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SPECIAL COMMITTEES - A RATIONALE

I. INTRODUCTION[1]

Financial markets must show absolute integrity and transparency because a positive perception by the public is essential to their proper functioning. For example, in less than forty-eight hours, the *Dow Jones Industrial Average* fell by more than fifty-five points following the announcement of Ivan Boesky's conviction for insider trading offences[2].

In a market where ownership has become increasingly concentrated and where related party transactions are common, the Québec Securities Commission (the **"Commission"**), following the example of the Ontario Securities Commission with Policy 9.1, has established the required mechanisms to alleviate conflicts of interest in certain transactions, by way of a document entitled policy statement No. Q-27 (the **"Policy"** or **"Q-27"**). In the opinion of the Commission, listed companies and other bodies corporate having access to financial markets must afford a fair treatment to all security holders

1 For convenience of reference, technical terms used in this Bulletin have the meaning assigned thereto in Policy Statement no. Q-27 or in the *Securities Act* (Québec).

2 Anthony BIANCO et al., "How the Boesky Bombshell is Rocking Wall Street", *Business Week*, December 1st, 1986, p.31.

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(the **"shareholders"**) by providing them with adequate information regarding certain proposed transactions. This Bulletin briefly describes the principal protective requirements established by the Commission and their consequences for the directors of a reporting issuer (the **"Corporation"**).

II. PROTECTIVE REQUIREMENTS IN CERTAIN TRANSACTIONS

The Policy applies to four types of transactions : (i) related party transactions; (ii) going private transactions; (iii) insider bids or insider exchange bids; and (iv) issuer bids. Failing a general exemption from the application of the Policy, four requirements may be imposed upon a Corporation. These requirements relate to the disclosure of information, financial valuation, directors' duties and minority shareholder approval. We will review each of these requirements based on the type of transaction being considered.

A. RELATED PARTY TRANSACTIONS

A Corporation entering into a transaction with a related party, usually an officer or a person who materially affects the control of the Corporation, must disclose to the Commission, in addition to the information normally required, a full description of the proposed transaction, the reasons therefore, the effects thereof, the history of the subject matter of the transaction, and the related party's interest in the proposed transaction where the value of the subject matter of the proposed transaction exceeds 25% of the Corporation's market capitalization.

In all cases, a financial valuation must be made in accordance with the provisions of the Policy. Q-27 specifies that the Corporation must ascertain that the valuer is qualified and independent. It also provides that the valuer shall be held liable under the *Securities Act* (the **"Act"**) for misrepresentations attributable to him, which are contained in the disclosure documents . The valuation method must be selected in accordance with the nature of the business, with the asset, liability or security being examined, and the valuation must be made as of a date not more than 120 days prior to the date the transaction.

It should be noted that the Corporation must allow the valuer to meet with management and must provide him with all information relevant to the valuation, including all financial information it has communicated to its financial advisors. In rendering his opinion, the valuer will refer to a range of values which shall be used by the directors to issue their recommendation on the fairness of the transaction. In practice, the special committee often requests the valuer or, less frequently, another expert, to issue a fairness opinion on which it may rely to make its recommendations to the Board and the shareholders.

The information required for the purposes of a valuation report will generally be more detailed than in the case of an ordinary valuation report. The Policy provides that a summary of the valuation must be included in the information circular or the proxy solicitation circular. This summary must include an overview of relevant prior valuations prepared in the 24 months preceding the tentative date of the transaction. Any difference between a prior valuation and the valuation in question must be explained in the valuation report.

With respect to the directors, the Commission is of the view that they are required to make a recommendation for the acceptance or the rejection of the proposed transaction and to disclose and justify their true personal opinion as to the fairness of the transaction. It will therefore be insufficient for them to state that they have no opinion or that the transaction is fair, based on the range of values.

Where the value of the subject matter of the transaction exceeds 25% of the Corporation's market capitalization, the Policy provides that the transaction cannot be carried out unless the approval of minority shareholders of each class or series of equity or voting securities is obtained. The level of minority approval required generally exceeds 50%. However, where the consideration to be paid to the interested party is more than, or the consideration received from the interested party is less than the average of the high and low ends of the range of values set by the valuer, the proposed transaction must then be approved by more than 66 2/3% of the votes.

Q-27 provides for a certain number of exemptions in connection with related party transactions. In particular, the Policy does not apply in the following cases:

a) where the Corporation has made no distributions under a prospectus or under a prospectus exemption set out in the Act, and where its securities are not listed on the Montreal Exchange; or

b) where fewer than 50 holders of its securities are residents of Québec and own less than 2% of the securities of any class; or

c) where the transaction involves a distribution of securities by a person solely interested in the transaction in its capacity as underwriter and where the distribution constitutes a related party transaction solely because the underwriter is an interested party, provided that the transaction complies with the requirements of applicable laws.

Q-27 provides for several specific exemptions regarding financial valuation and minority approval requirements. For example, the Corporation will be exempted from the requirement of obtaining a valuation in the following cases:

a) the price to be offered to shareholders was arrived at independently, within the twelve months preceding the date of the announcement of the proposed transaction;

b) the transaction involves the issuance of securities for cash, and these securities have been listed for trading on a stock exchange for at least twelve months, and there is a liquid market therefor;

c) the subject matter of the proposed transaction was acquired within the last twelve months in an independent transaction, and a valuer has certified in writing that the proposed consideration is equivalent;

d) all shareholders of a class or series participate in a rights offering made in compliance with the Act; a dividend distribution; or a distribution of assets of the Corporation directly to the shareholders, on a prorata basis and the participants are treated equally;

e) the proposed transaction is subject to the approval of a Court;

f) the subject matter of the transaction is transferred by the Corporation to a wholly-owned subsidiary or is attributed to a wholly-owned subsidiary; or

g) the value of the subject matter of the transaction does not exceed $500,000, the Corporation is listed on the Montreal Exchange in the case of an exploration company, and certain disclosure requirements have been complied with.

Minority approval of the proposed transaction shall not be required in some of the above-mentioned circumstances. Similarly, minority approval is not required if a person is already the registered holder of 90% or more of each class or series of equity or voting securities. The Policy also allows a person who does not meet all of the above requirements to request an exemption from the Commission.

B. GOING PRIVATE TRANSACTIONS

Disclosure and valuation requirements in related party transactions also apply, *mutatis mutandis*, in going private transactions. The duties of the directors and the special committee are the same as those provided for in related party transactions.

In the case of a going private transaction, the Policy requires that minority approval be obtained from the shareholders of each class or series of participating securities in which the interest of a shareholder may be terminated without his consent. The level of minority approval in a going private transaction will, as a rule, be more than 50%.

As regards exemptions, a financial valuation will not be required where there is a relatively liquid market for the securities subject to the offer. Minority approval of a going private transaction shall not be required if, at the time

of the transaction, a person is already a registered holder of 90% or more of each class or series of participating securities of the Corporation and a statutory appraisal remedy,or a substantially equivalent right, is available to the minority shareholders.

C. INSIDER BIDS OR INSIDER EXCHANGE BIDS

Disclosure, valuation and special committee requirements applicable to related party transactions apply, *mutatis mutandis*, to insider bids or insider exchange bids.

It should be noted that minority approval requirements do not apply to insider bids or insider exchange bids.

D. ISSUER BIDS

Disclosure and financial valuation requirements applicable to related party transactions apply, *mutatis mutandis*, to issuer bids.

Where the issuer bid involves an interested party, the Corporation should establish a special committee in accordance with the provisions of the Policy.

Minority approval requirements do not apply to an issuer bid.

III. PENALTIES

There are no explicit penalties in Q-27 for the violation of its provisions. However, one should note that the Policy came into force pursuant to a decision rendered by the Commission on October 5, 1992, and that any violation of a decision of the Commission is an offence under the Act. Fines for such offences range from $1,000 to $20,000 for physical persons, and from $1,000 to $50,000 in all other cases.

In addition, directors of a Corporation who violate the provisions of Q-27 could be held liable for a breach of their duties of loyalty and good faith, as provided for in the *Civil Code of Québec* and in the special statutes governing the Corporation, and could expose the Corporation to a suit by the shareholders.

IV. ADVICE TO CORPORATE DIRECTORS

Following this brief review of the requirements contained in the Policy, we suggest that the directors of a Corporation wishing to enter into a transaction governed by Q-27 should proceed as follows, in order to comply with the Policy and to minimize the risks of suits by the Commission or the shareholders:

a) obtain legal advice to determine whether the proposed transaction is subject to the Policy and if so, obtain practical advice on the steps to follow;

b) establish a special committee, that is a committee comprised of independent directors, which should retain the services of independent legal counsel;

c) select a qualified and independent valuer, provide him with access to all information required for his valuation and properly negotiate the costs of the valuation, since prices can vary considerably; and

d) prepare a record of the transaction describing all steps taken, the discussions of the directors and the general conduct of the transaction.

Obviously, compliance with the provisions of the Policy will involve expenses for the Corporation, namely as regards the cost of valuation, the fees of the special committee's independent counsel and the time spent on the matter by the members of the special committee. Nonetheless, the authorities seem to believe that these costs are necessary to preserve the integrity and fair reputation of Québec's financial markets. Note that Robert G. Wright, former President of the Ontario Securities Commissions, made the following comments on Policy 9.1, the Ontario equivalent of Q-27:

> "We appreciate that there is a cost to all of this, but we believe the cost is one that must be paid, both to insure fairness in individual transactions and, perhaps more importantly **to maintain investor confidence in Ontario's and Canada's capital markets.**"

We have had the opportunity to participate in several valuations conducted pursuant to Q-27, and have acted as legal counsel to several special committees. Do not hesitate to contact any member of the Business Law group at our firm if you have any questions with respect to the foregoing.

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