Some Reflections on *Magna* and Dual Class Share Structures

Professor Jeffrey G. MacIntosh
Toronto Stock Exchange Professor of Capital Markets
Faculty of Law
University of Toronto

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Contents

PART I: THE MAGNA TRANSACTION

1. The Transaction

The recent reverse dual class recapitalization (DCR) involving Magna International has re-focused attention on dual class structures (DCS) in Canada. How should such structures be regulated? Are there lacunae in the existing regulatory scheme either in respect of the creation of DCS, the governance of DCS, the collapsing of a DCS, or more generally (e.g. re related party transactions)?

Magna is a bit of an outlier, but outliers are often useful in exploring what is either good or bad about particular structures. Amoaku-Adu et al.[1] note that the Magna's voting leverage (the ratio of votes to shares) was 66.7, which was more than twice that of any other firm in their Canadian sample of DCS, and an order of magnitude greater than the average (6.43).

The facts of Magna are quite stark. Magna had two classes of shares – about 112 million publicly traded Class A shares, with one vote each, and 726,829 Class B shares, with 300 votes each. The latter were concentrated solely in the hands of the Stronach Family Trust. Thus, the trustees of the fund (*viz.* Frank Stronach) controlled 66% of the votes while owning 0.6% of the equity.

The reverse DCR, effected by way of statutory arrangement, saw Magna repurchase all of the Stronach Class B shares. In return, Stronach got US $300 million cash, 9 million common shares (into which all existing Class A shares were also converted), a four-year renewal of his generous "consulting" arrangement with Magna[2], worth an estimated US $120 million[3], and a 27% interest in Magna's E-Car division, specifically spun-out for that purpose.[4]

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[1] Ben Amoako-Adu, Brian F. Smith, Madhu Kalimipalli, "Concentrated Control: A Comparative Analysis of Single and Dual Class Structures on Corporate Value" (2005).

[2] While Stronach had not been a member of management for many years, his extraordinarily generous consulting contracts yielded cash income from Magna on the order of $40 million per year or more.

[3] The consulting fees are a proportion of Magna's pre-tax profits, being 2.75% in 2011, 2.50% in 2012, 2.25% in 2013, and 2.00% in 2014.

[4] Janet McFarland, "Magna panel neutral on shares deal", The Globe and Mail, p. B9, reports "Magna reveals Mr. Stronach wanted to maintain control of the electric vehicle division because he felt "it needed a 'focused and strong hand' to guide it through its early and formative stages." This is suggestive of the "Superman" theory of the DCR discussed below. As the text following suggests, there may have been other reasons for Stronach's interest.

It is difficult to value Stronach's 27% interest in the E-Car division. The deal obliges Magna to contribute US $220 million and Stronach US $80 million. Based strictly on these figures, Stronach's ownership interest is in line with his cash contribution. Moreover, the non-cash assets that Magna would contribute to the deal were the subject of a valuation by PricewaterhouseCoopers. However, the deal also cedes Stronach control of the board, driving a wedge between his cash flow rights and his voting rights. Given the history of Magna, the value of this control could be non-trivial.

A further issue is raised by the fact that the E-Car division is likely to experience much greater growth in the coming years than more traditional sectors of Magna's business.[5] This raises the issue of whether the PricewaterhouseCoopers asset valuation of the non-cash assets to be contributed by Magna is truly meaningful. The true measure of the value of the E-Car division lies in its earning power, and not in the value of its assets. The use of what is essentially a balance sheet measure to value a going concern could easily and substantially understate the value of the division. This suggests that Stronach may have purchased his 27% interest in the E-Car at a bargain-basement price, again understating the total value of the reverse DCR to Stronach.

Based strictly on the value of the shares and cash consideration, the deal was worth US $863 million to Stronach. Adding in the estimated value of the consulting contracts yields US $983 million. Adding in a (modest) fudge factor based on the value of the E-Car deal, Stronach received on the order of US $1 billion to part with his Class B control shares.

Based on cash flow rights, Stronach's Class B shares had a value of about US $45 million. It has been widely reported in the press that Stronach received a multiple of 18 times the value of the Class A shares for his Class B shares. However, this is based only on the value of the cash and shares received by Stronach. It leaves out of account the value of Stronach's share in the E-Car division (assuming that it has value is in excess of the $80 million that Stronach will invest). It also leaves out of

[5] See e.g. Greg Keenan, "Magna betting on a battery-powered future", 26 May 2010, The Globe and Mail, p. B1.

account the consulting contracts.   Based on the entire package of benefits received, the multiple is actually more on the order of 22.

2. The Market Reaction

a. The Transaction Itself

Needless to say, the reverse DCR has prompted a colourful menagerie of deprecatory epithets such as “excessive”, “outrageous”, “horrible”, “eye-popping”, “off the chart”, “unfair”, “unreasonable”, “far too sweet”, “blackmail”, “a very dangerous precedent”, and “extortion”.[6] The transaction is utterly without precedent – in terms of the multiple paid - in Canada and probably elsewhere. And indeed, it is truly extraordinary that shares with cash flow rights with a value of

[6] See e.g. Andrew Willis, “Magna payout turns spotlight on governance”, The Globe and Mail, 18 June 2010, p.B11 (“Mr. Stronach has been the poster boy for what's wrong with corporate governance, with his outsized compensation and vague distinction between Magna's business and the founder's passion.”); Tony Van Alphen, “Stronach draws fire for $416M pay packet; Stock-plan fight heats up as Magna, investors battle before the OSC”, Toronto Star, 19 June 2010, p. B1 (“Prominent investment counsel Stephen Jarislowsky, whose company holds no Magna stock, said Stronach should give back the B shares for free because he has awarded "outrageous" sums of money to himself over the years that far exceed the value of his multiple voting class or any annual compensation to industry peers worldwide.”); Tony Van Alphen, “Pension giants slam Magna plan Auto parts; New single-class stock proposal 'dangerous,' 'unreasonable' and far too sweet for Stronach, Teachers' and CPP say”, Toronto Star, 4 June 2010, p. B1; Janet McFarland, “Pension funds fight Magna deal”, Globe and Mail Update, Thursday, Jun. 03, 2010 9:44AM EDT (“In our minds, it is an entirely excessive, inappropriate and egregious price that we’re being asked to pay... CPPIB chief executive officer David Denison said Thursday in an interview. He said it also sets a “terrible” precedent if other companies choose to collapse their dual-share structures. “We haven’t seen too many situations which are as offensive, quite honestly, as this,” Mr. Denison added.”); Daryl-Lynn Carlson, National Post, 28 June 2010, p FP.2. Even those who supported the deal (for fear of losing the boost in price) were critical. See e.g. Greg Keenan, “Stronach buyout pricey, but deal provides upside; ISS points to stock's gains since idea was floated of buying out Magna chairman's controlling stake”, The Globe and Mail, 15 June 2010, p. B6 (“From a purely corporate-governance perspective, this proposal pushes the boundaries of shareholder tolerance and acceptance into formerly un-navigated territory,” [a spokesperson for Institutional Shareholder Services, a unit of New York based RiskMetrics Group] says, but added that defeating it would probably wipe out the gains in value Magna's shares have made since the deal was announced May 6, which have come despite extreme volatility on world stock exchanges.”).

approximating $45 million could be sold back to the company (in effect, to the other shareholders) for something on the order of a billion dollars.

However, there is another side to the story. Overall, Class A shareholders profited from the buyout. When the transaction was initially announced at the close of business on May 5, Magna's shares closed at US $62.53. The post-announcement close on May 6 was US $69.94 – a rise of 12%, representing an increase in market cap of US $830 million. Comparing the average trading average in the 20 days prior to the transaction (US $65) with the 20 days after (US $72.07) yields a similar percentage increase of 10.9%, representing market cap of US $792 million.[7]

When the transaction was announced, however, it still had to be approved by shareholders, regulators, and the courts. Thus, the announcement date increase does not tell the whole story. Perhaps the most useful way to determine the true value of the transaction is to compare Magna's share price prior to the announcement of the transaction to the price that prevailed after the last required approval was secured. The average trading price of Magna in the 10-day window before the announcement is US $65.29, while the average price in the 10-day window following the last approval[8] is US $80.70 – and increase of 23.6%. Over this same period of time,[9] the TSX Index dropped about 0.4%. If we thus assume that Magna's share price rose 24% in response to the reorganization,[10] the increase in market cap (and the benefit to Class A shareholders) was US $1.755 billion.[11] If we add to this the US $1 billion paid to Frank Stronach (essentially a transfer of wealth from the Class A shareholders to Stronach), a rough measure of the value created by the reverse DCR is US $2.755 billion, representing 37.68% of the pre-transaction value of Magna.

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[7] It should be noted that these figures remove neither market movements nor potentially confounding events. It is impossible to remove the effect of one particular confounding event; contemporaneously with the announcement of the reorganization on May 6, Magna announced unexpectedly good quarterly earnings, as well as the restoration of the company's regular dividend. A cynic might well suggest that this bundling of information, which potentially made the price reaction to the announcement appear more favourable than it actually was, was not a mere coincidence.

[8] And the August 31 drop dead date up to which the transaction could be cancelled by either Magna or Stronach.

[9] I have taken the TSX Index at the mid-point of the aforementioned 10 day periods.

[10] Magna's beta is 0.9, so that is a reasonably accurate assumption.

[11] There are further potential confounding events over this event period. In particular, Magna filed many press releases over the pertinent period relating both to the transaction and to other events.

At least two corrections appear to be in order, however. Magna announced better than expected results on May 6, as well as a restoration of the company's dividend. It is impossible to determine the price effect of this announcement, as it was bundled with the announcement of the transaction. However, once again, on August 6, the company announced better than expected earnings, plus an increase in the dividend. The market price advanced by US $4 or 5.3%. If we attribute a similar $4 increase to the earlier event, then we should subtract $8 from the increase in price observed between May 6 and September 1. If we do this, then the increase in price that is attributable to the transaction is US $7.41, representing $825 million in market cap. This means that the aggregate gain achieved by collapsing Magna's dual class structure is about $1.825 billion. This means that the Class A shareholders got 45% of the gain, and Stronach 55%.

This is quite an extraordinary figure. While largely unremarked upon, this is a rather stinging repudiation of the negative value created by Frank Stronach's control position in Magna. Whether this negative value was created by Stronach's consumption of perquisites (the consulting contracts?), his more-than-part-time dalliance with race horses, or Magna's conspicuous failures in strategic direction (such as ill-advised investments in horse racing tracks and real estate[12]), or these and some combination of other factors, remains unclear. But in any case it throws much light on why Class A shareholders would vote in favour of purchasing shares with cash flow rights of US $45 million for something on the order of a billion dollars.

Indeed, one of the ironies of the reverse DCR is that the greater the value-drain imposed by a controlling shareholder, the greater will be the willingness of the minority shareholders to pay a handsome premium to wrest back control. If the controller is doing a bang-up job of running the company, there will be relatively little interest or value in buying back control. It is only when the value-drain starts to mount that the appetite for a premium buyout will sharpen. As explored further below, this argues either for prohibiting DCRs, or more closely regulating the reverse DCR.

b. The OSC Announcement that it Would Hold a Hearing

[12] See e.g. Derek Decloet, "Thank God for Frank. What would we do without him?", The Globe and Mail, 5 June 2010, p. B1.

There is further information to be gained by examining the response of Magna's share price to approval of the transaction by the securities regulators, shareholders, and the courts. However, these market reactions are inherently ambiguous, since several factors were simultaneously at play. One is whether each approval resolved any uncertainty. Another is whether the transaction was a good thing (although the very positive overall price reaction to the deal seems to resolve this factor). Another is that the market might have felt that a refusal to approve the deal (by either the regulators, courts, or shareholders) would have given the Magna board the power to negotiate a more favourable deal (despite Stronach's inherently self-serving statements that the deal was offered on a "take it or leave it" basis).

Added to this, the market was constantly peppered with conflicting news stories about Magna, concerning such factors as whether the shareholders, the regulators, and the courts would approve. Expressions of outrage from some shareholders and commentators were counterpoised by declarations from other shareholders, investment bankers, and others that approving the arrangement would result in a significant increase in share price. In the end, it may well be that a great deal of heterogeneity existed in the market concerning one or more of these factors, *and* that these heterogeneous opinions were held by distinct cadres of institutional traders. If so, then there may not have been any "marginal" traders to unambiguously set the market price. This makes any event study of price changes (and what follows is not rigorous, but only impressionistic) rather problematic. This is discussed further below.

Consider first the approval of the securities regulators. Staff of the Ontario Securities Commission announced after the close of trading on June 15 that they would seek a cease trade order from the Commission to permanently enjoin the transaction. From the close of trading on the 15th day to the close on June 16, the first trading day following the announcement, the price fell 5.2%[13], representing \$412 million in market cap. However, the longer the event window, the smaller the price reaction. Comparing the average price in the 3 days preceding the announcement[14] to the 3 days afterwards[15]), the price was off only 2.2%[16], representing \$168 million in market cap. From 5 days before to 5 days after, we see less than a half percent reduction in price[17]. Thus, what at first looks like an

[13] From US \$71.44 to US \$67.76.
[14] That is, June 13, 14 and 15.
[15] That is, June 15, 16 and 17.
[16] From US \$69.24 to US \$67.74.
[17] From US \$68.28 to US \$67.97.

extremely negative reaction looks much more like a non-event with a slightly broader event window.

It would appear that the narrowest window is probably the most telling. On June 15, it was widely reported that powerful Institutional Shareholder Services ("ISS"), a division of New York-based RiskMetrics, had recommended that shareholders vote in favour of the deal.[18] From June 14 to June 15, the price jumped 3.2%.[19] Indeed, if we use as our starting point the price that prevailed 2 trading days prior to the news report (i.e. from June 11 to June 15) the price jumped a whopping 6.5%.[20] Thus, using a longer event window for the OSC announcement risks compounding the effect of both the announcement and the ISS story. It would thus appear that the OSC's announcement that a hearing would be held into the deal had a significantly negative effect on the market price.

c. Post-OSC-Announcement but Pre-Decision Events

Other stories came thick-and-fast following the Commission's late-in-the-day June 15 announcement that it would hold a hearing. In particular, on June 17, it was reported that; i) B.C. Investment Management Corporation (holding 1.4% of the Class A shares), Alberta Investment Management Corporation, and the Ontario Municipal Employees Retirement System ("OMERS") had joined the list of notable shareholders opposing the transaction;[21] ii) Goodman & Company, which controlled 4% of the Class A shares, announced it would support the deal; iii) Magna reported that of the 24% of Magna's shares that had been tendered by proxy, 99% were in favour of the deal; iv) Glass-Lewis, a U.S. proxy advisory firm affiliated with the OTPPB, had come out against the deal.[22] The net effect of tall of this news appears to have been essentially zero.

[18] See e.g. Greg Keenan, "Stronach buyout pricey, but deal provides upside; ISS points to stock's gains since idea was floated of buying out Magna chairman's controlling stake" The Globe and Mail, 15 June 2010, p. B6
[19] From US $69.21 to US $71.44.
[20] From US $67.07 to US $71.44.
[21] The others being the Canadian Investment Pension Plan Board ("CPPIB"), the Ontario Teachers Pension Plan Board ("OTPPB"), and Letko Brosseau & Associates of Montreal.
[22] Janet McFarland, Greg Keenan, Jacquie McNish and Jeff Gray, "Big funds join battle against Stronach deal; Three major B.C., Alberta and Ontario asset managers to vote against Magna's $863-million offer to founder", The Globe and Mail, 17 June 2010, p, B1.

d. The CIBC and PricewaterhouseCoopers Reports

On June 18, Magna voluntarily released a CIBC report commissioned by the special committee together with the PricewaterhouseCoopers report on the value of the non-cash assets to be contributed by Magna to the E-Car partnership. This too did not affect the market price and appears to have been a non-event.[23]

e. The OSC's Denial of Full Standing to Institutional Complainants

The OSC's determination to deny full standing to various institutional shareholders (mostly opposing the deal), but to grant them more limited "Torstar" standing[24] appears to be yet another non-event.[25]

f. The OSC Hearing and Decision

The OSC hearing took place on June 23 and 24. On June 24, at the conclusion of the hearing, the Commission announced that (subject to requiring Magna to make further disclosures to shareholders) it would allow the transaction to proceed. The Commission's decision does not appear to have materially changed the price (despite heavier than usual trading). From June 23 to June 24, the price rose a mere 0.7%.[26]

If we look at a longer window, we get a result that is only slightly different. Comparing the average price in the 5 trading days preceding the decision with the price prevailing in the 5 trading days afterwards (including the day of the

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[23] Some news reports quote analysts stating that it was not expected that there would be anything in the CIBC report that the market did not already know, since the report only did what many others had already done – compare the Magna transaction with other reverse DCRs. One might have expected that the valuation of the non-cash E-Car assets might have been significant, but if, as I suggest elsewhere, the true value of the E-Car division lies in its earnings power, about which the report says nothing, then perhaps it is not surprising that this report appears to have had no effect on price.

[24] That is, the ability to make arguments and offer opinion, but not to call witnesses or offer evidence.

[25] Greg Keenan and Janet McFarland, The Globe and Mail, 19 June 2010, p. B7.

[26] From US $69.59 to US $70.07 on June 24.

decision), the price dropped[27] just slightly more than half a percent.[28] While I have not determined the statistical significance of these changes in price, it would appear at first blush that the commission decision was a non-event.

However, it may be that the market anticipated the Commission's decision. Over the 3 days preceding the decision, the market price rose nearly 6.5%. It may be that a material factor in this increase was a news story that appeared on June 22 indicating that of the 50% or so of Magna shareholders that had submitted proxies, "an overwhelming majority" supported the plan.[29] This is highly significant, insofar as a recent decision of the OSC[30] suggests that the Commission will place great weight on shareholder approval – as in fact it did.[31]

From this evidence I conclude that the OSC decision to approve the deal (subject to enhanced disclosure) was largely anticipated by the market, and that this approval was viewed by the market as a very positive development.

g. Approval by Shareholders

Class A shareholders approved the arrangement on July 23. The price on that date (US $74.45) was 1% higher than the price on the preceding day (US $ 73.66), representing about $88 million in market cap. A 10-day window[32] shows an increase of 1.9%. These numbers suggest that shareholder approval was largely anticipated,[33] which would accord with prior disclosure by Magna that an

[27] From an average of US 68.34 to US $67.97.
[28] Any longer window overlaps the OSC's earlier announcement that it would be holding a hearing, and thus will reflect more than simply the affect of the decision itself.
[29] See e.g. Janet McFarland, Jeff Gray, and Greg Keenan, "Shareholders back Stronach deal, Magna to disclose", The Globe and Mail, 22 June 2010, p. B1.
[30] *Pulse Data*, 2007 ABASC 895 (Alta. Sec. Comm.).
[31] In addition, a UBS analyst was quoted as supporting the deal. ("Tasneem Azim, a financial analyst with UBS Securities Canada Inc., said the deal with Mr. Stronach represents "short-term pain for long-term gain" for common shareholders of Magna, with the potential to generate an additional $2-billion in the enterprise value of Magna.") *Ibid.* A further report on June 21 stated: "Richard Powers, associate dean of the University of Toronto's Rotman School of Business, said he doubted the OSC would strike the deal down without allowing shareholders to vote. "I predict it will go through," he said of Mr. Stronach's deal. "He always gets what he wants."" Jeff Gray, "Corporate Governance", The Globe and Mail, 21 June 2010, p. B2.
[32] Comparing the price 5 days before to 5 days after (including the approval date).
[33] A longer event window runs into Magna's August 6 announcement of better than anticipated earnings and an increase in the company's dividend.

overwhelming number of shares deposited as proxies were to be voted in favour of the transaction.

h. Lower Court Approval

The lower court hearing to approve the arrangement[34] was held on August 12-13, and the judgment approving the arrangement was delivered on August 17. Again, choosing an event date is tricky, since the conduct of the hearing, and not merely the decision itself can have an affect on the market price[35]. However, taking the pertinent event date as the two-day window comprising the day prior to the decision and the day of the decision (again, without filtering out market movements or potential confounding events), the price increased from US $75.96 to US $80.70. This is an increase of about 6.2%, representing $530 million in market cap. If we compare the average price in the 5 trading days preceding the lower court decision to the 5 days afterwards (US $75.76 and US $80.17), the percentage increase is 5.5%, representing US $494 million in market cap.[36] This suggests that the favourable decision of the court was perceived as a highly favourable event by the market. It also suggests that there was significant doubt that court approval would in fact be forthcoming.

i. Divisional Court Approval

The appeal to the Divisional Court was heard on August 26, and the court's judgment confirming the lower court ruling was delivered after markets closed on

[34] For reasons that are unclear, Magna's share price dropped 7.2% from Monday June 28 to Tuesday June 29, while the TSX index dropped only 3% - a net drop of 4.2%. Press reports on June 26 indicated that the same shareholders who opposed OSC approval would also oppose judicial approval of Magna's plan of arrangement. See Janet McFarland and Greg Keenan, "Magna's big shareholders dig in heels on Stronach buyout", 26 June 2010, p. B3. However, if this news was the cause of the material decline in Magna's price, one would have expected the decline to show up on June 28 and not June 29.
[35] The nature of a judge's interventions, for example, will sometimes give clues as to the judge's inclination.
[36] If we compare the average price in the 9 trading days preceding the lower court decision to the 9 days afterwards (US $76.19 and US $78.46), the percentage increase is 3%, representing US $255 million in market cap. Any longer window overlaps the decision of the appeals court. But in any case, there is likely more noise in this longer trading window.

August 30 (making August 31 the first day in which the news was reflected in the market price). Shortly after the court's ruling (also on August 30), CPPIB (the leader of the shareholder group opposing the deal) indicated that it would not appeal the Divisional Court's ruling.[37] From August 30 to August 31, the price rose 3.5%, a rise that reflects both the court's decision and CPPIB's decision not to appeal.

j. Drop Dead Date

A further milestone was passed on August 31 – the last date on which either Magna or Stronach could back out of the deal. From August 31 to September 1, the price rose another 5.1%.

3. Summary of Price Effects

What can we learn from these events? First and foremost, despite the onerous terms, the market was anxious that the deal be approved. And indeed, many press reports confirm the view that while the terms of the buyout were regarded as punitive, the deal was seen, in net, as a good thing for shareholders. Many of these reports quote shareholders as saying that they would "hold their noses" (or similar expressions of distaste) and approve the deal, in order to finally jettison Stronach as Magna's control shareholder.

Second, it would appear that the OSC's approval was largely anticipated. The price run-up in the days immediately preceding the OSC decision, however, corresponds with disclosure by Magna that of the shareholders who had submitted proxies, a significant majority were voting "yes". This suggests that the market believed that shareholder approval would be an important factor in the OSC's deliberations (as in fact it was). This may in turn show that the Commission's decision in *Pulse Data* has been interpreted as elevating the importance of shareholder approval in cases involving the exercise by the Commission of its public interest powers.

Third, the shareholder vote approving the arrangement was not a surprise. This is itself not surprising, given the number of prior press reports regarding shareholder

[37] Jeff Gray, "CPPIB won't appeal Stronach buyout ruling", The Globe and Mail, 31 August 2010, p. B2

sentiment in addition to data periodically released by Magna indicating how shareholders intended to vote.

Fourth, there was material doubt about whether the courts would approve the arrangement – despite 75% of the Class A shareholders having voted in favour. The *BCE* decision, which is now the leading decision on the judicial metric for the approval of an arrangement, is quite clear in stating that a court should take more than shareholder approval into account in deciding whether an arrangement is "reasonable and fair". *BCE* indicates that positive indicia of fairness include a recommendation by a committee of independent directors, and a valuation and/or fairness opinion. All of these factors have previously been given considerable weight by Canadian courts in determining whether the protection of the business judgment rule applies. Because none were present in the Magna transaction,[38] the market had good reason to believe that judicial approval might not be forthcoming. The fact that the Superior Court and Divisional Court did in fact approve the arrangement is consistent with the view that *Magna* has lowered the bar in determining what is "fair and reasonable" in an arrangement.

Fifth, the release of the information contained in the CIBC report and the valuation of the non-cash assets contributed by Magna to the E-Car partnership had no affect on the market price. This is significant insofar as it suggests that the market was already in possession of the information contained in the report. This interpretation is supported by the extremely narrow mandate given to CIBC by the Special Committee. The key element of the report was a comparison of the Magna transaction with other similar transactions, and in particular the premium paid to the departing shareholder(s).

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[38] On June 28, the Special Committee and the independent directors declared that, given the result of the shareholder vote, in addition to the positive market reaction to the transaction, they were of the opinion that the transaction was "fair and reasonable". The lower court properly discounted this opportunistic declaration, holding that it

> cannot be given any independent significance. The Court can only rely on these determinations to the extent it already has concluded that it can take the outcome of the Class A shareholder vote into consideration.

See para. 155. Shareholders are entitled to an independent view of whether the transaction is fair and reasonable, and not merely a derivative conclusion based on the views of others (i.e. shareholders and the market).

PART II: IS MAGNA CONSISTENT WITH PRIOR SECURITIES LAW? THE PUBLIC INTEREST DECISIONS

The Securities Act authorizes the securities regulators to make a variety of orders "if in its opinion it is in the public interest to make the order or orders."[39] Perhaps the most potent of these powers is the "cease trade" order,[40] which enables the regulators to make an order effectively equivalent to a court injunction in respect of a particular transaction. In *Magna*, staff of the Commission sought this type of order to prevent the reverse DCR from going ahead. That the Commission decided *not* to grant a cease trade order in *Magna* raises some rather interesting and vital questions about the scope of the power.

1. Unfairness versus Abuse of the Capital Markets

Consistent with past decisions, the Commission indicated that the public interest powers will not be enlisted merely because of a perception of unfairness. As the Commission put it:

> Abuse has been characterized by Commission decisions as something more than unfairness. A transaction such as this is not abusive simply because the price proposed to be paid is considered by certain investors to be outrageous...[41] We do take some comfort from the fact that an Ontario court will, as part of the arrangement process, be determining whether the arrangement giving effect to the Proposed Transaction is fair and reasonable. *Making such a determination is outside the purview of our jurisdiction as securities regulators.* [42] [emphasis added]

This is consistent with the leading case on the scope of the public interest powers – the *Canadian Tire* decision ("*Tire*")[43]. In *Tire,* the Commission stated that "it would wreak havoc in the capital markets if the Commission took to itself a jurisdiction to interfere in a wide range of transactions on the basis of its view of fairness through the use of the cease trade power under section 123." In *Tire,* the Commission also stated:

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[39] OSA s.127.
[40] OSA s.127(1)2.
[41] *Magna,* OSC, para. 43.
[42] *Ibid.* para. 47.
[43] *Re Canadian Tire Corporation* (1987), 10 OSCB 857.

> A showing of abuse is something different from, and goes beyond, a complaint of unfairness. A complaint of unfairness may well be involved in a transaction that is said to be abusive, but they are different tests. Moreover, the abuse must be such that it can be shown to the Commission's satisfaction that a question of the public interest is involved. That almost invariably will mean some showing of a broader impact on the capital markets and their operation.

Both *Magna* and *Tire* thus posit a critical distinction between *unfairness* and *abuse*. It is this somewhat slippery distinction that I would like to address.

As a starting point, it is worthwhile noting that neither concept is self-executing. Whether a particular transaction involves unfairness or abuse is strictly a matter of judgment about which reasonable people may differ. But more than that, I believe that there is a dangerous lack of clarity in the distinction, as enunciated by the Commission, that tends to impair the adjudicative authority and legitimacy of the Commission and the suasive power of its decisions.

I would like to make it clear that in so doing, I do not mean to cast aspersions whatsoever on any of those persons, past and present, who have made often difficult determinations about whether the public interest has been violated. I merely mean to suggest that there is room for debate about whether the scope of the public interest powers has been sufficiently particularized to offer securities markets some degree of certainty about when the powers will be utilized.

The roots of the conceptual fuzziness may be found in *Tire* itself. In deciding that the transaction in *Tire* was abusive, the Commission drew a parallel between its power to act on a showing of abuse and the equitable jurisdiction of the court enunciated in the watershed case of *Ebrahimi v. Westbourne Galleries Ltd.*[44] ("*Ebrahimi"*). In *Ebrahimi,* Lord Wilberforce, for the House of Lords, held in a case involving interpretation of the "just and equitable" ground for winding up, that strict compliance with one's legal obligations might not absolve one of liability.

> The 'just and equitable' provision does not, as the respondents suggest, entitle one party to disregard the obligation he assumes by entering a company, nor the court to dispense him from it. It does,

[44] [1973] A.C. 360 (H.L.).

> as equity always does, enable the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and other, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.

In *Tire*, the Commission likened its power to act in the public interest with Lord Wilberforce's "equitable" restraints, stating:

> In exercising our jurisdiction under section 123 in this case, we are, in one sense, subjecting "the exercise of legal rights to equitable considerations". Of course, the consideration here is the 'public interest' of section 123 and the Commission is mandated by law to exercise that jurisdiction. For the Commission to act, there must be a clear showing that the interests of the public marketplace are involved. But allowing for that, the thought and the spirit behind Lord Wilberforce's statement is important. Whether it is a court of equity, or the Commission exercising its regulatory jurisdiction pursuant to the legal authority vested in it, there always will be occasions where the exercise of private legal rights must give way to broader considerations -- in this case, considerations of the equitable operation of this Province's capital markets.

The courts of equity were expressly created to address *unfairness* in the courts of common law. The Oxford English Dictionary, the English language's most respected arbiter of meaning, defines equity, in the general sense, as "the quality of being equal or fair; fairness, impartiality..." Of the courts of equity, it states that "the original notion was that of... a decision in 'equity' being understood to be one given in accordance with natural justice, in a case for which the law did not provide adequate remedy, *or in which its operation would have been unfair*" (emphasis added). The Merriam-Webster also expressly defines equity as "fairness", and this accords with the meaning to be found in many other sources.[45]

There is more support for the view that "equity", as conceived by Lord Wilberforce in the corporate law context, means fairness. While Lord Wilberforce carefully confined his decision to the just and equitable ground for winding up, his remarks about "equitable" duties (grounded in the expectations

[45] One on-line legal dictionary states that "[i]n its broadest sense, equity is fairness." See http://legal-dictionary.thefreedictionary.com/equity. *Accord,* http://www.fact-index.com/e/eq/equity.html.

of the parties) have been widely adopted in Canada as the jurisprudential foundation of the statutory oppression remedy.[46] But it is also standard rote that the legal standard to be employed by the court under the oppression remedy is one of "fairness".[47]

Thus, in identifying the public interest jurisdiction with Lord Wilberforce's principles of equity, the Commission in *Tire* unwittingly adopted "fairness" as the trigger for the exercise of its jurisdiction, at the same time that they were expressly repudiating it.

There is ample reason to believe that the statutory mandate of the Commission *mandates* a concern about fairness. The *Securities Act* states:

> 1.1 The purposes of this Act are,
>
> (a) to provide protection to investors from *unfair*, improper or fraudulent practices... [emphasis added]
>
> 2.1 In pursuing the purposes of this Act, the Commission shall have regard to the following fundamental principles...
>
> 2. The primary means for achieving the purposes of this Act are...
>
> ii. restrictions on fraudulent and *unfair* market practices and procedures... [emphasis added]

The *Act* thus does not speak of restraining *abusive* practices, but *unfair* practices. The Commission seems to have entirely ignored this statutory instruction is crafting its public interest jurisprudence.

Remarkably enough, however, the Commission has enshrined the principle of fair treatment as the underpinning of its regulation of related party transactions ("RPTs"). The companion policy to MI 61-101 (which regulates RPTs) states[48]:

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[46] *See e.g.* the Ontario Court of Appeal decision in *Re Ferguson and Imax Systems Corp.*, (1983), 150 D.L.R. (3d) 718 (Ont. C.A.).
[47] Most recently, see the Supreme Court of Canada's decision in *BCE Inc. v. 1976 Debentureholders*, [2008] 3 S.C.R. 560, 301 D.L.R. (4th) 80 (S.C.C.).

[48] Para. 1.1.

> The... Ontario Securities Commission... regard it as essential, in connection with the disclosure, valuation, review and approval processes followed for insider bids, issuer bids, business combinations and related party transactions, that all security holders be treated in a manner *that is fair and that is perceived to be fair*." (emphasis added)

Given that the public interest powers are the primary means for addressing *unfair* RPTs, it seems rather odd that the Commission should restrict these powers to RPTs that are *abusive.* The Commission's statement that it is not its business to decide whether a transaction is unfair, therefore, is at odds both with its statutory mandate and its own quasi-legislative pronouncements. Moreover, there are very many in the public market who perceive the Magna transaction to be unfair, abusive, or worse. The Commission has therefore failed to comply with its own pronouncements not merely in the abstract, but in this particular case.

2. The Role of the Board of Directors and the Independent Committee

Why did the Magna transaction fail to merit the label "abusive"? Or even unfair? In my view, the OSC's approval is highly inconsistent not only with its own past decisions, but with the fundamental thrust of both corporate and securities law in the past 25 years. That thrust has been to put greatly enhanced weight on the procedural integrity of the decision-making process. A flawed decision-making process will typically result in a finding that the directors have acted in breach of their fiduciary duties, the oppression remedy, the public interest, or all of these. In turn, the key elements of a sound decision-making process are i) reliance on a committee of independent directors to protect minority shareholder interests, especially where there are powerful conflicts of interest; ii) reliance on independent advice suitable to the circumstances, often including a valuation, a fairness opinion, or an expert opinion on legal matters; iii) evidence that the board (and/or independent committee) informed itself of all information reasonably available in the circumstances.

Thus, for example, in the leading case of *Pente v. Schneider* in the Ontario Court of Appeal, the court held that in determining whether the company had acted oppressively,

> the real questions are whether the Committee was independent and whether the process undertaken by the Special Committee was in the best interests of [the company] and its shareholders in the circumstances.[49]

The court also stated, in dealing with the issue of who bears the onus of proof:

> The real question is whether the directors of the target company successfully took steps to avoid a conflict of interest. If so, the rationale for shifting the burden of proof to the directors may not exist. If a board of directors has acted on the advice of a committee composed of persons having no conflict of interest, and that committee has acted independently, in good faith, and made an informed recommendation as to the best available transaction for the shareholders in the circumstances, the business judgment rule applies. The burden of proof is not an issue in such circumstances.[50]

However, the elements that address the issue of the onus of proof are in fact the underpinnings of the business judgment rule itself. Only if the board has acted in accordance with the stated requirements, will it earn the protection of that rule. The above passage thus squarely adumbrates the ultimate arbiter of procedural propriety – taking steps to address extant conflicts of interest.

There are two additional elements of the business judgment rule that are worthy of note. As the Court of Appeal states, the board must have "acted on the advice" of the independent committee. Thus, an implicit element of the test, as applied in *Pente* (and elsewhere), is that the directors *actually make a positive recommendation* in respect of the transaction under consideration.

The only exception arises under the takeover bid rules, pursuant to which a board may decide *not* to make a recommendation to shareholders (although the board must then explain why it is not making a recommendation). In the takeover context, however, shareholders are presented with a much simpler choice: to accept or not accept what is virtually always a premium above market price. The existing market price is the product of disinterested market forces, and provides an objective benchmark against which the firm may be valued (particularly as both

[49] Para. 39.
[50] Para. 38.

acquirer and target must disclose any material information in their possession that has a bearing on this value).[51]

Second, the cases hold that senior management may act for an independent committee only in the limited capacities of advisor and agent.

Virtually all of the key *indicia* of propriety referenced by the Court of Appeal were absent in *Magna*. The transaction was negotiated in the first instance by senior management without the knowledge or approval of the full board, let alone a committee of independent directors. As the OSC notes, senior management would obviously have felt enormous pressure to conform to the wishes of the man with whom they were negotiating, upon whom their livelihoods depended.[52] The transaction was then essentially presented as a *fait accompli* to the board, which was unsuccessful in securing any major changes to the deal.

Although a "special committee" was empanelled, the mandate of the committee, according to the Commission, was "fatally flawed" in at least three respects;

> First, the Special Committee appears to have been limited to considering and reviewing the Proposal "developed by executive management for submission initially to the Stronach Trust". As noted above, executive management had a fundamental conflict of interest in negotiating any aspect of the Proposed Transaction with the Stronach Trust. The Special Committee should not have been limited in its terms of reference to considering only the Proposal developed by executive management with the Stronach Trust.

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[51] In *Magna*, Stronach was the only holder of Class B shares, which did not trade in the public market. Before the squeeze-out of other Class B shareholders in 2007, however, there *was* an objective benchmark – and it was only slightly greater than the trading price of the Class A shares.

[52] According to the Commission (para. 215):

> The members of executive management (Mr. Walker, Mr. Galifi and Mr. Palmer) had a fundamental conflict of interest in attempting to negotiate the terms of a transaction with Mr. Stronach, who was both their boss and the controlling shareholder of Magna. Apart from the inherent conflict in negotiating a transaction with Mr. Stronach, the members of executive management of Magna may also have had a personal interest in whether or not Mr. Stronach continued in a management role at Magna and on what terms.

> Second, the Special Committee's mandate was only to "review and consider" the Proposal. It was not authorized to negotiate those terms, although the Special Committee appears to have taken a broader view of its mandate.
>
> Third, the Special Committee's mandate was only to "report to the Magna Board as to whether the Proposal should be submitted to the Class A Shareholders for their consideration". Accordingly, the Special Committee, by its mandate, was not to consider broader issues such as whether the Proposed Transaction was in the best interests of, or was fair to, the Class A Shareholders. By its mandate, the Special Committee was only to decide whether the Proposed Transaction should be submitted to a shareholder vote.

The Commission thus concluded that "[i]n our view, the Special Committee's mandate and terms of reference were, in the circumstances, fundamentally flawed."[53] In short, the deliberations of the Special Committee, such as they were, should be completely discounted.

The Commission might well have added that the Special Committee did not act on an informed basis – another key element of the business judgment rule both in Canada and the United States. For example, the true value of the E-car division lay not in the value of its assets, but in its earning power. How could the board properly evaluate the deal (or even whether it should be put to shareholders) without knowing exactly what they were giving Stronach?

Remarkably enough, having come to the conclusion that the workings of the special committee were fatally flawed, the Commission then stated that:

> We considered intervening in the Proposed Transaction on the grounds that the Special Committee process was inadequate. Ultimately, however, we were not satisfied that we had sufficient evidence before us of the actual process followed by, and the actual deliberations of the Special Committee, to come to a definitive conclusion... We had very limited additional information with respect to the Special Committee process. Further, detailed submissions were not made by Staff or the Opposing Shareholders with respect to the specific issues discussed above... Accordingly, we concluded, on balance, that we did not have sufficient evidence or grounds to intervene in the Proposed Transaction on the basis that the Special Committee process was inadequate.

[53] Para. 224.

This is a remarkable statement in a number of respects. Surely if the Commission was persuaded that they lacked the proper information on which to come to a reasoned decision, they should have denied their approval absent better and satisfactory evidence. In this respect, the Commission failed to hold itself to the same standard of account as it and the courts would (or at least used to) hold a board of directors. A central element of the business judgment rule is that the directors acted on an *informed* basis. If a board were to throw up its hands and say 'we just don't have enough information, but we'll approve this transaction anyway,' that would be a clear violation of the business judgment rule. Securities markets deserve a better example from their premier regulator.

Moreover, the idea that the Commission would lend its imprimatur to a transaction to which the courts would deny the protection of the business judgment rule is both extraordinary and unprecedented. It is all the more remarkable insofar as the Commission added:

> If directors wish to obtain the benefits arising from the review of a related party transaction by a special committee of independent directors, they must ensure that the process followed appropriately manages the conflicts of interest of all parties and that the mandate of that committee is sufficiently broad and authorizes the Special Committee to address the key issues in the circumstances.

In the past, the Commission has routinely defined and applied its public interest powers in such a way as to make the public interest restraints *more demanding* than applicable corporate law. Thus, for example, *Tire* and its progeny have enshrined the principal that the Commission may exercise its public interest powers absent the breach of any statute, rule, regulation, or policy statement. In the same vein, the Commission has, in effect, fashioned its own public interest corporate law where the boundaries of applicable corporate law have appeared too narrow. A sterling example is the decision in *Re Standard Trustco*,[54] in which the subject corporation was governed by two statutes that impressed duties of care upon its directors. However, rather than exploring whether these statutes had been violated (and whether these violations constituted a breach of the public interest),

[54] *Re Standard Trustco Ltd.* (1992) 15 OSCB 4322.

the Commission carefully outlined its very own public interest duty of care - enabling it to define the duty in a manner more congenial to it.[55]

Thus, for the Commission to fail to intervene in a case where the courts would deny the protection of the business judgment rule[56] is a marked departure from prior practice. That the Commission would chose the facts of *Magna* to do so is all the more surprising.

The Commission's ruling indicates that a positive recommendation of independent directors based on a sound procedure is no longer considered a fundamental element of shareholder protection. But the ruling goes even farther. It indicates that in a situation in which there are *fundamental conflicts of interest* that have fatally tainted both the independent committee's and the board's deliberations, and which have not been addressed in any other way by the board, *it will still approve the transaction.* The key element is now whether the shareholders have approved.

This is a fundamental re-imaging of the role of the board of directors as a whole, and of the independent committee in particular. Over the past several decades, independent directors have increasingly been seen by academics, regulators, courts, corporate governance organizations and investors as vital, if not indispensable protectors of minority shareholder rights. The role of independent directors has never been conceived as a mere substitute for informed shareholder choice. In *Magna*, the Commission comes perilously close to asserting that there is nothing that a board or an independent committee can do that shareholders can't do for themselves. This is to ignore virtually the entire *corpus* of academic and practical knowledge that we have accumulated about corporate governance in the past 80 years. As early as 1932, Berle and Means identified free rider and collective action problems that seriously impair shareholder incentives to employ their voting power as a meaningful counterbalance to the self-interested exercise of management authority.

Independent directors serve a gatekeeper function that has assumed a pivotal role in shareholder protection in the past quarter century. Shareholder approval is in no way equivalent. Shareholders do not have the same access to information as directors. Nor do they have the time, the budget, or the incentive that directors possess. Independent directors function as motivated proxies for unmotivated

[55] See e.g. Jeffrey G. MacIntosh, "Standard Trustco Case Signals Expansion of the 'Public Interest' Powers of the Securities Regulators" (1993) 1 Corporate Financing 38.
[56] As discussed below, I find the courts' approval of the arrangement no less unprecedented.

shareholders. To confuse the one with the other is to turn the clock back on corporate governance by many decades.

3. The Broader Interest of the Capital Markets

In *Tire*, the Commission stated that in order to exercise its equitable jurisdiction, "there must be a clear showing that the interests of the public marketplace are involved."

In my view, the distinction between that which is merely private, and that which is infected with a public interest, eludes rational explication. Any case that affects as many shareholders as *Tire* or *Magna* could be said to affect capital markets at large. In addition, virtually every Commission decision, and particularly those with some element of novelty (whether as to the nature of the transaction or the particular concatenation of evidential and/or legal elements under consideration) affects capital markets by defining an incentive structure for the future behaviour of capital market actors.

Magna is illustrative. The decision of the Commission will unquestionably shape the incentives of market participants not only in other reverse DCRs, but many other types of transactions. There are many elements of the decision in *Magna* that are both novel and possessed of far-reaching precedential consequences, including: the Commission's deference to shareholder voting; the Commission's deference to the jurisdiction of the court to see that justice (or "fairness") is done; the Commission's failure to require a valuation of the Class B shares;[57] the Commission's decision not to require a "fairness" opinion; the Commission's decision not to require either the committee of independent directors, nor the board as a whole, to positively endorse the transaction. In the face of its robust precedential value, it simply cannot be argued that Magna transaction does not have important implications for the capital markets as a whole.

The Commission expressly acknowledged the element of novelty in the *Magna* facts, while simultaneously asserting that the case involved no new law:

[57] While we are told that Stronach insisted that the transaction be submitted as an arrangement, so that a court would be able to opine on the fairness of the transaction, this also conveniently dispensed the board from the legal requirement to make a valuation of the Class B shares that would otherwise have applied under s.23(4) of the Act.

> The Proposed Transaction is an extraordinary transaction. We are not aware of any comparable transaction carried out in Ontario capital markets. The transaction raises a number of unique issues, although the securities law principles we should apply in resolving those issues are clear.[58]

This statement assumes that legal principles can be defined in isolation from facts. This is highly questionable. Broad-textured legal standards – such as acting in the public interest, or determining what is abusive and what is merely unfair – can mean virtually anything in the abstract. The substantive content of the law becomes meaningful only when furnished with a body of precedent which applies abstract principles to particular factual contexts.

Interestingly, the difference between private and public interests was soundly rejected in *Tire.* The controlling shareholders (the Billeses) and the offeror independent dealers of Canadian Tire argued that the dispute between the Class A shareholders and the would-be acquirers was purely a private one for the courts to deal with.[59] The Commission had no difficulty in rejecting this argument on the facts:

> The contention that the issue here is a private one between two classes of shareholders is far wide of the mark. A purported sale of control in the circumstances set out above, where the rights of the holders of some 83 million Class A shares are concerned, is not a private matter, although individual rights in terms of a particular shareholding are involved. This is demonstrably a public matter involving a major public company and one that concerns and impacts on the public marketplace.

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[58] Para. 22.

[59] The Commission stated: "With respect to the argument about the public interest, as that term is used in section 123 of the Act [the public interest powers], Mr. Wright argued that the Class A shareholders are not in any way the public. Theirs is a private interest, he argued, and if they feel they have a legitimate complaint against the controlling shareholders, they should litigate that matter in the courts. This was not an appropriate case for the exercise of the Commission's jurisdiction." Similarly, "Mr. Heintzman, on behalf of Fred, made five basic submissions. The first echoed Mr. Wright's submission that what the complainants, that is, the Class A shareholders, were really seeking was a private remedy more appropriate to the courts than to a bearing before the Commission."

Obviously, the same can be said of the Magna transaction, which also involved a sale of control implicating the interests of many shareholders.[60]

But the Commission's comments go beyond the factual context of *Tire* itself. After noting that the bailiwick of the courts is to adjudicate the private rights of the actors, while that of the Commission is to look to the broader public interest, the Commission stated that "intervention in matters that from one aspect are of a private nature will, from another aspect, be seen to have public market implications."[61]

Why then, in *Magna,* does the Commission state that it takes comfort that the transaction will be reviewed for fairness by a court? *Tire* posits that whatever the mandate of the courts with respect to private rights, the mandate of the Commission lies in respect of capital markets at large – and ne'er the twain shall meet. Taken seriously, this means that the Commission should neither take comfort from – nor umbrage at – what transpires in the judicial domain.

Indeed, one could almost interpret "taking comfort from" as regulatory deference to judicial expertise. This entirely inverts the historical pattern, in which courts –

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[60] In *Tire,* the Commission went on to suggest that *any* takeover bid would involve a consideration of public, and not merely private issues:

> Yet it is well known that takeover bids, the rules applying to them and how they are conducted, are very much a public matter in the sense of their concern to, and impact on the marketplace and its perceived integrity. The Commission, accordingly, has always played a major role in overseeing such transactions.

If takeover bids (affecting as they do the control of public companies in addition to the welfare of many shareholders) definitionally engage the public interest, then so must a reverse DCR involving a billion dollar payout.

[61] More fully, the Commission stated:

> Moreover, the argument that this matter more properly belongs before the courts, mistakes the respective roles of the courts and the Commission in overseeing the management and actions of public companies and protecting shareholders' interests... In carrying out its regulatory function, the Commission necessarily impacts on the rights and obligations of companies, directors and shareholders. But it does so from the perspective of the regulation of the public markets and their fair and efficient operation... The courts, on the other hand, adjudicate rights between shareholders and their companies... But the role of the Commission... is to regulate shareholder and corporate conduct in the context of, and for the purpose of, regulating the public securities markets. Again, the line will not always be clear as intervention in matters that from one aspect are of a private nature will, from another aspect, be seen to have public market implications."

spurred on by doctrines of administrative law[62] - have routinely "drawn comfort" from regulatory approval in applying *corporate law* doctrines. Worse, it raises the prospect that any substantive determination will get lost in the cracks, as the regulators defer to the courts, and the courts to the regulators. Indeed, there is a suggestion of this in *Magna*. As noted, the OSC indicated that it "took comfort" in the fact that a court would be reviewing the transaction for fairness. On appeal, the Divisional stated:

> The Application Judge sets forth, at paragraphs 29 to 37 of his Endorsement, the findings of the OSC Panel and consequential events. The overall impact of the OSC scrutiny has been to ensure full disclosure and transparency through the Circular and Supplement, for the benefit of shareholders in their decision-making with respect to the proposed Arrangement. There is no suggestion that Magna failed to satisfy the requirements mandated by the OSC.[63]

In other words, the court felt comfortable that the transaction was fair, in part, because of the OSC review, while the OSC took comfort that the transaction did not violate the public interest, in part, because a court would review the transaction for fairness. This sets a rather unfortunate precedent.

4. The Role of Shareholder Approval

That shareholders were being asked to vote on the transaction was a pivotal factor in Commission approval:

> In the circumstances, whatever views we may have as to the terms of the Proposed Transaction and its fairness to shareholders, we believe that it is the shareholders of Magna that should ultimately decide whether the Proposed Transaction proceeds. That is a business and financial decision that shareholders are entitled to make.

However, this reliance on shareholder approval, coupled with the lack of a recommendation being made to shareholders by the board or the Special Committee, and the fact that it was a related party transaction, prompted the

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[62] The Supreme Court of Canada has instructed the courts, in hearing appeals from decisions of administrative bodies, to give wide deference to these bodies when they are acting within their area of expertise. See e.g. *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557.

[63] *Re Magna International Inc.* (2010), 101 O.R. (3d) 721 (Div. Ct.), para. 31.

Commission to make sure that shareholders had all of the information that the Special Committee had, in order to make an informed decision. Thus, the Commission ordered that various informational items in the possession of the committee be included in the management proxy circular sent to shareholders.[64]

This is a novel approach. In the past, both regulators and courts have stressed the need for various procedural protections *at the board level*, including a positive recommendation by an independent committee, a valuation (where relevant, as here), and a fairness opinion. None of these protections were present in the Magna transaction.

This suggests a significant turning point in the Commission's approach to reviewing major transactions – an approach that finds support in its recent decision in *Neo Material Technologies*[65]. In that case, as against prior decisions that had stressed that at some point a poison pill must go (the only issue being the timing), the Commission allowed a pill to remain in place even though it was clear that it was management's intention to use it on a "just say no" basis. The pivotal factor in the Commission's decision was shareholder approval of the poison pill – although prior decisions had made it clear that shareholder approval was only one of many factors to take into account, and that ultimately shareholders should be able to decide for themselves whether to accept or reject the bid. Allowing a majority of shareholders to approve a "just say no" strategy (assuming that this was actually in

[64] After noting that under Ontario securities law, shareholders must have sufficient information to allow them to make an informed decision, the Commission stated (paras. 31-32):

> In this case, those circumstances include the fact that (a) the Proposed Transaction constitutes a material related party transaction between Magna and the Stronach Trust, and (b) neither the Board nor the Special Committee has made any recommendation to Shareholders as to how they should vote on the Proposed Transaction, or as to their view of the fairness of the Proposed Transaction to Shareholders. In addition, no fairness opinion has been obtained with respect to the Proposed Transaction. Because neither the Board nor the Special Committee is providing a recommendation, Shareholders are left to their own devices in making the decision as to how they will vote. In considering whether disclosure in the Circular is adequate, we also recognize that the Proposed Transaction is complex and some portions of the consideration to be paid to the Stronach Trust are difficult to evaluate.
>
> In these circumstances, the disclosure in the Circular must, to the extent reasonably possible, provide Shareholders with substantially the same information and analysis that the Special Committee received in considering and addressing the legal and business issues raised by the Proposed Transaction.

[65] (2009), 32 OSCB 6941, 63 B.L.R. (4th) 123. See also *Pulse Data*, *supra*, note 30.

the minds of the shareholders when they approved the pill) obviously deprives the minority the ability to sell their shares, and is highly inconsistent with any previous decision.[66]

Without question, shareholder approval ought to be an important factor for the regulators to take into account. Having said that, I would suggest that the Commission placed excessive weight on this factor in *Magna*. For one thing, it leaves out of account the imperfections in the shareholder voting process that have long-since been a standard feature of academic critiques of corporate governance. As first noted by Berle and Means in their 1932 classic, The Modern Corporation and Private Property,[67] shareholder voting is characterized by what we now call free rider and collective action problems. These problems, which bias the result of corporate votes in favour of management, are not entirely overcome by the presence of the presence of institutional shareholders.

Moreover, it has often been asserted that institutional voters that do business with a particular corporate issuer may be strong-armed by management, by threats both explicit and implicit, to withdraw business should the institution fail to vote with management.[68]

Giving shareholders the same information that the special committee had cannot replicate the instructional to-and-fro that goes on in a committee setting. Nor do many shareholders have the expertise, focus, wealth of firm-specific knowledge, or commitment of independent directors. Asking shareholders to act as a *de facto* independent committee of the board is simply asking too much, and no amount of disclosure – including disclosure of the pertinent board and committee processes – can replicate the important function that independent directors perform. In a related party transaction of this size and importance, it does not seem to stretch the intellect to believe that disclosure is insufficient. What the Commission ought to have done (and had jurisdiction to do) is to have required a fairness opinion, a positive recommendation of the independent committee and of the full board, and a valuation of the Class B shares being repurchased.

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[66] With the exception of *Pulse Data* in B.C., *supra*, note 30.

[67] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (2nd ed.) (New York: Harcourt, Brace and World, 1967) (1st ed. published by Transaction Publishers, 1932).

[68] See e.g. Jeffrey G. MacIntosh, "Institutional Shareholders and Corporate Governance in Canada" (1996) 26 Can. Bus. L. J. 145.

PART III: IS MAGNA CONSISTENT WITH REGULATORY POLICIES UNDERLYING CONTROL TRANSACTIONS?

1. Control Transactions and the Takeover Bid Rules

Magna was a corporate control transaction. While it did not involve an offer from a third party, it is nonetheless closely analogous to a takeover bid. Thus, the policy considerations that inform the regulation of takeover bids ought to apply in equal measure to a transaction of this nature.

Since the takeover bid provisions were introduced in the 1960's, an underlying *desideratum* of the takeover bid provisions has been to ensure the equal treatment of the shareholders of the target company.[69] With limited exceptions, the *Securities Act* is structured so that controlling and non-controlling shareholders are to receive equal consideration. As Appendix A illustrates, the equality principle is not a mere side-show, but a fundamental element of the regulatory scheme. These include the requirement that a "formal bid" be made when any shareholder or coalition of shareholders acquire control of 20% or more of the votes of a class of shares, the rule requiring that identical consideration be paid to all shareholders, the "integration" rules, the requirement for pro rata take-up in partial bids, the requirement to pay an increase in consideration offered to all shareholders, the prohibition against collateral agreements that have the effect of increasing the consideration paid one or more shareholders, withdrawal rights, the early warning system, the minimum bid period requirement, and other features of the rules.

The limited exceptions do little to detract from the sanctity of this principle. Under the "private agreement" exception, an offeror may purchase control in a private transaction from no more than 5 persons at a price that is no greater than 115% of the market price. This permits a controlling shareholder or large block holder to receive a premium of no more than 15% - a rather stark contrast with the 1800% premium realized in the Magna transaction, to say the least.

[69]The wisdom of the equal treatment rationale for takeover bid regulation can easily be contested. See e.g. Jeffrey G. MacIntosh, "The Poison Pill: A Noxious Nostrum for Canadian Shareholders" (1989) 18 Can. Bus. L.J. 276. For the purpose of my comments here, I take this rationale as given, and focus on the inconsistency between the Commission's decision in *Magna* and this foundational principle of the takeover bid rules.

2. The TSX Coattail Requirement

The TSX coattail requirement, introduced in 1987, is another key feature of the equality regime. It was designed to ensure that where there is a DCS, an offeror cannot purchase control by paying a premium for one class of shares only. Thus, for example, had Magna had a coattail,[70] any third party offer for the Class B shares would also have had to have been made to the Class A shareholders.

3. Share Repurchases in Corporate and Securities Law

In addition, both corporate and securities law forbid an issuer from selectively repurchasing shares from particular investors. Aside from limited exceptions (such as pre-contracted redemption or retraction rights), an issuer may only effect a share repurchase pursuant to an offer made to all shareholders. The rules effectively ban "greenmail", which consists of repurchasing the shares of a single shareholder of a class at a premium to market without offering the same deal to other shareholders.[71] Again, the motivation is equality of treatment.

Although *Magna* involved a share repurchase, it neatly dodged the application of the repurchase rules not only by undertaking the transaction as an arrangement, but by having summarily turfed out the other Class B shareholders only 2 years previously, paving the way for Stronach to receive the entire premium paid to the Class B shares.

4. Summary

The bottom line is this. In a closely allied field of securities law, the principle of equality of treatment is foundational. In *Magna*, equality of treatment was denied minority shareholders. It was denied the public Class B shareholders who were forced out in 2007 at a much lower premium. It was denied the Class A shareholders who not only did not receive an 1800% premium, but had the

[70] It did not, having been grandfathered when the coattail requirement was introduced in 1987. It has been reported that there are 28 other companies that currently trade on the TSX (with a combined market cap of $145 billion) that were similarly grandfathered and lack coattails, including Rogers and Shaw Communications. See Andrew Willis, "Magna payout turns spotlight on governance", The Globe and Mail, 18 June 2010, p.B11.

[71] A "greenmailer" will typically have purchased or threatened to purchase a control block, making it clear that he plans to unseat current management. See e.g. *Unocal v. Mesa Petroleum,* 493 A.2d 946 (Del. S.C. 1985).

privilege of *paying for it*. This makes the OSC's approval of the transaction all the more remarkable. It also suggests a rather serious deficiency in the regulation of reverse DCRs.

PART IV: IS MAGNA CONSISTENT WITH CORPORATE LAW?

1. The Arrangement Provisions

The Magna transaction was effected as an "arrangement" under the Ontario Business Corporations Act. Pursuant to this provision, virtually any kind of transaction can be effected by obtaining the approval of a court. In the first stage of a two-stage process, the court determines what constituencies will vote to approve the transaction, in addition to the required majority or super-majority. In the second stage, the court determines whether the transaction is "fair and reasonable."

In *Magna*, Pepall J. made an order calling a special shareholders meeting for the purpose of the shareholder votes, and specified that three confirming votes should be sought: an ordinary resolution of the Class A shareholders; a special resolution of both classes of shareholders voting together; and a special resolution of the Class B shares. As long as Stronach voted his shares, the second and third were foregone conclusions. It was thus the first – a so-called "majority of the minority" vote - that really mattered. In the end, about 75% of the Class A shareholders voted to confirm the reverse DCR. This proved to be a pivotal factor in the court's approval of the transaction as "fair and reasonable".

Historically, the approval of an arrangement as "fair and reasonable" has depended on a proportional distribution of benefits and burdens. As further elaborated below, any semblance of a proportionality test was discarded (*per incuriam*) by the courts in *Magna*.

2. The Absence of a Fairness Opinion

A number of aspects of the court's determination are troubling. CIBC, the independent financial expert retained by the Special Committee, indicated that it would be unable to provide a fairness opinion to the committee because (in the words of the lower court) it was unable "to opine on [the] future trading multiples [of the new common shares]" [72] and "any fairness opinion would require it to opine on future trading multiples and, by extension, share trading prices which CIBC says are inherently unpredictable and change over time." [73] CIBC also indicated that it was its practice, and general industry practice, not to deliver a fairness opinion in these circumstances. The court accepted this rationale for the absence of a fairness opinion.[74]

This has a ring of unreality to it. Investment bankers generate valuations and fairness opinions for both public and private firms all the time based on highly speculative matters such as projections of future cash flows. With respect to predicting Magna's share price, the court stated:

> It is common ground that the majority of research analysts in Magna's industry use multiples of enterprise value ("EV") to earnings before interest, taxes and depreciation ("EBITDA") in deriving price targets for the Class A Shares.

The concept of "enterprise multiple" is a simple one. It is the ratio of enterprise value to EBITDA. The denominator, enterprise value, is defined as the market capitalization plus the value of debt and preferred shares[75], minus total cash and cash equivalents.[76] Thus:

EM = (market cap + debt + preferred shares – cash) / EBITDA

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[72] Para. 75:

> Under the terms of its engagement, CIBC was not required to deliver a fairness opinion with respect to the proposed Arrangement. CIBC says that its customary practice in fairness opinions is to forego expressing any opinion regarding the likely trading price of an issuer's securities following the announcement or completion of a transaction. In the case of the proposed Arrangement, CIBC considered that the proposed elimination of the Class B Shares would not significantly affect the "fundamental valuation" of Magna but recognized that it would result in significantly greater dilution than had occurred in precedent dual class share reorganizations. Given that the primary rationale for the proposed Arrangement was an increase in the trading multiple for Magna's Class A Shares, CIBC considered that, in the present circumstances, any fairness opinion would require it to opine on future trading multiples and, by extension, share trading prices which CIBC says are inherently unpredictable and change over time.

[73] Para. 75.

[74] Para. 143.

[75] Plus minority interest, if there is any.

[76] Cash is excluded because it does not contribute to the earnings power of the company.

Enterprise value is commonly thought to be a superior metric with which to evaluate takeover bid candidates (with a low enterprise multiple signifying an attractive takeover candidate). Compared to the P/E ratio, for example, it takes into account the value of the debt that an acquirer must assume. It also washes out the effect of different countries' taxation policies.

It is easy to calculate average industry-wide enterprise multiples. A good approximation of Magna's post-transaction market value of equity can thus be obtained by assuming that Magna's enterprise multiple is equal to the market average, plugging the other required figures into the above equation, and solving for market capitalization.

Further information may be gleaned by calculating the standard deviation of the average enterprise value, in order to shed light on the likely range of enterprise values (and hence market caps) for Magna post-transaction. This might well have been used as a basis for the fairness opinion that CIBC stated it was unable to provide.

Determination of market capitalization in this manner would tend to show the value of the overall benefit to Magna of shucking off its inefficient dual class structure. It does not, however, resolve perhaps a more central issue: by what metric should the court evaluate the "fairness" of the manner in which the benefit is split between the public shareholders and the sellers of control?

3. What Constitutes "Fairness"?

a. The Courts' "Fairness" Test: What the Market Will Bear

According to the lower court judge, "the core issue was whether the benefits of the proposed Arrangement to the Class A shareholders are worth the cost to them." [77] The court's cost-benefit test thus focuses exclusively on whether the benefit to the Class A shareholders of repurchasing control exceeds the cost. It is not in fact a test of proportionality at all. Rather it is a test of "what the market will bear". So long as the price paid is a penny less than the overall benefit achieved (i.e. shareholders receive a penny of the overall benefit, no matter how large that overall benefit is), the deal qualifies as "reasonable and fair". There is no sense of

[77] *Magna* (lower court), para. 55.

balance between the intrinsic value of the thing being sold, and the price being paid.

This is an extreme view of what constitutes "fairness". While a wide range of normative theories might be enlisted, very few, if any, would describe a completely one-sided transaction as "fair". Fairness inherently demands *some* proportionality in the distribution of benefits and burdens. To say that a transaction that allocates 99.99% of the benefit of a transaction to one party is "fair" defies logic and common sense.

b. Fairness as Proportionality

The idea of fairness as proportionality has long since been enshrined in our legal system. As noted, the equitable jurisdiction of the court is essentially a warrant to ensure that legal outcomes are fair. This idea is embodied in equitable maxims such as "equity is equality". It is also evident in many other legal contexts, including maritime salvage rules, unconscionability doctrine in contract law, usury laws, governmental setting of prices for monopoly utilities, and laws forbidding price gouging or the charging of excessive consideration.[78] In corporate law, achieving fairness has consistently been held to be the central mission of the court under the statutory oppression remedy.[79] As I have indicated above, it is also at the core of the statutory mandate imposed upon Canadian securities regulators. Indeed, it is a foundational policy behind every aspect of securities regulation, including registration requirements, insider trading rules, takeover bid regulation, primary market disclosure requirements, secondary market disclosure requirements, the public interest powers, and various regulatory incursions on corporate governance. In none of these contexts would the "what the market will bear" metric satisfy the demands of fairness.

c. The Rise in Magna's Share Price as an *Indicium* of Fairness

In *Magna*, two factors were instrumental in persuading the court that the "what the market will bear" test was satisfied. The first was shareholder approval, which I discuss in the section immediately following. The second was the price rise coincident upon the announcement of the transaction.

[78] See e.g. Ontario's *Consumer Protection Act*, S.O. 2002, c. 30.
[79] *BCE, supra* note 47.

A rise in market price is indeed good evidence that the market believes that *some* of the benefit of the transaction will accrue to shareholders. While the magnitude of this increase can be used (as I have done above) to estimate the relative distribution of benefits and burdens, it is noteworthy that the courts made no attempt to do this. The fact of an increase in price, *simpliciter*, was sufficient.

This emphasizes the absence of any proportionality concern in the judicial test. The market price test is a binary test with two possible outcomes; either some value will likely accrue to the shareholders, or it will not. This is as crude a theory of fairness as it is possible to devise.

d. Shareholder Approval as an *Indicium* of Fairness

Much the same can be said about shareholder approval. So long as *any* measurable benefit accrues to the shareholders, they are likely to vote in favour. Here, though, practical and legal factors are instrumental variables. This is well illustrated by the facts of Magna. As a practical matter, absent a demonstration of oppressive conduct, no court could force Stronach to sell, or impose any particular terms for parting with control. Thus, the alternative to voting down the arrangement would have been that Stronach would have remained in control for an indeterminate period of time, inflicting an indeterminate amount of damage on the company. Even if a buyout on more satisfactory terms might eventually be achieved, the very uncertainty of the available alternative means that any prospective benefits will necessarily be subject to a high discount rate. Stronach was able to magnify this uncertainty (and the corresponding discount rate) by declaring that the deal was offered on a "take it or leave it" basis, and stating that he was perfectly happy with the status quo. The message that this conveys is 'if you don't buy me out now on these terms, don't look for another buyout proposal any time soon.' In these circumstances, it is no surprise that shareholders opted for a "bird in the hand" rather than two in the bush.

The law is also a shadow variable. If the law, for example, were to explicitly limit the premium payable to the superior-voting class in a reverse DCR, that would make it impossible for the company to propose a reverse DCR on such one-sided terms. While this might persuade controllers like Stronach to remain ensconced in their control positions, the legislature might also establish a drop dead date on or before which all no-coattail dual class structures must be collapsed. This combination of legal controls would have led to a much more favourable outcome for the minority shareholders of Magna.

Somewhat more modestly, if the "reasonable and fair" arrangement doctrine were to be based on proportionality, and this notion of proportionality reasonably tethered to relative equity interest, this would limit what controllers like Stronach could exact as tribute for departing with their controlling interests. It is true that Stronach might have responded by remaining in control and continuing to extract generous consulting fees and other perquisites from Magna. However, not knowing Stronach's true reservation price, we cannot be confident that he would not in fact have sold at a considerably less generous price.

The point is that the law establishes the ground rules that define what is and what is not possible. Stronach proposed a one-sided buyout only because he believed that he could. It is unfortunate the both regulators and courts offered their imprimatur to this belief.

e. Fairness and Efficiency

Thus far, the discussion has focused on fairness. But what of efficiency? The Ontario *Securities Act* makes *both* fairness and efficiency foundational principles.[80]

In many contexts, fairness and efficiency are coincident. This will generally be the case with voluntary market transactions in which a good or service is bought and sold. The consensual nature of the transaction tends to ensure that all parties are treated fairly; if they did not believe that this was the case, then they would not transact. By the same token, economists generally assume that a voluntary transaction is Pareto efficient. That is, all parties are made better off and no one hurt. Again, the driver is the consensual nature of the transaction. In agreeing to transact, each party reveals a belief that he/she will be better off transacting than not transacting. Assets are moved from lower to higher-valued uses, satisfying the economist's concern for allocative efficiency.

Even "voluntary" transactions may be inconsistent with fairness, efficiency, or both. The requirement that the transaction be voluntary contains hidden assumptions about the range of choices available. If one party, for example, can artificially constrain the choices available to the other – or takes advantage of

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[80] The Act states: "The purposes of this Act are, (a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets." Ontario *Securities Act*, R.S.O. 1990, c. S-5, s.1.1.

constrained choice, the result may not be widely perceived to be either fair or efficient. In the former category is the thief who confronts his victim with "your money or your life". In this situation, most people will "voluntarily" choose life. However, since the thief has artificially constrained the victim's choices, such a transaction" is neither truly voluntary, fair, nor efficient (it cannot be assumed that the stolen goods are being transferred to a more highly valuing use). In the latter category are salvage cases, in which a salver takes advantage of the constrained choice of a vessel on the high seas to extract highly punitive terms for rescue of vessel and crew. While many people would this as unfair, many economists would view it as efficient, since any exchange is virtually certain to be Pareto optimal – and because it gives rise to potent market incentives to engage in salvage operations.

More pertinent to the Magna case, the fairness concept employed by the court is distributionally-centred and static in nature: it regards only the welfare of the immediate parties to the transaction as relevant. Efficiency, however, is dynamic. It looks to the incentives created by particular rules for future conduct, and whether these incentives are likely to facilitate the process of transferring economic resources to their most highly valuing use. It is concerned with distributional outcomes only to the extent that they shape incentives and define future behaviour.

Let us accept for purposes of argument that the outcome of the Magna case is "fair" to minority shareholders (whether on the basis that they earned at least a penny of the joint gain, they bought in knowing what they were buying, or they in fact reaped substantial benefits from the transaction). The rulings nonetheless create perverse incentives for future market actors. Post-*Magna*, shareholders have a powerful incentive to manoeuvre themselves into a control position, and use their power of control ineffectively or even perversely to diminish corporate value, knowing that the value of their control shares will rise. This argument applies with special force to the 80 or so grandfathered companies that have a dual class structure but no coattail. A highly profitable strategy, post-*Magna*, is to buy up shares of a superior voting class, establish a control position, run the company into the ground, and extract a King's ransom as the price for collapsing the dual class structure. Indeed, the greater the slack, consumption of perquisites, inefficient empire-building, strategic misdirection, and/or other agency costs, *the greater the premium that the controller will be able to extract.* Thus, even if one accepts the view that Magna shareholders were treated fairly, the result of the OSC and court decisions is to create pervasive inefficiencies in Canadian capital markets.

Perhaps the most common defence of the Magna arrangement is that shareholders knew what they were buying, and bought in at prices that reflected Stronach's control position. This and other spurious defences trade, in part, on the difference between fairness and efficiency, and are dealt with at greater length below.

f. Trading on the Limits of Corrective Justice: Free Riders, Collective Action Problems, and Judicial Slack

As Amoaku-Ado et al.[81] suggest, the incentive of the controller to engage in the consumption of private benefits is greatly mitigated by a strong system of minority shareholder rights. Even with the most vigorous minority rights, however, there is inevitably slack in any system of corrective justice. This slack arises out of free rider and collective action problems. It also arises from the inherent limits of judicial intervention in business decision-making.

Free rider and collective action problems impair the incentive of any shareholder (or coalition of shareholders) to sue derivatively to redress wrongs done to the corporation. In addition, however, there are inherent limits to the power of regulators and courts to police corporate managements. The source of the difficulty is the business judgment rule. The business judgment rule is a recognition that judges are ill-placed to make *post hoc* judgments regarding the wisdom of management decision-making. It is based on sound principles of judicial administration and is a necessary restraint on the liability of directors and officers. Nonetheless, the business judgment rule creates opportunities for both misfeasance and malfeasance by corporate managers. The core of the business judgment rule is procedural. Because judges feel ill at ease in second-guessing the substance of business decisions, the business judgment rule has been built around a core of procedures which, if observed, will shield business decisions from review. These are: (i) the board established a committee of independent directors to review the matter under consideration, and ceding the committee the power to engage outside assistance at corporate expense; (ii) the board and the independent committee informed themselves of all information reasonably available; (iii) the committee of independent directors engaged relevant outside expertise to assist it (e.g. a valuation, if relevant; outside legal advice, if relevant, etc.); (iv) the board acted in good faith; (v) the board took steps to address pertinent conflicts of

[81] *Supra*, note 1.

interest. If these boxes are checked, then application of the business judgment rule is a virtual certainty.

The problem is that the "check the boxes" approach to corporate liability is a far from airtight protection for minority interests. It has been repeatedly argued, and demonstrated by numerous empirical studies, that nominally "independent" directors may be anything but. The independence of an "independent" director may be compromised by a close personal relationship between the CEO and the director. It may be compromised by paying "independent" directors sufficiently generous remuneration (particularly for directors such as ex-politicians or retired civil servants who have a low opportunity cost) that fear of losing the directorship utterly voids any independent judgment. It may be compromised by an "I'll scratch your back if you scratch mine" relationship whereby, for example, the CEO of corporation A sits on the board of corporation B, while the CEO of corporation B sits on the board of corporation A. It may also be compromised by ceding under-the-radar perks to "independent" directors, such as rent-free access to expensive vacation properties, providing tickets, transportation, and accommodation to sought-after sporting events, or by other means.

Similarly, the independence of outside advice from investment bankers, auditors, or others can easily be compromised by the lure, explicit or implicit, of substantial future business for towing the line. In short, there is ample room for the opportunistically minded to exploit the inbred shortcomings of the business judgment rule to engage in opportunistic predation.

g. The Absence of a Positive Recommendation by the Special Committee and the Board

The absence of a positive recommendation to the shareholders by either the Special Committee or the board is an unusual and substantial departure from normal practice. Ever since *Smith v. Van Gorkum*, the understanding of corporate and securities law practitioners in both the U.S. and Canada has been that it is essential to have a fundamental transaction blessed by a committee of independent directors. In this respect, *Magna* may substantially undermine the nature of the protection furnished minority shareholders by non-management directors.

h. The Absence of an Valuation (Independent or otherwise) of the Class B Shares

Again, at least since *Smith v. Van Gorkum*, where questions of valuation have arisen in fundamental transactions, it has been expected by courts and regulators alike that an independent valuation will be secured. The Magna transaction is again a fundamental departure, and this departure is likely to have serious ramifications on the foundations of both corporate and securities law.

It is noteworthy that had the transaction been effected as an issuer bid, the board of directors would have been required to value the Class B shares.

i. The Absence of Dissent and Appraisal Rights

When recommending the introduction of the statutory dissent and appraisal right, the Dickerson Committee envisioned that this right would play a key role in balancing the interests of the majority and the minority shareholders. No such right was furnished to shareholders in Magna.

4. Why are These Things Important?

The absence of the various protections noted above has a number of ramifications. These include:

i) The *Magna* case is very much at odds with the foundational drivers of modern corporate and securities law. This inconsistency tends to bring the law into disrepute.

ii) Both by virtue of the aforementioned inconsistency with the basic tenets of securities law, and the 1800% premium paid (or 2200%, depending on how calculated), the *Magna* decision will tend to shake public confidence in the capital markets – one of the most oft-cited drivers of securities legislation and indeed part of the Commission's official statutory mandate.[82]

[82] "1.1 The purposes of this Act are... (b) to foster fair and efficient capital markets and confidence in capital markets."

iii) The regulatory and court decisions will result in a material weakening of minority shareholder rights.

I would also suggest that the *Magna* decisions are likely to raise, at least incrementally, the cost of capital for Canadian corporations. It has become something of a cottage industry in the academic literature to demonstrate how the consumption of private benefits by controlling shareholders not only makes minority shareholders worse off, but leads to the slower growth of capital markets and local economies, and a higher cost of corporate capital. The *Magna* decision invites controlling shareholders in dual class structures to up the ante in their consumption of private benefits, in the knowledge that they can then demand a *higher* premium to sell out.

The *Magna* decisions strip the board of directors of any real bargaining power in negotiating with an entrenched controller who is looking to sell out. If the law were to require a fairness opinion, an independent valuation, a positive recommendation from an independent committee and from the board as a whole, the furnishing of an appraisal remedy, etc., it would give the board a variety of tools to pare back overly ambitious demands from the controlling shareholder. Any experienced negotiator will know that it is much more effective to negotiate within the confines of superimposed restraints than to have a mandate at large. That is why any capable car salesperson will always disclaim the authority to approve a car purchase contract. At some point, he or she will inevitably run out the door and seek the approval of the ultimate arbiter of the all car perks – the invisible sales manager. Superimposed legal restraints, such as a requirement to secure a fairness opinion, have similar instrumental value. They tie the hands of the board and the board to negotiate from a position of strength, rather than weakness.

Part V: The Deficient Related-Party Transaction Rules

As a related party transaction ("RPT"), the Magna transaction was subject to Multilateral Instrument 61-101. The purpose of 61-101 is to ensure that minority interests are treated fairly on the occurrence of an RPT. The instrument does this by creating procedural hurdles for the carrying out of RPT transactions. The two major protections are an independent valuation of the assets that are the subject matter of the transaction, and the approval of the transaction by a majority of the minority of shareholders.

One of the curiosities of the Magna transaction is that, despite being, in effect, an issuer bid, the issuer bid rules were not applied. Had they been, Magna would have had to secure a "formal valuation" of the offeree securities – i.e. the Class B shares. Magna would also have been required, even aside from Pepall J,'s order as part of the arrangement proceedings, to secure the approval of a majority of the Class A shareholders.

Rather, the RPT rules were applied. What is particularly astonishing about these rules is that both the formal valuation and majority of the minority requirements may be dispensed with if the subject matter of the RPT does not exceed 25% of the market cap of the issuer.[83] This is an astonishing regulatory lacuna that allows a large cap issuer like Magna to engage in multi-billion dollar transactions with related parties without either a formal valuation or a majority of the minority vote.

More generally, 61-101 does not, in any respect of any of the transactions that it covers (insider bids, issuer bids, and RPTs), mandate a favourable recommendation from a committee of independent directors or the board as a whole. Nor does it mandate a fairness opinion. A fairness opinion is not pre-empted by valuation. A valuation can show shareholders what they are paying, or what they are getting, without telling shareholders anything about whether that is fair in the circumstances. All of these things should be required for all of the types of transactions covered by 61-101.

Part VI: The "Willing Shareholder" Argument

Many have argued that we should have little sympathy for the Class A shareholders, since all shareholders knew what they were getting into when they purchased Class A shares in Magna, and paid a discounted price that reflected the dual class structure. Thus, it is argued, the result was the correct one.

In general, an obvious objection to this argument, whether in respect of Magna or other corporations, is that some shareholders bought passage on the Titanic before they knew it was going down.

[83] MI 61-101, para. 5.5(a); para. 5.7(1)(a).

What about those who did in fact buy Class A shares at a discount that reflected the dual class structure and the value of Stronach as a controller? Without question, the reverse DCR resulted in an accrual of value to those shareholders. In this sense, there is nothing "unfair" about the outcome.

And yet, I believe the conclusion that *therefore* the result was a correct one is deeply flawed. As noted above, the OSC and court decisions view the transaction from a static, rather than a dynamic perspective. They fail to recognize that regulatory and court decisions create incentive structures for future behaviour. In judging the correctness of the decision, the primary focus should be on the dynamic affects of the decisions.

In a dynamic, efficiency-oriented perspective, the law is structured in such a way as to discourage rent-seeking (i.e. the consumption of private benefits) by controlling shareholders. The *Magna* decisions have precisely the opposite effect.

Another critical flaw in the "willing shareholder" argument is that it assumes that the regulators and courts should do no more than the market expects them to do; i.e. conform to the mean market prediction. The pre-announcement share price of Magna, for example, can be parsed into two pieces. The first is the value of Magna under existing management, with a dual class capital structure in place. The second is a premium that reflects the potential for a future collapse of Magna's dual class structure, with a resulting benefit to the Class A's.

Under the 'willing shareholder' argument, if the regulators or courts do more than the market expects them to do, Class A shareholders receive an undeserved windfall gain.

But there is no reason, from an efficiency point of view, to require either courts or regulators to conform to the market's expectation. As an example, suppose (to make things simple) that all DCS companies have two classes that are exactly identical except that one class possesses one vote per share, and the other class does not vote. Suppose also that it turns out to be efficient to restrain a corporation from repurchasing its voting shares in a reverse DCR at a premium greater than 50%, but that regulators and courts permit controllers to receive a premium as high as 500%. Finally, suppose that the market is well aware of the 500% premium rule, that all recent reverse DCRs have been consummated at a 500% premium, and that the market fully expects both regulators and courts to apply that rule in the future.

In this case, shares of the non-voting class will trade at a large discount to the voting class (and a larger discount than that which would prevail in a world with a 50% rule). It is hard to imagine that the non-voting shares will be priced so that if there is indeed a reverse DCR at 500%, the non-voting shares will go *down* in value. Rather, it seems rational that the market would price such shares such that they will go up in value, much as happened in the Magna transaction.

The purpose of the illustration is to show that, in a market with rational expectations, the market will impound the inefficient rule into the share price, and the market will still be a "fair game" in the sense in which that term is used by economists. Shareholders who buy in during the currency of the inefficient rule do not appear to suffer because of it.

However, this is misleading. By raising agency costs, inefficient rules increase the cost of capital, impair allocative efficiency, and ultimately lower aggregate investor returns.[84] Thus, the "willing shareholder" argument fails because it again misidentifies the "correct" result with a static, distributive justice perspective.

Part VII: Are There Governance Lessons to Be Learned From Magna?

It is interesting and perhaps telling that companies with dual class structures have *more* independent directors than companies with single class structures.[85] One hypothesis is that the higher number of such directors is used as a bonding device to reassure the market that agency costs will be controlled. Another is that in dual class companies, independent directors are mere window-dressing whose presence is designed to enhance the appearance of shareholder protection but without the reality.

While I have no systematic way of divining which is correct, my suspicions lean more to the latter than the former. In a company with a controller shareholder, independent directors serve at the pleasure of the controller. Moreover, nominally independent directors can be co-opted by generous pay or other perks. Magna's chairman of the board, for example, earns a $300,000 salary plus stock options that resulted in at least one year in a payout of $800,000. One might well question how

[84] E.g. La Porta et al., "Law and Finance", (1998) 106 J. Pol. Econ. 1113.

[85] Paul A. Gompers, Joy Ishii, and Andrew Metrick, "Extreme Governance: An Analysis of Dual-Class Firms in the United States" (2010) 23 Rev. Fin. Stud. 1051.

much truly independent judgment such a director exercises. Because the institution of the "independent" director has come to assume so much importance in corporate governance, this question is not a trivial one.

I believe that *Magna* also illustrates a wider danger, which occurs when courts and regulators apply a "check the boxes" approach to governance without delving beneath the surface. By "check the boxes", I mean that all of the required procedural hurdles have been met. In recent years, both courts and regulators have leaned away from the review of the substantive merits of impugned transactions and toward a review of the procedural pedigree. In fact, as I have been at pains to argue, while Magna checked all the applicable boxes, the transaction violates many of the fundamental underpinnings of contemporary corporate and securities law. But this does not appear to have troubled either the OSC or the courts.

In the regulatory domain, this is in stark contrast to the *Canadian Tire* decision, which held that the Commission may intervene with its public interest powers even where there is no contravention of any statute, regulation, rule, or policy. In the judicial domain, there is essentially no canvassing of any arrangement jurisprudence save the decision of the Supreme Court of Canada in *BCE*. While it is natural to pay attention to a decision from the top court in the land, the arrangement jurisprudence is deep, extending as far back as the 19th century. The arrangement mechanism was at one time virtually the only way to do a fundamental corporate transaction, and many previously decided cases might have been of assistance to the court in deciding whether the *Magna* transaction was "fair and reasonable". In particular, one strain that runs through the older cases is the idea of the proportionate sharing of the burden of a transaction among all corporate constituents. This principal of balance might have persuaded the court that it a transaction is not fair and reasonable only because everyone gets something out of it.

Part VIII: What Explains Dual Class Structures?

There are a number of theories that purport to explain why we observe dual class structures. These include the following.

1. Shareholder Expropriation
2. Management Discipline
3. Superman/Asymmetric Information

4. Human Capital
5. No Harm Done

The empirical literature suggests no clear winner. All of these theories find some support, leading to the conclusion that companies with dual class structures are heterogeneous in nature.

1. Shareholder Expropriation

Under the shareholder expropriation theory, controlling shareholders engineer DCRs in order to expropriate wealth from minority shareholders. They trade on shareholder collective action problems and free riders to have dual class structures installed, purchase a majority of the superior voting class to obtain unopposed control, and then engage in perquisite consumption and other forms of agency costs. Once the controller is ensconced in power, he/she/it is impossible to remove via a hostile takeover bid or by any other involuntary mechanism save a court order.

There is empirical support for the view that separating cash flow and control rights diminishes corporate value. The evidence, however, is uneven. Thus, for example, Lins (2003)[86] found that separating cash flow and control rights resulted in diminished corporate value in emerging markets, but not in developed markets. Claessens et al., (2002)[87] found diminished value in 8 East Asian countries, as did and Gompers, Ishii & Metrick (2010)[88] in the United States. Generally, it would appear that the greater the "wedge" (the ratio of voting rights to cash flow rights) the greater the reduction in value. However, the effect of the wedge varies dramatically with the strength of investor protection and takeover laws (Nenova 2003[89]).

[86] Karl V. Lins, "Equity Ownership and Firm Value in Emerging Markets" (2003), 38 J. Fin. & Q. Anal. 159.
[87] S. Djankov; and L. H. P. Lang. "The Separation of Ownership and Control in East Asian Corporations" (2002), 38 *Journal of Financial Economics* 81.
[88] Paul A. Gompers, Joy Ishii, and Andrew Metrick, "Extreme Governance: An Analysis of Dual-Class Firms in the United States" (2010) 23 Rev. of Fin. Stud. 1051.
[89] Tatiana Nenova, "The value of corporate voting rights and control: A cross-country analysis" (2003), 68 J. Fin. Econ. 325.

Aside from direct studies on the Canadian market (discussed below), the study by Gompers, Ishii & Metrick (2010)[90] of the U.S. market probably has the greatest relevance to Canada. In their sample, the average "wedge" (voting rights/cash flow rights) was 60/40 (i.e. voting leverage" of 1.5, which is much smaller than that observed in Canada). Defining a "separation sample" as those cases in which voting rights were greater than 50% *and* cash flow rights were less than 50%, they found that corporate value decreased (increased) with lower (higher) insiders' cash flow rights. They also found that corporate value was negatively correlated with insiders' voting rights. They describe their results as "economically large and statistically significant", *especially for the separation sample*.

Amoako-Adu et al. (2009)[91] investigated a sample of Canadian firms that had dual class structures in 1998, 2000, 2002, almost all of which had a coattail. Interestingly, these firms were found to have statistically significantly more outside directors than other firms (66.2% v. 61.6% for single class controlled companies). The average voting leverage in their sample was 6.43, with a median of 3.43. Magna was deleted from sample as outlier, since its voting leverage of 66.7 was more than twice that of the firm with the next highest leverage.

Amoaku-Adu et al. found that Tobin's Q was lower for companies with dual class structures than single-class firms with a controlling shareholder (in which the controller held an average of 46% of the shares). Further dual class firms sold at an average 12.9% discount when compared to single-class controlled firms matched by size, industry, leverage, and number of outside directors. Also of interest, Amoaku-Adu et al. found no difference in Tobin's Q between controlled single-class companies, and widely held single-class companies.

The authors concluded that entrenchment via a dual class structure leads to higher agency costs. In addition, controlling shareholders have both a good and a bad side. On the good side, they are effective monitors of management. On the bad side, they appropriate private benefits. The authors also concluded that pyramiding of single-class firms also leads to lower corporate value.

2. Management Discipline

[90] *Supra,* note 88.

[91] Ben Amoako-Adu, Brian F. Smith, Madhu Kalimipalli, "Concentrated Control: A Comparative Analysis of Single and Dual Class Structures on Corporate Value" Wilfrid Laurier University.

The management discipline theory posits that controlling shareholders are in a good position to monitor management, and to expeditiously replace underperforming managers should the need arise.

As noted, Amoaku-Adu et al. in their study of Canadian firms found evidence that controlling shareholders can indeed be good monitors. Schwartz and MacIntosh also found empirical evidence that controlling shareholders are good monitors.[92] However, the monitoring effect dissipates at low levels of controlling shareholder ownership, since the controller does not bear much of the cost of poor management (Gompers, et al., 2010[93]).

While there is thus support for the management discipline hypothesis, it should be emphasized that the benefit of improved monitoring may not be shared by minority shareholders. For example, Schwartz and MacIntosh[94] found that where there is a controlling shareholder, accounting measures of profitability improve – but the price to earnings ratio is actually lower. This suggests that controlling shareholders more than dissipate the benefits of enhanced monitoring by consumption of perquisites and other shareholder agency costs.

3. The Superman Theory, the Human Capital Theory, and Asymmetric Information

The Superman theory posits that the controlling shareholder/CEO is a "Superman" with extraordinary managerial abilities of great (and unique) value to the corporation. It further posits that there is a danger that market will fail to recognize the CEO as a Superman and he/she will be displaced via a hostile takeover bid. Thus, a dual class structure is a necessary and/or prudent protection against market myopia to ensure that the Superman stays on the job.

A slightly different theory is the Human Capital theory. In this theory, the CEO if not other senior managers require job security before they will invest in acquiring firm-specific human capital. The dual class structure provides that job security.

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[92] Larry Schwartz and Jeffrey G. MacIntosh, "Do Institutional and Controlling Shareholders Increase Corporate Value?" in Ronald J. Daniels and Randall Morck, eds., Corporate Decision-Making in Canada (Calgary: Univ. of Calgary Press, 1995) 303.

[93] *Supra*, note 88.

[94] *Supra*, note 92.

Under either of these theories, the firm is better off with a dual class recapitalization. However, if the CEO is an unrecognized Superman, then the market will not attribute value to the DCR. Rather, it will focus on the negative aspect of DCRs (namely, entrenchment). Thus, the market price should go down.

Under the Human Capital theory, however, the market does not necessarily need to know or believe that the managers are Supermen; only that the DCR will provide them with the incentive to invest in acquiring firm-specific human capital. Thus, the market price should go up (at least if the benefit outweighs the cost of entrenchment). In any case, the Human Capital theory should have a more positive (or less negative) effect on price than the Superman theory.

There is some empirical support for the view that a DCR has a positive effect on share price. In particular, in examining post-DCR performance (in a sample that included no IPO DCRs), Lehn et al. (US, 1990[95]) found higher growth in sales, total assets, and operating earnings than in single-vote cohorts. They also found that profit margins improved after the DCR, and that the DCR firms had more subsequent equity offerings (a sign that the firm is doing well and that the market is receptive to purchasing more shares).[96]

Dimitrov and Jain (2006[97]) also looked at U.S. DCRs – in this case, spanning the period from 1979 to 1998. In their sample, prior to the DCR, controlling shareholders held a mean of 39.4% of the shares. Like Lehn et al., Dimitrov and Jain found that, post-DCR, these firms engaged in significantly more SEOs (40%, versus 9% of cohorts). They also found that DCR firms had a higher growth rate than non-DCR firms (with cumulative average residuals of 23.1% in the 4 years following the DCR). While return on assets and return on equity were comparable to single-class firms matched by industry and size, there was higher growth in sales, assets, and operating income (matched by industry and size). In addition, the subset of firms that did SEOs grew faster than those that did not, and had higher CARs (52.6%).

These results lend more support to the Human Capital theory than the Superman theory.

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[95] K. Lehn, J. Netter, and A. Poulsen, "Consolidating Corporate Control: Dual-Class Recapitalizations versus Leveraged Buyouts" (1990), 27 *Journal of Financial Economics* 557.
[96] On the other hand, agency theory suggests that managers will issue shares when they know that the firm is overvalued in the market.
[97] Valentin Dimitrova and Prem C. Jain, "Recapitalization of one class of common stock into dual-class: Growth and long-run stock returns" (2006), 12 J. Corp. Fin. 342.

4. No Harm Done

The No Harm Done theory essentially sees DCRs as a non-event. It is based on the assumption that minority shareholder rights are sufficiently strong that a dual class structure confers no advantage in effecting wealth transfers from minority shareholders to the controller.

This theory also has empirical support. In a 2010 paper, Jog, Zhu, and Dutta[98] examined TSX-listed restricted voting shares over the 1996-2005 period. They found no statistically significant difference in Tobin's Q, return on assets, or long term stock market performance compared to non-DCR firms. They also found no statistically significant difference in abnormal returns to announcements of M&A activity (i.e. no evidence of inefficient investment projects or diversifying acquisitions). Nor was there any statistically significant difference in dividend payouts. Jog et al. concluded that legal controls (*especially the coattail requirement)* and reputational concerns adequately restrained controlling shareholders.

This may be compared, however, to an examination by King and Segal[99] of the effect of cross-listing on Canadian DCR firms. Since cross-listing exposes a firm to liability under U.S. law, any increase in firm value suggests that U.S. law is more protective of minority shareholder rights than Canadian law. King and Segal found that "cross-listed [Canadian] firms with dual-class shares exhibit a permanent increase in valuation regardless of the level of U.S. investor holdings, consistent with firm level bonding." This is inconsistent with the "No Harm Done" theory which posits that Canadian law is sufficiently strong to make a DCR a non-event.

5. Summary

The ambiguous empirical record suggests that DCR firms are heterogeneous. All of the theories seem to play a role in explaining why we observe DCR firms.

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[98] Vijay Jog, PengCheng Zhu, and Shantanu Dutta, "Impact of Restricted Voting Share Structure on Firm Value and Performance" (2010), 18 Corp. Gov: An Intl. Rev. 415.
[99] Michael R. King and Dan Segal, "The Long-Term Effects of Cross-Listing, Investor Recognition, and Ownership Structure on Valuation" (2008), Rev. Fin. Stud. 2393.

Part IX: What Policy Responses to Dual Class Structures are in Order?

The heterogeneous nature of DCR firms suggests that a ban on dual class structures would not be a good idea. While dual class structures are harmful in some cases, they are beneficial in others.

Nonetheless, it is clear that the potential for harm to shareholders is material. I would suggest the following policy responses are in order.

1. Place a Sunset Clause on all Outstanding Dual Class Structures Without a Coattail, Coupled with a Reverse-DCR Premium Cap

When the requirement for a coattail was introduced in 1987, approximately 80 Canadian dual class firms were grandfathered out of the requirement, and which therefore lack coattail protection. Failing the adoption of a coattail, the OSC should set a sunset clause on these dual class structures. To ensure that minority shareholders are not exposed to the risk of a Magna-type reverse DCR, however, the sunset requirement should be coupled with a cap on the premium that may be paid to the superior-voting class.

2. Amend MI 61-101

MI 61-101 must be amended to close the gaps outlined above, so that there are adequate shareholder protections in place on the occurrence of a reverse-DCR. In particular, the broad exemptions from the majority of the minority voting and valuation requirements must be eliminated or strongly circumscribed. A fairness opinion should be required, in addition to a list of factors that form the basis of the fairness opinion. A positive recommendation of a committee of independent directors and of the board as a whole should be required.

In addition, the issuer bid and related party transaction rules should be applied in the case of reverse DCRs. Minority shareholders should always have dissent rights.

3. Additional Regulation of DCRs

Existing protections should be maintained (such as the requirement for a majority of the minority vote). However, shareholders should receive an OSC-generated disclosure statement that discusses both the possible benefits and harms occasioned by dual class structures. In order to make both the DCR and any future reverse DCR more transparent, the OSC should require that inferior and superior voting classes have equal rights (save voting). There should be a mandatory sunset provision on a dual class structure, so that, failing a confirming majority of the minority vote every 2 or 3 years, the superior voting class converts into inferior voting shares. Perhaps most importantly, the terms of the coattail attached to the inferior voting shares should be mandated. As Jog et al. suggest, the coattail seems to be the most effective protection for minority shareholders against predation by controlling shareholders.

4. Independent Directors

To ensure that nominally independent directors are not co-opted, a cap should be placed on the remuneration of independent directors. Non-transparent forms of remuneration such as personal favours emanating from a controlling shareholder or a member of management should be banned. Mutual back-scratching directorships, where senior managers sit on each other's boards, should be banned.