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Empty Voting

By Bryce Tingle

Cases Considered:

TELUS Corporation v Mason Capital Management LLC, 2012 BCCA 403 and *Mason Capital Management LLC v TELUS Corporation*, 2012 BCSC 1582

The most talked about Canadian corporate legal decision this year has been a British Columbia Supreme Court judgment in relation to TELUS' attempt to convert a class of non-voting shares into voting shares. It was not even the ruling that had everyone talking, but several paragraphs of *obiter* near the end of the decision. The *obiter* concerned the phenomenon of "empty voting" and it was deemed sufficiently newsworthy to be reported in the national newspapers and discussed in legal blogs and articles on both sides of the border.

"Empty voting" is a concept that has arisen in corporate law scholarship over the past six years or so to describe situations where a shareholder's economic interest in the company has been decoupled from its voting rights. This might occur, for example, when an investor borrows shares to vote them in ways that will drive down the corporation's value.

The B.C. Supreme Court decision, Mason *Capital Management LLC v TELUS Corporation*, 2012 BCSC 1582 discusses an actual instance of this occurring in the United States. A hedge fund with a significant stake in the target of a merger borrowed enough shares of the acquiring business to materially improve the chances the shareholders of the acquiror would approve the proposed merger. The hedge fund had no economic interest in the acquiring business; indeed the more the acquiror overpaid for the target, the better the hedge fund's returns as a shareholder of the target.

In a way there is nothing particularly new about empty voting. It has always been theoretically possible for a shareholder to short-sell a corporation's shares and then strategically vote in ways calculated to drive down the price. What has changed is that certain institutional investors (hedge funds are the usual culprits) have grown more creative and the rise of derivatives market has made it easier to execute empty voting strategies. Futures, call options, share swaps and even credit default swaps can all either vacate an investor's economic interest in a company or permit it to profit even if the share price declines.

The rise and rise of the derivatives market (estimated at over $700 trillion last year – or about nine times the economic output of the world) has increased the opportunities and attractiveness of empty voting. The *TELUS* decision thus presented the perfect circumstances for a legal firestorm: the tinder of a relatively new phenomenon; the gasoline of that phenomenon violating some of the most cherished assumptions of legal doctrine (corporate law's assumption

shareholders always care about the long term best interests of the company); and the spark of a legal decision that for the first time in Canada addressed the issue directly.

The British Columbia Court of Appeal in *TELUS Corporation v Mason Capital Management LLC,* 2012 BCCA 403 reversed the lower court's decision and addressed the *obiter* concerning empty voting directly, if inconclusively. Neither of the B.C. courts seemed to realize that the facts in *TELUS* might make it a poor vehicle for resolving the thorny issues raised by empty voting.

The Background

TELUS was formed through a 1999 merger of two large telecommunication companies. In order to comply with federal law, the merged entity had to have 2/3 of its voting shares held by Canadians. As foreign investors would own slightly more than 1/3 of the combined entity, the company adopted a capital structure with two classes of shares: voting and non-voting. The shares were to be identical aside from the differences in voting rights. Indeed, the company articles provide that the non-voting shares are to be converted into voting shares if the applicable foreign ownership restrictions are lifted.

The non-voting shares historically have traded at a slight discount to the voting shares. Gradually the foreign investors have exited TELUS' stock and there now appears no reason to have two classes of shares. TELUS' board decided it would propose the shareholders approve a share swap of non-voting for voting shares on a one-for-one basis. The price differential between the two classes of shares narrowed sharply after the announcement of the proposed plan.

It is at this point that a U.S. hedge fund, Mason Capital, stepped in. Mason Capital ultimately accumulated shares carrying with them 33 million votes, but has a much smaller economic stake in the company. One academic commentator with financial ties to Mason (and therefore, one assumes, access to accurate information) suggests that Mason has an economic interest equal to 18 million votes (or 5.5% of the outstanding shares) (see B. Black, Equity Decoupling and Empty Voting: The Telus Zero-Premium Share Swap, M&A Lawyer, October 2012.) The B.C. courts seem to accept TELUS' contention that Mason's economic interest is much more like 0.21% of the company's capital.

The quantum of Mason's economic interest in TELUS is difficult to determine because it has been borrowing both voting and non-voting shares in order to short the latter and go long on the former. In other words, Mason has no interest in whether TELUS becomes a more valuable company; it has an interest in the value of non-voting shares going down relative to voting shares. It wants the price differential between the two classes of shares to open up again.

The TELUS board maintains that they advocated the share swap for several reasons, all linked to the long-term welfare of the company. First, good corporate governance favours the distribution of voting rights in accordance with capital investment. Second, the consolidation of the shares into a single class is expected to increase the liquidity and depth of the market for TELUS shares. The new class of shares will be cross-listed on the TSX and NYSE – currently only the non-voting shares trade on the U.S. Exchange.

Though the two reported B.C. decisions don't mention it, there might also have been considerations of fairness operating on the directors since the predecessor shares to the non-voting shares were at one time exactly the same as the predecessors of the voting shares. In

other words voting rights were expropriated from the non-voting shareholders at the time of the merger to satisfy legal requirements.

Mason takes the position that voting rights are worth something – which is undoubtedly correct – and the proposed share swap thus represents a transfer of wealth from the holders of voting shares to the holders of non-voting shares. It also observes that TELUS' management principally owns non-voting shares, including long-term incentive plans involving non-voting shares.

Mason's academic defenders point out not only this conflict of interest, but also the late date the board decided to create a special committee (evidence that it was ratifying a *fait accompli*) and certain weaknesses in the fairness opinion obtained by the committee. The fairness opinion seems to look at only whether the voting shares will benefit from the transaction (or at least not be harmed), rather than whether the gains from the transaction will be split fairly between the two classes of shares. (The problem being, of course, that the non-voting shares stand to receive the lion's share of the gains).

The Recent British Columbia Court of Appeal Decision

On October 12th, in the Court of Appeal comprehensively reversed the much talked about B.C. Supreme Court decision in favour of Mason. It held on one crucial procedural issue that a shareholder meeting requisition sent by a registered shareholder (the Canadian Depository for Securities) on behalf of a beneficial shareholder (Mason) is valid.

The lower court had argued that the requirement of the B.C. *Business Corporations Act,* SBC 2002, c 57, (similar in most respects to the corporations acts elsewhere in Canada) that requisitioning shareholders provide their names and addresses would be made a pointless nullity if it only meant the depository's name and address were to be provided. (In Canada and the U.S. nearly all public company shares are held through depositories).

The lower court also argued that the right of the directors to ignore a meeting requisition if it appeared motivated by a personal grievance could only be made available to the directors if the beneficial shareholders requisitioning the meeting were identified.

The Court of Appeal disagreed. It took a narrow reading of the *Business Corporations Act.* A "shareholder" in the Act is defined as a registered shareholder. The directors can ignore a meeting requisition but they don't have an obligation to do this, so their inability to do so in a situation where they don't know who is asking for the meeting, doesn't frustrate any requirement of the Act.

The Court also disagreed with the lower court on the narrow factual question of whether Mason's proposed shareholder resolutions were *ultra vires* the corporation's articles.

On the question that garnered most of the attention in the lower court's decision, the Court of Appeal criticized the chambers judge's *obiter* on empty voting. While acknowledging, "[t]he limited financial stake that Mason has in TELUS is a cause for concern," it went on to observe, "TELUS has not pointed to any authority that suggests that courts have inherent jurisdiction to control abuses. Courts are entitled to intervene only when they have specific authority to do so under statutory provisions." Adopting a strong position of judicial restraint it concluded, "[t]o

the extent that cases of "empty voting" are subverting the goals of shareholder democracy, the remedy must lie in legislative and regulatory change."

Observations

The B.C. Court of Appeal is surely correct that it would be unwise for courts to fashion their own remedies for cases of empty voting. For one thing it is not even clear what empty voting means. Indeed, it is not clear whether the TELUS case even involves a case of empty voting, notwithstanding the reams of ink and paper expended on this aspect of the case.

While Mason had little interest in a corporate strategy designed to advance the best interests of the company as a whole, it did have a big economic interest in the question it was asked to vote upon. It was an interest that differed from, say, the interests of non-voting shareholders, but it is not clear that it differed much from the interests of the holders of voting shares. Like them, Mason had an economic interest that the share swap occur on terms advantageous to the holders of the voting rights.

Any resolution of the issue of empty voting is going to have to consider in what circumstances an economic interest differs too much from the best interests of the corporation as a whole. The principle of "one share, one vote" has already seen erosion in the industrialized world. Several European countries, for instance, have enacted laws that restrict voting only to shareholders who have continuously held their stock for a certain period of time.

Many of the current Canadian corporate governance reforms are designed to give shareholders greater power in corporate decisions. The TSX has just published rules that will give shareholders the ability to vote against specific directors without having to propose an alternative slate (see Notice of Approval Amendments to Part I and Part IV of the TSX Company Manual, October 4, 2012, here). The Canadian Securities Administrators are thinking of revising the poison pill rules in ways that will enshrine shareholder approval in the process (see OSC Looks to Rewrite Rule Book on Poison Pills, Globe & Mail, Nov. 29, 2011, here). The Ontario Securities Commission's 2012 Annual Report (available here) revisited issues designed to enhance shareholder democracy that had been originally set out in a Staff Notice last year (see OSC Staff Notice 54-701 here). Say on pay proposals are circulating the country (including in last year's OSC Staff Notice) as we observe the impact of the new U.S. rules in the second proxy season since they were enacted (see Say on Pay Thriving in Canada: First Defeat for Management, National Post, June 18, 2012 here).

The TELUS case is a salutatory reminder that shareholders do not necessarily have the best interests of the corporation as a whole at heart. They are also untroubled by any obligation to see fairness done to holders of other classes of shares.

The ultimate result of the TELUS decision is befuddling as well to those inclined to distrust the parochial outlook of investors. When the TELUS shareholder meeting was ultimately held on October 17th, 62.9% of the voting shares were voted in favour of the share swap (see here).

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