its notice filed with the TSX a summary of any appraisal or valuation of the issuer, its material assets or securities prepared within the preceding two years. For the purposes of the TSX rules, an "appraisal or valuation" includes both an independent appraisal or valuation and material non-independent appraisal or valuation.

It is important to note that, for the purposes of Ontario Securities Rule 61-501, Quebec Securities Commission Policy Q-27 and the normal course issuer bid rules of the TSX, a single asset of an issuer could, depending on the circumstances, be considered to constitute "material assets".