CURRENT DEVELOPMENTS
Share Buybacks

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Good Morning Ladies and Gentlemen. Let me give you a little bit of a different perspective and provide you with some of the Canadian experiences in the area of share buybacks. Early in the 1970s the Canadian corporate law was fundamentally revised and radically changed from an outgrowth of English concepts developed in the late 19th and early 20th centuries which were based upon UK traditions and experiences, to a broad and flexible enabling statute permitting business organisations in corporate form to have wide powers.

I have had an opportunity to read a recent article by David Partlet and Gregory Burton of the Australian National University which was published in the February 1988 edition of the Australian Law Journal headed "The Share Repurchase Albatross and Corporation Law Theory". Let me take two quotes from this paper to reflect, I think, the fundamental difference in approach between Canadian corporate law and what may be Australian corporate law. At the beginning of their article the following quote appears:

> "Anglo-Australian discourse on corporation law has reflected a dominant world first paradigm. The corporation is commonly re-edified as a public institution which should be a microcosm of the modern democratic welfare State".

That is totally unfamiliar in terms of describing Canadian or North American corporations. The authors recommend consideration of a fresh approach to corporate law and I quote what they refer to as the contract paradigm. They recommend as follows:

> "To be an optimal medium for voluntary transactions the corporation must offer capitalists all the powers which can beneficially be used in those transactions and as much freedom as possible to construct by contract the optimal type of corporate form for the particular transaction they wish to carry out ... The law created by the State to govern corporations should therefore license the corporate form as of right and provide and promote optimal facilities

> for private ordering arrangements concerning the corporate powers and structures. The resulting presumption will be against legally imposed mandatory regulation unless it can be affirmatively justified as optimising the contractual process ... Regulation to satisfy competing public interests should be imposed directly through other branches of the law (for example, planning and environmental law) in a way which least interferes with the efficiency and structure of the corporate form, not through company law itself." (p.140-1).

That, I would say, is a very accurate description of the Canadian viewpoint with respect to corporate law.

As was indicated by the earlier speaker, one of the reforms made in Canadian corporate law in the 1970s was the abolition of the rule in Trevor v. Whitworth [1887] App. Cas. 409, that a corporation could not purchase its own shares - a rule which our commentators noted was implemented by the House of Lords at a time when the principle of limited liability was a relatively new concept in England, having been introduced in the Companies Act only a few years earlier. The rationale behind the rule was that limited liability combined with the practice of share repurchases would impair the corporation's capital and thus prejudice the rights of creditors.

In 1967, the Interim Report of the Select Committee on Company Law (Ontario) concluded that there was no valid justification for prohibiting companies to repurchase their shares. As the committee observed:

> "Over fifty years of experience in Ontario with redeemable preference shares and the experience in the United States with the right to purchase common shares would indicate that, provided adequate safeguards exist, there need be no apprehensions concerning the protection of the rights of creditors and others in permitting companies to purchase their shares." (p.35)

The Committee further noted a number of reasons for which share repurchase may be a legitimate and useful power:

> "For example, companies may wish to purchase outstanding common shares in order to provide for incentive, bonus stock option plans without being required to extend their equity base to provide the required shares. Purchase of outstanding common shares is a feasible method whereby a company could contract its equity base as the financial requirements of the company may dictate. The right to purchase common shares could also facilitate mergers and acquisitions in some cases and certainly provides a much needed flexibility for closely-held companies and their shareholders in the event of the death or retirement from the business of one of the principal shareholders." (p.37)

The Committee, in recommending the abolition of the rule in Trevor v. Whitworth, recognised the potential for abuse in the purchase by a company of its own common shares at values which reflect the net worth of the company, rather than at prices which equate the amount paid up on the shares plus a limited premium, as in the case of the purchase or redemption of preference shares. As a safeguard against potential abuse, the following recommendations were also made:

> "... a company may, subject to any restrictions contained in its charter, purchase its own common shares out of surplus unless the corporation is insolvent or would thereby be made insolvent." (p. 38)

And in addition:

> "... the power of a company to purchase its outstanding common shares shall be exercised only by the directors acting in good faith and in the best interests of the company." (p.38)

Violation of these provisions would expose the directors to civil liability, thereby ensuring that a corporation's financial position would receive careful consideration whenever transactions of this kind were contemplated.

Thus in Canada, corporations may repurchase their common shares under corporate law subject to only two restrictions. The first is any restriction that may be placed in the articles of the company itself. Generally speaking, corporations do not place any restrictions in their articles; certainly public corporations do not, but some private corporations may as part of the negotiation among the shareholders of the corporation in putting together a form of corporate partnership. The second restriction, which is a statutory restriction found in section 32 of the Canada Business Corporations Act (the "CBCA") and section 30 of the Business Corporations Act (Ontario) (the "OBCA"), is that a corporation may repurchase its shares provided it satisfies the solvency test in the statute. That solvency test requires that the directors be satisfied that after the repurchase, the corporation will be able to repay its liabilities as they become due, and that the realisable value of its assets (which includes the unrealised appreciation of the corporations' assets above the historical carrying cost on the books) will exceed the aggregate of the liabilities and the stated capital. With respect to the realisable value of assets, the Dickerson Committee in its "Proposals for a New Business Corporations Law for Canada" stated:

> "We acknowledge that there are risks in allowing unrealized appreciation in the value of assets to be used in measuring solvency. At the same time, however, the general rise in price levels in recent years has made it obvious that it is absurdly conservative always to insist upon the use of

> historical cost in valuing assets ... Judgement has to be used in each case, and we think that corporate directors should be allowed to use their judgement as to whether unrealized increments in value should be taken account of."

In addition, there are, as the Select Committee on Company Law recommended, personal liabilities on the directors of the corporation should they abuse these solvency tests, and generally speaking there are no requirements for shareholder approval to proceed with any repurchases. As a result of these safeguards, the creditors of the corporation are fully protected and the stated capital of the remaining shares continues undiminished.

As I said, share repurchases are simply another method of distributing corporate surpluses to shareholders. Under both the CBCA (section 37) and the OBCA (section 35), shares which are repurchased are cancelled or, if the corporate articles restrict the maximum number of shares that can be issued, they are restored to the status of authorised or unissued shares. Most Canadian public corporations have an unlimited authorised share capital and can issue any number of shares. Generally speaking, then, repurchased shares are cancelled, and therefore have no voting rights. The cancellation of repurchased shares effectively rebuts concerns that the repurchase of shares by a corporation permits the directors and other insiders to consolidate control and entrench themselves in power at the expense of other shareholders.

While Canadian corporate legislation affords broad, flexible, enabling corporate power, securities legislation, on the other hand, provides protection to shareholders with respect to the exercise of that power. Any offer by a company to acquire its common shares in Canada, including the purchase of a single share, is defined as what we refer to as an "issuer bid" and is subject to specific rules under securities regulation relating to such bids. The only exemption from that is the repurchase of debt which is not convertible into equity.

Under securities legislation, the repurchase by a company of a single common share is subject to the same regulatory pattern and protective measures for the benefit of the shareholders that are available in the case of a takeover bid made to the shareholders. These rules apply even where the repurchase is less than the threshold amount of 20 percent, which would otherwise apply on a takeover. In effect, any repurchase of shares is regulated on the same basis as if a third party was making a takeover bid for the shares of the company. Now that seems quite reasonable to me because, from the shareholders' point of view, an offer by the company to repurchase their shares has exactly the same effect as a third party bid; and therefore the same protection should be provided. These protections include the requirements that the offer must be made to all of the shareholders of the company, that it be made on a pro-rata basis, and that any purchases taken up be done pari passu. The offer must be open for a minimum

period of 21 calendar days in order to give the market, the shareholders and others sufficient time to absorb and digest the offer and to make investment decisions whether or not to accept the offer. Identical consideration must be paid to everyone and there may be no collateral benefits for any person. And, as in the case of takeover bids, a full issuer bid circular must be prepared and mailed out to all of the shareholders, containing full disclosure of all material facts relating to the company, to assist the shareholders in making their investment decisions. Of course, where the company itself is offering to buy back its own shares, this duty of disclosure is even higher than where a third party is making an offer, because the company must put its own shareholders in exactly the same position with respect to information as the insiders of the company.

Accordingly, as a result of these rules, selective or targeted share repurhases (known as greenmail in the United States) are prohibited. Private purchases from selected and preferred shareholders are illegal and cannot be done. Any attempt to do so would be regularly blocked, not only by the minority shareholders with an oppression action, but also by the Securities Commission. If it did succeed, then the transaction would be subject to restraints including the possibility that all of the shareholders be offered the same opportunity to have their shares repurchased.

In addition, under the policies of the Ontario Securities Commission (and in particular Policy 9.1), where a public company offers to buy back its own shares, an independent valuation, prepared without a minority discount by an independent financial expert, must be provided to the shareholders by the offering corporation, so that the shareholders can assess what the financial expert considers to be the full and fair value of the shares of the company. This valuation must be filed publicly with the Securities Commission; a summary of the valuation must be sent to the shareholders, and copies of the complete valuation must be made available to the shareholders without charge if it is not otherwise fully produced in the issuer bid circular.

The only meaningful exemption from the requirement of an independent valuation where an issuer bid is made to the shareholders is where, after the bid, the shareholders who have not accepted the offer will have available a market in which to trade their shares which is not materially less liquid than the market before the offer was made. In other words, if a company proposes to buy back, let us say, only 20 percent of its shares, and it can be proven to the Securities Commission that the remaining market will be not materially less liquid after the offer, assuming successful completion, then a valuation will not be required. Where, however, this cannot be shown, a valuation is necessary. In order to prove the exemption, independent financial letters must be filed by investment dealers after reviewing the market for the shares, and in addition, the stock exchange on which the shares are listed must agree with the assessment of the independent financial advisor.

Under our securities laws, the public corporation offering to buy back its shares is an insider of itself. Any offer and repurchase of shares is subject to the full rigours of our insider trading laws, including civil liabilities against the directors. Under our rules, a corporation or an insider cannot repurchase its shares without prior disclosure to the shareholders of all material facts that would reasonably be expected to have a significant effect on the market price or the value of the shares or that could be an important factor to an investor making a decision whether or not to accept the offer.

In addition to these regulations, we have regulations by our stock exchanges dealing with stock repurchases made through the stock exchanges. A corporation may offer to repurchase its shares in a market-orientated fashion through the facilities of the stock exchange. When they do so they are subject to the stock exchange rules. The other kind of repurchase is, of course, where the corporation mails an offering circular directly to the shareholders, outside of the facilities of the exchange, in the same way as a takeover bid is made.

The stock exchange will permit a listed company to repurchase its shares in small amounts at the market price over an extended period of time without valuations to shareholders or special disclosures - other than specific disclosures of the intent of the corporation to commence these market repurchases by issuing press releases and filing notices of intent. But once that has been done, then the corporation can purchase its stock in the market in the normal course. We call these "normal course issuer bids". A restriction on price is that the corporation cannot pay for the shares more than the most independent bid price for the stock. In addition, the amount of stock that can be repurchased is limited to 2 percent of the corporation's issued shares during any 30 day period and over a twelve month period to the lesser of 10 percent of the public float (which excludes the holdings of insiders) or 5 percent of the issued shares. These rules are meant to prevent market manipulation, and to prevent a serious impact upon the trading patterns of the stock and the liquidity of the market itself, or to otherwise cause an aberration in the market price.

Where a listed company wants to exceed these limits by purchasing shares through the stock exchange, it becomes subject to the other rules that I have referred to, namely, the same kind of rules that are applicable with respect to takeover bids, and the requirement that the offer be made, on a fully disclosed basis, equally to all shareholders.

In addition, under the corporate law areas, the exercise of the duties of the directors in causing a corporation to offer to buy back its shares is subject to the fiduciary duties to act in the best interests of the corporation. In Canada, as well, our expanding oppression remedy would also be available should a security holder argue that the directors are improperly

exercising their powers and are acting in a manner which is unfairly prejudicial to the interests of the security holders, which includes creditors as well as shareholders of other classes of shares.

I think the experience in Canada with respect to takeover bids and the ability of the directors of a target company to offer to repurchase their shares has resulted in benefits to shareholders. Share repurchase programs and substantial issuer bids have proven in Canada to be effective tools in the hands of the directors of a public target company to provide increased values to shareholders. Where a unilateral bid is made that fails to reflect the proper value of the shares, the target company shareholders can benefit through a competitive offer made for their shares at a higher price by the target company itself. This enhances the auction process and can only result in maximising shareholder values. Where a third party is not prepared to pay the proper value for control there is no reason why the shareholders cannot receive the full value for their shares from the company itself, whether by way of dividend distribution or competitive share repurchase offers. Furthermore, over the twelve or fifteen years that corporations in Canada have had the ability to repurchase their shares, there have been no examples of abuse in the exercise of this power which might militate against the current public policy, which I have outlined.

The other areas with respect to issuer repurchases and bids, I think, in terms of benefits, have probably been summarised in the reports of the Australian Committees quite accurately and I do not think there are any major differences in terms of the values or the benefits that the Canadian regulators thought they were getting at the time they made these changes. Thank you very much.