

There is a long-standing controversy over the question of whether controlling and minority shareholders should be treated equally in sales of control. Ontario securities law adopts a mandatory 'equal opportunity rule' that requires acquirers in most cases to extend a premium offer to purchase controlling shares to minority shareholders and controlling shareholders on equal terms. This article concludes that, having regard to theory, empirical evidence, and the specific rules in place, the most coherent explanation for Ontario's mandatory approach is that it assists target shareholders in extracting gains from acquirers of control. As a matter of theory, there is no need for a mandatory rule if the purpose of the rule is to deter inefficient sales of control to buyers interested in diverting value from the minority, but a mandatory rule makes sense if the purpose is to increase the purchase price of control blocks. The extraction hypothesis is consistent with existing empirical evidence, as well as with this article's event study based on the possible sale of control of Canadian Tire in the 1980s (the case that provided the impetus for the mandatory equal opportunity rule we observe today in Ontario). Finally, the particulars of the rule in place, such as the exemption for firms existing when the rule was imposed, are consistent with the extraction theory but not with other theories, especially a 'fairness' theory of equal treatment.

Key words: sales of control/Ontario securities law/Canadian Tire

I Introduction

One of the many questions surrounding the law and economics of transfers of corporate control is whether the gains resulting from the sale of a control block of stock should be shared among all shareholders or whether some shareholders should be allowed to realize an unequal share of the proceeds.¹ Various versions of the 'equal opportunity rule'

* Faculty of Law, University of Toronto.

† Thanks to Michael Trebilcock, George Triantis, Ralph Winter, Albert Yoon, and participants at the American Law and Economics Association Conference for helpful comments.

1 See, e.g., William D. Andrews, 'The Stockholders' Right to Equal Opportunity in the Sale of Shares' (1965) 78 Harv.L.Rev. 505 [Andrews, 'Stockholders' Right']; Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991) [Easterbrook & Fischel, *Economic Structure*]; Lucian Arye Bebchuk, 'Efficient and Inefficient Sales of Corporate Control' (1994) 109 Q.J. Econ. 957 [Bebchuk, 'Sales of Control']; Einer R. Elhauge, 'The Triggering Function of Sale of Control Doctrine' (1992) 59 U.Chi.L.Rev. 1465

(EOR) are imaginable, and various versions exist. Roughly, the EOR requires the gains to the acquiree from a sale of control (the control premium) to be shared among all shareholders equally, or, at least, on a *pro rata* basis.

Ontario, the jurisdiction that is the focus of this article, has adopted a mandatory version of the EOR that requires equal treatment not only within a class of shares but also across classes of shares. This article seeks to understand and explain Ontario's approach as a contribution to the broader debate on the equal opportunity rule. Part II below reviews the existing law and economics literature on equal opportunity in private sales of control transactions, as well as the rule under Ontario securities law. Part III turns to explaining why the mandatory rule exists in Ontario. As I explain, the most coherent explanation of the mandatory EOR in Ontario is that target firms benefit from the EOR to the extent that the rule extracts greater total consideration for the control block than in the absence of the EOR. Part IV analyses existing empirical evidence on the EOR and dual classes in Ontario, as well as an empirical case study of the controversial attempted sale, in 1986–1987, of a control block in Canadian Tire. The evidence is consistent with the hypothesis that the EOR serves as a rent-extraction device. Part V summarizes and concludes.

II *The law and economics of the equal opportunity rule*

A THE ECONOMICS

In a pioneering article, William Andrews suggests that when a controlling shareholder sells a control block, non-controlling shareholders should have a right to share in the proceeds:

The rule to be considered can be stated thus: whenever a controlling stockholder sells his shares, every other holder of shares (of the same class) is entitled to have

[Elhauge, 'Triggering Function']. For other questions on the corporate law of control changes, specifically concerning whether corporate managers should be passive in the face of a hostile takeover bid, see Easterbrook & Fischel, *ibid.*; Henry G. Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *J.Pol.Econ.* 110; Lucian Arye Bebchuk, 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' (1985) 98 *Harv.L.Rev.* 1695; Lucian Arye Bebchuk, 'The Sole Owner Standard for Takeover Policy' (1988) 17 *J.Leg.Stud.* 197; Ronald J. Gilson, 'A Structural Approach to Corporations: The Case against Defensive Tactics in Tender Offers' (1981) 33 *Stan.L.Rev.* 819; Ronald J. Gilson, 'Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense' (1982) 35 *Stan.L.Rev.* 51; Sanford J. Grossman & Oliver D. Hart, 'Takeover Bids, The Free Rider Problem and the Theory of the Corporation' (1980) 11 *Bell J.Econ.* 42; Alan Schwartz, 'Search Theory and the Tender Offer Auction' (1986) 2 *J.L.Econ. & Org.* 229; Lucian Arye Bebchuk, 'Why Firms Adopt Antitakeover Arrangements' (2003) 152 *U.Pa.L.Rev.* 713; Jennifer Arlen & Eric Talley, 'Unregulable Defenses and the Perils of Shareholder Choice' (2003) 152 *U.Pa.L.Rev.* 557.

an equal opportunity to sell his shares, or a pro rata part of them, on substantially the same terms. Or in terms of the correlative duty: before a controlling stockholder may sell his shares to an outsider he must assure his fellow stockholders an equal opportunity to sell their shares, or as high a proportion of theirs as he ultimately sells of his own.²

While Andrews describes corporate case law as supporting his position,³ his analysis is also normative. He makes two types of arguments: fairness and economic arguments. The fairness arguments are grounded on 'the equality of profit opportunity among shareholders on which the corporate relation is predicated.'⁴ It is not clear, however, why shareholders would place significant weight on equality over other concerns, particularly wealth creation.⁵ For example, if shareholders were asked to choose between an unequal distribution of wealth that made each of them better off financially and an equal distribution of very little profit, there is little reason to suppose that they would choose the equal distribution.⁶ In addition, a rule that allows an unequal distribution that disadvantages a diversified shareholder in one setting may be one that advantages her in a different context.⁷ Shareholders may accept occasional losses to realize greater gains in other contexts.

Andrews' economic justification for the EOR is that the rule helps deter sales of control to 'looters,' that is, controllers who seek to gain privately at the expense of the corporation and minority shareholders. Suppose there is an offer for 50 per cent of the shares held by a particular shareholder at a considerable premium. Under the *pro rata* version of the EOR that Andrews advocates, if shareholders all tender into the offer, the controlling shareholder will continue to hold 25 per cent of the shares (50 per cent of the original holding of 50 per cent). If selling to a looter lowers the value of the equity, the seller will bear a significant portion of the costs. The EOR thus helps deter sales to looters.

Andrews' analysis fails to address the fundamental problem with the EOR: it deters some value-maximizing sales of control.⁸ It is probable that those in control of a corporation get some private benefits resulting

2 Andrews, 'Stockholders' Right,' supra note 1 at 517.

3 In particular, his argument relies on *Perlman v. Feldmann*, 129 F. Supp. 162 (D. Conn. 1952), rev'd on other grounds, 219 F. 2d 173 (2d Cir. 1955). As noted by Elhauge, 'Triggering Function,' supra note 1, *Perlman* is an exception to the norm.

4 Andrews, 'Stockholders' Right,' supra note 1 at 545.

5 Easterbrook & Fischel, *Economic Structure*, supra note 1.

6 *Ibid.*

7 *Ibid.*

8 See *ibid.*; Bebchuk, 'Sales of Control,' supra note 1.

from that control.⁹ That is, they enjoy benefits that they do not share with minority shareholders.¹⁰ In order to persuade the controller to sell its shares, it will be necessary to compensate it for any lost control benefits. If the purchaser of control cannot extend an offer to the controller alone but, rather, must make the same offer to all shareholders, there may be little opportunity for private gain to the purchaser, even if the acquisition would increase the total value produced by the corporation. For example, suppose that under Controller A, who owns fifty of the 100 outstanding shares, the total value of the corporation is \$110: \$10 in private control benefits, plus \$1 per share. Controller B would increase the value of the corporation to \$120: \$5 in private control benefits, plus \$1.15 per share. In the absence of the EOR (call it the Market Rule, or MR, following Bebchuk¹¹), if Controller B could make a take-it-or-leave-it offer, the price would be \$60.01 to Controller A for fifty shares. This would give B a profit of \$2.49 ($= \$62.50 - \60.01). The EOR, however, would prevent the transaction. Under the *pro rata* rule Andrews suggests, B would have to offer \$1.26 per share (this leaves A, who would sell twenty-five shares, with a value of $\$60.25 = (\$1.26 \times 25) + (\$1.15 \times 25)$). B would lose money at this price, with negative net profits of $-\$0.50 (= \$62.50 - \$63)$.

Thus, there is a trade-off: the EOR deters both inefficient and efficient sales of control. Key for the following analysis is that there is no reason to suppose that private incentives to adopt the EOR will align with the social good.¹² Outside buyers capture less value under the EOR than under the MR. First, more purchases are deterred by the EOR than by the MR, since under the EOR some transactions will not take place because of the purchaser's inability to compensate the seller for lost private benefits of control.¹³ Second, when purchases take place, the outsider will capture less value than under the MR. This is because the buyer must set a price per share that is high enough to compensate the seller

9 See, e.g., Milton Harris & Artur Raviv, 'Corporate Governance: Voting Rights and Majority Rules' 20 J.Fin.Econ. 203 [Harris & Raviv, 'Corporate Governance']. For recent empirical evidence confirming the presence of sometimes very large (sometimes well over 50 per cent of the public value of the corporation) private benefits of control in different countries around the world, see Alexander Dyck & Luigi Zingales, 'Private Benefits of Control: An International Comparison' (2004) 59 J.Fin. 537 [Dyck & Zingales, 'Private Benefits']; Tatiana Nenova, 'The Value of Corporate Votes and Private Benefits: A Cross-Country Analysis' (2003) 68 J.Fin.Econ. 325 [Nenova, 'Corporate Votes'].

10 These benefits come in a variety of forms, such as pecuniary gains from information learned *qua* controller that may help the controller in other businesses and excessive executive compensation or self-dealing, as well as non-pecuniary benefits from, for example, pride.

11 Bebchuk, 'Sales of Control,' *supra* note 1.

12 *Ibid.*

13 *Ibid.*

for lost control benefits but is also available to minority shareholders. Consequently, minority shareholders capture greater gains when there is a transaction under the EOR. Private parties may adopt the EOR in an effort to capture more value from a future buyer, even if it has the efficiency-reducing side effect of deterring some efficient transactions.¹⁴

B ONTARIO'S EQUAL OPPORTUNITY RULE

The Ontario Securities Act (OSA) includes a version of the EOR. According to s. 89 of the act, any purchase of shares that would result in the purchaser's having over 20 per cent of a class of shares is a 'takeover bid,' and various requirements, including equal treatment, arise. However, there are exceptions to the 'takeover bid' definition.¹⁵ The most relevant exception arises where the offer to acquire is made to five persons or fewer *and* is not at a significant premium: if the price for the control block is at 115 per cent of the market price or less, there is no 'takeover bid.'¹⁶ I will return to this exemption below; in the mean time, I set it aside and treat the EOR as requiring precisely equal treatment, rather than the roughly equal treatment Ontario's rule actually sets out.

Under s. 97(1) of the OSA the terms of the takeover bid must be offered to all members of the class. Under s. 97.2(1), all members of the class may tender, and if more shares are tendered than are desired by the acquirer, the acquirer may purchase shares only on a *pro rata* basis. Thus, if

14 This analysis has a strong parallel in Aghion and Bolton's analysis of liquidated damages: Philippe Aghion & Patrick Bolton, 'Contracts as Barriers to Entry' (1987) 77 *Am.Econ.Rev.* 388 (a party considering breaching a contract must receive an attractive alternative contract offer in order to profit from the breach, given the existence of significant liquidated damages; this implies that the breaching and non-breaching parties to the original contract can benefit to the detriment of the new party). Similarly, Albert Choi describes the rent-extraction properties of golden parachutes, which can cause the acquirer to pay a higher price in order to compensate executives and thus leave the target with a greater share of the surplus from a takeover: Albert Choi, 'Golden Parachute as a Compensation Shifting Mechanism' (2004) 20 *J.L.Econ. & Org.* 170. Both these rent-extraction devices are vulnerable, however, to renegotiation of the initial contract. I take renegotiation seriously in the analysis below, relying on it to help explain the mandatory nature of the EOR in Ontario. The closest analogue to the use of the EOR as a rent-extraction device comes from the work of Bebchuk and Zingales, who show how selling some minority shares can help a controlling shareholder extract rents from a future acquirer even under the MR, since minority shareholders are not a part of the negotiation over the change in control: Lucien Arye Bebchuk & Luigi Zingales, 'Ownership Structures and the Decision to Go Public: Private versus Social Optimality' in Randall K. Morck, ed., *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000) 55. See also Luigi Zingales, 'Insider Ownership and the Decision to Go Public' (1995) 62 *Rev.Econ.Stud.* 425 [Zingales, 'Insider Ownership'].

15 *Ontario Securities Act*, R.S.O. 1990, c. S.5, s. 100.1.

16 O.S.A., s. 100.1(1).

100 percent of the shares are tendered into a bid for 50 per cent of the shares, then 50 per cent of each shareholder's shares will be taken up. There are also rules integrating pre-bid and post-bid acquisitions into the takeover bid. Under s. 93.2(1), any acquisition by the offerer made ninety days in advance of the bid must be at the same or lower consideration on a per-share basis than that offered in the bid; the same applies to acquisitions made twenty days after the expiry of the bid pursuant to s. 93.3(1). Finally, under s. 97.1 there is a general anti-avoidance provision holding that no collateral benefit that in substance increases the consideration to a particular offeree shareholder is permissible.

The OSA creates an EOR within a class of shares, but this leaves scope for significant inequality across share classes. That is, the rule extends only to offers within a class, and thus it permits firms to contract around the EOR, despite the mandatory language in the OSA, simply by forming more than one class. In Ontario, dual (or more) class share structures are common. Amaoko-Adu *et al.* report that as of December 1987, over 15 per cent of the corporations on the Toronto Stock Exchange (TSX) listed at least one class of restricted shares.¹⁷ This remained true of large corporations on the TSX in the late 1990s.¹⁸ The statutory existence of the EOR could help explain the historical reliance on this type of arrangement: some firms prefer the MR and must use multiple classes of shares to contract around the statutory EOR. How voting rights are allocated across classes is a separate question (there may be reasons for and against variable voting rights¹⁹), but the existence of separate classes may have resulted from the statutory EOR.

The issue in more recent times is complicated by legal and regulatory developments relating to 'coattail provisions,' which are adopted in the articles of incorporation and establish the EOR across classes. A coattail may, for example, provide that in the event of a successful takeover bid

17 Ben Amaoko-Adu, Brian Smith, & Jacques Schnabel, 'The Risk of Dual Classes of Shares: Are There Differences?' (1990) 42 *J.Econ. & Bus.* 39 at 39.

18 See J. McFarland, 'Ownership of Firms Broadening, Report Says' *The Globe and Mail* (23 October 1997) B15 (report issued by Fairvest Securities Corp. in 1997 found that 17.5 per cent of firms on the TSE 300 index had dual-class stock). Ben Amaoko-Adu & Brian Smith, 'Dual Class Firms: Capitalization, Ownership Structure and Recapitalization Back into Single Class' (2001) 25 *J.Banking & Fin.* 1083, report that there was a decline in the number of dual-class firms during the 1990s, with the percentage of dual-class firms out of all TSE firms falling from a high of 16.7 per cent at the end of 1979 to a low of 10.2 per cent at the end of 1998.

19 See Harris & Raviv, 'Corporate Governance,' *supra* note 9; Daniel Fischel, 'Organized Exchanges and the Regulation of Dual Class Stock' (1987) 54 *U.Chi.L.Rev.* 119; Ronald J. Gilson, 'Evaluating Dual Class Common Stock: The Relevance of Substitutes' (1987) 73 *Va.L.Rev.* 807 [Gilson, 'Relevance of Substitutes']; Jeffrey N. Gordon, 'Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 *Calif.L.Rev.* 3 [Gordon, 'Ties That Bond'].

that offers different compensation to different classes of shares, the non-voting or otherwise subordinate shares have conversion rights into voting shares. It may also provide that the subordinate voting shares are enfranchised, rather than converted, in order to discourage differential offers in a takeover bid.

The current rules on coattails resulted in large part from the *Canadian Tire* case.²⁰ In that case, Canadian Tire had adopted a coattail provision that provided that in the event of an acquirer's purchasing 50 per cent or more of the voting shares of Canadian Tire without extending the offer to non-voting shares, the non-voting shares were enfranchised. To mix metaphors, this was clearly a leaky coattail, and the controlling shareholder took advantage of this. Three members of the Billes family, who owned 61 per cent of the voting shares collectively, agreed to sell 49 per cent of their shares at a price of \$160.24 to a shareholder that already owned 17 per cent of the voting shares. Prior to the bid's emergence, the voting shares had been trading at around \$40.00. There were 3.45 million voting shares and about 82 million non-voting shares, but no offer was made for the non-voting shares. While the offer did not technically trigger the coattail, the Ontario Securities Commission (osc) held that the offer was 'grossly abusive' of the non-voting shareholders and of the spirit of the coattail. It invoked its public-interest powers under what is now s. 127 of the osa to quash the takeover offer.

It would be difficult to characterize the transaction as abusive of non-voting shareholders if they did not reasonably expect to be included in a takeover bid. The coattail was leaky on its face. Moreover, the non-voting shares traded at a considerable discount to the publicly traded voting shares: in June 1986, before the bid arose, the public float of the voting shares, which constituted about 9.5 per cent of the voting shares, traded at around \$24, while the non-voting shares traded at around \$15. In October, when two Billes family members made public an intention to sell their shares, which together were 40.6 per cent of the voting shares, the price gap between the share classes increased, with the voting shares trading above \$40 while the non-voting shares continued to trade around \$15. The initial existence of a divergence in price, as well as an increase in the gap when the intention to sell was announced, must have reflected the market's expectation that any premium from a takeover would be shared among the voting shareholders but not among the non-voting shareholders. The value of a vote itself, outside an obvious control block, is close to zero.²¹ There is

20 *CTC Dealer Holdings v. Canadian Tire Corp. Ltd.*, (1987) 10 O.S.C.B. 857, aff'd (1987) 21 O.A.C. 216 (Ont. Div. Ct.).

21 Easterbrook & Fischel, *Economic Structure*, supra note 1; Harris & Raviv, 'Corporate Governance,' supra note 9; Sanford J. Grossman & Oliver D. Hart, 'One Share—One

no private control benefit associated with the outsiders' votes, since they are not in control, nor are the votes useful (pivotal) in seeking to obtain control, since any change of control depends entirely on the consent of the controlling shareholder. The reason the voting shares outside the control block in the *Canadian Tire* case would have had value above the non-voting shares is that the market anticipated that any take-over premium would accrue, in part, to voting shares, because of the intra-class EOR, and not to the non-voting shares.

It is a fair inference, therefore, that the market appreciated that the coattail provided little value to non-voting shares. To describe the proposed transaction as 'grossly abusive' of the minority and the market is questionable, given that the market *expected* control to change hands without triggering the coattail. The market's naïveté was manifest not in its reliance on a leaky coattail but, rather, in its failure to anticipate the osc's intervention.

The *Canadian Tire* case set off a policy discussion about what ought to be done to protect minority shareholders in different classes in the event of a change of control.²² The outcome was that the osc did not formally adopt any new rules, but Canadian stock exchanges did.

The Toronto Stock Exchange, in conjunction with the Montreal, Vancouver, and Alberta Stock Exchanges, changed rules in 1987 to require coattail provisions wherever there is a takeover bid pursuant to applicable securities regulation that involves 'restricted shares.'²³ Restricted shares include subordinate voting shares, non-voting shares, multiple voting shares, and shares that have some other limitation on their right to vote (such as a limit on the number of shares that any individual shareholder may vote). In particular, under TSX rules the coattail provision must provide that where there is a takeover, as defined by relevant securities legislation, where over 50 per cent of common shares have been deposited into a bid (but not necessarily taken up), and where the consideration offered to common and restricted shares differs, the restricted shares have a right of conversion.²⁴ The TSX allows for some variation in this rule in the cases where rights other than voting rights differ across share classes.²⁵

Vote and the Market for Corporate Control' (1988) 20 J.Fin.Econ. 175; Luigi Zingales, 'What Determines the Value of Corporate Votes?' (1995) 110 Q.J.Econ. 1047.

22 See Jacob S. Ziegel *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations*, 3d ed. (Toronto: Carswell, 1994) at 964–6.

23 See 'Policy of the Toronto Stock Exchange on Takeover Protection for Holders of Restricted Shares,' 30 July 1987.

24 *Toronto Stock Exchange Company Manual* (May 2005), s. 624(1) [*TSX Manual*].

25 *Ibid.*

The TSX rule also includes a general anti-avoidance provision that states,

The criteria are designed to ensure that the fact that Common Securities are not of the same class as Restricted Securities will not prevent the holders of Restricted Securities from participating in a take-over bid on an equal footing with the holders of Common Securities. If, in the face of these coattails, a takeover bid is structured in such a way as to defeat this objective, TSX may take disciplinary measures against any person or company or listed issuer under the jurisdiction of TSX who is involved, directly or indirectly, in the making of the bid. TSX may also seek intervention from regulators in appropriate cases.²⁶

The attitude of the OSC and of the courts in the *Canadian Tire* case would also inform any actions by a firm contemplating contracting around the EOR. Given the description of a bid designed to avoid the coattail in that case as 'grossly abusive,' it seems probable that the TSX and the OSC will approach as improper any case in which control could change with a class of shareholders not able to participate in the transaction, at least for firms incorporated after 1 August 1987, when the rule took effect.²⁷ As a consequence, for all practical purposes, there is a mandatory EOR under securities law for public firms in Ontario that extends even across share classes.

III *Explaining the equal opportunity rule*

Not only is the EOR the rule in Ontario, it is the mandatory rule. This presents a puzzle. There is an inefficient bias to adopt the EOR because of rent-extraction motives.²⁸ If a mandatory rule were to exist, then, the natural one to expect would be a mandatory MR. Given that there are already inefficiently high incentives to adopt the EOR, why has Ontario made the rule mandatory? Apart from the possibility that it was simply a value-destroying mistake, a hypothesis I discuss below when considering empirical evidence, there are two other kinds of explanation.

A FAIRNESS

One explanation is simply to accept what the Commission in *Canadian Tire* suggested to be the rationale for the mandatory EOR: fairness. It is

²⁶ Ibid.

²⁷ Indeed, the OSC disallowed another transaction that violated what it took to be the spirit of the EOR in *Re H.E.R.O. Industries Ltd.* (1990), 13 O.S.C.B. 3775 (disallowing attempt to purchase block of shares by one buyer through private agreement exemption (115 per cent price premium exemption mentioned above), given that market price at the time had been inflated by a public takeover offer to minority shareholders by a different bidder).

²⁸ Bebchuk, 'Sales of Control,' supra note 1.

simply unfair for the controlling shareholder to reap individually the gains from a sale of control. Aside from the dubious merits of the fairness point in its own right, as discussed above, it does not serve as a convincing explanation of the rule that we see in place. In particular, the uneven application of the coattail aspect of the rule as implemented is inconsistent with the primacy of fairness. The TSX's coattail provision applies only to firms that listed subordinate shares on the TSX *after* the provision came into force in August 1987. If fairness requires coattail protection, why would the rule apply only to share classes listed after 1987? On the other hand, if the rule were about strategically committing the firm to the EOR, as I discuss in detail shortly, it would be consistent to apply it only to firms listing after 1987.²⁹

B COMMITMENT

Another possible explanation of the coattail rules is that the mandatory nature of the EOR rule serves as a commitment device.³⁰ The only context in which the controlling shareholder would prefer the EOR to the MR is at the time of the sale of minority shares to the public. That is, it is the *anticipation* of deterred inefficient sales or future rents that is important to the decision to adopt the EOR initially. The EOR does not *in its operation* benefit the controlling shareholder; indeed, it harms the controlling shareholder in two ways. First, it deters inefficient sales of control that, while value-reducing overall, could nevertheless benefit the controller. Selling to a looter may be profitable (and if it is not, the incumbent simply will not sell). Second, while the EOR may extract additional rents from acquirers, some of these additional rents are shared with minority shareholders. It is better for the controlling shareholder, after the sale of shares to the public, to have the MR in place; this will maximize the joint surplus available to acquirer and incumbent at the time of the future acquisition.

There is an asymmetry, then, in the choice of EOR versus MR at the time of the IPO and after. At the IPO, the controlling shareholder may choose either rule, but after the IPO the MR will always be preferred (assuming that future share sales are relatively unimportant). There is a potential path dependence: the MR in a charter is unlikely to change at a firm with a controlling shareholder, even if it is efficient to change, while

29 As I discuss in more detail below, suppose that the commitment exists to bring benefits to the controlling shareholders in initially selling minority shares. Only for new listings would the controlling shareholder realize the benefits of the coattail, since controlling shareholders at older firms have already sold minority shares to the public.

30 For an analogous argument about the merits of restricting dual-class stock, see Gordon, 'Ties That Bond,' *supra* note 19.

there will be impetus to change the EOR in a charter even if change is inefficient.³¹

This analysis leads to the following possibility: the mandatory EOR in Ontario could be in place as a commitment device that prevents the controlling shareholder from opportunistically switching from the EOR to the MR after the IPO (or after significant share sales are no longer anticipated). If such opportunism were possible, the initial gains to the controlling shareholder from adopting the EOR would be lost, since minority shareholders will anticipate future opportunism. Having a mandatory rule in place, on the other hand, allows minority shareholders to rely on the rule.

It is helpful to consider two possibilities in turn, since the welfare implications of each are different. First, the mandatory EOR could be in place to deter opportunistic switching to the MR that allows inefficient sales of control to take place. Second, the mandatory EOR could exist to commit to extracting rents from acquirers.

C EFFICIENT COMMITMENT: PREVENTING INEFFICIENT SALES OF CONTROL

To analyse the question of whether the controlling shareholder is likely to be able to induce an opportunistic switch to the MR to allow an inefficient sale of control, suppose that the mandatory coattail requirement jointly created by the OSC in its case law and the TSX did not exist and that the EOR within a class of shares were optional. A corporation with only one class of equity could switch from the EOR to the MR by voting to abandon the EOR within the class or by recapitalizing. In particular, creating two classes of shares and having the minority shareholders switch classes could accomplish this transition. This is what occurred in the *Canadian Tire* case, which arose before the mandatory EOR across classes.

There are two important obstacles, each likely sufficient to prevent it, to a transition to the MR from the EOR in order to allow an inefficient sale of control. First, there are strict rules in Canadian corporate statutes about amending the articles of incorporation in a manner that affects the rights of shareholders. In the Ontario Business Corporations Act, for example, s. 170(1) allows the corporation to change the rights of issued shares as set out in the articles of incorporation but requires the amendment to pass by a 'special resolution' (a two-thirds majority) of

31 Ronald J. Daniels & Edward M. Iacobucci, 'Some of the Causes and Consequences of Concentrated Corporate Ownership in Canada,' in Randall K. Morck, ed., *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000) 81, discuss the path dependence of ownership structure: because of free-rider problems, moving from an inefficiently concentrated structure to a more widely held structure may not be possible. They also discuss the role of the EOR in hindering such a change of structure. For a fuller discussion of path dependence and corporate law, see Lucian Arye Bebchuk & Mark J. Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' (1999) 52 *Stan.L.Rev.* 775.

each affected class.³² Likewise, s. 170(1) allows a corporation to amend its articles to create a new class of shares but requires approval by special resolution. Moreover, under s. 170(1), each existing class of shares is entitled to vote and must approve by special resolution the creation of an equal or superior class of shares. Finally, s. 185 allows shareholders the right to dissent from any such amendments and to have their shares purchased for 'fair value,' as measured by the shares' pre-amendment value.

Further voting requirements are found in securities law. Both the OSC³³ and the TSX³⁴ require a majority of minority shareholders to approve any capital reorganization involving the creation of a class of restricted shares. Any move to recapitalize to permit inefficient sales of control would meet opposition from minority shareholders.

A charter amendment to abandon the EOR within a class or across existing classes in order to allow an inefficient sale of control is unlikely to pass on its own. And any attempt at 'bribing' the minority shareholders to accept the amendment, perhaps through the promise of a 'sweetener' special dividend to minority shareholders, would bring greater costs than benefits to the controlling shareholder. By assumption, the gains to the controlling shareholder from switching to the MR arise because the switch allows an inefficient, value-reducing sale of control. By definition, then, the controlling shareholder cannot compensate the minority such that both the controlling shareholder and the minority are better off.

Taking now the intra-class EOR within the OSA as given but continuing to assume the non-existence of the inter-class EOR, even supposing *arguendo* that a reorganization that would give rise to an additional class of non-voting shares, and hence the MR, is successfully proposed, such a reorganization would not result in the MR. For the MR to arise, that is, for minority shareholders to be excluded from sharing in a control premium, minority shareholders would have to switch from holding voting shares to holding non-voting shares.³⁵ There are two main methods for reorganizing into two share classes and thus changing from the EOR to the MR: either all shareholders can be given an option of converting their common shares into newly created non-voting shares, or all shareholders can receive a dividend of non-voting shares.³⁶

In the context of a widely held corporation, there is a free-rider problem after a recapitalization has been approved.³⁷ Consider a case

32 R.S.O. 1990, c. B.16.

33 OSC Rule 56-501, pt. 3.

34 *TSX Manual*, supra note 24, s. 624(n).

35 It is legally possible to reorganize into two classes of shares with equal votes. For clarity, however, I will refer to the different classes as 'voting' and 'non-voting.'

36 See Gilson, 'Relevance of Substitutes,' supra note 19.

in which shareholders have an option to exchange voting for non-voting shares. Management may offer some financial inducement for shareholders to exchange their voting shares for non-voting shares. Collectively, the (non-management) shareholders may be better off refusing to exchange their shares, since this allows the disciplinary effect of hostile takeovers to continue to exist, but it may be privately profitable for each individual shareholder to trade its shares to get the benefit of the inducement. If no other shareholders switch, the shareholder gets the benefit of the inducement without entrenchment; if all other shareholders switch, management is entrenched, so the individual may as well take the inducement.³⁸ Consequently, a mandatory ban on dual-class share structures may be efficient.

A controlling shareholder after a reorganization cannot take advantage of a similar free-rider problem among shareholders to create the MR and allow an inefficient sale of control. In the widely held context, the only benefit of not switching shares is to keep control contestable; since contestability is a public good, shareholders switch.³⁹ In the context of a controlling shareholder, control is not contestable, but switching classes can have an effect on the minority's returns from a sale of control. A minority shareholder will switch only where the inducement to switch exceeds the expected value of sharing in a takeover premium.

Continuing to assume that the EOR exists only to deter value-reducing transactions, the controlling shareholder will not find it profitable *ex ante* to induce switching. This is because the benefits of not switching, sharing in the proceeds from a change of control transaction, are identical for controlling and minority shareholders alike because of the intra-class EOR. In order to induce a minority shareholder to switch into the non-voting class, the controlling shareholder must promise a sweetener that, in expected terms, exceeds the benefits of staying in the voting class. This, in turn, implies that the controlling shareholder must promise to pay more to those who switch than it would expect to receive in an inefficient change of control transaction. This is a money-losing proposition for the controlling shareholder.

For these reasons, Ontario's mandatory EOR is not necessary to commit to deterrence of inefficient transactions – once the MR is in place, controlling shareholders cannot profitably induce a change to it in order to make a value-decreasing sale.

37 Gordon, 'Ties That Bond,' *supra* note 19. See also Richard S. Ruback, 'Coercive Dual-Class Exchange Offers' (1988) 20 J.Fin.Econ. 153.

38 The probability that the individual shareholder's decision is pivotal to whether control is contestable is very small for most shareholders in most widely held corporations.

39 *Ibid.*

D PRIVATELY OPTIMAL COMMITMENT: EXTRACTING SURPLUS FROM ACQUIRERS

The EOR may also be adopted in order to extract greater surplus from future acquirers where such acquisitions are efficient. Once again, however, even if choosing the EOR is optimal at the IPO stage, after the IPO there will be an incentive for the controlling shareholder to opt for the MR rather than the EOR, since a larger share of the surplus is available to the controlling shareholder if the MR is in place.

Here, in contrast to the context of inefficient acquisitions, shareholders would have an incentive to abandon the EOR in the face of a potential efficient transaction that the EOR would otherwise deter. Suppose that a buyer of control that will increase value makes a take-it-or-leave-it offer to purchase a control block at a price that would not induce the controlling shareholder to sell, given the existence of the EOR. Suppose, for example, that there are 100 shares with a value of \$1 each and that the controlling shareholder, who owns fifty shares, realizes private benefits of \$12. Suppose that the prospective purchaser would realize private benefits of control of \$10 and generate public value of \$1.10 per share. The purchaser would increase the firm's total value from \$112 to \$120. The most the prospective purchaser would pay for the control block is \$65, which is more than the value of the block to the controlling shareholder (\$62). The EOR, however, implies that the controlling shareholder would not sell, since a price of \$65 for fifty shares would net it only \$60.⁴⁰ The EOR here prevents a Pareto-efficient transaction. But if the prospective purchaser made an offer of \$65 for the voting shares conditional on the EOR's being abandoned, the minority shareholders would vote to repeal the coattail requirement: \$1.10 per share of public value is better than \$1.00.⁴¹

It is a small step from this analysis to see that a mandatory intra-class EOR in a firm with only one class of equity, or a combination of a mandatory intra-class EOR and a mandatory coattail in a firm with two classes of equity, could help commit the corporation to extracting rents from acquirers. Suppose that an acquirer in the above example gets private benefits of control of \$20. It would be willing to acquire the firm even with the EOR: assuming all shareholders tender, the controlling shareholder would demand a minimum price of \$1.38 per share (or \$69 for fifty shares), which is less than the acquirer's maximum price of \$1.50

40 \$60 comprises $\$1.30 \times 25$ for the shares that it sells, plus $\$1.10 \times 25$ for the shares it is unable to sell because of the EOR.

41 Collective action problems, other than familiar rational apathy concerns, are less of a concern in a voting context than in a decision-to-tender context. See Lucian Arye Bebchuk, 'Toward Undistorted Choice and Equal Treatment in Corporate Takeovers' (1985) 98 Harv.L.Rev. 1695 (discussing the advantages of voting in overcoming collective action problems among shareholders facing takeover bids).

per share for fifty shares, or \$75 total. But suppose that the acquirer made a credible take-it-or-leave-it offer of \$62.01 for the controller's fifty shares conditional on the abandonment of the EOR. The minority shareholders should vote in favour in order to realize the higher public value of the firm under the acquirer.

Thus the EOR may not credibly commit the firm to extract rents from acquirers, given the possibility of voting to abandon it. If the acquirer or controlling shareholder can threaten not to undertake a transaction unless the EOR is dropped, minority shareholders may decide to abolish it. To put it another way, the idea behind the rent-extraction explanation of the EOR is that it commits the controlling shareholder, in bargaining with the acquirer, to divert surplus to a third party, the minority shareholders, through the EOR.⁴² This then affects the bargaining between acquirer and incumbent. The possibility of renegotiating the EOR undermines the commitment. *Ex ante*, of course, the controlling shareholder will not want to be able to renegotiate, since doing so will prevent it from capitalizing future rent extraction when selling minority shares. This is what a mandatory coattail, or a mandatory EOR within a class, accomplishes: it makes renegotiation impossible and thus commits the firm to extracting rents from acquirers.

This understanding of the rule is consistent with Ontario's self-interest. The rent-extraction explanation of the mandatory EOR suggests efficiency losses from the rule, since some efficient sales of control may be deterred (a result the target shareholders accept in exchange for the private gains from higher acquisition prices in the transactions that do take place). However, the rule applies to targets in which Ontario shareholders hold a significant stake. Since many acquirers of control blocks will be out-of-province (indeed, out-of-country), Ontario's adoption of the mandatory approach could be optimal for it, even if sub-optimal globally.

The specifics of the rule in Ontario are also consistent with the rent-extraction explanation. To reiterate and expand on a point briefly raised earlier, the 'grandfathering' approach to implementation of the mandatory coattail provision by the TSX is consistent with rent extraction. Only firms that listed after the rule was adopted in 1987 were required to have a coattail provision. If, for example, fairness required coattails, the rule should have applied to all firms. Fairness cannot coherently explain the rule as adopted.

On the other hand, if the rule were about rent extraction, such that dual-class firms could commit to an inter-class EOR in a way that a

42 See Schelling's famous discussion of how bargaining can be affected by pre-commitment: Thomas C. Schelling, *The Strategy of Conflict* (Cambridge, MA: Harvard University Press, 1960).

charter-based coattail would not have committed the firm, it might have been understandable to grandfather existing listed firms. If the rule arose in response to the political influence wielded by controlling shareholders, the grandfathering clause makes sense.⁴³ Controlling shareholders benefit from the commitment of the EOR at the time of selling shares to the public, but not afterward, as discussed. Thus, grandfathering already-listed firms does not harm existing controlling shareholders but does help new controlling shareholders commit to extracting rents from future acquirers and thus attract higher returns from a sale of equity to minority shareholders.

If the rule were strictly about maximizing Ontario welfare through rent extraction, then it might or might not have been appropriate to grandfather. Imposing the provision on already-existing firms would have transferred wealth from controlling shareholders to the minority, but if most shareholders were from Ontario, this would be a relatively neutral transfer from a social perspective. The greater expected acquisition price because of the EOR, on the other hand, would come at least partially from foreign acquirers and thus would be a benefit to Ontario. If, on the other hand, the transfer from the controlling shareholder to the minority were harmful to Ontario because of significant foreign ownership of the minority shares, the grandfathering approach could have had a (parochial) social-welfare explanation.

In summary, the grandfather clause eliminates fairness as a coherent explanation of the coattail; on the other hand, grandfathering is consistent with the rent-extraction hypothesis.

Another specific element of the Ontario rule that is consistent with the rent-extraction explanation of the EOR is the exemption from takeover regulation in the OSA of private purchases of control from five or fewer sellers at a price not exceeding 115 per cent of the market price for minority shares.⁴⁴ While I have discussed the EOR as though it required pure equality of treatment between shareholders, the 115-per-cent exemption deviates from this approach to some extent.

The exception for such purchases is consistent with rent extraction and inconsistent with fairness. Fairness can be dealt with briefly: if fairness requires equal treatment, it is difficult to say why a 15-per-cent

43 An explanation of adoption of the mandatory EOR as a value-reducing mistake is that it was not a mistake at all but, rather, a transfer to minority shareholders by effective minority shareholder lobbyists. There are two problems with this explanation. First, minority shareholders are dispersed and hence, predictably, less influential politically than controlling shareholders. Second, such a theory cannot explain the rule adopted, since the grandfathering approach prevents a transfer to minority shareholders. For newly incorporated firms, any benefit from the EOR for the minority must be paid for up front by the minority.

44 OSA, *supra* note 15 at s. 100.1(1).

premium is permissible. It is unsatisfactory to suggest that allowing only a little unfairness is fair.

On the other hand, the 115-per-cent exemption makes sense from a rent-extraction perspective. The EOR extracts rents because the acquirer must pay sufficient consideration to compensate the incumbent controller, who can sell only a *pro rata* fraction of its shares into the bid, for lost private control benefits. In a situation where the incumbent would be willing to accept less than a 15-per-cent premium for the control block relative to the quoted price of shares outside the control block, the private benefits of control are relatively insignificant. This is particularly so in the context of a dual-class corporation in which the controlling shareholder may hold only a small percentage of shares. For example, if the control block consists of 10 per cent of the total number of shares, a 15-per-cent premium for the block indicates that private benefits of control represent at most 1.5 per cent of value. Where private benefits are low, imposing the EOR would not serve to extract significant rents from acquirers, since relatively little additional consideration is required to compensate for lost private benefits of control.

This is not an entirely satisfactory explanation of the 115-per-cent exemption, however. The EOR may extract some rents in cases where the private benefits of control are small, so there would be at least some motivation to retain it even in these circumstances. However, there are countervailing considerations. Compelling the acquirer to make a public takeover bid through the operation of the EOR would significantly increase the transaction costs of the sale of shares. For example, the OSA requires both the offerer and the directors of the offeree corporation to prepare information circulars containing extensive information about the bid.⁴⁵ Not only is this circular costly to compile, it risks the disclosure of competitively sensitive information.⁴⁶ A formal takeover bid is also subject to a significant waiting period: the bid must be open for at least thirty-five days.⁴⁷ If the potential gains from the transaction are small, the costs of proceeding by way of a public takeover bid may deter such bids. Moreover, even accepting the contestable proposition that these informational requirements generally make sense to protect relatively uninformed shareholders, the regulations are less important for a purchaser of a control block, who presumably is

45 See *ibid.* at ss. 94.2(1), 95(1). A catchall provision requires the offerer to disclose 'any ... matter not disclosed in the take-over bid circular that has not previously been disclosed, is known to the offeror, and that would be reasonably be expected to affect the decision of the security holders of the offeree issuer to accept or reject the offer.' O.S.C. Form 62-504F1, item 23.

46 See Easterbrook & Fischel, *Economic Structure*, *supra* note 1; Merrit Fox, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment' (1999) 85 Va.L.Rev. 1335.

47 OSA, *supra* note 15 at s. 98(1).

sophisticated and informed. Relaxing the EOR requirement in these cases does not sacrifice rent extraction to a significant extent and avoids unnecessary regulatory and other transaction costs.

The 115-per-cent exemption is therefore consistent with rent extraction: it arises only where the rent-extraction properties of the EOR are relatively unimportant and where the significant transaction costs of a formal takeover bid could deter the transaction. There is a rent-extraction cost from permitting a deviation from the EOR,⁴⁸ but the benefits from avoiding transaction costs outweigh it.

IV *Empirical evidence*

A EXISTING EVIDENCE

I have argued that the *mandatory* EOR in Ontario is consistent with a desire for firms with controlling shareholders to extract rent from acquirers in sales of control blocks. In this section, relying on the foregoing analysis, I review a number of relevant empirical studies and conduct a study of the *Canadian Tire* case to analyse the effects of the mandatory EOR in Ontario. The evidence, on balance, is consistent with rent extraction.

A key element of the argument is that the prospect of a change of control affects share value. Canadian studies are consistent with the evidence elsewhere:⁴⁹ voting shares trade at a premium to non-voting shares, which reflects differential expected gains in change-of-control transactions (recall that there is unambiguously an intra-class EOR), since publicly traded voting shares outside a control block do not themselves bring private benefits.⁵⁰ Smith and Amoako-Adu find that takeover premiums in change-of-control transactions that take place are

48 Not only are the general rent-extracting properties of the EOR unavailable where the exemption applies, the availability of the exemption could affect bargaining between the acquirer and acquiree at the margin. If, for example, the acquiree would, in the absence of the exemption, extract effectively an 18-per-cent premium, the joint surplus to the acquirer and the incumbent controlling shareholder may be greater by going the private sale route. This, in turn, will affect the surplus the acquiree expects and, thus, what minority shareholders are willing to pay for shares. That is, it could undermine the rent-extraction properties of the EOR at the margin by affecting bargaining.

49 See, e.g., Ronald C. Lease, John J. McConnell, & Wayne H. Mikkelson, 'The Market Value of Control in Publicly Traded Corporations' (1983) 11 J.Fin.Econ. 439; Haim Levy, 'Economic Evaluation of Voting Power of Common Stock' (1983) 38 J.Fin. 79; Zingales, 'Insider Ownership,' supra note 14; Dyck & Zingales, 'Private Benefits,' supra note 9; Nenova, 'Corporate Votes,' supra note 9.

50 See, e.g., Brian Smith & Ben Amoako-Adu, 'Relative Prices of Dual Class Shares' (1995) 30 J.Fin. & Quantitative Analysis 223; Elizabeth Maynes, 'Takeover Rights and the Value of Restricted Shares' (1996) 29 J.Fin.Res. 157 [Maynes, 'Takeover Rights'].

significantly related to the pre-existing premium for voting shares.⁵¹ Elizabeth Maynes finds that regulatory changes in the rights of non-voting shares to share in change-of-control transactions significantly changes the relative prices of voting and non-voting shares, which is consistent with the premise that the premium to voting shares results from anticipated gains in takeovers not available to non-voting shares.⁵²

Maynes's study also supports another key premise in the argument: that the regulatory rules governing the EOR have a significant effect on share value. Maynes examines the reaction to two proposed regulatory changes in 1984 in Ontario (before the *Canadian Tire* decision). On 2 March 1984, the OSC announced a proposal under which it would no longer approve any prospectus pertaining to restricted shares unless the restricted shares were given coattail protection.⁵³ Even though the proposed policy did not purport to be retroactive, Maynes finds that the ratio of the prices of voting to non-voting shares fell significantly as a result of the announcement. There was thus apparently a perception that the OSC might extend the rule to cover all firms (which, as I have noted, would have been more consistent with the 'fairness' rationale for the rule). When the OSC reversed itself and did not include the coattail requirement in its final policy, the ratio rose again.

Maynes's study confirms that the premium for publicly traded voting shares relates to expected premiums in a change-of-control transaction and that regulatory changes affect share value. Because the study measures relative prices, however, one cannot infer whether the voting shares or non-voting shares rose or fell, which, in turn, implies a difficulty in determining *why* the ratio fell. Determining the answer to this question is important to my analysis here.

There are three reasonable hypotheses about the effects of the regulatory imposition of a mandatory EOR. First, the rent-extraction hypothesis predicts that the non-voting⁵⁴ shares would increase in value following the imposition of the EOR, in anticipation of sharing in the rents of future sales of control. Because the increase to the non-voting shares derives in part from future acquirers, the total value of equity should increase under the EOR, even as voting shares under this hypothesis would lose value, since the joint surplus available to acquirers and controlling shareholders (and to voting shareholders generally, because of the intra-class EOR) is lower under the EOR.

51 Smith & Amoako-Adu, *ibid.*

52 Maynes, 'Takeover Rights,' *supra* note 50.

53 'OSC Position Paper: Draft and Interim Policy on Restricted Shares and Request for Comments' (2 March 1984).

54 In what follows, I refer to 'voting' and 'non-voting' shares, though the analysis would also apply to the regulatory imposition of the EOR within a single class of shares with a control block and a minority.

A second hypothesis, which I will call the 'inefficient deterrence' hypothesis, is that the imposition of the EOR is simply a mistake: it deters efficiency-enhancing sales of control at the expense of the total value of the corporation. The total value of equity of voting shares would unambiguously fall under this hypothesis, while non-voting shares could increase or decrease in value. For inefficiency, the only requirement is that the total value of equity falls. Clearly, if non-voting shares fall in value following the imposition of the EOR, this is sufficient for us to conclude that the EOR is wrong-headed: net gains from sales of control are deterred.

Third, the regulatory imposition of a mandatory EOR could deter inefficient sales of control. Under this 'efficient deterrence' hypothesis, non-voting shares should increase in value following the adoption of the EOR, while voting shares should fall because they no longer anticipate sharing the proceeds of a sale that benefits them at the expense of non-voting shareholders. On net, the total value of equity should rise because of the deterrence of value-reducing sales of control. The efficient deterrence hypothesis, as I argue above, has weak theoretical support, since non-voting shareholders would predictably not adopt the MR if doing so harms them; they do not face a collective action problem. Below I review empirical evidence that supports my rejection of the efficient deterrence hypothesis.

The following summarizes the implications of the hypotheses:

Hypothesis	Value of Voting Shares Following Imposition of EOR	Value of Non-voting Shares Following Imposition of EOR	Value of Equity Following Imposition of EOR
Rent extraction	DOWN	UP	UP
Inefficient deterrence	DOWN	?	DOWN
Efficient deterrence	DOWN	UP	UP

Empirical studies of the share-price effects of the imposition of the EOR are not able perfectly to distinguish the competing hypotheses. There are two problems. First, as the comparison above indicates, the rent-extraction and efficient deterrence hypotheses have similar implications for stock affected by the regulatory change. Second, any study of share prices in response to voluntary or regulatory adoption of the EOR omits changes in the value of the control block, since shares in this block do not trade. Examining share-price movements in response to changes in the rule governing equality of treatment in takeover reveals only how the minority shareholders have fared; this is clearly an incomplete picture. Even if minority shareholders, on balance, suffer from the adoption of a particular regime, if the control block gains more than

the minority shareholders lose on net, the rule's adoption is efficient. Because of this, empirical testing of the EOR is necessarily incomplete.

There is evidence that, even if it is not dispositive, sheds some light on the effects of the EOR in Ontario. Maynes conducted a study in which she measured the stock-price reactions of reorganizations in Ontario that resulted in dual-class voting structures.⁵⁵ She examined fifty-four proposed dual-class recapitalizations of firms that took place between 1976 and 1988, or largely before the *Canadian Tire* decision in 1987. Prior to this decision and its fallout, such a move to two classes would result in a move from the EOR to the MR, absent a binding coattail.

One of the interesting aspects of this study concerns the impact of coattail provisions. Maynes predicts that adoption of a coattail would have a negative effect on share value, essentially because of the inefficient deterrence hypothesis. This is not a compelling prediction. Maynes reports that over half the firms in the sample had a majority shareholder, that the average shareholding of the largest shareholder was 40 per cent, and that all firms had a shareholder with at least 15 per cent of the shares.⁵⁶ Thus, Maynes's share-price predictions and related observations generally concern minority share value, not the value of the control block, which does not trade. Controlling shareholders do not benefit from the adoption of the EOR unless (a) the EOR is good for the minority; and (b) controllers internalize minority benefits at least in part, as when the corporation is selling shares. It would therefore be peculiar for a controlling shareholder (or any other shareholder) to propose the voluntary adoption of a coattail that is bad for minority shareholders; yet this is the implication of Maynes's prediction.

More plausible predictions about coattails in Maynes's sample are that their adoption in reorganizations would have positive effects (for efficient deterrence or rent-extraction reasons), or no effects at all, on minority share value. There are theoretical and empirical reasons to predict zero effects. Theoretically, as discussed, a voluntary EOR adopted for rent-extraction reasons is vulnerable to renegotiation, and thus it may have little effect. Empirically, as in the *Canadian Tire* case, coattails have often been drafted in easily evaded forms. In Maynes's sample, consistently with these reasons, coattails were adopted in 62 per cent of cases but did not have statistically significant effects on value.⁵⁷

55 Elizabeth Maynes, 'Reallocation of Voting Rights and Shareholders' Wealth' (1992) 25 *Can.J.Econ.* 538 [Maynes, 'Reallocation'].

56 *Ibid.* at 542.

57 Of course, it is also possible that coattails and equal treatment simply do not matter much, but this is inconsistent with the finding of Maynes's earlier study that proposed regulatory changes to equal treatment did affect share prices. Maynes, 'Takeover Rights,' *supra* note 50.

Maynes found that the value of equity appreciated, on average, as the result of the recapitalization. However, she also found that the source of the gains was not the recapitalization *per se* but, rather, the promise of higher dividends to the non-voting shares that often accompanied the proposal. The recapitalization itself tended, she found, to reduce value.

Maynes concludes that the recapitalizations negatively affected the takeover market, helped to entrench management, and hence, all things being equal, reduced value. The problem with this conclusion is that the firms generally already had controlling shareholders, either *de facto* or *de jure*; a controlling shareholder would not benefit from entrenchment. More persuasively, Maynes also suggests that the recapitalizations may have reduced value because minority shareholders anticipated that the controller would reduce its overall equity stake over time while retaining control by continuing to hold voting but not non-voting shares. This would weaken the controller's incentives to manage optimally.

Aside from these control effects, Maynes's study is relevant to the debate over the EOR. First, the study supports the conclusion that a mandatory EOR is not necessary, as a general matter, to prevent opportunistic recapitalizations that would allow inefficient sales of control, thus undermining the plausibility of the efficient deterrence hypothesis. Equity value (*i.e.*, publicly traded minority shares) increased, on average, following the restructurings,⁵⁸ which suggests that minority shareholders were, on average, compensated by higher dividends for any losses resulting from the abandonment of the EOR. A mandatory rule is not necessary to protect minority shareholders from opportunism; both theory and evidence suggest that they are capable of protecting themselves. This analysis rejects the view of the mandatory rule in Ontario as an efficient law that deters opportunistic adoption of the MR.

Second, Maynes concludes that recapitalizing in itself – that is, holding dividends constant – reduced minority share value. A sufficient condition for the conclusion that the EOR inefficiently deters sales of control is absent. In what I will call the 'strong form' version of the inefficient deterrence hypothesis, Easterbrook and Fischel predict that the EOR would make all shareholders, including the minority, worse off.⁵⁹ If the

58 This is not to say that there were no restructurings that reduced value; there were. These tended not to include higher dividends. It is not clear whether these deals typically took place before 1984, when the OSC imposed majority-of-minority approval requirements.

59 Easterbrook & Fischel, *Economic Structure*, supra note 1 at 716: 'If the premium must be paid into the corporate treasury, people may not consent to the sale of a controlling bloc; if minority shareholders may sell on the same terms as the controlling shareholder, bidders may have to purchase more shares than necessary, possibly causing the transaction to become unprofitable. Minority shareholders would suffer

minority shares in Maynes's study increased in value as a result of the movement from the EOR to the MR, then this would tend to indicate inefficient deterrence from the EOR, especially since control concerns and agency costs from the recapitalizations would tend to lower the value of the minority shares. Instead, share prices fell because of the recapitalization itself, which is consistent with the EOR's increasing value. To be sure, given confounding effects in the recapitalization from control concerns, it is possible that the movement from the EOR to the MR increased value, but a sufficient condition for such a conclusion, that is, that minority share value increased, was absent.

B CANADIAN TIRE CASE STUDY

In this section I review evidence surrounding the lengthy, involved battle for control of Canadian Tire. General conclusions are obviously unwarranted, given the narrow scope of the evidence, but the results of the study are consistent with the rent-extraction hypothesis.

1 *Facts*

Canadian Tire is a hardware, automotive, and home-improvements retailer structured effectively as a franchise system, with Canadian Tire Corp. in the business of selling new stores to 'dealers' and of selling products to the dealers for resale.⁶⁰ Prior to the takeover bid saga that developed in 1986, the Billes family collectively controlled Canadian Tire Corp. through their ownership of voting shares. Three siblings, Martha, Alfred, and David, each owned 20.3 per cent of the voting shares. The dealers, through a jointly owned corporation, collectively owned 17.5 per cent of the voting shares. There was a public float of around 9 per cent of the voting shares. The siblings and the dealers collectively owned only a small fraction of the non-voting shares.

Alfred and David became eager to sell their shares in 1986 and privately retained an advisor to contact potential bidders. Rumours of an impending sale caused a two-day flurry of trading on 2 and 3 September 1986, eventually leading the Toronto Stock Exchange to halt trading until the rumours were addressed. The company issued a statement, after markets closed on 3 September, that it knew of no reason for the unusual trading; Billes family members also claimed not to know of a family member's selling.

There was another halt on trading on 15 October pending an announcement, eventually made on the 15 October, that the Billes

under either rule, as the likelihood of improvements in the quality of management declined.'

60 The facts in the following are taken from the OSC's and courts' opinions on the case and from various press reports in the *Toronto Star*.

brothers, but not Martha, had retained an advisor to assist them in selling their shares. This put 40 per cent of the voting stock in play.

Various rumours circulated as to who might be interested in purchasing the Billes brothers' shares. After markets closed on 20 November 1986, Cara Operations Ltd., a Canadian food-service business, announced that it was interested in amalgamating with Canadian Tire. While not announcing specifics, Cara said that its offer would be financially attractive to both voting and non-voting shareholders. The proposed deal, an amalgamation, would have required two-thirds approval of both classes of shares.

In the mean time, the Billes brothers had concluded that an attractive way to sell their shares would be to propose to a prospective acquirer that it make a bid at a significant premium for 49 per cent of the voting shares. Doing so would allow them to avoid the coattail requirements that require a bidder to make a follow-up offer on equal terms to non-voting shares when making a premium purchase of 'a majority' of voting shares.

In the evening of Friday 28 November, the dealers announced that they would seek to purchase 49 per cent of the voting shares. They did not announce specific terms of the bid. The TSX halted trading until the dealers provided specifics. The non-voting shares resumed trading on 3 December, probably because it had become clear that they were not directly implicated by the specifics of the bid, while the voting shares did not trade again until 4 December, when details were announced, by which time all the Billes siblings (first the brothers, then Martha) had disclosed that they had agreed to sell into the dealers' bid. The dealers' bid, as disclosed on 4 December, announced a sliding-scale price per share for 49 per cent of the voting shares. The price paid would be higher depending on the number of voting shares tendered into the bid, up to a maximum of \$160 per share. The scale was constructed to ensure that the Billes brothers effectively received \$100 per share, no matter how many voting shareholders tendered into the deal. That is, even if they could sell only a fraction of shares into the bid because of equal treatment of all voting shareholders, the weighted average of the price per share for shares sold and the value of the shares not purchased would be \$100. This is a stark example of how the EOR extracts rents and increases the consideration paid for a control block.

While Cara reiterated its amalgamation bid around Saturday 6 December, it was made clear by the Billes siblings that they would be tendering to the dealers' bid and had signed a lock-up agreement to that effect.

The dealers mailed their bid to voting shareholders on 9 December 1986. Following vigorous complaining by non-voting shareholders about being excluded, the OSC announced on 10 December that it would

hold hearings into the dealers' bid, with its staff arguing that the dealers' bid should not be allowed to proceed. The osc, jointly with the Quebec Securities Commission, announced late on 14 January 1987 that it would block the proposed acquisition. The osc provided reasons, including its description of the proposal as 'grossly abusive' and of the Billes' actions as 'unfair' and 'dishonest,' on 9 February. The Ontario Divisional Court upheld the commission's decision, publishing its views late on 12 March 1987. The Ontario Court of Appeal denied leave to appeal these decisions late on 16 April.

While the Court of Appeal's decision ended legal wrangling over the dealers' bid, it did not stop litigation over control of Canadian Tire. On 23 April 1987 there were media reports that Martha Billes planned to sue her brothers for breaching a shareholders' agreement that they had with one another. She sought to purchase their voting shares for \$12.25 per share, following a remedy set out in the agreement itself. This litigation was seen as hindering the ability of any of the Billeses to sell their shares.⁶¹

Ultimately, the impasse was not resolved until 22 July 1997, when Martha Billes purchased her brothers' shares.

2 *Market reactions*

Table 1 below sets out the results of an event study of abnormal returns on both voting and non-voting shares on thirteen significant dates in the Canadian Tire drama. To calculate abnormal returns, I estimated the market model, $R_c = \alpha + \beta R_m$, where R_c is the daily return of Canadian Tire and R_m is the daily market return, using data from the Canadian Financial Markets Research Centre database from 1985. The total market return of the TSE 300 was used for daily market returns. In each case, I examine returns on the day during which trading on the information could first take place, with the exception of the initial take-over rumours, which were reported to have affected trading over two days before the Toronto Stock Exchange halted trading. The last column sets out the likely inference from the event for the probability of either a sale of control in general or a sale to the dealers in particular.

3 *Analysis*

As indicated by the last column of Table 1, it is helpful to categorize the different events according to their effect on observers' prior beliefs about the general probability of a sale of control and about the probability of a

61 See, e.g., Kenneth Kidd, 'Lawsuit Filed by Martha Billes May Not Get to Court for Two Years,' *The Toronto Star* (25 April 1987): 'Effectively, observers say, that stalls any effort by brothers Alfred W. and David Billes to sell out their combined 40 per cent voting stake in Canadian Tire Corp. Ltd.'

TABLE 1
Canadian Tire Event Study

Date	Event	Voting Abnormal Returns (z-statistic)	Non-voting Abnormal Returns (z-statistic)	Inference
2-3 September 1986	Takeover rumours leading to halt on trading	32.4%*** (9.43)	10.6%*** (5.6)	Sale of control more probable
4 September 1986	Denial of imminent sale	-19.2%*** (-5.57)	-5.6%*** (-3.0)	Sale of control less probable
16 October 1986	Billes bros. announce intention to sell	3.3% (1.0)	4.9%*** (2.6)	Sale of control more probable
21 November 1986	Cara bid announced	4.9% (1.4)	2.4% (1.3)	Sale of control more probable
4 December 1986	Dealers' bid announced	68.2%*** (19.8)	-13.2%*** (-7.0)	Sale to dealers more probable
8 December 1986	Billesse reiterate commitment to dealers	9.9%*** (2.9)	-0.7% (-0.4)	Sale to dealers more probable
9 December 1986	Dealers mail bid	6.6%* (1.9)	-7.2%*** (-3.8)	Sale to dealers more probable
10 December 1986	OSC announces hearing	-11.9%*** (-3.4)	0.1% (0.4)	Sale to dealers less probable
15 January 1987	OSC blocks bid	-34.6%*** (-10.1)	6.5%*** (3.5)	Sale to dealers less probable
10 February 1987	OSC gives reasons	-2.7% (-0.8)	3.5%* (1.9)	Sale to dealers less probable
13 March 1987	Ontario Div. Ct. upholds OSC	-23.5%*** (-6.8)	5.8%*** (3.1)	Sale to dealers less probable
20 April 1987	Ontario Ct. of Appeal denies leave	1.8% (0.5)	0.4% (0.2)	Sale to dealers less probable
23 April 1987	Martha Billes sues brothers	-7.4%*** (-2.2)	-4.5%*** (-2.4)	Sale of control less probable

***Significant at 1% level of confidence; **Significant at 5% level of confidence; *Significant at 10% level of confidence.

sale to the dealers. There are three events that would lead to the conclusion that a general bid for control was *more* probable: the rumours; the Billes brothers' announcement that they were selling; and Cara's initial bid. It is interesting to note that abnormal returns *for both classes* were positive on all three events and that two of the three returns for non-voting shares were statistically significantly different from zero. This suggests that concerns generally about a value-reducing sale of control to a looter were not prominent. Indeed, non-voting shares realized greater abnormal returns than voting shares on the announcement that the Billes brothers were contemplating selling their 40-per-cent block of voting shares. The market anticipated either that the acquirer would increase value for non-voting shares going forward or that the acquirer would offer to purchase non-voting shares at a premium. Given that the market was not counting on the EOR to apply (see reaction to the dealers' bid for 49 per cent of the shares), it is apparent that the market did not rely on the EOR to deter inefficient sales of control. The possibility of a sale of control was perceived as good news, even without the protection of the EOR. This evidence is inconsistent with the efficient deterrence hypothesis.

The converse is also true: events that decreased the general probability of a bid created negative abnormal returns both for voting and non-voting shares, further supporting the conclusion that the EOR was not required to deter inefficient sales of control. Both the denial by Canadian Tire and the Billeses following rumours of sale and the decision of Martha Billes to sue her brothers and potentially create a stalemate in the sale of control created statistically significant negative abnormal returns.

Voting and non-voting shares reacted very differently, however, to the bid made by the dealers. When the dealers announced their bid, when the Billes brothers publicly reiterated their commitment to the dealers' bid, and when the dealers mailed their bid, voting shares realized positive abnormal returns, while non-voting shares realized negative abnormal returns. There are two interpretations of this divergence. First, it could be that, while the market anticipated that a sale of control in the abstract would benefit non-voting shareholders, a sale to the dealers would raise looting concerns. Given that a large part of Canadian Tire's business was supplying the dealers with merchandise, it would not be implausible to conclude that minority shareholders could suffer under the dealers' control: the dealers would have an incentive to set low wholesale prices that advantaged them as dealers even as it hurt them as shareholders in Canadian Tire Corp. Second, the divergence might have resulted because the dealers' bid explicitly excluded consideration for non-voting shares, while voting shares were presented with the opportunity to take advantage of the intra-class EOR and to sell at a significant

premium. That is, non-voting shareholders anticipated that a potential acquirer might voluntarily extend a bid to both classes of shares (though at a discount to voting shares; non-voting shares traded at a fraction of the value of the voting shares), and one emerged that did not do so; hence, non-voting shares lost value.

There was a similar divergence in returns for voting and non-voting shares on events that indicated that regulation would not permit a bid to proceed without including non-voting shareholders. When the OSC blocked the dealers' bid and when the Divisional Court upheld the decision, non-voting shares realized statistically significant positive abnormal returns, while voting shares realized statistically significant negative abnormal returns. With the exception of positive returns to voting shares when the Court of Appeal denied leave, other similar events, such as the OSC's announcement that it would challenge the decision and the release of the OSC's reasons, led to similar directions in abnormal returns, but these, for the most part, were not statistically significant.

Again, there are two possible interpretations of the divergence. First, it could be that the decisions were seen as reducing the possibility of a sale to a looter that would have benefited the voting shareholders but not the non-voting shareholders. Second, the non-voting shareholders may have benefited because the imposition of the EOR by the regulators and courts implied that they would share in the rents from an efficient sale of control; conversely, the voting shareholders suffered because rents from a sale would be shared with non-voting shareholders.

To summarize, given the vast and increasing difference in the prices of voting and non-voting shares despite similar cash flow rights, it is apparent that the market did not expect the EOR to apply. Nevertheless, the prospect of a change in control generally was perceived as favourable news both for voting and for non-voting shareholders. This suggests that the EOR was not necessary to protect non-voting shareholders from a sale to a looter.

When it was perceived that regulators would impose the EOR, voting shares fell in value and non-voting shares increased in value. This allows rejection of the strong form version of the inefficient deterrence hypothesis, which suggests that the EOR costs all shareholders, controlling and minority alike. However, the EOR could nevertheless have been inefficient in this case if the voting shares fell by more than the non-voting shares gained. Unfortunately, this net effect cannot be determined. An examination of the losses falling on publicly traded voting shares does not indicate the losses from the decision falling on the controller.⁶²

62 These losses are smaller than the losses suffered by those holding publicly traded voting shares. The controlling shareholder loses from the EOR either because some privately profitable sales of control are deterred or because some of the surplus

While the EOR was not required to prevent a sale to a looter in the abstract, its imposition in the face of the dealers' bid resulted in gains to non-voting shareholders. This could be an example of efficient deterrence if the particular sale to the dealers would have reduced value. Of course, even if this were so, the EOR as a general proposition appears to have been inefficient, given that both non-voting and voting shares increased when events revealed a higher probability of a bid from an unknown bidder at a time when the market did not anticipate that the EOR would apply. Alternatively, the imposition of the EOR may have increased value for non-voting shareholders because of anticipated rent extraction in the event of a sale of control.

On balance, the evidence from the Canadian Tire saga is not consistent with either the efficient deterrence hypothesis or the strong form of the inefficient deterrence hypothesis and is consistent with the rent-extraction hypothesis.⁶³

V CONCLUSION

Ontario has adopted a mandatory intra-class EOR within its securities law, and the Toronto Stock Exchange, following on the *Canadian Tire* decision, has established a mandatory inter-class EOR as well. This article has shown that the only coherent explanation of Ontario's *mandatory* EOR is that it better commits the corporation to the rent-extraction

from a sale is diverted to minority shareholders, but the losses from deterrence are offset (relative to minority voting shareholders) by continued enjoyment of private benefits of control. To put it another way, the controlling shareholder gets either a takeover premium, in the event of a successful sale, or its share of the public value of the corporation plus private benefits of control, if the sale does not take place. On the other hand, the publicly traded voting shares get either a takeover premium or their share of the public value of the corporation. The overall effect on voting shares is less dramatic than the losses suffered by publicly traded voting shares, but the precise magnitude of the losses is unknown.

63 In order to get a more robust sense of the effects of the decision, I also ran event studies on a portfolio of 114 publicly traded subordinated voting shares, as well as on portfolios of forty-six voting and non-voting shares where both classes of a firm were publicly traded. The results, not reproduced here, were not robust for the event window chosen, nor were they typically statistically significant. The *Canadian Tire* decision had a statistically significant effect on Canadian Tire itself but not on other similarly situated firms. Strong inferences about the effects of the surprise imposition of the EOR by the OSC in *Canadian Tire* are not warranted on the basis of the evidence, but the case study is consistent with the rent-extraction hypothesis.

properties of the rule. A mandatory inter-class EOR is unnecessary to protect minority shareholders from inefficient sales of control, but such a rule better commits a potential acquirer to share surplus with minority shareholders. The empirical evidence is consistent with the rent-extraction explanation.