SOME LEGAL ASPECTS OF "GOING PRIVATE" AND MANAGEMENT BUYOUTS IN CANADA

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Good Morning Ladies and Gentlemen.

Before I share with you some of our experiences in Canada with respect to leveraged buyouts and "going private" transactions of public corporations and, subsequently, government privatisations, I would like you to know how much of a pleasure it is for me to have been invited to participate in your Banking Law Conference. I have not been to a banking law meeting in North America before held in a casino and I am looking forward to participating in the action today and tomorrow.

In addition, I would also like you to know how overjoyed my wife and I are with your island continent. It is our first trip to Australia and we have only seen a small part of it - however, the beauty of your country and the warmth and friendliness of all the people we have met already left us with a deep impression and we are already looking forward to another and more extended visit.

Now let me share some of our Canadian experiences.

Under the general topic of leveraged and management buyouts, I am going to review some of the current Canadian issues that are relevant in acquiring a 100 percent interest in a public corporation. These are LBOs of the de-merger type referred to by David Saunders. A management buyout of a private or closely held corporation is really a straight forward leveraged asset or share acquisition and does not raise the same sensitive concerns of forceable acquiring of the interests of dissident minority shareholders who do not want to sell their shares. Herein of the protection of minority shareholder rights, an expanding and fruitful area in Canadian jurisprudence and administrative practice - both in the courts and before the securities commissions and stock exchanges. For my purposes, a leveraged buyout assumes 100 percent ownership in order that the assets and cash flow of the target can be applied to carry and reduce the acquisition debt. The methods of paying down the acquisition debt include, as has been referred to, the divestiture of key assets, which is only possible on a 100 percent acquisition of the public company. A badly structured leveraged acquisition designed to use the target's assets and cash flow that fails to achieve 100 percent ownership leaves the purchaser and perhaps its lender as hostage to the demands of aggressive, well-heeled and well-advised minority shareholders, who in our country will include institutional investors and pension funds seeking to maximise their return.

Takeover Bids - 90 Percent Acceptance

In Canada the most legally secure and quickest method of acquiring 100 percent control of a public company is through a takeover bid by the buyout group made for all the shares of the target. The bid is conditional upon the tender of 90 percent of the shares subject to the bid. If there is 90 percent acceptance then under the statute, as I think your Australian statutes provide, the balance can be squeezed out at the same price without the consent of the non-tendering shareholders (subject to the rights of the non-tendering shareholders to apply to court to seek the "fair value" of their shares under the appraisal remedy). The trick, of course, is to obtain the high level of 90 percent acceptance of <u>all</u> the shares. In this respect, the same problems exist in Australia as in Canada: namely, that it is easy for a shareholder or group of minority shareholders holding only 10.1 percent of the class to block the acquisition.

There are significant legal risks in Canada for a purchaser and its lender where the purchaser acquires less than 90 percent of the target's shares under a bid and then attempts subsequently to squeeze out the remaining minority shareholders without their consent and thereby obtain 100 percent of the shares and access to the target's assets and cash flow. By contrast, in the United States, upon acquiring 51 percent or more under a tender offer, a second stage merger can usually be implemented where the purchaser votes its newly acquired control block to force the cash-out of the minority, subject to their appraisal rights. The same procedure cannot be safely used in Canada without substantial risk, except in specific and highly structured transactions involving corporations in the Province of Ontario.

Where control, but less than 90 percent, of a federal Canadian corporation is acquired under a bid, minority shareholders have successfully applied to the courts and obtained interim injunctions to prevent a second stage cash-out merger or amalgamation from proceeding to squeeze out or acquire their interests without their consent. In those cases (which have not been overruled) the courts have upheld the claims of the minority that amalgamation procedures are meant to be implemented for business purposes and cannot be utilised to acquire their shares compulsorily against their will, even at a fair price. Consequently, under Canadian law the appraisal right is not the sole remedy for minority shareholders to counteract the voting power of the majority in its attempt to force out the minority.

As some of you may know, the Ontario Securities Commission is a strong protector of minority shareholder rights in Canada. The Commission has issued cease trading orders to prevent cash-out amalgamations unless approved separately by a "majority of the minority" shareholders. However, the courts have even gone farther and have enjoined cash-out tag-end amalgamations even though approved by a "majority of the minority", taking into account the shares tendered under the prior takeover bid.

Purchase Amalgamation

The problems associated with having to achieve a 90 percent acceptance by the target's shareholders under a takeover bid may be avoided where the buyout group can proceed with the acquisition by means of what we call an amalgamation merger. Under this procedure, the buyout group forms a purchasing company that enters into an amalgamation or merger agreement directly with the target company. The amalgamation must be approved by only two-thirds of the shares voting at the meeting, as opposed to 90 percent of all the shares having to be deposited under the takeover bid. The terms of the amalgamation would provide in effect that the shares of the target company are converted into preference shares of the amalgamated company which are then immediately redeemed for cash, leaving the purchasing company as 100 percent owner of the equity of the amalgamated corporation.

The benefit of the amalgamation acquisition procedure in Canada is that the buyer and its lender either acquire 100 percent of the target or none at all and are not subject to the risk of being left high and dry with a significant but less than 100 percent interest in the target and without access to the target's assets and cash flow.

There is a rub, however, where the management/employee buyout syndicate or other third party desires, as often is the case, to lock up the transaction by having the existing controlling shareholder or enough shareholders to constitute effective control of the target agree beforehand to vote in favour of the amalgamation at the agreed price and to use their best efforts to see the transaction completed and, especially, not to sell their shares to a possible subsequent and higher bidder once the deal is announced. Failure by management to tie up the controlling shareholder invites competing bids. Moreover, in the event of a bidding war, the management group loses control over pricing and other financial aspects of the transaction.

Where the control person agrees to the transaction with the leveraged buyout group, then in addition to the usual two-thirds shareholder vote required under corporate law, the Ontario Securities Commission will generally consider the deal as a "going private" transaction as opposed to a third party acquisition. This requires a special "majority of the minority" approval by the shareholders of the target, excluding the votes of the controlling shareholder, in order to approve the amalgamation.

In these circumstances where there is a lock up agreement between the buyout group and the controlling person, the Ontario Securities Commission will not require an independent valuation of the target company's shares provided that the transaction between the buyout group and the controlling shareholder and the price for the shares are negotiated on an arm's length basis, the minority shareholders receive identical consideration for the sale of their shares of the target that the controlling shareholder receives and the controlling shareholder does not receive any collateral benefits which could be attributed to provide additional value for the sale of his shares such as special termination, retirement or consulting payments.

Leveraged Buyouts Under the Ontario Business Corporations Act

The Business Corporations Act of the Province of Ontario (the "OBCA") is the first and so far the only Canadian corporate statute which has specific provisions authorising "going private" or compulsory acquisition transactions in addition to the 90 percent takeover bid procedure. The OBCA applies only to corporations incorporated in Ontario.

Where the target is an Ontario corporation the requirement that 90 percent of all the shares must be deposited under the bid can be reduced to receiving the favourable vote or deposit of a "majority of the minority" shares of the target, again excluding the shares held by any shareholder that exercises effective control over the target corporation and agrees to support the transaction prior to its implementation.

Where the financing to be made available to the buyout group is contingent upon the assets of the target being available as security, the buyer would proceed by way of a takeover bid with a prior lock up agreement with the controlling shareholder to deposit his control block under the bid. The bid would be conditional upon deposit of a "majority of the minority" of the shares (not 90 percent of all shares) and would clearly disclose to the target's shareholders the lock up agreement with the controlling shareholder and the buyer's intent, upon obtaining a "majority of the minority" of the shares under the bid (as well as the shares of the controlling shareholder), to take up and pay for the deposited shares and then proceed by a second step "going private" transaction to squeeze out the remaining non-tendered shares at the same price.

The second step in a multi-stage transaction may be effected, among other ways, through the following methods:

(a) a statutory arrangement pursuant to which all shareholders (other than the buyer) transfer their shares to a subsidiary of the buyer in exchange for cash or redeemable preference shares of that subsidiary, which are then redeemed for cash shortly after the arrangement;

(b) an amalgamation of the target corporation and a wholly-owned subsidiary of the buyer on a basis whereby the buyer would receive all the common shares of the amalgamated corporation and the public shareholders would receive redeemable preference shares of the amalgamated corporation which would be redeemed for cash shortly after the amalgamation;

(c) a consolidation, or reverse split, of the shares of the target corporation on a basis whereby all shareholders of the target (other than the buyer) would receive fractional shares which would be redeemed or retired for cash;

(d) a reclassification of the shares of the target corporation (other than those held by the buyer) into redeemable preference shares which would be redeemed shortly after the reclassification; or

(e) the sale of all the undertaking and assets of the target corporation to a subsidiary of the buyer followed by the liquidation of the target and the distribution of its assets to its shareholders.

In order to secure "majority of the minority" approval, the buyer should obtain an exempting order from the Ontario Securities Commission prior to the bid, enabling it to vote the "majority of the minority" shares deposited under the prior bid in the subsequent going private transaction in order to compulsorily acquire the non-tendered shares from the balance of the minority. The shares deposited in the prior transaction may be included in the calculation of the minority approval if, at the time of the prior transaction, the intent to effect the going private transaction was clearly disclosed and a summary of a valuation was provided. Where such intent was clearly disclosed but no valuation was required for the prior transaction, if the consideration per share in the going private transaction is at least equal in value to the consideration per share paid in the prior transaction, then the shares deposited or accepted in the prior transaction may similarly be included in the calculation of minority approval. This procedure is provided for in the statute and allows the transaction to be completed without the risks from the minority that I have previously referred to.

In this type of multi-stage acquisition, the lender would have to be prepared to advance funds at the time of the initial purchase of shares under the bid and before 100 percent of the target is acquired. Of course, if 90 percent of all the shares are deposited under the bid, then the balance could be acquired shortly thereafter. If, however, only a "majority of the minority" of the shares are tendered under the bid, then the lender's security for its advances could <u>not</u> then include a guarantee from the partially owned target subsidiary nor otherwise use the target's assets to secure the loan to the buyer. The use of the target's assets would have to await completion of the second stage of the acquisition.

Obviously, any attempt to use the target's assets prior to acquiring 100 percent of its shares would be met, or should be met, with lawsuits by the minority as to the improper use of the target's assets for the benefit of the controlling shareholder. This has nothing to do with any violation or prohibitions against financial assistance because under Canadian rules companies have much broader rights to provide financial assistance with respect to the purchase of their own shares; rather, this would be a claim against the directors for breach of their fiduciary duties in using assets of a company for the benefit of a shareholder, which would be founded not only on that breach but also on an oppression remedy which is gaining great favour in Canadian courts.

Independent Valuations

I have spoken to you a little bit about the "majority of the minority" concept which has found its way into the policies of our main securities commission and has also been adopted by the Ontario legislature. The other key aspect of management buyouts in Canada is the requirement of an independent valuation of the shares of the target company. Ontario Securities Commission policy requires that a valuation of the target corporation without a minority discount be prepared by an independent valuator and that such valuation be disclosed to the shareholders of the target in connection with the going private transaction. This is similar to the valuation requirement for a going private transaction under the OBCA.

The valuation must be based upon techniques that are appropriate in the circumstances after considering either "going concern" or liquidation assumptions or both, together with other relevant assumptions, and must opine as to a value or range of values for the participating securities without any downward adjustments to reflect the fact that the participating securities do not form part of a controlling interest. Ontario Securities Commission policy also provides for an exemption from the valuation requirement where (i) the price offered was negotiated in an arm's length transaction whereby control of the target changed within one year prior to the privatisation, (ii) there was no prior event in the affairs of the corporation which was undisclosed at the time of the change of control of the corporation and which, if it had been disclosed, could reasonably have been expected to have affected the negotiated price in the arm's length transaction, and (iii) no intervening event in the affairs of the corporation has occurred which could reasonably have been expected to increase the value of the corporation.

With respect to the requirement that independent valuations be made, it is becoming an issue in Canada as to whether financial advisors who have recently been engaged by the control person or who otherwise have participated in the bid are independent for this purpose.

Fairness Opinion to Independent Committee of Directors

An independent committee of the board of directors of the target corporation may be formed to protect the interests of the minority shareholders in connection with a going private transaction. The independent directors may require an opinion of an independent investment dealer as to the fairness to the minority shareholders of the terms of the going private transaction from a financial point of view. If the valuation for the going private transaction is prepared by an investment dealer selected by the buyer, the fairness opinion should be provided by another investment dealer who can provide an independent appraisal of the valuation.

Financial Assistance

Section 42 of the Canada Business Corporations Act (the "CBCA"), which is almost identical to section 20 of the OBCA, deals with some of the same matters which are found in section 129 of the Australian Companies Code. Section 42 of the CBCA provides as follows:

> "42.(1) Prohibited loans and guarantees. - Except as permitted under subsection (2), a corporation or any corporation with which it is affiliated shall not, directly or indirectly, give financial assistance by means of a loan, guarantee or otherwise
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> (a) to any shareholder, director, officer or employee of the corporation or of an affiliated corporation or to an associate of any such person for any purpose, or
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> (b) to any person for the purpose of or in connection with a purchase of a share issued or to be issued by the corporation or affiliated corporation,
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> where there are reasonable grounds for believing that
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> (c) the corporation is or, after giving the financial assistance, would be unable to pay its liabilities as they become due, or
>
> (d) the realizable value of the corporation's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, after giving the financial assistance, would be less than the aggregate of the corporation's liabilities and stated capital of all classes.
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> (2) Permitted loans and guarantees. - A corporation may give financial assistance by means of a loan, guarantee or otherwise

(a) to any person in the ordinary course of business if the lending of money is part of the ordinary business of the corporation;

(b) to any person on account of expenditures incurred or to be incurred on behalf of the corporation;

(c) to a holding body corporate if the corporation is a wholly-owned subsidiary of the holding body corporate;

(d) to a subsidiary body corporate of the corporation; and

(e) to employees of the corporation or any of its affiliates

(i) to enable or assist them to purchase or erect living accommodation for their own occupation, or

(ii) in accordance with a plan for the purchase of shares of the corporation or any of its affiliates to be held by a trustee.

(3) Enforceability. - A contract made by a corporation in contravention of this section may be enforced by the corporation or by a lender for value in good faith without notice of the contravention."

One of the leading cases in Canada on prohibited financial assistance by a corporation in connection with a purchase of its shares is Central & Eastern Trust Co. v. Irving Oil Ltd. (1980), 110 D.L.R. (3d) 257, involving a mortgage granted by a Nova Scotia company to a Canadian trust company, the proceeds of which were paid to the owners of the company's shares as part of the purchase price on the sale of the shares to third parties. The Supreme Court of Canada held the mortgage to be void because it violated a provision of the Nova Scotia Companies Act analogous to paragraph 42(1)(b) of the CBCA. The Court also reversed the Court of Appeal's ruling that the mortgage was enforceable to the extent that the moneys were applied by the vendor to extinguish the liabilities of the company stating (at p.262):

"What we are concerned with here is the validity of the mortgage transaction, and the use made by Mr. Brown of the purchase moneys paid for his shares appears to me to be an entirely separate issue. The stigma of illegality attaching to a security given by a company in connection with the purchase of its shares is not erased by the fact that a portion of its purchase price was employed by the vendor in reduction of the company's liabilities."

Since the purchase and sale of the company's shares was conditional upon securing the mortgage, the Court's ruling rendered the entire transaction void.

In Noren Investments Ltd. v. Brownie's Franchises Ltd. (1986), 33 D.L.R. (4th) 359, the British Columbia Court of Appeal recently dealt with the giving of financial assistance by a corporation to a third party in the acquisition of its shares through an arm's length transaction under legislation similar to section 42 of the CBCA. Fees generated under a royalty agreement were to be made payable by the corporation to the selling shareholder in an arrangement which was clearly providing that a portion of the value of the corporation's shares was to be satisfied by such fees. Although it was part of the overall transaction, the royalty agreement was not executed until after the corporation had been sold and had become a wholly-owned subsidiary of its new holding body corporate.

In interpreting provisions similar to section 42(1) and section 42(2)(c) above, the Court of Appeal affirmed the trial court's interpretation of section 42(2)(c) that financial assistance by a subsidiary which is wholly-owned at the time it gives assistance is permissible even if such assistance was contemplated as part of the transaction by which the shares of the wholly-owned subsidiary were purchased. Lambert J.A. stated the following (at p. 4):

> "During the closing on February 28, 1980, Brownie's became a wholly owned subsidiary of First Food Corporation, its holding company. It was a wholly owned subsidiary when the royalty agreement was executed and became a legal commitment, binding on Brownie's. It was a wholly owned subsidiary throughout the period when the financial assistance was given. The fact that it was not a wholly owned subsidiary when the purchase scheme was initially conceived cannot be relevant to the application of [the statutory exemption]."

In addition, the decision in Noren Investments would seem to suggest that it is simply the interests of the minority shareholders which are to be protected by the prohibition of financial assistance. The trial court commented (at p. 367):

> "... [the exemption] was enacted to eliminate barriers to financial assistance being given by a subsidiary or by a holding company where the interests of the shareholders of the subsidiary or the holding company were fully protected. Where the subsidiary is wholly-owned there are no minority shareholders whose interests are affected. Nor is there any evidence that creditors of Brownie's were prejudiced by Brownie's assisting First Food to purchase Brownie's shares."

It is likely that the trial court's reference to the absence of prejudice to creditors was made to emphasise its point, and that the exemption would have been allowed even if such prejudice had been present. The argument that the exemption under section 42(2)(c) was intended only to permit guarantees to be given by wholly-owned subsidiaries in support of loans made to their parents was rejected by the trial court.

Conflicts of Interest

If I may, I just might make one or two comments with respect to the issue of conflicts of interest which David Saunders raised before. Clearly conflict of interest is an issue in Canada as well. It may be broken down into two areas: one case where you do have a major shareholder of a public corporation and in a second case where you do not. Where you have a major shareholder then clearly from a buyout group's perspective you have to deal with that major shareholder since without him you cannot do a deal. If he is prepared to do a deal then you enter into the kind of lock up transactions that I have referred to and proceed with one of the forms of acquisition to get 100 percent of the target company's shares.

In Canada as well, if the controlling shareholder himself would like to buy out the minority and acquire 100 percent of the company, then that is what we refer to as an "insider bid". Under an insider bid, the controlling person is obligated before proceeding with the bid to provide to the minority an independent valuation of their shares on a 100 percent block basis, without minority discount, The controlling shareholder then proceeds with one of the methods I have previously referred to to obtain a "majority of the minority" in order to acquire the minority's stock. In addition, there are full disclosure obligations on the insider to place the public shareholders, in theory, in the same position as to information about the company as the controlling shareholder, including any internal appraisals of assets that he may have made during the last two years for his own purposes, as well as any valuations that may have been prepared by outsiders during the preceding two years.

What does management do in public companies where there is no controlling shareholder? One of the strategies being developed is to conduct a strategic study of the company in order to ascertain the methods of maximising shareholder values for all of the shareholders of the company. This is a defensible action by management because management clearly has a duty to act to maximise values for shareholders. This method will include a review and canvass of all options available to the public company including, among other things, restructurings of the company, partial divestitures, spin-outs of assets, large dividends and borrowings. It could include partial liquidation of the assets. It could include distributions by way of subordinate and floating rate notes, all of which are intended to increase value to the shareholders, to break up the common share that they hold which might, for example, trade at $20 into a series of other securities which in aggregate would trade at $30 or more and leave the shareholders with the same on-going equity interest in the company.

Obviously, in a strategic study which reviews methods of maximising shareholder values, one of the options is a management buyout. If a buyout by management can be shown to produce the highest value for the shareholders, then management can prepare a proposal to give to the directors for their approval. What usually happens at this stage is that a special and independent committee of the board of directors is set up, which deals with management on an arm's length basis, just as if management was a third party because effectively management is making that kind of a proposal. The independent committee will then retain independent financial advisors who will advise the directors with respect to the proposals. Management will have its own financial advisors and its own legal advisors. The company will then retain independent financial and legal advisors, and will negotiate and deal with the management buyout proposal on these terms.

Undoubtedly, in a management buyout the board and the independent directors will not proceed with nor recommend to the shareholders this kind of a transaction unless they receive a fairness opinion to the effect that the management proposal is "fair and reasonable" from a financial point of view to the shareholders of the company.

Often of course the risk here is that such management buyout proposals, once they are initiated and unless there is some formal lock up agreement involved, will become merely the commencement of an option for control for the company which, from the directors' point of view, is not all bad because that surely would lead to increased values for shareholders, which is part of their duties.

I hope this has been helpful for your experiences here. Thank you.