

Dual Class Share Structures and Minority Shareholder Recourse in Canada

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I. Introduction

In the past, corporate governance in its traditional sense has been defined as dealing specifically with the way in which suppliers of finance to corporations ensure they receive a return on their investment.¹ Commentaries produced by academics, such as Berle and Means,² and their contemporary counterparts, such as Shleifer and Vishny,³ are examples of this account of corporate governance. The traditional research question has been phrased: How do investors get managers to give back their money and why do they invest given the agency issues inherent in the modern corporation?⁴ The idea is that, as ownership is separated from management, management can potentially take advantage of the latitude afforded to them by passive shareholders, and impose agency costs by acting in an ill-advised or self-serving manner.⁵

Based on the traditional account of corporate governance, we have seen a host of corporate governance reforms in the American context, which have been replicated all over the world, including in Canada. These reforms have mainly focused on gatekeepers who can keep management in check. These gatekeepers include auditors, lawyers, and directors of

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¹ Andrei Shleifer & Robert W. Vishny, “A Survey of Corporate Governance” (1997) LII: 2 The Journal of Finance 737 at 737.

² A. Berle & G. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932).

³ Shleifer & Vishney, *supra* note 1.

⁴ *Ibid.* at 737.

⁵ *Ibid.* at 738.

corporations⁶ — with *Sarbanes-Oxley*⁷ in the U.S. as the model. Although these reforms are significant, the focus on gatekeepers has been at the expense of more detailed consideration of the Canadian corporate economy, and how to address minority shareholder recourse specifically in this context. The approach that is required to address both governance issues and minority shareholder recourse differs depending on exactly how ownership and control is separated in Canadian corporations.

In Canada, “family capitalism” still predominates, and not just in small, closely-held corporations. A common mechanism that is used in Canada to separate ownership and control in public corporations is a dual class shareholding structure (DCSS). DCSS means that control block holders (who are generally the founding family or related to the founding family) hold shares with multiple voting rights attached to them, while public shareholders have a single or no vote attached to their shares.⁸ For example, in Magna Inc., the Stronach family owns Class B shares, with 500 votes per share, while the public shareholders have Class A shares, which carry only 1 vote per share.⁹ The Molson debacle, which has been played out in the Canadian media recently, provides another example. Eric Molson, through Pentland Trust, alone controls 50.1 per cent of the voting shares of Molson Inc., while holding limited equity.¹⁰

In 2000, 126 out of 795 companies listed on the TSE300¹¹ had DCSS.¹² By 2003, 52 of the 207 companies in the S&P/TSX composite

⁶ John C. Coffee Jr., “Understanding Enron: It’s About Gatekeepers, Stupid” (2002) 57 Bus. Law. 1403 at 27; Poonam Puri & Stephanie Ben-Ishai, “Proportionate Liability Under the CBCA in the Context of Recent Corporate Governance Reform: Canadian Auditors in the Wrong Place at the Wrong Time?” (2003) 39 Can. Bus. L.J. 36 at 38.

⁷ U.S., Bill H.R. 3763, *Sarbanes-Oxley Act of 2002*, 107th Cong., 2002 (enacted).

⁸ Industry Canada, *General Trends on Corporate Governance Practices Amongst Canadian Firms: 1999 – 2001: A preliminary analysis of select governance data for Canadian firms* by Stephen R. Foerster, Robert Gross, Daniel Shapiro, Martin Toner & Gil Yaron (Ottawa: Industry Canada, 2004) at 10 [Industry Canada].

⁹ Shareholder Association for Research and Education, *Second Class Investors: The Use and Abuse of Subordinated Shares in Canada* (Vancouver: SHARE, 2004) at 8 [SHARE].

¹⁰ Dana Flavelle, “Eric Molson sidesteps cousin to solidify Coors deal” *The Toronto Star* (11 November 2004) D04.

¹¹ The TSE300 is an index for shares trading on the Toronto Stock Exchange [TSX]. The TSE300 is a collection of 300 companies and is used to measure how the TSX

index¹³ had DCSS.¹⁴ As a result, many Canadian corporations are controlled by a small group of shareholders through their exclusive or disproportionate possession of the voting shares of the corporation, potentially to the detriment of the public minority shareholders.¹⁵

With the reality of family capitalism, maintained in large part by DCSS, in mind, the critical corporate governance question in Canada needs to be reframed. The appropriate question should be: How do we control, restrain, and make accountable the controlling shareholders of public corporations? In this model, control and accountability of management is still important, but should be secondary in emphasis. Professor Poonam Puri, and I have recently completed an analysis of the corporate and securities law framework in Canada, where we conclude that the persistence of DCSS in Canada is evidence of the structural weaknesses in our legal framework — both in terms of the actual content of the legislation as well as its application and enforcement by courts and regulators. Based on this unpublished study Part II first situates the push and pull of DCSS and next Part III briefly addresses the structural weaknesses in Canadian corporate and securities law. Part IV considers the limits of recent reforms intended to alter the nature of minority shareholder recourse in the context of family capitalism and DCSS in Canada. Part V concludes by emphasizing that the most significant source of reform to minority shareholder recourse in Canada comes from

“market” is performing. The TSE300 has been replaced by the Standard & Poor's TSX composite index (S&P/TSX).

¹² Gil Yaron, *Canadian Institutional Shareholder Activism in an Era of Global Deregulation* (February 2002) [unpublished, archived at the Shareholder Association for Research and Education (SHARE), online: <http://www.share.ca/files/pdfs/02_02_11_final2.pdf>] at 21.

¹³ The S&P/TSX is an index used to measure how the Toronto Stock Exchange is performing. It is provided by Standard & Poor — a provider of independent credit ratings, indices, risk evaluation, investment research, data and valuations. The S&P/TSX composite index is maintained by the S&P/TSX Canadian Index Policy Committee. For more information and criteria for inclusion on the index, refer to the description provided on the TSX Group website, online: <<http://www.tse.com/en/pdf/0000Description.pdf>>.

¹⁴ Elizabeth Church, “Board Games: Special share classes hard to give up. Despite growing opposition to two-tiered voting rights, there’s been little change” *The Globe and Mail* (25 September 2003) B4.

¹⁵ *Ibid.*

the judiciary and the judiciary's understanding of the current Canadian context.

II. Push and Pull of DCSS

When considering the influence of DCSS on minority shareholders in Canada, it is useful to examine both the arguments for, and those against, the use of DCSS. Some advocates for DCSS in Canadian corporations argue that such structures tend to promote shareholder choice — however, such choice tends to be constrained by the limited investment options in the Canadian market, frequently attributed to tax rules requiring a certain amount of Canadian content.¹⁶ Others argue that DCSS allows for traditional family values to endure in Canadian corporations — however, although this makes intuitive sense, empirical studies involving the oppression remedy have shown that such values are not prevalent in Canadian corporations.¹⁷ Another possible strength of DCSS is that it tends to encourage entrepreneurship, since the entrepreneur can be reassured control through the use of DCSS once the corporation goes public.¹⁸ Although such control may be beneficial over the short-term, once the corporation has been public for some time, with significant public interest issues at stake, such control is often problematic.

A re-examination of the use of DCSS in Canadian corporations, shows just how detrimental they can be to minority shareholders. Such structures tend to suppress, or eliminate altogether, any opportunity for corporate democracy — an idea that has regained popularity with the recent popular culture focus created by such projects as *The Corporation*.¹⁹ DCSS also replicate many of the central agency problems

¹⁶ Jennifer Wells, “One share, one vote: it works” *The Toronto Star* (24 May 2003) C01.

¹⁷ Stephanie Ben-Ishai & Poonam Puri, “The Canadian Oppression Remedy Judicially Considered 1995-2001” *Queen's L. J.* [forthcoming in December 2004].

¹⁸ Janet McFarland & Elizabeth Church, “Board Games: Corporate Canada Opens Up” *The Globe and Mail* (21 September 2003).

¹⁹ Mark Achbar, Jennifer Abbott & Joel Bakan, *The Corporation* (Vancouver: Big Picture Media Corporation, 2004).

associated with some public corporations.²⁰ The controlling shareholders may collude with management to extract the private benefit of their control.²¹ The controlling shareholders might also be tempted to engineer “sweetheart” deals with related firms in order to siphon off a disproportionate share of the public company’s earnings.²² In addition, there is the risk of a member of the controlling family, for their own reasons of vanity or sentiment, attempting to run the company for too long or transferring the control to a family member who is ill suited for the job, often to the detriment of minority shareholders.²³

III. Corporate Law

Canadian corporate law plays a significant role in enabling DCSS to exist. For the most part, Canadian corporate law statutes are of an enabling nature,²⁴ and allow for corporations to create capital structures with DCSS, whereby two classes can have equal rights to the residual of the corporation, but distinct voting rights. However, Canadian corporate law statutes do contain certain protective features, which are mandatory and act to protect minority shareholders or non-voting shareholders. These features include a mandatory right to vote upon the triggering of a fundamental change.²⁵ There are two main problems with this mandatory voting right.

The first problem is that in most cases where DCSS exists, the right to vote is meaningless for minority shareholders, because the controlling shareholders’ multiple votes will easily and quickly displace the public shareholders’ votes, unless a separate class vote is required for the public minority shareholders.²⁶ Even where there are large blocks of

²⁰ Shleifer & Vishny, *supra* note 1 at 738.

²¹ *Ibid.*

²² *Ibid.*

²³ *Ibid.* at 737-38.

²⁴ Jeffrey G. MacIntosh, “Institutional Shareholders and Corporate Governance in Canada” (1996) 26 Can. Bus. L.J. 145 at 152-53.

²⁵ *Ibid.* at 172.

²⁶ For example, in the federal *Canadian Business Corporations Act*, R.S.C. 1985, c. C-44 [“CBCA”], section 176 provides that (1) The holders of shares of a class or ... of a series are, unless the articles otherwise provide in the case of an amendment referred to in paragraphs (a), (b) and (e), entitled to vote separately as a class or

public shareholders, such as institutional investors, in the Canadian context their votes tend to be largely influenced by management. This problem is magnified by the fact that voting is not confidential in Canada.²⁷ A second problem, that is often a critical issue for public minority shareholders, is that takeovers and being treated equal to controlling shareholders²⁸ are not addressed as a fundamental change that requires shareholder approval of this sort.²⁹

Outside of the right to vote, there are also statutory remedies available to public minority shareholders, such as the derivative action³⁰

series on a proposal to amend the articles to (a) increase or decrease any maximum number of authorized shares of such class, or increase any maximum number of authorized shares of a class having rights or privileges equal or superior to the shares of such class; (b) effect an exchange, reclassification or cancellation of all or part of the shares of such class; (c) add, change or remove the rights, privileges, restrictions or conditions attached to the shares of such class and, without limiting the generality of the foregoing, (i) remove or change prejudicially rights to accrued dividends or rights to cumulative dividends, (ii) add, remove or change prejudicially redemption rights, (iii) reduce or remove a dividend preference or a liquidation preference, or

(iv) add, remove or change prejudicially conversion privileges, options, voting, transfer or pre-emptive rights, or rights to acquire securities of a corporation, or sinking fund provisions; (d) increase the rights or privileges of any class of shares having rights or privileges equal or superior to the shares of such class; (e) create a new class of shares equal or superior to the shares of such class; (f) make any class of shares having rights or privileges inferior to the shares of such class equal or superior to the shares of such class; (g) effect an exchange or create a right of exchange of all or part of the shares of another class into the shares of such class; or (h) constrain the issue, transfer or ownership of the shares of such class or change or remove such constraint. For a review of the differences in the provincial corporate statutes, see Ronald J. Daniels, "Should Provinces Compete? The Case for a Competitive Corporate Market" (1991) 30 McGill L.J. 130.

²⁷ Section 141 of the *CBCA* provides that (1) Unless the by-laws otherwise provide, voting at a meeting of shareholders shall be by show of hands except where a ballot is demanded by a shareholder or proxyholder entitled to vote at the meeting. (2) A shareholder or proxyholder may demand a ballot either before or after any vote by show of hands.

²⁸ Industry Canada, *supra* note 8 at 10.

²⁹ MacIntosh, *supra* note 23 at 172.

³⁰ Section 239 of the *CBCA* provides that (1) Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate. (2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is

and the oppression remedy.³¹ However, aside from issues of cost (general to all litigation) and rational apathy, the recourse available through these remedies is often hindered by a key structural defect in the courts — the judiciary tends to take DCSS as a given. The Canadian judiciary is often unwilling to take this structure into account in their analysis of management and controlling shareholders' actions or even to allow the existence of such a structure to enable them to depart from the use of the business judgment rule.

For example, if the Molson-Coors merger does not go through because class voting is required and 1/3 of the public shareholders vote against it — any legal challenge to Eric Molson's decision not to pursue another deal or accept another deal regardless of how much is offered will likely fail.³² A similar scenario played out in *Schneider*,³³ where the Ontario Court of Appeal upheld the controlling shareholders veto of a sale to Maple Leaf Foods in favour of a sale to Smithfield Foods despite the fact that Maple Leaf offered a substantially higher price. Using the business judgment rule, the Ontario Court of Appeal held that, as controlling shareholders, the controlling family was not obliged to sell to anyone and had a veto on any offer, so long as the board took active steps to independently assess proposed transactions and subsequently made reasoned, informed, and independent recommendations.³⁴ The reality is

satisfied that (a) the complainant has given notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action; (b) the complainant is acting in good faith; and (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

³¹ Section 241 of the *CBCA* provides that (1) A complainant may apply to a court for an order under this section. (2) If, on an application under subsection (1), the court is satisfied that in respect of a corporation or any of its affiliates (a) any act or omission of the corporation or any of its affiliates effects a result, (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

³² Flavelle, *supra* note 10.

³³ *Maple Leaf Foods Inc. et al. v. Schneider Corporation et al.* (1998), 42 O.R. (3d) 177 [C.A.] [*Schneider*].

³⁴ *Schneider*, *ibid.* at 178-79.

that, even with a fair and diligent board, which may or may not be independent, it is impossible to overcome the fact that, by virtue of DCSS, family shareholders who control the votes will inherently have the decision-making power.

IV. Securities Law

In terms of the Canadian regulatory framework, securities law is generally meant to compliment corporate law. In this context, the public interest power available to provincial securities regulators is one potential method for providing recourse for minority shareholders of corporations that employ DCSS. A provincial securities regulator, in the DCSS context, last used this power in the late seventies in the *Canadian Tire*³⁵ case where a takeover was at issue — however, this power has not been re-used since. Following *Canadian Tire*, coattail provisions were put into place to ensure that public minority shareholders are able to participate in takeover activity. However, it is unlikely that this is a full explanation for the fact that the public interest power has not been re-used by Canadian securities regulators. We may not be seeing a range of issues that securities regulators are dealing with privately. This leaves open questions of transparency and limits the broader understanding and development of case law surrounding DCSS, which could be used in other contexts — such as in an oppression action.

V. Impact of Recent Reforms

Recently, we have seen a shift in focus with respect to corporate governance matters in the Canadian context, back to Canada and those governance issues specific to Canada. This shift has brought increased public attention to the issues surrounding DCSS. For instance, SHARE³⁶

³⁵ *Re C.T.C. Dealer Holdings Ltd. et al. and Ontario Securities Commission et al.* (1987), 59 O.R. (2d) 79 [Div. Ct.] [*Canadian Tire*].

³⁶ The Shareholder Association for Research and Education—a national not-for-profit organization that states its goal as: helping pension funds build investment practices that protect interests of plan beneficiaries and contribute to a just and healthy society.

has issued a report that is very critical of DCSS.³⁷ Industry Canada also issued a preliminary report that examines the general trends on corporate governance practices among strictly Canadian firms between 1999-2001.³⁸ The TSX³⁹ has introduced rules that would require a symbol notation on DCSS corporations.⁴⁰ We have also seen the Ontario Securities Commission (OSC) take over corporate governance oversight from the TSX. In that context, the OSC has proposed reforms that would require disclosure of material relationships between controlling shareholders and management with corresponding civil liability for those gatekeepers who certify such disclosure.⁴¹ While disclosure and awareness are important to public minority shareholders, the small Canadian market and the limited choices, given our foreign ownership rules, place limits on the impact of these developments.⁴²

VI. Conclusion

In light of an analysis of the push and pull of DCSS, the structural flaws in our corporate and securities law framework, and the limits of recent corporate governance reforms, the most significant source of, or potential for, change comes from the judiciary. It would be helpful to see a developing case law that creates a public body of knowledge in the DCSS context. To that end, it is important to have a public record of all private agreements reached between securities regulators and DCSS corporations — or at least statistics on how many have been reached. An important role could also be played by social context education for the judiciary and advocates who bring cases before them. With a better understanding of the DCSS context, advocates will be in a better position

³⁷ SHARE, *supra* note 9.

³⁸ Industry Canada, *supra* note 8.

³⁹ For more information on the TSX, refer to the TSX Group website, online: <<http://www.tse.com>>.

⁴⁰ TSX Group, *Symbol Change Initiative*, online: <<http://www.tse.com/en/symbol/Extension.html>>.

⁴¹ Ontario Securities Commission (OSC), Toronto Stock Exchange – Request for Comment: Corporate Governance Policy – Proposed New Disclosure Requirement, online: <http://www.osc.gov.on.ca/MarketRegulation/Marketplaces/Exchanges/tr/TSE/xrr-tse_20041029_rfc-corp-gov-pol.jsp>.

⁴² Wells, *supra* note 14.

to highlight to the judiciary the nature of DCSS and the inherent dangers for public minority shareholders that can present themselves even in day-to-day activity — not just in a takeover situation.