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Hedge Fund Activism Canadian Style

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Abstract

The forthright brand of shareholder activism hedge funds deploy became during the 2000s a significant feature of Canadian corporate governance. This paper examines hedge fund activism "Canadian style." The paper characterizes the interventions hedge funds specialize in as "offensive" shareholder activism and uses a heuristic device, "the market for corporate influence", to identify the variables that dictate how frequent such activism is likely to be. This analytical structure is used to explain why hedge fund activism has become part of the Canadian corporate governance landscape and has displaced at least partly a Canadian shareholder "culture of passivity."

Keywords: Shareholder Activism, Hedge Funds, Canada

JEL Classifications: G34, G38, K22, N22

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Introduction

In a 1998 article I argued that those who predicted "the birth of an activist movement in Canada" as a result of a then recent Quebec Superior Court decision that permitted corporate "gadfly" Yves Michaud to circulate to corporate governance resolutions to shareholders of two Canadian banks were reading too much into the decision.[1] Subsequent events have largely vindicated this assessment, as a 2012 study of the shareholder proposal mechanism dealt with in the *Michaud* case found "that the shareholder 'culture of passivity' persists."[2] Nevertheless, the shareholder activism landscape in Canada has changed markedly since the late 1990s. This is due to the emergence of a forthright brand of activism collective investment vehicles known as hedge funds deploy. A *Globe & Mail* columnist observed in 2012 that "Canada has become a promised land for activist shareholders...."[3] This paper will describe how and why the "offensive" brand of shareholder activism in which hedge funds specialize has become part of the Canadian corporate governance landscape and has displaced at least partly the Canadian shareholder "culture of passivity".

Offensive shareholder activism occurs when an investor lacking a meaningful stake in a company builds up a sizeable holding on the assumption the company is delivering suboptimal shareholder returns and intends to agitate for change if management does not take

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1 Brian R. Cheffins, "Michaud v. National Bank of Canada and Canadian Corporate Governance: A 'Victory' for Shareholder Rights?" (1998) 30: 1 Can. Bus. L.J. 20, 21-22, 70-71.

2 Evaristus Oshionebo, "Shareholder Proposals and the Passivity of Shareholders in Canada: Electronic Forums to the Rescue?" (2012) 37: 2 Queen's Law Journal 623, 626 (acknowledging, though, an increase in proposals submitted to Canadian corporations since a 2001 liberalization of the relevant rules in s. 137(1) of the Canada Business Corporations Act, RSC 1985, c. C-44, as amended).

3 Boyd Erman, "New Investor Activism a Tug of War Between Upside, Pitfalls," Globe & Mail, November 22, 2012, B2.

steps to correct matters.[4] A 2012 boardroom coup at Canadian Pacific Railway Ltd. (CP), the iconic railway operator, constitutes the most prominent instance of this form of activism in a Canadian context.

CP's stock hit a two year low on the Toronto Stock Exchange (TSX) in September 2011 and a 2012 press report said that "For years we've been laughing behind John Cleghorn's back at the National Club about what a putrid company Canadian Pacific Railway is (Cleghorn was CP's chairman of the board from 2006 to 2012)."[5] Between late September and late October 2011 Pershing Capital, a New York-based hedge fund run by Bill Ackman, spent over $1 billion to acquire more than 12 per cent of CP's shares.[6] According to filings Pershing Capital was required to make with securities regulators due to acquiring such a sizeable stake, it believed CP's shares were undervalued and intended to engage in discussions with management, the board and other shareholders to improve the situation.[7] Negotiations between CP's board and Pershing Capital broke down and Pershing Capital launched a campaign soliciting support from shareholders to secure the election of a number of its nominees as CP directors at CP's May 2012 annual shareholder meeting.[8] With Pershing Capital destined to win easily six CP directors, including Cleghorn and chief executive officer (CEO) Fred Green, agreed not to stand for re-election, thereby clearing the

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4 Brian R. Cheffins, *Corporate Ownership and Control: British Business Transformed* (Oxford: Oxford University Press, 2008), 392.

5 Jacquie McNish, "The Giant Killer: Inside CP's Overthrow", Globe & Mail, May 19, 2012 (share price); Derek DeCloet, "Dear Bill Ackman: Save Us From Ourselves", Globe & Mail, Report on Business, Annual Top 1000 Rankings, June 13, 2012. On Cleghorn's tenure, see http://www.forbes.com/profile/john-cleghorn/ (last visited January 6, 2013).

6 McNish, "Giant Killer", *supra* note xx and accompanying text.

7 Andrew McDougall, "Six Lessons Learned from the CP Rail Proxy Battle", July 9, 2012, available at http://www.osler.com/NewsResources/Six-Lessons-Learned-from-the-CP-Rail-Proxy-Battle/ (last visited October 18, 2012).

8 Steven M. Davidoff, "America's Latest Export to Canada: Shareholder Activism", New York Times, February 15, 2012, B1.

way for the election of a sufficient number of Pershing Capital's nominees to give Pershing control of the board.[9]

A Canadian business columnist said of events occurring at Canadian Pacific, "In the annals of cozy Canadian corporate governance, coup d'états are rare historic events."[10] Another maintained the CP incident was very much out of character for Canada, saying of Bill Ackman, "we Canadians are not men of action. We'd like to be more like you, but it's not easy. Our business community is rather different from America's....It's a small, polite group of people for a small, polite country...No one wants to be the attack dog."[11] It is true that corporate Canada had never seen previously as dramatic an intervention at such a prominent company.[12] Nevertheless, the CP confrontation was part of a broader trend affecting Canadian corporate governance. Since around 2000 there have been numerous occasions where hedge funds like Pershing Capital have bought sizeable stakes in Canadian publicly traded companies perceived to be underperforming and have sought to profit from an anticipated corporate turnaround, commenced voluntarily or otherwise.

Offensive shareholder activism has affected British Columbia-based companies as well as companies headquartered elsewhere in Canada. For instance, after Connecticut-based hedge Pirate Capital LLC bought in 2005 a 7% stake in Intrawest Corp., a publicly traded and Vancouver-based resort operator it believed was significantly undervalued, Pirate Capital

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9 McNish, "Giant Killer", *supra* note xx and accompanying text.

10 Terence Corcoran, "Historic Coup at CP Rail", National Post, May 4, 2012.

11 DeCloet, "Dear Bill", *supra* note xx.

12 See, for example, Boyd Erman, "Boardroom Coup a Warning to Directors who Can't Deliver", Globe & Mail, May 18, 2012, B1 ("But to see a full-on proxy battle that resulted in the ouster of most of the board and the chief executive officer at one of the 40 largest public companies in Canada is another step down the road.")

successfully lobbied the Intrawest board to put the company up for sale.[13] In 2006, private equity firm Fortress Investment Group bought Intrawest for $2.8 billion and Pirate Capital, which by that point had increased its stake in Intrawest to 18%, made a $75 million profit from selling out.[14]

A protracted tussle between Vancouver-based telecommunications giant Telus Inc. and hedge fund Mason Capital Management about a plan the company announced in 2012 to convert non-voting Telus shares into voting common shares might appear to be an even more prominent example of British Columbia-oriented offensive shareholder activism. In fact, Mason Capital's strategy was quite different from that dictated by the standard hedge fund activism playbook. As this paper will discuss, its intention was to profit from changes in the value of Telus common shares that would result if Telus' share consolidation proposal was defeated rather than from targeting perceived corporate underperformance.

While offensive shareholder activism has become an important feature of Canadian corporate governance, little has been said about the topic in the academic literature. Correspondingly, this paper will describe the emergence of hedge fund activism in Canada, identify the legal and economic variables that have set the scene for its rise to prominence and offer some predictions on whether the trend will be sustained. A key point the paper makes is that in various ways the environment for offensive shareholder activism has become more hospitable in Canada over the past dozen or so years. Nevertheless, the small size of the domestic hedge fund "industry" in global terms poses a potential obstacle to the continued growth of hedge fund activism Canadian style.

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13 Fiona Anderson, "Activist Shareholders May Target Intrawest, Analyst Claims", Vancouver Sun, August 26, 2005, F1; Lori McLeod, "Intrawest v. Pirate: Expect a Battle of Wills", National Post, March 13, 2006, F1.

14 Tony Wong, "Investment Firm Buying Intrawest", Toronto Star, August 12, 2006, D1.

The paper does not assess whether the emergence of offensive shareholder activism has been a "good" thing for Canadian corporate governance, in large measure because it is premature to do so. There currently is a lack of Canadian-specific data available on the impact that hedge fund activism has on corporate performance and shareholder returns.[15] Correspondingly, what the paper does in normative terms is to provide the historical, legal and institutional context for future empirical research that will provide evidence on the costs and benefits of hedge fund activism in Canada.

The paper proceeds as follows. Part I identifies the key characteristics of offensive shareholder activism for which hedge funds have become well known, distinguishing in so doing offensive shareholder activism from takeover bids and from the "defensive" interventions "mainstream" institutional shareholders typically undertake. Part I also describes why the Telus/Mason Capital face-off was a marked departure from the standard hedge fund activism playbook. Part II documents the rise of hedge fund activism Canadian style, indicating in so doing that while the story began as the 1990s drew to a close interventions by hedge funds only achieved prominence in the 2000s. Part III identifies in a general way the factors likely to determine levels of offensive shareholder activism in a jurisdiction over time. Part IV draws upon Part III's insights to explain why this corporate governance tactic, especially as deployed by hedge funds, has moved to the forefront in Canada over the past dozen or so years. Part V concludes, speculating briefly on the future of offensive shareholder activism in Canada in so doing.

I. The Nature of Offensive Shareholder Activism

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[15] Boyd Erman, "Activist Investors Emerge, But Value Still Hidden", Globe & Mail, November 20, 2012, B1 (saying of results of activist challenges involving large publicly traded Canadian companies that "there was hardly a clear picture", acknowledging in so doing the small sample size and short-time frame).

Shareholder activism has been equated with "proactive efforts to change firm behaviour or governance rules."[16] Shareholder activism designed to change firm behaviour can be directed at social goals as well economic goals.[17] However, socially oriented shareholder campaigns launched by actors whose goals are unrelated to enhancing risk-adjusted shareholder returns have historically failed to have a meaningful impact on corporate operations.[18] Correspondingly, in practical terms interventions designed to boost shareholder returns and alter corporate governance arrangements have occupied shareholder activism's centre-stage. Even once shareholder activism is conceived of in this narrower way, its scope extends well beyond the "offensive" shareholder activism in which hedge funds typically engage. A helpful way to illustrate the point is to distinguish this form of activism from its "defensive" counterpart as well as from two other corporate governance tactics investors can theoretically deploy, takeover bids and empty voting.

A. Comparing Offensive and Defensive Activism

A common scenario where shareholder activism is directed towards changing firm behaviour or corporate governance is where a shareholder who already has a sizeable stake in a company becomes dissatisfied with the status quo. Instead of relying on the stock market to exit and cut losses suffered, the shareholder reacts by lobbying quietly for change or with a public challenge to management. Activism of this sort can be thought of as "defensive" in orientation because the shareholder taking the lead is reacting to events so as to protect its

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16 Bernard S. Black, "Shareholder Activism and Corporate Governance in the United States", in Peter Newman (ed.), The New Palgrave Dictionary of Economics and the Law (London: Palgrave Macmillan, 1998), 459, 459, cited by Paul Rose, "Sovereigns as Shareholders" (2008) 87 N.C. L. Rev. 83, 120, n. 181; Bruce E. Aronson, "A Japanese Calpers or a New Model for Institutional Investor Activism? Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan," (2011) 7 N.Y.U. J. L. & Bus. 571, 574, n. 1.

17 Black, "Shareholder", *supra* note xx, 459.

18 K.A.D. Camara, "Classifying Institutional Investors" (2005) 30 J. Corp. L. 219, 235-36.

substantial pre-existing investment in the company.[19] When "mainstream" institutional shareholders such as pension funds, mutual funds and life insurance companies engage in shareholder activism, it will usually be of this defensive sort.[20] Moreover, it will typically occur behind closed doors. As Professor Janis Sarra observed in a 2003 article, "Canadian institutional investors...have a history of quiet and collaborative intervention, as opposed to confrontational or public proxy battles. They meet with corporate officers when they are concerned about particular strategies or corporate conduct."[21]

While in Canada defensive shareholder activism is generally a quiet affair, there have been some public showdowns. For instance, with the shares of Alberta-incorporated and Toronto Stock Exchange-listed magnet and bicycle maker YBM Magnex International Inc. having fallen from $20 to $1 amidst a criminal probe and allegations of links to Russian mafia figures, in 1998 Canadian pension and mutual funds owning approximately half of the company's shares relied on court proceedings to install a new board of directors.[22] Likewise, with telecommunications giant Nortel having been laid low by a major accounting scandal the Ontario Teachers' Pension Plan (OTPP), a 1 per cent shareholder, and the Canadian Coalition for Good Governance, a trade group representing a large proportion of Nortel's institutional shareholders, lobbied publicly for a boardroom shakeup that resulted in 2005 with the departure of five of Nortel's ten directors.[23] More recently, when in 2012 fund

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19 Brian R. Cheffins and John Armour, "The Past, Present, and Future of Shareholder Activism by Hedge Funds", (2011): 1 37 J. Corp. L. 51, 56.

20 Cheffins and Armour, *ibid*.

21 Janis Sarra, "Shareholders as Winners and Losers Under the Amended Canada Business Corporations Act", (2003): 39: 1 Can. Bus. L.J. 52, 66.

22 Steven Chase, "Institutional Investors Stage YBM Board Coup", Globe & Mail, September 23, 1998.

23 Theresa Tedesco, "Nortel to Overhaul Board", National Post, September 29, 2004, F1, Paul Waldie, "Teachers Pushing to Change Nortel Board", Globe & Mail, November 19, 2004, B3; Theresa Tedesco, "Wilson Early Casualty of Governance Hounds", National Post, January 12, 2006, FP1.

manager Invesco Trimark Ltd. requested a shareholder meeting to vote on the dismissal of incumbent directors at home improvement retailer Rona Inc. it did so as an investor which had held a substantial stake in the company for a number of years, not as "a hedge fund looking to make a quick buck."[24]

A defining feature of defensive shareholder activism is that the shareholder or shareholders taking the initiative will have held a sizeable stake in the company before stepping forward. This "initial endowment" will be absent with offensive shareholder activism.[25] What happens instead is that an investor lacking a meaningful stake in a company builds up one "offensively" on the presumption that the firm is failing to maximize shareholder returns and proceeds with the intention of agitating for change to unlock shareholder value if management does not take the initiative. As Pershing Capital's boardroom coup at CP illustrates, this is the sort of shareholder activism for which hedge funds have gained notoriety.

The adjective "offensive" potentially connotes an aggressive posture towards incumbent management. This form of activism does not necessarily imply, however, shareholder/executive antagonism. While hedge fund activists have a reputation for being confrontational, they in fact often refrain from agitating for change.[26] The business model such investors typically adopt explains why.

There is a substantial overlap in investment philosophies between activist hedge funds and "value investors" who seek through diligent analysis of corporate fundamentals to

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24 Tim Kiladze, "Invesco's No Short Term Opportunist with Rona", Globe & Mail (Breaking News), November 14, 2012; see also Marina Strauss and Shirley Won, "Investors Call for a Clean Sweep at Rona", Globe & Mail, November 15, 2012, B1.

25 Cheffins and Armour, "Past", *supra* note xx, 56.

26 *Ibid.*, 57.

purchase shares trading at a bargain price, the proverbial dollar for 50 cents.[27] The sub-set of hedge funds that engage in offensive shareholder activism typically relies on this "value approach" to identify undervalued companies as potential targets.[28] As and when an activist hedge fund's analysis is borne out by a market correction rather than due to any prompting by the hedge fund this will be relatively "easy money" for the hedge fund. The situation will be much the same if the board of a company, purely on its own initiative, makes changes that serve to increase shareholder returns.

Activist hedge funds which buy sizeable stakes in target companies where shareholder returns improve without any form of intervention are essentially engaging in the successful "stock picking" to which value investors aspire. The readiness to take a hands-on role to shake things up is the crucial additional dimension of offensive shareholder activism executed by hedge funds. Instead of simply waiting for the market to self-correct in the manner a typical value investor would, activist hedge funds are prepared to take the initiative and accelerate matters by pressing for changes calculated to boost shareholder returns.

West Face Capital, a Toronto-based investment firm founded in 2006 by Greg Boland and run by him, illustrates the offensive shareholder activism business model in operation. Boland made a name for himself on the trading desk at RBC Dominion Securities during the 1990s due to success spotting undervalued securities and when he founded West Face Capital the idea was that funds he launched would invest in underperforming companies and agitate for change if necessary.[29] West Face subsequently often was a patient investor in public

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27. Bruce C. N. Greenwald, Judd Kahn, Paul D. Sonkin and Michael van Biema, *Value Investing: From Graham to Buffett and Beyond* (Hoboken, N.J.: John Wiley & Sons, 2004), xv.

28 This overview of the investment approach of activist hedge funds is drawn from Cheffins and Armour, "Past", *supra* note xx, 57-58.

29 Jacquie McNish, "War and Peace and Cold Cuts", Globe & Mail, Report on Business Magazine, February 24, 2012.

companies that would wait for the market to catch up and limited any interaction with management to cooperative dialogue.[30] There also were instances where companies West Face invested in initiated changes designed to improve shareholder returns without any overt prompting. For instance, in 2012, a few weeks after West Face announced it had acquired a 1 per cent stake in Calgary-based oil and gas company Talisman Energy Inc. the Talisman board responded to lacklustre shareholder returns by replacing the incumbent CEO and did so without lobbying by West Face or other shareholders.[31]

While West Face Capital did not launch any sort of activist campaign at Talisman Energy, it was well-known by 2012 that West Face Capital had the tools and experience to make life difficult for incumbent managers.[32] In 2009, Air Canada parent ACE Aviation offered Boland a seat on the board of directors to persuade West Face Capital, a 15 per cent shareholder in ACE Aviation, to withdraw a request for a special shareholders meeting to replace the company's directors.[33] Similarly Boland became in 2011 a director of meat and baked goods producer Maple Leaf Foods Inc. in return for West Face Capital, which became a 10 per cent shareholder in 2010, withdrawing a shareholder resolution calling for the company to reduce the number of board seats and install a new cohort of independent directors.[34]

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30 McNish, "War", *ibid.*; Boyd Erman, Jacquie McNish and Tim Kiladze, "Meeting with Activist Investor Sets Stage for McCain's New Test", Globe & Mail, August 12, 2010, B1.

31 Boyd Erman, "Talk Heats up of Talisman Sale as Teachers, West Face Buy In", Globe & Mail, August 25, 2012, B2; Boyd Erman, "Talisman Board got the Message Before a Fight", Globe & Mail (Breaking News), September 10, 2012.

32 Boyd Erman, "With CEOs as a Target, Manzoni's Exit was Inevitable," Globe & Mail, September 11, 2012, B2.

33 "ACE Aviation Causing Frustration", Hamilton Spectator, December 11, 2008, A15; Chris Sorensen, ACE May Put Cash in Airline, Toronto Star, June 9, 2009, B4.

34 Jacquie McNish, "The Thorn in Maple Leaf's Side has no Plans for a Quick Exit", Globe & Mail, December 7, 2010, 1; Jacquie McNish, Activist Wins Seat on Board of Maple Leaf", Globe & Mail, February 4, 2011, B1.

B. Offensive Shareholder Activism vs. Takeover Bids

If a company is underperforming and its share price is suffering accordingly, it could theoretically be vulnerable to a takeover bid launched by a bidder who calculates it would be worthwhile to make an offer to the shareholders to buy their equity with a view to obtaining voting control so as to install a new management team.[35] While hedge funds engaging in offensive shareholder activism identify underperforming companies in a similar way and are prepared to take action to create value, they are unlikely to follow up by executing what law professors Ronald Gilson and Alan Schwartz label a "transfer by sale" by purchasing a majority of the shares from existing investors (e.g. by way of a successful tender offer).[36] The most dramatic strategy a hedge fund engaging in offensive shareholder activism is ever likely to deploy will be a proxy contest designed to obtain a majority of board seats, a method of obtaining corporate control Gilson and Schwartz call a "transfer by vote".[37] This is what occurred with CP, where after the dust settled the board was comprised of eight directors from the Pershing Square side and seven CP incumbents.[38]

Activist hedge funds eschew transfers by sale because they prefer not to tie up capital in the form of majority or sole ownership of companies.[39] Though activist hedge funds concentrate funds invested in a considerably smaller number of companies than a conventional mutual fund, acquiring outright control of companies targeted could well

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35 Brian R. Cheffins, *Company Law: Theory, Structure and Operation* (Oxford: Oxford University Press, 1997), 119.

36 Ronald J. Gilson and Alan Schwartz, "Sales and Elections as Methods for Transferring Corporate Control", (2001) 2 Theoretical Inquiries in L. 783, 790.

37 *Ibid.*

38 Brent Jang, "As Harrison Climbs on Board, Ackman's Vision Becomes Reality", Globe & Mail, June 30, 2012, B1.

39 Cheffins and Armour, *supra* note xx, 59.

introduce idiosyncratic portfolio risk even an activist hedge fund would find inordinate.[40] Companies also may simply too big for a hedge fund to buy outright. As of 2012, the market capitalization of companies listed on the TSX averaged nearly $1.3 billion.[41] This means that buying up all of the shares would be a tall order for, say, West Face Capital, given a total of $2.5 billion in assets under management in all funds.[42] West Face Capital is, moreover, very large by the standards of Canadian based hedge funds. As of 2010, only 9 per cent reported having assets under management exceeding $200 million.[43]

There in fact are numerous Canadian publicly traded companies where size would likely not preclude a fully fledged takeover, at least with an investment firm with scale similar to West Face Capital. With the $1.3 billion TSX market capitalization average being biased upwards by a minority of companies of much greater size and with a majority of Canadian public companies being traded on lower profile exchanges, Canada has "a great many companies with very small market capitalizations."[44] Still, research on hedge fund activism by U.K. academic Dionysia Katelouzou illustrates that hedge funds prefer to operate as minority shareholders, regardless of the size of the companies being targeted. She found, based on a cross-country dataset she compiled of over 400 instances of hedge fund activism occurring between 2000 and 2010, that the proportion of shares held by hedge funds activists

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40 Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, "Hedge Fund Activism, Corporate Governance and Firm Performance," (2008) 63: 4 J. Fin. 1729, 1752 (making the same point to explain why activist hedge funds tend not to target very large companies).

41 TMX, "TMX Group Equity Financing Statistics – August 2012", available at http://www.tmx.com/en/pdf/MonthlyFinancingSummary.pdf (last visited October 30, 2012) (indicating that there 1,573 issuers listed and that overall market capitalization was $2.043 trillion).

42 McNish, "War", *supra* note xx.

43 Canadian Hedgewatch, January 2011, 41, Table 1.6.

44 Christopher Nicholls, "The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*", (2006), available at http://www.tfmsl.ca/docs/V4(3A)%20Nicholls.pdf (last visited November 6, 2012), 127, 154.

at the highest point averaged 11.6 per cent.[45] For Canadian companies in the dataset, the figure was 13.1 per cent.[46]

Hedge fund activists do sometimes say they intend to acquire outright voting control of companies they target. Only rarely, though, do they end up prevailing.[47] For instance, among the over 400 instances of hedge fund activism Katelouzou identified as occurring between 2000 and 2010 there were 37 occasions where a hedge fund launched a takeover bid but only once did the hedge fund end up with a majority stake in the targeted company.[48]

When hedge funds launch takeover bids the ostensible objective of which is to obtain outright voting control these bids typically either fade away as an engagement takes its course or are beaten out by a higher offer.[49] This occurred, for example, with Lions Gate Entertainment Corp., a film producer and distributor based in Vancouver and run from Santa Monica, California, and Carl Icahn and his hedge fund Icahn Partners. Icahn, a well-known "corporate raider" during the 1980s and a prominent hedge fund activist during the 2000s,[50] believed Lions Gate's shares were undervalued and bought a 4 per cent stake in 2006.[51] In 2009, the Icahn group upped its Lions Gate stake to nearly 15 per cent of the shares, indicating in so doing that it continued to believe the shares were undervalued but saying in

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45 Dionysia Katelouzou, "Hedge Fund Activism, Corporate Governance and Corporate Law: An Empirical Analysis Across 25 Countries" (2012), Ph.D. thesis, 138.

46 *Ibid.*, 139.

47 Alon Brav, Wei Jiang and Hyunseob Kim, "Hedge Fund Activism: A Review" (2009) 4: 3 Foundations and Trends in Finance 185, 203.

48 Katelouzou, "Hedge", *supra* note xx, 132 (37 takeover bids), 138 (indicating that the largest ownership stake by a hedge fund in the dataset was a 51 per cent holding arising from a takeover bid Laxey Partners by for Swiss manufacturer Implenia AG).

49 Cheffins and Armour, *supra* note xx, 60.

50 Cheffins and Armour, *ibid.*, 78.

51 Jay Palmer, "The Little Studio That Could", Barron's, July 10, 2006, 15.

addition that board representation might be sought.[52] Lions Gate rebuffed Icahn and he seemingly lost interest in the company.[53]

In 2010 the Icahn group reappeared on the scene, making an offer to buy all of Lions Gate's outstanding shares. Given, however, that the offer of $6 per share did not incorporate any kind of control premium it is doubtful whether the takeover bid was a serious one. As one shareholder said of Icahn, "If he was really interested in Lions Gate he would offer $12 and take the whole thing. He's trying to upset management."[54] The Icahn group subsequently increased its offer to $7 but ended up only owning 38 per cent of the shares.[55] A follow up takeover bid also failed, as did a proxy contest launched to obtain substantial board representation.[56] In 2011, the Icahn group exited Lions Gate with the company and its leading shareholder agreeing to buy back the shares for $7 each.[57]

C. Offensive Shareholder Activism and Empty Voting

While the 2012 CP/Pershing Square saga was a headline grabbing affair,[58] the attention it garnered was rivalled by a British Columbia-oriented battle where a hedge fund bought up a sizeable percentage of the targeted company's shares and challenged

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52 Michael Garrahan, "Icahn Move on Lionsgate Could be Screen Classic", Fin. Times (Asia ed.), February 26, 2009, 16. The Icahn group had the year before raised its stake to 9.2 per cent: Andy Fixmer and Michael White, "Lions Gate Seen as a Bargain by Billionaire Investor Icahn, who Doubles Personal Stake", Vancouver Sun, October 22, 2008, F6.

53 Lauren A.E. Schuker, "Icahn Raises Bid to Try to Secure Lions Gate Control", Wall St. J., March 13, 2009, B4; Peter Lauria, "Icahn Locks 'Gate'", New York Post, February 17, 2010, 31.

54 Brett Pulley, "Icahn Begins Hostile Offer for Lions Gate After Snub", Vancouver Sun, March 20, 2010, D6.

55 Michael White and Ronald Grover, "Icahn Gets 'Blocking Power' in Lions Deal", National Post, July 2, 2010, FP4.

56 "Denied", New York Times, December 15, 2010, 8.

57 Ryan Nakashima, "Icahn Dumps Stake in Lions Gate", Globe & Mail, Aug. 31, 2011, B5.

58 *Supra* note xx and related discussion.

management. The protagonists were Telus Corp., the Vancouver-headquartered telecommunications company, and New York-based Mason Capital Management. In 1999, after Alberta-based Telus merged with BC Telecom Inc. the new Telus Corp. ensured it complied with foreign ownership restrictions affecting Canadian telecommunications companies by creating a class of non-voting common shares that were issued to GTE, an American company that had a controlling interest in BC Telecom.[59] When Verizon, GTE's successor, subsequently divested itself of its stake in Telus Corp. the percentage of Telus shares held by foreign investors fell well below maximum levels permitted by law.[60] With the rationale underlying the non-voting stock now gone, Telus management announced a plan as 2012 got underway to eliminate the company's dual class share structure by consolidating the voting and non-voting shares. The pitch Telus made in favour of the capital reorganization was that it would enhance the liquidity and marketability of the company's shares and bring Telus into line with corporate governance best practice.[61]

While Telus' non-voting shares historically traded at a discount relative to the voting common shares of 4.5% over the three years prior to announcement of consolidation plan, the company said the non-voting shares would be converted on a one-for-one basis to common shares.[62] Mason Capital promptly acquired nearly 19 per cent of Telus' common shares and 0.4 per cent of the company's non-voting shares.[63] It then publicly denounced the share

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59 Harvey Enchin, "Telus Fights for Equality", Vancouver Sun, May 4, 2012, A15; *Telus Corp. v. Mason Capital Management*, 2012 BCCA 403, paras. [7]-[8].

60 Enchin, "Telus", *supra* note xx; *Telus Corp. v. Mason Capital Management, supra* note xx, para. [9].

61 *Telus Corp. v. Mason Capital Management, supra* note xx, para. [10]; Jamie Sturgeon, "Telus Plans to Convert Equity to Voting Stock", National Post, February 22, 2012, 9.

62 *Telus Corp. v. Mason Capital Management, supra* note xx, paras. [11]-[12].

63 Mason Capital Management LLC, "Alternative Monthly Reporting System Report of an Eligible Institutional Investor Under Part 4 of National Instrument 62-103", April 10, 2012, para. 7(a); David Pett, "Uncertainty over Telus Single Class Share Plan", National

consolidation plan, saying the Telus proposal "represent(ed) a significant and undeserved transfer of value from the voting shareholders to owners of the non-voting stock."[64] Mason Capital's stance put Telus' plan in jeopardy because the threshold Telus set for matters to proceed was approval by two-thirds of the votes cast by the holders of common shares as well by two-thirds of the votes cast by the holders of non-voting shares.[65] Facing certain defeat, Telus withdrew its plan.[66]

The contest between Telus and Mason Capital Management had numerous subsequent twists. These included litigation concerning Mason Capital's right to call a shareholder meeting and a fresh vote by Telus shareholders on the share class consolidation plan where the absence of any amendments to the corporate constitution or changes to the Telus' capital structure meant only majority approval by the common shares was required and a 63 per cent majority was in fact obtained.[67] Throughout the Telus/Mason Capital saga a widely remarked upon feature was the nature of Mason Capital's investment.

Mason Capital's 19 per cent stake in Telus' common shares represented nearly $2 billion worth of shares, a huge investment for a hedge fund. Mason Capital's economic exposure to Telus' business fortunes, however, was much more modest. Mason Capital responded to Telus' share class consolidation plan by buying not only 32.7 million voting and

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Post, April 23, 2012 (citing the views expressed by Telus' chief financial officer, who said Mason Capital acquired its sizeable stake after the announcement of the share class consolidation plan).

64 Quoted in Pett, "Uncertainty…", *supra* note xx.

65 Pett, "Uncertainty…", *ibid.*; Andrew MacDougall, Robert M. Yalden and Jeremy Fraiberg, "A Call to Arms on Empty Voting", August 2, 2012, available at http://www.osler.com/NewsResources/A-Call-to-Arms-on-Empty-Voting/

66 Rita Trichur, "Telus Won't Concede Defeat", Globe & Mail, May 10, 2012, B1.

67 *Telus Corp. v. Mason Capital Management, supra* note xx, paras. [23] (describing the rationale for adoption of the simple majority threshold); [50, 86] (indicating that Mason Capital could call the shareholders' meeting it had requested); Luann Lasalle, "Shareholders Back Telus on Share Plan," Times Colonist, October 18, 2012, C9 (outcome of vote).

602,300 non-voting shares but also by using to derivatives to "short" 10.9 million voting shares and 21.7 million non-voting shares. This meant its net position was only 416,000 shares, representing one-quarter of one per cent of Telus' share capital with a market value of $24 million.[68]

Telus' announcement of its capital reorganization caused the discount at which Telus' non-voting shares traded to fall from 4 per cent to under 1 per cent in anticipation that the non-voting shares would be converted on the one-to-one basis Telus proposed.[69] The logic underlying Mason Capital's shorting of Telus' shares was that if the company's plan was defeated the spread between the two classes of shares would revert to prior levels.[70] Under such circumstances Mason Capital would profit substantially and, due to its hedging, would do so without running the risk that Telus' financial performance would impact upon Mason Capital's investment returns.

Telus CEO Denis Entwistle denounced Mason Capital's intervention on the basis the hedge fund was "not here for the long haul, unlike our team members and our true committed long-term shareholders."[71] He said of the method Mason Capital had used to intervene "I find it morally objectionable" and "a great example of what is wrong within the capital markets."[72] He characterized Mason Capital's tactics as an example of "(e)mpty voting...a

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68 Enchin, "Telus Fights", *supra* note xx.

69 Pett, "Uncertainty", *supra* note xx; Boyd Erman, "Market Shows Telus is Trouncing Mason", Globe & Mail, September 15, 2012, B1; Terence Corcoran, "Corporate Games", National Post, May 11, 2012, 11 ("In the weeks since the share plan was announced in February, the Telus voting premium was wiped out of the market.")

70 Enchin, "Telus", *supra* note xx and related discussion.

71 Luann Lasalle, "Telus CEO Blasts Hedge Fund Play", Vancouver Province, May 10, 2012, A32.

72 Trichur, "Telus Won't", *supra* note xx.

troubling and disgraceful practice that gives a hedge fund considerably more votes than its economic interests warrant."[73]

Empty voting was defined by the B.C. Court of Appeal in litigation arising from Telus/Mason Capital saga as "the accumulation of votes by a party that has a very limited financial stake in a company."[74] The term was coined by law professors Bernard Black and Henry Hu in the mid-2000s to convey the idea that where an investor uses derivatives to hold more votes than shares the votes will be emptied of an accompanying economic interest.[75] They identified hedge funds as being in the vanguard of the decoupling of the economic return on shares and the corresponding voting power.[76]

When Black and Hu first drew attention to empty voting involving hedge funds there was intense interest in their findings and the use of empty voting by hedge funds continues to attract the attention of academics.[77] One might correspondingly assume that empty voting is an important part of the playbook of hedge funds specializing in shareholder activism. This is not the case. Instead, the deployment of empty voting is antithetical to the sort of offensive shareholder activism in which hedge funds typically engage.

For an investor who engages in offensive shareholder activism the anticipated upside will be the improvement in shareholder returns occurring after the investor buys shares in the targeted company. For hedge funds engaging in this form of activism, they can only benefit if they have economic exposure to the fortunes of the companies they target. Having votes

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73 Lasalle, "Telus CEO", *supra* note xx.

74 *Telus Corp. v. Mason Capital Management, supra* note xx, para. [73].

75 Henry T.C. Hu and Bernard Black, "Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, (2006) 61: 3:Bus. Lawyer 1011, 1014.

76 *Ibid*.

77 Ben White, "Thesis on Hedge Fund Tactics Gives Investors a Shock", Financial Times, October 6, 2006, 29; Wolfgang Ringe, "Hedge Funds and Risk-Decoupling – The Empty Voting Problem in the European Union", Seattle Univ. L. Rev. (forthcoming).

devoid of an economic interest will correspondingly be of little interest to them. Indeed, to the extent that a decoupling of the economic return on shares from the corresponding voting power will be attractive to hedge funds engaging in offensive shareholder activism, they will want economic ownership that *exceeds* their formal voting rights and results in "hidden" ownership.[78]

For an activist hedge fund, hidden ownership will be attractive because the investment it makes before the public becomes aware of its stake will largely dictate the benefits it captures as a result of overall improvements in shareholder returns. What an activist hedge fund does early is crucial because once its stake becomes public knowledge investors will typically treat the news as a buy signal and drive the share price upward in a way that means that shares purchased thereafter will no longer be a bargain. As a Canadian stock market analyst observed as far back as 1996, "If somebody accumulates 10 per cent, I think the street (the investment community) can expect something to happen...."[79] A *Globe & Mail* journalist made the same point specifically about shareholder activists in a 2012 article entitled "Riding the Coattails of Activist Investors", saying that the presence of a stock on a list of companies in which activist investors held a stake of 10% or more was "not a guarantee that the stocks...will be profitable, but it's an encouraging sign."[80] Given the likely investor reaction, once a hedge fund activist's intervention is publicly known post-disclosure improvements in shareholder returns will typically have to be shared fully with the market.

For an offensive shareholder activist, regulation does much to dictate the maximum block of shares which can be purchased by "stealth". Most countries have in place rules

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78 On the hidden ownership terminology, see Hu and Black, "Empty", *supra* note xx, 1014.

79 Quoted in Carolyn Leitch, "Changes Possible at Trimac", Globe & Mail, October 11, 1996, B12.

80 Ian McGugan, Riding the Coattails of Activist Investors", Globe & Mail, October 25, 2012, B19.

imposing an obligation to disclose major share ownership stakes in publicly traded companies.[81] Though the norm globally is 5 per cent in Canada the threshold is set at 10 per cent by provincial securities law.[82]

A hedge fund activist fully prepared to adhere to its disclosure obligations may nevertheless be able to push the benefits captured by stealth beyond the limit implied by law by relying on derivatives that facilitate the decoupling of economic exposure to shares from voting rights normally linked with share ownership.[83] For instance, in the early- and mid-2000s it was accepted market practice in the United States for activist hedge funds confronted with federal securities law rules requiring the filing of a Schedule 13D ownership report within ten days of acquiring 5 per cent or more of a company's shares to use derivatives known as total equity return swaps (TRS) to acquire an economic interest exceeding the 5 per cent level while refraining from divulging their positions due to owning outright less than 5 per cent of the shares.[84] Hence, assuming hidden ownership facilitated by TRS or similar derivatives does not trigger the ownership disclosure rules in the country in which a target company is incorporated,[85] hedge funds engaging offensive shareholder activism will be inclined to use derivatives in precisely the opposite way contemplated by empty voting.

Katelouzou's research on hedge fund activism confirms that to the extent decoupling economic exposure from voting rights is associated with hedge fund activism the tendency will be for hedge funds to opt in favour of hidden ownership rather than empty voting. From

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81 Michael C. Schouten and Mathias Siems, "The Evolution of Ownership Disclosure Rules Across Countries", (2010) 10: 2 J. Corp. L. Studies 451, 458-60.

82 Schouten and Siems, *ibid*., 460; Mark R. Gillen, *Securities Regulation in Canada*, 3rd ed. (Toronto: Thomson Carswell, 2007), 458.

83 Cheffins and Armour, *supra* note xx, 65.

84 *Ibid*.

85 This has been the law in the U.K. since 2007: Schouten and Siems, *supra* note xx, 452, 476.

her dataset of over 400 activist campaigns occurring between 2000 and 2010 she identified from press reports 17 instances where a hedge fund activist deployed equity decoupling techniques.[86] Only four of these involved empty voting.[87] These findings accord with other evidence indicating that despite the academic attention devoted to empty voting in practice activist hedge funds rarely hedge away the economic significance of the shares they acquire.[88]

While Telus' CEO characterized Mason Capital's efforts to disrupt the company's share class consolidation as empty voting and while the British Columbia courts seemed to accept this characterization when adjudicating aspects of the dispute between Mason Capital and Telus,[89] it is not even entirely clear that Mason Capital was engaging in empty voting.[90] Hu, in an affidavit filed in the Telus/Mason Capital litigation, said Mason Capital was "clearly an empty voter."[91] His co-author Black maintained on the other hand that for votes

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86 Katelouzou, "Hedge", *supra* note xx, 147.

87 Katelouzou, *ibid.*, 147-48 (Table 11).

88 Christopher Faille, "Some Find 'Empty Votes' Concern … Empty", HedgeWorld News, October 24, 2007 (discussing views expressed at a roundtable on hedge fund activism); Steve Johnson, "'Vote-buying' Controversy Rumbles On", Financial Times, FTfm, September 14, 2009, 9 (quoting an unnamed "industry figure" who said of empty voting by hedge funds "We really don't see examples of it happening in the US or the majority of Europe"); Ellen Kelleher, "Inquiries Starting into Empty Voting", Financial Times, FTfm, September 26, 2011, 3 (quoting Vanessa Knapp, a London lawyer, as saying "There's uncertainty as to whether there's a problem there or not").

89 *Telus Corp. v. Mason Capital Management, supra* note xx, paras. [73]-[74], [79]-[81]; *Re Telus Corp*. (2012) BCSC 1919, paras. 328-55.

90 Julius Melnitzer, "'Empty Voting' Clouds Shareholder Rights Law", November 14, 2012, B12.

91 Quoted in Anita Anand, "Telus Win Scores for Shareholders", National Post, October 18, 2012, FP11.

on shareholder resolutions that affected the value of voting rights Mason Capital did have an economic interest in the outcome and thus was not engaging in empty voting.[92]

Regardless of whether Mason Capital was an empty voter or not, it is clear that its tactics were not part of the playbook to which investors engaging in offensive shareholder activism typically adhere. It did accumulate its 19 per cent stake rapidly in the manner that would be expected. On the other hand, Telus was hardly the sort of under-performing company offensive shareholder activists normally target. As a columnist for the *National Post* said in 2011, "Nobody can fault (Telus CEO) Mr. Entwistle's performance at Telus, a Canadian star that has cut a profitable independent course in the rapidly changing telecom industry. As the company frequently tells investors, shares of Telus have returned 92% since the beginning of 2010."[93] Mason Capital, moreover, said nothing in its filing with Canadian securities regulators disclosing its ownership stake in Telus about the company's shares being undervalued and refrained from declaring any intention to seek changes to managerial policy. It said instead that its purpose was to vote against Telus' share consolidation plan.[94] Hence, while the Telus/Mason Capital saga has proved to be one of the more newsworthy shareholder activism incidents affecting a publicly traded Canadian corporation and while the protagonist was a hedge fund, it was not an example of the sort of offensive shareholder activism for which hedge funds have achieved notoriety and which constitute the subject matter of this paper.

II. The Emergence of Hedge Fund Activism Canadian Style

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92 Bernard Black, "Equity Decoupling and Empty Voting: The Telus Zero-Premium Share Swap", M&A Lawyer (forthcoming) at 2 (version available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2150345).

93 Corcoran, "Corporate", *supra* note xx.

94 Mason Capital Management LLC, "Alternative", *supra* note xx, para. 8; Rita Trichur and Boyd Erman, "Telus Share Consolidation Plan at Risk", Globe & Mail, April 11, 2012, B5 (discussing the filings Mason Capital made with securities regulators).

While Pershing Capital's 2012 CP campaign has been to date the most dramatic intervention by an activist hedge fund at a prominent Canadian company, Pirate Capital's intervention in Intrawest's affairs in 2005-06 illustrates that the CP affair was by no means unprecedented.[95] Data Dionysia Katelouzou has compiled on instances of shareholder activism by hedge funds provides a helpful way of tracking the emergence of this corporate governance technique in Canada. She searched press reports and related sources for the years between 2000 and 2010 to find instances in 25 countries other than the United States where hedge funds and similarly structured collective investment vehicles built up a stake "offensively" in a target company and proactively sought to promote change.[96] Among a total of over 400 activist campaigns she identified that occurred between 2000 and 2010, 59 involved Canadian target companies, the third highest total after Britain (128 instances) and Japan (103) among the 17 of the 25 countries where hedge fund activism occurred.[97] While there were instances of hedge fund activism in Canada during the early 2000s, the popularity of this corporate governance technique grew dramatically in the mid-2000s before tailing off in 2009 and 2010 (Figure 1).

Figure 1: Instances of Hedge Fund Activism Involving Canadian Companies, 2000-10



95 *Supra* notes xx to xx and related discussion.

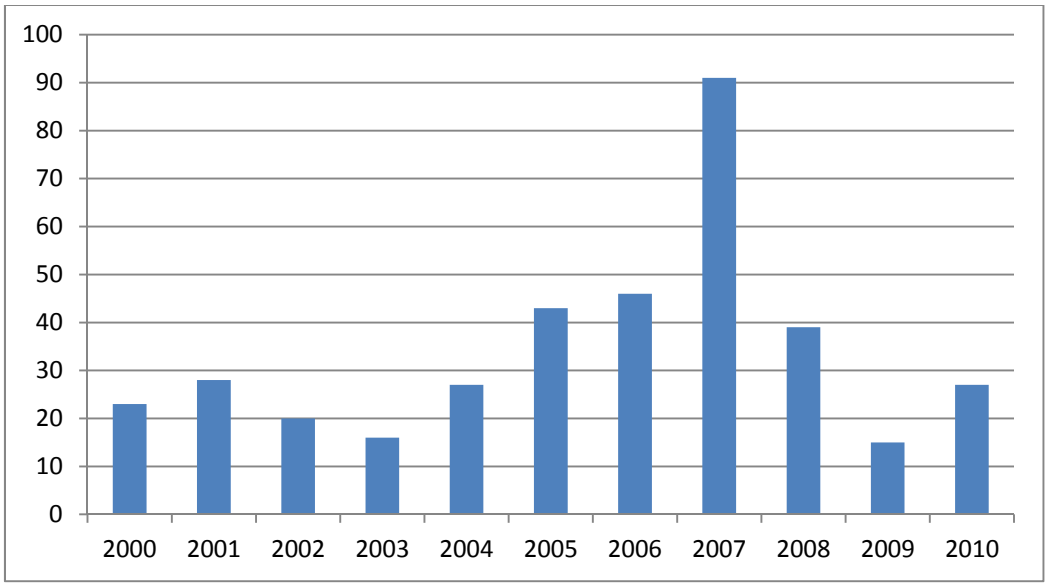
96 Katelouzou, "Hedge", *supra* note xx, 16, 89.

97 Katelouzou, "Hedge", *ibid.*, 91, 95-96.

Source: Katelouzou (2012)

The trend was similar elsewhere. With the 16 other countries in Katelouzou's dataset where hedge fund activism occurred between 2000 and 2010 the chronological pattern resembled Canada's (Figure 2), with instances of hedge fund activism peaking in the middle of the 2000s. In the United States, hedge fund activism first occurred with regularity in the late 1990s and became a major corporate governance phenomenon in the mid-2000s.[98]

Figure 2: Instances of Hedge Fund Activism Involving non-U.S. Companies (Canada Excluded), 2000-10



Source: Katelouzou (2012)

Katelouzou chose 2000 as the start date for her research on the basis that hedge fund activism was largely unknown prior to then.[99] In so doing she did not seek to identify exactly when hedge fund activism commenced in earnest, nor was there any need for her to do so because she was seeking to carry out a cross-country comparison of hedge fund activism, with particular reference to the impact of corporate law, rather than provide a definitive

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98 Cheffins and Armour, "Past", *supra* note xx, 79-82.

99 Katelouzou, "Hedge", *supra* note xx, 16.

historical account of hedge fund activism.[100] In fact, Katelouzou's start date matches quite closely the beginning of the story of hedge fund activism in Canada, as leading practitioners of this corporate governance tactic first stepped forward as the 1990s drew to a close.

Katelouzou identified for the purposes of her research the activist funds which intervened most often and the leading protagonist in Canada was New York-based Crescendo Partners, which was involved in 14 engagements with publicly traded Canadian companies.[101] Eric Rosenfeld founded Crescendo Partners in 1998,[102] having previously run the merger arbitrage operation at Wall Street broker Oppenheimer & Co. and focused on numerous Canadian "situations" in so doing.[103] Crescendo Partners took its first stake of 10 per cent or more in a Canadian company in 1999 when it invested in Spar Aerospace Ltd. and orchestrated a boardroom coup that resulted in Rosenfeld becoming chairman of the board.[104]

Enterprise Capital Management, the Goodwood Fund, Salida Capital and West Face Capital followed behind Crescendo Partners on Katelouzou's list of the most active activist funds with three Canadian engagements each. Enterprise Capital was set up in 1997 as a "catalyst fund" with a mandate to target underperforming companies by a former deputy chairman of the Bank of Nova Scotia and two former ScotiaMcLeod research analysts.[105] A former Bay Street research analyst established the Goodwood Fund in 1996 to invest in

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100 Katelouzou, *ibid*., 14.

101 Katelouzou, *ibid*., 99 (Table 2).

102 Brian Milner, "Crescendo Clamours for Cell-Net", Globe & Mail, August 9, 1999, B1. On the date of Crescendo's founding, see http://www.crescendopartners.com/ (last visited October 29, 2012).

103 Richard Siklos, "Why Wall Street 'Arb' Loves to Deal in Canada", December 11, 1996, 3.

104 Barry Critchley, "Things May be Looking Up", Financial Post, January 26, 1999, D02 (Spar as Crescendo Partners' first major stake in a company); Edward Alden, "Shareholders Take Over Spar to Sell It", Financial Times, May 14, 1999, 29 (outcome).

105 Don MacDonald, "Shareholders Start to Revolt", Montreal Gazette, June 18, 1999, F1; Peter Kuitenbrouwer, "Silent No More", National Post, August 16, 1999, C1.

undervalued companies and to sell out whenever the market self-corrected.[106] Toronto-based Salida Capital was launched in 2001.[107] Greg Boland, who had been a portfolio manager for Enterprise Capital, launched West Face Capital in 2006 and promptly set up a hedge fund that would agitate for change at underperforming companies.[108]

These fledgling hedge fund activists were not the most prominent practitioners of offensive shareholder activism in Canada during the late 1990s. The leading protagonist instead was TMI-FW Inc., which was not a hedge fund or other form of collective investment vehicle marketed to investors. Instead, the Ontario Teachers' Pension Plan Board, the billionaire Bass brothers of Fort Worth, Tex. and Thomas Taylor, the Basses' long- time investment adviser, set up TMI-FW in 1996 as a three way venture.[109] TMI-FW, which Taylor characterized as "a catalyst investor",[110] specialized in indentifying and buying large stakes in underperforming companies.[111]

With companies TMI-FW targeted Taylor would visit senior management to discuss turnaround plans.[112] Where a company's problems were serious and the executives dragged their feet, TMI-FW would seek support from other investors to push for a corporate

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106 Jade Hemeon, "Money Manager Trades Bay St. for Country Life", August 17, 19997, E1.

107 Joanna Pachner, "We're Back from the Abyss", Globe & Mail, August 14, 2009, B1.

108 McNish, "War", *supra* note xx; Jacquie McNish, Tara Perkins and Boyd Erman, "The Move to Freeze Out the McCains", Globe & Mail, August 10, 2010, A1 (identifying 2007 as the date when West Face Capital was established).

109 Steven Chase, "Teachers, Bass Brothers, Taylor Part Ways," Globe & Mail, October 23, 1999, B1.

110 Kimberley Noble and Andrew Willis, "Texans Invade Corporate Canada", Globe & Mail, September 27, 1997, B1.

111 Brent Jang, "TMI-FW Sells Trimac Stake", Globe & Mail, April 8, 1998, B1; Steven Chase, "Bass Family Group Buys 6% of Nova", Globe & Mail, July 28, 1998, B1; Casey Mahood, "Teachers Will Hold on to Portfolio", Globe & Mail, October 26, 1999, B5.

112 Jacquie McNish, "CEOs Whistling Tommy's Tune", Globe & Mail, January 30, 1998, B1.

shakeup.[113] For instance, at Moore Corp. Ltd., a Toronto-based business forms maker, MacMillan Bloedel, a major British Columbia headquartered forest company, and Burnaby-based funeral home operator Loewen Group Inc., Taylor joined the board and the board subsequently replaced the chief executive officer.[114]

During the late 1990s the TMI-FW alliance was thought of as an important Canadian corporate governance phenomenon. The *Financial Times* observed in 1997 that "Canadian executives might well be concerned by a Texan investment philosophy that is much more aggressive than that to which they are accustomed."[115] The *Globe & Mail* indicated in 1998 that Taylor was "having a very real impact on how Canadian companies are managed."[116] Nevertheless, the alliance was short-lived, with Taylor, the Ontario Teachers' Pension Plan Board and the Bass brothers each having gone their separate ways as 1999 drew to a close.[117]

Katelouzou's data indicates there was a marked drop in the number of Canadian hedge fund activism incidents between 2008 and 2009 and again between 2009 and 2010 (Figure 1). Indeed, the number of incidents she reports for 2010 (two) was the lowest since 2003. An inference one might draw from this is that in Canada hedge fund activism was a mid-2000s fad. In the United States, there was speculation to this effect in the immediate

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113 Mathew Ingram, "Quiet Texan No Table Pounder", Globe & Mail, May 11, 1998, B1.

114 McNish, "CEOs", *supra* note xx (Moore; Macmillan Bloedel); Mathew Ingram, "Should Agrium Beware TMI-FW?", Globe & Mail, January 6, 1998, B2 (Moore); Mathew Ingram, "Two Strikes on Tommy Taylor", Globe & Mail, June 8, 1999, B2 (Loewen).

115 Scott Morrison, "Texans Take Aim at Canada", Financial Times, October 24, 1997, 27.

116 McNish, "CEOs", *supra* note xx.

117 Chase, "Teachers", *supra* note xx.

wake of the 2008 financial crisis.[118] The *New York Times* said, for example, in a 2009 story there was "Among Activist Investors, a New Hesitancy."[119]

The financial crisis did side-swipe hedge fund activism in the U.S. to some degree but hedge funds continued to target publicly traded companies with reasonable regularity during the crisis and in its immediate aftermath.[120] Moreover, by 2011, hedge funds were grabbing headlines again in the U.S. with interventions affecting *Fortune 500* constituents Kraft Foods Inc. and McGraw–Hill Companies.[121] Media reports suggest that similarly even if the financial crisis was a blow to hedge fund activism in Canada, a rebound quickly ensued.

A 2011 Canadian Press report indicated "disgruntled shareholders (were) increasingly flexing their muscles when it comes to underperforming corporations" and explained this partly on the basis that "(d)epressed share prices allow investors like hedge funds to scoop up and turn around undervalued companies."[122] One of the lawyers who represented Pershing Capital in its 2012 proxy contest with CP was quoted in the press as saying "Activist investors are more active than they have historically ever been."[123] The *Financial Times* said in a 2012 story about Jana Partners', an activist hedge fund that had built up a 4 per cent stake in Calgary-based fertilizer group Agrium Inc. and was pressing for the break-up of the company, "New York hedge funds have...travelled north of the border frequently this

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118 Cheffins and Armour, "Past", *supra* note xx, 53, 93-95.

119. Zachery Kouwe, "Among Activist Investors, a New Hesitancy", N.Y. Times, March 25, 2009, F6.

120 Cheffins and Armour, "Past", *supra* note xx, 95-96.

121 *Ibid.*, 53.

122 Sunny Freeman, "Activist Investors Seize on Economic Uncertainty to Press for Change", Canadian Press, November 6, 2011, available in Factiva.

123 Jim Middlemiss, "Proxy Fights Take on New Meaning", National Post, September 27, 2012, LP1 (quoting Kevin Thomson of Davies Ward Phillips & Vineberg).

year."[124] The upshot is that activism by hedge funds emerged as an important feature of Canadian corporate governance in the early 2000s and is apparently not a fad. What explains the rise of hedge fund activism Canadian style? The next two Parts of the paper address this issue.

III. Factors Likely to Dictate the Prevalence of Offensive Shareholder Activism: A Synopsis

I have set out elsewhere a fully developed analysis of the factors likely to determine levels of offensive shareholder activism.[125] The details will not be rehearsed here. Nevertheless, a distilled synopsis of the determinants of levels of offensive shareholder activism provides a helpful departure point for Part IV's discussion of the Canadian scene.

A. Deciding to Engage in Offensive Shareholder Activism: The Cost-Benefit Analysis

Logically investors will only engage in offensive shareholder activism if they anticipate the benefits they will derive will outweigh their costs. There is an imbalance in the distribution of costs and benefits that acts as a significant deterrent to such interventions: activist shareholders typically must bear all the costs associated with intervening but due to having only a minority stake in the targeted company will receive only a fraction of the improvements in shareholder return their efforts generate. Put more formally, assuming c_i represents the expected costs associated with exercising influence to improve shareholder returns at a target company, b_i signifies the expected benefits for the firm's shareholders from the activist's intervention and α is the proportion of the target firm's shares held by the potential activist (where $0 < \alpha < 1$), then intervention will only be sensible for a potential activist if the following inequality is satisfied:

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124 Dan McCrum, "Jana in Plea to Agrium Investors", Financial Times, October 2, 2012, 21.

125 Cheffins and Armour, "Past", *supra* note xx, Part III.

$$c_i < \alpha\, b_i \qquad (1)$$

The elements of c_i include various types of transaction costs. These are the search costs associated with finding potential target companies, dealing costs related to buying and selling shares (e.g. brokers' commissions and the spread between the bid and ask prices for shares) and communication costs (e.g. expenses activists incur contacting other shareholders to seek support and disbursements associated with making required filings with securities regulators). C_i additionally encompasses financing costs. Those who have the skills required to identify undervalued companies accurately and have the fortitude required to confront incumbent executives to lobby for change will typically not be wealthy enough personally to buy up major stakes in publicly traded companies. Individuals with these attributes can, however, potentially side-step the financing costs associated with offensive shareholder activism by raising capital from investors willing to back an investment fund with a suitable mandate. Managers of activist hedge funds in effect rely on this approach.

The benefits of activism to a target company's shareholders as a whole (b_i) will comprise any increase in shareholder return an intervention generates. For an activist shareholder the percentage of shares owned will set an upper bound on the proportion of these benefits the activist can derive (i.e. $\alpha\, b_i$). For the activist shareholder, the fact that a target company's share price typically rises once its stake becomes public knowledge imposes a further limitation on b_i: the benefits an activist will capture will typically be measured by reference to when the market first becomes aware of the activist's involvement.[126] Put more formally, if we take λ (where $0 < \lambda < 1$) to be the maximum block of shares which can be purchased by "stealth", inequality (1) should be modified to state the conditions for activism as follows:

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126 *Supra* notes xx to xx and related discussion.

$$c_i < (\text{argmin } \{\alpha, \lambda\})\, b_i \qquad (2)$$

B. The Market for Corporate Influence

A range of variables operating at the firm level can affect in a particular case the costs and benefits associated with offensive shareholder activism. However, for present purposes—seeking to explain the emergence of hedge fund activism Canadian style—systemic factors are of greater interest. A helpful way to identify and analyze these systemic factors is by deploying a heuristic device, "the market for corporate influence." As we have seen, when one is seeking to define the parameters of offensive shareholder activism it is instructive to distinguish between attempts to use a sizeable minority stake in a public company as a platform to press for change and bids to obtain full voting control.[127] The latter is a key element of what law professor Henry Manne famously referred to as the market for corporate control.[128] The former – offensive shareholder activism -- underpins what can be termed the market for corporate influence, rather than control.

The market for corporate influence heuristic is instructive because the variables likely to influence levels of offensive shareholder activism can be organized by reference to a "supply side" composed of factors dictating the number of companies constituting plausible targets and a "demand side" comprised of factors likely to affect the willingness of investors to pursue such opportunities. On the supply side, instances where a potential activist assumes shareholder engagement will improve shareholder returns (i.e. $b_i > 0$) constitute a necessary pre-condition for offensive shareholder activism.[129] Companies where a potential activist will believe $b_i > 0$ are likely to share three characteristics. First, and most obvious, the

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127 *Supra* notes xx to xx and accompanying text.

128 Henry G. Manne, "Mergers and the Market for Corporate Control," (1965) 73 J. Pol. Econ. 110.

129 An exception is where private benefits of control are available, but this should not be a common scenario with hedge funds: Cheffins and Armour, "Past", *supra* note xx, 67.

activist will need to think a company is underperforming and believe changes in strategic direction, financial policy or corporate governance would correct the situation.

Second, investors likely to be open-minded about changes a hedge fund activist intends to propose will need to own a large proportion of the shares in the potential target company. This is because the extent to which an undervalued company represents an opportunity to generate benefits from activism depends on the feasibility of bringing about change. On this count ownership structure is a potentially crucial limiting factor. A shareholder activist is unlikely to be able to make credible proposals for change if a "core investor" controls a sufficiently large block of votes to veto unwelcome shareholder resolutions. Correspondingly, an investor engaging in offensive shareholder activism will logically target companies with diffuse share ownership.

Third, corporate law will need to bestow shareholders with suitable rights. While an appropriate ownership structure will be a necessary condition for a successful activism campaign, corporate law also must provide an activist hedge fund legal tools that can be used to prompt an otherwise recalcitrant management team to respond. Legal rules that dictate the leverage a shareholder activist will have include those governing the scope shareholders have to determine the composition of the board, to counteract the advantages management has in securing shareholder support through the solicitation of proxies and to bring a suit alleging managerial wrongdoing or mistreatment of shareholders.

Even taking for granted that there are companies where $b_i > 0$ and change is theoretically feasible, offensive shareholder activism will not occur if the anticipated costs associated with intervention (c_i) exceed the benefits potentially available to the potential activist, factoring in the partial ownership stake that will be involved (α) and the need for the potential activist to buy shares by stealth (λ). Correspondingly, to ascertain the extent to which conditions are propitious for offensive shareholder activism it is necessary to consider

not only the opportunities for the profitable exercise of influence (the supply side) but also the factors that may affect investors' ability and willingness to exploit such opportunities. These factors shape the demand function in the market for corporate influence.

To illustrate, technological advances that drive down transaction costs can shift the demand function. For instance, improvements in data transmission and computing power that make it easier for potential activists to track down and analyze corporate financial data will cut search costs and can potentially foster offensive shareholder activism.[130] Innovations that reduce dealing costs associated with accumulating and unwinding substantial stakes in publicly traded companies should have the same effect.[131] Technological improvements that trim communication costs should do so as well. Before the advent of the internet shareholder activists had to mail letters to shareholders or pay for ads in newspapers to make their points. Now activists can use e-mail, websites and social media such as Facebook and Twitter to communicate instantly and cheaply with potential allies and supporters.[132]

With financing costs, while those who anticipate generating superior risk-adjusted returns by engaging in shareholder activism can garner the financial resources required to proceed by running an investment fund that has sufficient capital,[133] laws governing collective investment vehicles can be an obstacle. Lawmakers, to protect otherwise potentially vulnerable retail investors, can impose requirements on collective investment vehicles that circumscribe the investment strategies and compensation practices of approved

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130 John H. Armour and Brian R. Cheffins, "Origins of 'Offensive' Shareholder Activism in the United States" in Jonathan G.S. Koppell (ed.), *Origins of Shareholder Advocacy*, (New York: Palgrave Macmillan, 2011), 253, 260-61.

131 Cheffins and Armour, "Past", *supra* note xx, 72.

132 *Ibid*., 72-73.

133 *Supra* note xx and related discussion.

funds.[134] In the U.S. hedge funds have historically operated largely outside the scope of regulation of this sort by taking advantage of exemptions granted for "private investment companies."[135] Pension fund and endowment investment in hedge funds increased dramatically shortly after Congress expanded these exemptions in an institutional investor-friendly manner in the mid-1990s. The rapid accumulation of capital by hedge funds was more than sufficient to fund offensive shareholder activism in the U.S. on a reasonably wide scale, even if only a small sub-set of hedge funds actually engaged in activism.[136]

IV. Variables Influencing the Emergence of Hedge Fund Activism: the Canadian Case

This Part focuses on key aspects of the supply and demand sides of the market for corporate influence to explain why offensive shareholder activism by hedge funds has achieved prominence in Canada over the past dozen or so years. The analysis must be suggestive rather than definitive. Due to a lack of suitable data, rigorous empirical testing is currently not feasible. Correspondingly, satisfactorily disentangling fully truly crucial variables from plausible but ultimately spurious conjectures is not possible. Nevertheless, in accounting for the emergence of offensive shareholder activism as an important Canadian corporate governance trend, Part III's theoretical insights provide a helpful departure point.

A. Supply Side

1. Undervalued Companies

Among the variables that likely contributed to the rise of offensive shareholder activism by hedge funds in Canada in the 2000s, some related to the supply side of the market for corporate influence while others affected the demand side. The presence of undervalued companies constitutes one element of the supply side of the market for corporate influence

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134 Cheffins and Armour, "Past", *supra* note xx, 73.

135 *Ibid.*, 88.

136 *Ibid.*, 88-89.

that likely came into play. This is because there apparently were numerous such firms in Canada when hedge fund activism first began to occur.

Just prior to founding Crescendo Partners in 1998 Eric Rosenfeld was quoted in the press as saying "Value investors will go wherever in the world there's value -- and there's value in Canada."[137] Jim Doak, one of the founders of Canadian hedge fund activist Enterprise Capital Management, said in 1999 "A lot of companies we get involved in have lazy capital. The rate of return on reinvestment is poor."[138] A 1999 *Montreal Gazette* article that identified Enterprise Capital Management as "the really scary guys on Bay St. these days" referred to "the sleepy precincts of the Canadian corporate sector, where poor profitability and stock performance are endemic."[139] A fund manager at Invesco Inc. concurred in a 1999 interview with the *National Post*, saying of Canadian corporate culture "There are many examples of companies with dismal track records and dismal management."[140] Even as of 2004, after hedge fund activism had begun in earnest in Canada, the president of a corporate governance advisory service maintained "There is a good opportunity out there for (investors) to come in and shake up boards that just aren't getting it."[141]

A 2003 working paper the Bank of Canada issued confirms that undervaluation was a feature of the Canadian corporate scene, at least as compared with the United States. Researchers Michael King and Dan Segal examined data for the period 1991 to 2000 for close to 10,000 U.S. and Canadian publicly traded companies to test conjectures that

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137 Sandra Rubin, "Now Available in Canada: Shareholders with Attitude", Financial Post, December 27, 1997, 16.

138 Kuitenbrouwer, "Silent", *supra* note xx.

139 MacDonald, "Shareholders", *supra* note xx.

140 Kuitenbrouwer, "Silent", *supra* note xx.

141 Keith Kalawsky, "Hedge Funds Take Off the Gloves", Financial Post, October 22, 2004, Investing, 1 (quoting Bill Mackenzie of Fairvest).

Canadian-listed firms traded at a discount to their U.S. counterparts.[142] They found, based on a range of valuation measures that included book price per share/stock price and earnings/stock price ratios, that Canadian companies indeed had a lower relative valuation even after controlling for company size, industry, the cost of equity, profitability, dividend policy, accounting policy and the risk-adjusted return of the stock market where a company was listed.[143] To the extent Canadian companies were indeed undervalued compared to matched sets of U.S. public companies there potentially should have been numerous instances where $b_i > 0$.

2. Ownership Structure

There are Canadian examples which illustrate that ownership structure affects the likelihood of offensive shareholder activism and the success of the interventions that occur. In 2006 Bill Ackman's Pershing Capital made a sizeable investment in Canadian Tire Corp., believing that the retailer was underperforming, and began agitating for change.[144] Martha Biles, daughter of a co-founder of the company and controller of 61 per cent of the votes due to her ownership of shares with multiple voting rights attached, thwarted Pershing.[145] That adventure taught Ackman not to target companies where due to the voting structure control lay firmly elsewhere.[146] Correspondingly, when Ackman returned to Canada to engage in offensive shareholder activism with Canadian Pacific his target had diffuse share ownership.

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142 Michael King and Dan Segal, "Valuation of Canadian- vs. U.S.-Listed Equity: Is There a Discount", (2003) Bank of Canada Working Paper 2003-6, 2, 7.

143 King and Segal, *ibid.*, 9-17.

144 Lori McLeod, "U.S. Hedge Fund Kicks the Tire", Financial Post, July 4, 2006, FP1.

145 McLeod, "U.S.", *supra* note xx; Tim Kiladze, " Activist Shareholder Bill Ackman Defends His Ilk", Globe & Mail, Breaking News, May 2, 2011.

146 Kiladze, " Activist", *supra* note xx.

Pershing Capital became the company's largest stockholder when it bought its initial 12.6 per cent stake in 2011.[147]

West Face Capital's intervention at Maple Leaf Foods in 2010-11 also illustrates the significance of ownership structure. The company was a chronic underperformer.[148] Nevertheless, offensive shareholder activism was futile from 1995 to 2010 because of a *de facto* partnership between the Ontario Teachers' Pension Plan, owner of 36 per cent of the shares, and the McCain family, owner of 32 per cent.[149] In 2010, however, Maple Leaf Foods became much more widely held as OTTP sold 10 per cent of Maple Leaf Foods' shares to West Face Capital and disposed of the rest of its stake by way of a public offering.[150] Before the end of the year West Face Capital requisitioned a shareholders' meeting to have shareholders vote on a resolution concerning the independence of incumbent directors.[151] West Face's activist campaign galvanized investors and the Maple Leaf Foods board deduced that despite the McCain's sizeable ownership stake the shareholders would likely endorse what West Face Capital was proposing.[152] The company headed off an embarrassing public defeat by offering Greg Boland, West Face Capital's chief executive, a directorship, by pledging to reduce the size of the board and by agreeing to use an independent search firm to identify suitable new directors.[153]

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147 McNish, "Railway", *supra* note xx.

148 McNish, "War", *supra* note xx.

149 Jacquie McNish, Tara Perkins and Boyd Erman, "The Move to Freeze Out the McCains", Globe & Mail, August 11, 2010, A1.

150 McNish, Perkins and Erman, "Move", *supra* note xx; Boyd Erman, "Maple Leaf's Board is in the Spotlight", Globe & Mail, November 30, 2010, B2.

151 Jacquie McNish, "The Thorn in Maple Leaf's Side has no Plans for a Quick Exit", December 7, 2010, B1; Mary Gazze, "Maple Leaf Foods Shakes Up its Board", Toronto Star, February 4, 2011, B1.

152 McNish, "War", *supra* note xx.

153 Tim Shufelt, "Activist Wins Role at Maple Leaf", February 4, 2011.

The fact that the presence of dominant shareholders is a deterrent to offensive shareholder activism is highly relevant in the Canadian context. A much-remarked upon feature of Canadian corporate governance is the prevalence of publicly traded companies with dominant shareholders as compared to the U.K. and the U.S., where dispersed share ownership is the norm among larger public firms.[154] This ownership pattern discourages hedge fund activism in Canada. A 2012 *Globe & Mail* article that drew attention to the fact that 10 per cent of the Standard & Poor's/TSX 60 index of Canada's biggest companies had recently faced a challenge from an activist investor illustrates the point. According to the article, "The number is much higher if you consider the fact that close to half the firms in that index are controlled by a large shareholder, and so are untouchable."[155]

While ownership structure is a deterrent to offensive shareholder activism in Canada, a partial unwinding of control blocks likely created a more congenial setting for such interventions as hedge funds first stepped forward in Canada. At beginning of the 1990s more than three-quarters of companies traded on the Toronto Stock Exchange had a controlling shareholder.[156] During the 1990s the grip of families owning dominant stakes in public companies loosened somewhat and various foreign parents of publicly traded Canadian subsidiaries exited.[157] Correspondingly, between 1990 and 1994 the number of

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154 Sarra, "Shareholders", *supra* note xx, 55; Ronald J. Daniels and Edward M. Iacobucci, "Some of the Causes and Consequences of Corporate Ownership Concentration in Canada" in Randall K. Morck (ed.), *Concentrated Corporate Ownership* (Chicago: University of Chicago Press, 2000), 81, 82; Randall Morck and Bernard Yeung, "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them" (2006), 293-94, available at http://www.tfmsl.ca/docs/v4(5)%20morck.pdf

155 Erman, "Activist Investors", *supra* note xx.

156 Toronto Stock Exchange Committee on Corporate Governance in Canada (Peter Dey, chair), *Where Were the Directors?* (Toronto: Toronto Stock Exchange, 1994), 13 (quoting Fairvest Securities Corporation).

157 Bernard Simon, "Investors Revolt in Sleepy Canada", Financial Times, May 18, 1993, 23; Bernard Simon, "Canadian Groups Loosen Family Ties", September 8, 1993, 19; Ronald J. Daniels and Paul Halpern, "Too Close for Comfort: The Role of the Closely Held

widely held firms in the TSE 300 index increased from 60 to 125 and between 1994 and 1999 the number of companies in the TSE 100 index having a shareholder who owned 20 per cent or more of the shares fell from 39 to 28.[158] This partial shift towards dispersed share ownership should have increased the population of underperforming companies where $b_i > 0$.

While a partial unwinding of control blocks during the 1990s likely helped to foster offensive shareholder activism by hedge funds in Canada the receptivity of key investors to activist initiatives probably played a more important role. As the 20th century drew to a close one of the more important capital market developments in Canada was a dramatic growth in the proportion of shares mainstream institutional investors – pension funds, insurers and mutual funds – held in Canadian public companies (Figure 3).[159] Given this trend, and given that institutional investors are more likely to vote than individuals who own shares,[160] Canadian companies became increasingly closely attuned to the views of key institutional shareholders. As corporate governance expert Peter Dey said in 2011, "If any board chair gets a call from a significant institutional shareholder I can't imagine that being rejected."[161]

Figure 3: Proportion of Shares of Canadian Public Companies Owned by Individuals, "Mainstream" Institutional Shareholders (Pension Funds, Insurers and Mutual Funds), Non-Residents and Others (Measured by Book Value), 1961-2006

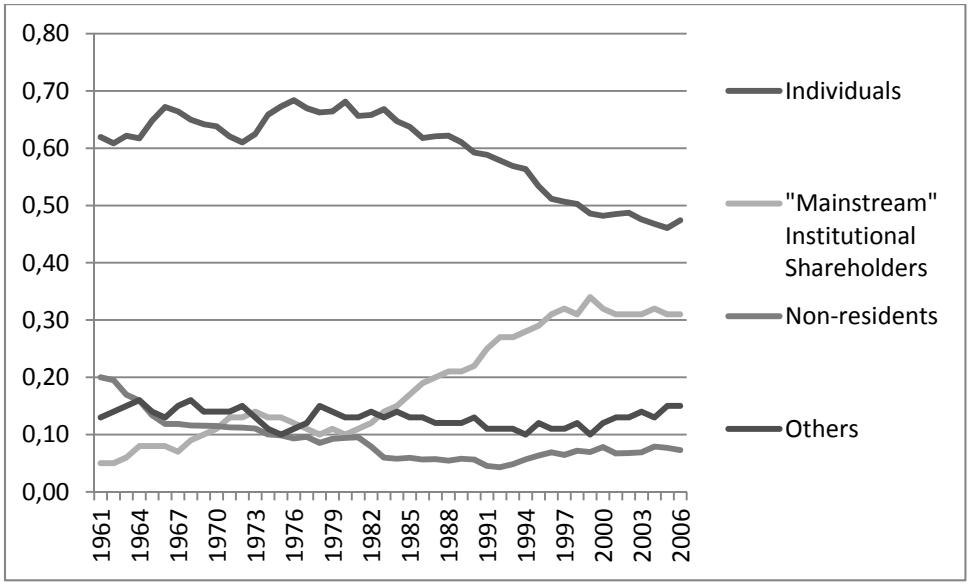
Corporation in the Canadian Economy and Implications for Public Policy" (1995) 26: 1, Can. Bus. L.J. 11, 48, 53, n. 105; "The Mighty Fallen", Economist, September 14, 1996, 68.

158 Daniels and Halpern, "Too", *supra* note xx, 31; Rod McQueen, "The Rise of the Savvy Shareholder", National Post, February 20, 1999, D04.

159 Peter Foster, "Shareholder Activism More Bark than Bite", National Post, June 16, 1999, C07.

160 Vanessa Lu, "High Noon Arrives in Proxy Fight", Toronto Star, May 17, 2012, B01.

161 Janet McFarland, "Big Shareholders Press for More Dialogue with Boards," Globe & Mail (Breaking News), June 9, 2011.



Source: Data supplied by Kristian Rydqvist, compiled from Statistics Canada figures for a paper by Rydqvist, Spizman and Strebulaev (2010)[162]

The surge in share ownership by mainstream institutional investors ultimately provided a boost for offensive shareholder activism in Canada but it was not a given the trend would have this effect. The default position of pension funds, mutual funds and insurance companies, still very prevalent during the 1990s, was to exit poorly performing companies rather than rock the boat by confronting management.[163] A 1993 *Business Quarterly* article that drew attention to growth of institutional shareholders in Canada indicated this "had not been mirrored by a similar growth in the power to influence their investments nor has it been

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[162] Kristian Rydqvist, Joshua Spizman and Ilya Strebulaev, "The Evolution of Aggregate Stock Ownership", (2010), unpublished paper, available at https://www.ifk-cfs.de/fileadmin/downloads/events/conferences/2011-07-01-Rydqvist_et_al.pdf (last visited November 6, 2012), providing background on Canadian data at 6.

[163] Jeffrey G. MacIntosh, "The Role of Institutional and Retail Investors in Canadian Capital Markets", (1993) 31: 2 Osgoode Hall L.J. 371, 380-83; Stephen I. Erlichman, "Canadian Institutional Investor Activism in the 21st Century: The Sleeping Giants Awaken", (2003), Proceedings of the 9th Queen's Annual Business Law Symposium at Queen's University, Kingston, Ontario (2003), 199, 200-1, available at http://www.fasken.com/files/Publication/61059f9e-98a7-421e-b789-038de4225c10/Presentation/PublicationAttachment/1aef388a-a976-4567-aadf-06e2d4b47998/SLEEPINGGIANTS.PDF (last visited November 7, 2012).

balanced by an appropriate voice in corporate governance."[164] A *Financial Times* article from the same year said of Canadian public companies "many institutional investors still sense they have more to lose than to gain by flexing their muscles over corporate governance."[165] The chairman and chief executive officer of the Caisse de depot et placement du Quebec, which manages the pension assets of Quebec public employees, likewise observed in 1995 that Canadian "institutional investors did not hurl thunderbolts at our companies."[166]

Despite the traditional aversion of Canada's mainstream institutional shareholders to confrontation, their growing importance would in fact ultimately provide an important boost for hedge funds inclined to engage in shareholder activism. With pension funds, mutual funds and insurance companies holding larger than ever stakes in Canadian companies as the 1990s drew to a close among fund managers the "friction cost" – the drop in the share price that occurs when an investor with a substantial holding seeks to sell its stake – associated with exiting from poorly performing companies was a cause of growing concern.[167] Fund managers correspondingly became increasingly willing when they did not like what a company was doing to sit tight and support plans for change.[168] A successful 1999 campaign to unseat incumbent directors at papermaker Repap Enterprises Inc. that TD Asset Management Inc. backed publicly underscored how things had changed when a spokesperson

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164 Kathryn E. Montgomery and David S.R. Leighton, "The Unseen Revolution is Here", Business Quarterly, Autumn 1993, 39, 40;.

165 Simon, "Investor", *supra* note xx.

166 Jean-Claude Delorme, "Corporate Governance in the Year 2000" in Ronald J. Daniels and Randall Morck, *Corporate Decision-Making in Canada* (Calgary: University of Calgary Press, 1995), 651, 652.

167 Andrew Willis, "In Praise of Pushy Managers", Globe & Mail, July 3, 1997, B12; on institutional shareholders and "friction cost", see Kimberley Noble and Andrew Willis, "Texans Invade Corporate Canada", September 27, 1997, B1.

168 Neville Nankivell, "Institutional Shareholders as Activists", Financial Post, March 18, 1997.

for the bank remarked that historically "it was on pain of death that you ever got quoted in the paper."[169]

The partial dissipation of the stigma associated with confrontation among Canada's mainstream institutional investors during the 1990s did not mean they had become willing to seek out and invest in undervalued companies and agitate for change.[170] It fell to activist hedge funds to fill that gap. Still, the fact mainstream Canadian institutional shareholders had become increasingly receptive to the idea of change rather than exit meant that as activist hedge funds arrived on the scene they had potentially crucial allies. For instance, in 1999 an Invesco Inc. fund manager praised Crescendo Partners and Enterprise Capital on the basis they were "very capable. They're very common-sense. Patient. Disciplined. I'm very impressed. I think they serve a real role in capital management."[171] The hedge funds continued to win over institutional shareholders in the years following. As Crescendo Partners' Eric Rosenfeld explained in a 2012 interview:

> "(Institutional investors) used to think if I don't like something, I'll just sell. They didn't realize that they could change things. There wasn't much activism previously, so they didn't realize they could have someone do it for them. Once we explained it, and sometimes twice, that all you have to do is vote for us and we'll do all the hard work, it changed."[172]

Even now hedge funds cannot take institutional shareholder support for granted. Stephen Jarislowsky, founder of Jarislowsky and Fraser, a Montreal-based investment firm

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169 Kuitenbrouwer, "Silent", *supra* note xx (quoting Kym Robertson).

170 Rod McQueen, "Shareholder Values", Financial Post, May 18, 1996, 6.

171 Kuitenbrouwer, "Silent", *supra* note xx (quoting Scott Penman).

172 Scott Deveau, "Unwelcome to the Club", Financial Post, May 12, 2010, FP1.

with nearly $40 billion under management as of 2012,[173] labelled as "vultures" activist investors who step forward in response to the weak market value of companies.[174] Bill Ackman complained when he was seeking to round up support from fund managers for his CP proxy battle "Literally, one of the guys said, 'I see these guys at the Toronto Club. I know the board. I really can't go up against them.'"[175] Still, the fact that CP's incumbent directors ultimately capitulated because they knew Pershing Capital would win the proxy contest indicated that institutional shareholders were in fact more than willing to support an activist hedge fund that was prepared to spearhead a challenge and had provided a compelling argument for change.[176]

The activist hedge funds, for their part, were well aware of how important mainstream institutional backing was to their cause. Jim McDonald, a founder of Enterprise Capital Management, explicitly acknowledged that encouragement from mainstream institutional shareholders amplified the firm's clout, observing in 1999 "For the institutions to be supportive of these actions is a very constructive development. On our own, it would be difficult to be successful."[177] He also said of TD Asset Management Inc. in relation to the Repap Enterprises intervention "It's one thing for us, who some might characterize as opportunistic, but when the TD Bank is willing to stand up and be counted, that's a fabulous

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173 Peter Hadekel, "Competition May Have Led to Legend's Departure," Montreal Gazette, November 7, 2012, A26.

174 Ross Marowits, "Activist Investor Could Push SNC-Lavalin to Sell Concessions," Waterloo Region Record, Sept. 26, 2012, C8.

175 Deveau, "Unwelcome", *supra* note xx.

176 Erman, "Boardroom", *supra* note xx: "While Canadian shareholders have historically been reticent to publicly grouse about management (it does make things so uncomfortable at cocktail parties), give them a standard bearer for change such as Mr. Ackman and it's very clear they will fall in line."; MacDougall, "Six Lessons", *supra* note xx ("institutional shareholders are willing to support change if someone else spearheads a proxy battle and provides a compelling argument for change").

177 Macdonald, "Shareholders", *supra* note xx.

development."[178] The upshot is that the change of heart among mainstream institutional investors concerning shareholder activism likely contributed substantially to the growth of hedge fund activism in Canada.

3. Shareholder Rights

There has been recognition in media coverage of Canadian-oriented hedge fund activism that the country's legal regime provides an accommodating platform for hedge fund activism. Steven Davidoff, a law professor and regular contributor to the *New York Times*, observed in an article focusing on the CP/Pershing Capital activism saga "Canada's legal rules also make Mr. Ackman's shareholder activism easier."[179] Matthew Cumming, a McCarthy Tetrault lawyer, remarked in a blog intended primarily for U.S. investors "activist investors in Canada have a variety of rights and remedies that can create significant leverage for them in effecting change at a target company."[180] Likewise, a 2012 article in the *Globe & Mail*, having drawn attention to various features of the legal landscape in Canada, observed "No wonder Eric Rosenfeld's Crescendo Partners...loves to shop in Canada."[181] The head of Kingsdale Shareholder Services, which advises companies facing proxy fights, said similarly at a 2012 conference that corporate law rules that enabled shareholders to stir the pot made Canada the "land of milk and honey" for activists.[182]

The scope dissident shareholders have to take the initiative in calling a shareholder meeting has been identified as one aspect of Canadian corporate law helpful to activist hedge

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178 Kuitenbrouwer, "Silent", *supra* note xx.

179 Davidoff, "America's", *supra* note xx.

180 Matthew Cumming, "5 Things US Activist Investors Need To Know About Canada," available at http://www.canadianmergersacquisitions.com/2012/06/01/5-things-us-activist-investors-need-to-know-about-canada/ (last visited November 12, 2012).

181 Sophia Cousineau, "How Lowe's bid got Lost in Translation," Globe & Mail, September 18, 2012, B2.

182 Erman, "New Investor", *supra* note xx.

funds.[183] Section 143 of the Canada Business Corporations Act gives shareholders owning 5 per cent or more of a company's shares the right to call a shareholders' meeting. In contrast, s. 211(d) of the Delaware General Corporation Law, the legislation under which three out of five U.S. public companies are incorporated,[184] provides only that the board of directors or persons authorized by the articles of incorporation or the by-laws can call a meeting.[185] Delaware companies only rarely use the discretion afforded to them to entitle shareholders owning a prescribed percentage of shares to call a general meeting.[186]

A second feature of Canadian corporate law that has been credited with increasing the leverage of activist hedge funds is the relative ease with which incumbent directors can be removed.[187] Section 109 of the Canada Business Corporations Act empowers shareholders to remove directors by an ordinary resolution that can pass with a simple majority of votes cast.[188] Section 141(k) of the Delaware General Corporation Law similarly provides for removal by shareholder vote. Exercising this right is contingent, however, on the calling of a shareholder meeting and, as we have just seen, there is typically little scope for shareholders to take the initiative under Delaware law.

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183 Cumming, "5 Things", *supra* note xx; Davidoff, "America's", *supra* note xx; "Opalesque Round Table Series 2012: Canada", (2012), 22, available at http://www.opalesque.com/RT/CanadaRoundtable2012.html (quoting Darcy Morris, co-founder, Ewing Morris Investment Partners).

184 John Armour, Bernard Black and Brian Cheffins, "Delaware's Balancing Act", (2012) 87: 4 Indiana L.J. 1345, 1348.

185 Kenneth G. Ottenbreit and John E. Walker, "Learning from the Delaware Experience: A Comparison of the Canada Business Corporations Act and the Delaware General Corporation Law" (1998) 29: 3 Canadian Bus. L.J. 364, 378, 390.

186 Sofie Cools, "The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers", (2005) 30: 3 Del. J. Corp. L. 697, 732.

187 Middlemiss, "Proxy", *supra* note xx (citing views expressed by Kevin Thomson of Davies Ward Phillips & Vineberg, the law firm that acted for Pershing Square in its face-off with CP); Boyd Erman, "Open for Takeovers", National Post, April 21, 2006, 1.

188 On the definition of "ordinary resolution", see Canada Business Corporations Act, s. 2.

If a Delaware company has, as is permitted by s. 141(d) of the Delaware General Corporation Law, a classified board, shareholder dismissal rights are compromised further. A classified board is one where there is retirement by rotation, meaning that only a fraction (usually a third) of the seats on the board is affected by a single election.[189] When a board is organized in this fashion due to s. 141(k)(i) directors can only be removed for cause rather than purely at the discretion of the shareholders. Historically a majority of companies included in the S&P 500 stock market index had staggered boards but due to shareholder pressure now only about one-quarter now have this scheme in place.[190]

What is known as the oppression remedy is a third feature of Canadian corporate law that has been identified as advantageous for hedge funds contemplating engaging in shareholder activism.[191] The oppression remedy enables a shareholder in a company to sue for relief in circumstances where the company has oppressed, unfairly prejudiced or unfairly disregarded the shareholder's interests.[192] The Delaware General Corporation Law lacks a corresponding provision.[193]

Though the oppression remedy was originally designed with closely held companies in mind, minority shareholders of Canadian publicly traded companies have in various instances used this mechanism to obtain relief.[194] Institutional investors have even stepped

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189 Michael E. Murphy, "Attacking the Classified Board of Directors: Shaky Foundations for Shareholder Zeal" (2010) 65: 2 Bus. Lawyer 441, 442.

190 Steven M. Davidoff, "The Case Against Staggered Boards", NYT Blogs, Dealbook, March 20, 2012, available at http://dealbook.nytimes.com/2012/03/20/the-case-against-staggered-boards/ (last visited November 13, 2012).

191 Cumming, "5 Things", *supra* note xx.

192 See, for example, Canada Business Corporations Act, s. 241.

193 Ottenbreit and Walker, "Learning", *supra* note xx, 374.

194 See, for example, Stephanie Ben-Ishai and Poonam Puri, "The Canadian Oppression Remedy Judicially Considered: 1995-2001", (2004) 30: 1 Queen's L.J. 79, 92.

forward on occasion, with some success.[195] Case law, however, compromises at least partially the ability of hedge fund activists to rely on the oppression remedy.

The relevant jurisprudence indicates that a shareholder who "buys into" oppression, in the sense that the oppressive conduct occurred before the investor bought shares, is unlikely to get relief on the basis of past oppression.[196] This creates a problem for activist hedge funds. To understand why, assume a company's share price has fallen due to managerial failings a court would be prepared to label "oppressive" or "unfairly prejudicial". An activist hedge fund quickly buys up a substantial holding in what it perceives to be an undervalued company. If the hedge fund subsequently launches oppression remedy proceedings based on allegations of what occurred prior to its acquisition of shares the proceedings will likely be dismissed on the basis that the hedge fund bought into the oppression.

The Ontario Superior Court's dismissal in 2006 of an oppression remedy application by Greenlight Capital LP, a New York hedge fund, illustrates why the case law creates a problem for hedge funds. Greenlight Capital acquired10 per cent of the ordinary shares of MI Developments Inc., a publicly traded real estate company which Canadian business magnate Frank Stronach controlled and reputedly used to prop up an expensive and ailing race track business close to his heart.[197] Mr. Justice Ground justified his decision partly on the basis that Greenlight should have anticipated what might happen when it bought its MI Development shares, saying "The degree of control by Stronach could not have come as any

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195 John J. Chapman, "Institutional Activism: Current Trends and Emerging Legal Issues", (2007) 44 Can. Bus. L.J. 327, 330-32 (citing *UPM-Kymmene Corp. v. Repap Enterprises Inc.* (2004) 250 D.L.R. (4th) 526 (Ont. C.A.))

196 Chapman, "Institutional", *supra* note xx, 341-42.

197 *Greenlight Capital Inc. v. Stronach* (2006) 22 B.L.R. (4th) 11 (Ont. Sup. Ct. J.). For background on the dispute, see Derek DeCloet, "Hedge Funds aren't Going to Stand for Frank's Horsing Around", Globe & Mail, March 24, 2005, B1.

surprise to Greenlight in light of Stronach's publicly expressed views and business philosophy...."[198]

While Canadian corporate law may give an activist hedge fund more tools to work with than Delaware law, the bolstering of shareholder rights was not an obvious catalyst for the emergence of hedge fund activism in Canada as the 2000s. In order for corporate law to play this role there should have been amendments to Canadian corporate law that bolstered the bargaining power of shareholders just as hedge fund activism got underway. Subject to a caveat concerning proxy voting discussed in section B.3 below, this did not occur. Instead, empirical research on shareholder rights indicates the status quo prevailed.

Mathias Siems, working with an academic team the Cambridge U.K.-based Centre for Business Research (CBR) assembled, compiled a 10 variable shareholder protection index for 20 countries that tracked changes occurring between 1995 and 2005.[199] The CBR index incorporated variables dealing with the powers shareholder meetings can exercise, shareholder voting mechanics, director dismissal by shareholders, minority shareholder litigation and shareholder protection against an investor acquiring a large ownership stake without making a takeover bid.[200] The score for each of the 20 countries, save for one, was higher in 2005 than it had been a decade earlier.[201] The lone exception was Canada, which, based primarily on an analysis of the Canada Business Corporations Act, was awarded the

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198 *Greenlight Capital Inc. v. Stronach, supra* note xx, [108].

199 Mathias Siems *et al.*, "CBR Extended Shareholder Protection Index", available at http://www.cbr.cam.ac.uk/research/projects/project2-20output.htm (last visited November 13, 2012).

200 For an overview, see John Armour *et al.*, "Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis", (2009) 6: 2 Journal of Empirical Legal Studies 343, 354-57.

201 Armour *et al.*, "Shareholder", *ibid.*, 357.

same score in 1995 as it had in 2005.[202] Indeed, the scores attributed to Canada for each of the 10 variables in the CBR shareholder rights index remained unchanged for each year between 1995 and 2005.[203] To the extent that Canada's score accurately reflects the protection corporate law affords to shareholders, improvements in shareholder rights did not prompt the emergence of hedge fund activism in the 2000s.

B. Demand Side

1. Search Costs

Search costs associated with finding potential target companies are one category of costs associated with exercising influence (again c_i) that shape the demand side of the market for corporate influence. Due to revolutionary changes in information technology, a potential shareholder activist can currently find plausible targets much more easily than would have been the case throughout much of the 20th century.[204] In the case of the United States, however, commercial providers were supplying detailed financial information on public companies instantaneously at a relatively modest cost for at least a decade prior to activist hedge funds stepping forward in earnest in the late 1990s.[205] Correspondingly, falling search costs provide at best a secondary explanation for the rise of the offensive shareholder activism in the U.S.

In Canada, as in the United States, as the 1990s got underway fund managers and other professional traders could readily access via computers information supplied by commercial data providers on the history and financial status of a wide range of publicly

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202 *Ibid.*

203 Siems *et al.*, "CBR", *supra* note xx, 21-27.

204 Armour and Cheffins, "Origins", *supra* note xx, 260-61.

205 Cheffins and Armour, "Past", *supra* note xx, 83.

traded companies.[206] Hence, search costs had fallen dramatically well before the emergence of offensive shareholder activism in Canada.[207] However, further changes occurring in Canada during the late 1990s may have helped to foster the offensive shareholder activism that began very shortly thereafter.

Historically companies with shares publicly traded in Canadian provinces complied with requirements to provide prescribed financial data by filing paper documentation with securities regulators on a province-by-province basis. Beginning in 1997, however, the System for Electronic Document Analysis and Retrieval (SEDAR) provided a one-step multi-jurisdictional electronic filing system and the information filed was made available immediately to investors by way of the internet.[208] The resulting increase in "information liquidity" likely made it easier to identify and analyze underperforming companies.[209] Falling search costs may therefore have contributed to the rise of hedge fund activism in Canada in the 2000s.

2. Dealing Costs

To the extent that technological advances drive down dealing costs associated with accumulating and unwinding substantial stakes in publicly traded companies, this should create additional opportunities for profitable offensive shareholder activism.[210] In the U.S., technological improvements that made the mechanics of share dealing more efficient

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206 Alexandra Eadie, "Financial Quotation Services Find Technological Enhancement Pricey", Globe & Mail, March 7, 1988, C4; Patrick Fellows, Computers and Software Available to Get Access to TSE Quotes", Toronto Star, April 27, 1993, C2.

207 Jeffrey MacIntosh, "If it Ain't Broke…", Canadian Investment Review, Winter 1994-95, 37, 38 (focusing on monitoring managers).

208 Marguerite Mooney, "Canadian Securities Regulators Introduce Electronic Filing", Int. Fin. L. Rev., August 1996, 23; David Zgodzinski, "SEDAR Offers Key Facts on Canadian Companies", Globe & Mail, October 23, 1997, B23.

209 Richard J. Nathan, "Corporate Governance at the Speed of Light", (1996) 19 O.S.C.B. 6125, 6125.

210 *Supra* note xx and related discussion.

combined with de-regulation to cut dealing costs dramatically during the final decades of the 20th century.[211] Given, however, that the most dramatic changes occurred before hedge fund activism got underway in the U.S. in the late 1990s this trend at best indirectly fostered activism by hedge funds.[212]

As was the case in the United States, dealing costs fell substantially in Canada as the 20th century drew to a close, but well in advance of hedge fund activism's arrival. An order of the Ontario Securities Commission that abolished fixed commission rates in 1983 prompted the rise of discount brokers and forced full-service brokerage houses to cut their commission rates substantially.[213] There also were technological improvements. An executive from stockbroker Dean Witter Reynolds (Canada) Inc. said in 1990 "When I started 20 years ago, we had 50 guys in an office, we'd be at our desks with a black phone and there would be one quote machine in the corner. Now we've got computers and radios."[214] Dealing costs fell further prior to the emergence of hedge fund activism when during the mid-1990s the Toronto Stock Exchange switched from floor-based trading to all-electronic trading and moved away from trading in eights of a dollar to decimalization.[215]

While the decline in dealing costs Canada experienced during the 1980s and 1990s may have come too early to be a cause of hedge fund activism in the 2000s the growing

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211 Cheffins and Armour, *supra* note xx, 72.

212 *Ibid.* at 84.

213 Jack Willoughby, "OSC Opts for Negotiated Stock Commissions", Globe & Mail, June 26, 1982, B1; John Stackhouse, "Bay Street's Day of Reckoning", Globe & Mail, July 20, 1990, 22.

214 Stackhouse, "Bay Street's", *supra* note xx.

215 Eric A. Kirzner, "The Toronto Stock Exchange's New Electronic World", Canadian Investment Review, Spring 1992, 83; Bertrand Marotte, "Bittersweet Final Day Signals End of an Era", Hamilton Spectator, April 24, 1997, D1; Sean Cleary, Kevin Kerr and John Schmitz, "Transaction Costs for TSE-Listed Stocks", Canadian Investment Review, Spring 2002, 20 (providing empirical data on transaction cost trends between the late 1980s and late 1990s).

prominence of alternative trading systems (ATS) may well have played a role. ATSs, computer-based trading platforms that bring together orders of buyers and sellers independent of established stock exchanges, were a growing presence in the U.S. in the late 1990s.[216] In Canada, in contrast, ATSs were marginal players until the mid-2000s, having been barred from operating in Canada by Canadian securities regulators until 2001.[217] ATSs then made substantial inroads into the Toronto Stock Exchange's monopolistic dominance of share trading and did so in a way that may well have facilitated offensive shareholder activism.[218]

When trading occurs via the Toronto Stock Exchange buying or selling large blocks of stock can be difficult to execute with sufficient anonymity to preclude a substantial price disruption.[219] ATSs provide, in contrast, "dark pool" liquidity that facilitates trading by big buyers and sellers that does not move prices.[220] Given that practitioners of offensive shareholder activism look to buy up and ultimately dispose of sizeable stakes in targeted companies, the emergence of ATSs in the mid- and late-2000s should have reduced c_i in a way that helped to foster hedge fund activism Canadian style.

3. Communication Costs

A decline in communication costs, a sub-set of c_i incurred by activist shareholders as they seek to gain support from otherwise neutral investors, likely was an additional factor contributing to the rise of hedge fund activism in Canada. This was due to deregulation more

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216 Serge Boisvert and Charles Gaa, "Innovation and Competition in Canadian Equity Markets", Bank of Canada Review, Summer 2001, 15, 18.

217 Les Whittington, "Alternative Trading Systems Get Green Light", Toronto Star, August 17, 2001, C3; David Dias, "He's a Market Maker", National Post, September 1, 2007.

218 Karen Mazurkewich, "Men of Shadows", National Post, November 7, 2009, FP 1.

219 Andrew Willis, "Judith Robertson's Little Black Book", Globe & Mail, April 29, 2005, 48.

220 Derek DeCloet, "TSX Still Top Dog, Despite Alpha's Bark", Globe & Mail, May 10, 2007; Rita Trichur, "Trading Maven Takes on Bay St.", Toronto Star, September 2, 2008, A13.

than improved technology. Though the emergence of social media in the mid-2000s roughly coincided with the rise of offensive shareholder activism in Canada, the rapid growth of the internet and e-mail in the 1990s provided ample opportunity for convenient, low-cost communication between investors well before hedge fund activism got underway in earnest.[221] The key change instead was a 2001 amendment to the Canada Business Corporations Act that liberalized rules governing solicitation of proxies by dissident shareholders.

The 2001 change did not alter Canada's scores on the 10 variable shareholder-protection index Cambridge's CBR compiled because proxy regulation is not an element in the index.[222] Nevertheless deregulation likely did provide a helping hand for offensive shareholder activism. Developments in the U.S. are instructive. In 1992, the federal Securities and Exchange Commission sought to facilitate interaction between shareholders by cutting back on instances where parties seeking change through the proxy process had to comply with otherwise applicable federal proxy requirements, most notably an obligation to file relevant documentation for review by the Commission.[223] While hedge fund activism did not begin in earnest in the U.S. until the 1990s were drawing to a close, the 1992 reforms meant that when hedge funds were otherwise prepared to move to the forefront as shareholder activists they had ample scope to communicate with fellow stockholders as they targeted underperforming companies.[224]

The pattern in Canada was similar in various respects. The Canada Business Corporations Act requires a shareholder who solicits proxies to prepare and send proxy

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221 For a technology timeline, see Shannon Proudfoot, "The Great Connection", Montreal Gazette, April 10, 2009, A12.

222 *Supra* note xx and accompanying text.

223 Cheffins and Armour, *supra* note xx, 90.

224 *Ibid*., 91.

documentation in prescribed form to the corporation affected, its shareholders and officials administering the legislation.[225] Prior to 2001 these requirements applied whenever a shareholder engaged in any "communication to a shareholder under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[226] Correspondingly, informal discussions, even telephone calls, between shareholders constituted potentially illegal vote solicitation punishable by fines and even jail terms.[227] The proxy rules correspondingly acted as a deterrent to shareholder oversight of corporate affairs.[228]

In 2001 the CBCA was amended to permit a shareholder not acting on behalf of management to solicit up to fifteen shareholders to form a voting alliance without requiring that shareholder to prepare and distribute a dissident proxy circular.[229] An exemption was also created for a shareholder seeking support from fellow shareholders by way of a public broadcast or publication.[230] The *Globe & Mail* said that due to the reforms "(t)here is now almost no barrier to corporate activism."[231]

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225 Canada Business Corporations Act, 150.

226 Canada Business Corporations Act , s. 147(c), now repealed, s. 150; Sarra, "Shareholders", *supra* note xx, 78.

227 Sarra, "Shareholders", *supra* note xx, 78; "Institutions Must Join Corporate Activism's Ranks", Globe & Mail, March 9, 2002, B7.

228 MacIntosh, "Role", *supra* note xx, 388; Montgomery and Leighton, "Unseen", *supra* note xx, 44.

229 Canada Business Corporations Act, s. 150(1.1), discussed by Sarra, "Shareholders", *supra* note xx, 79-80.

230 Canada Business Corporations Act, s. 150(1.1), discussed by Sarra, "Shareholders", *supra* note xx, 80.

231 "Institutions Must Join", *supra* note xx; see also Karen Howlett, "Investors Given Powers to Fight Boards", Globe & Mail, November 26, 2001, B1 ("Canadian institutional investors will have a lot more power in the nation's boardrooms under sweeping revisions to rules governing shareholder activity.")

The *Globe and Mail*'s characterization was something of an exaggeration. The changes only applied to corporations governed by the Canada Business Corporations Act, under which only around 10 per cent of Canadian businesses incorporate.[232] Also, the 2001 CBCA amendment did not alter National Instrument 51-102, a document issued by the Canadian Securities Administrators (CSA) for implementation by provincial securities regulators that imposed proxy solicitation requirements similar to the pre-2001 CBCA.[233]

On the other hand, at the time the CBCA proxy rules were liberalized almost 50% of Canada's largest 500 non-financial corporations were incorporated under the legislation.[234] Also, in 2006 the proxy solicitation provisions in the Ontario Business Corporations Act, the legislation under which the largest number of Canadian businesses incorporate,[235] were amended in a manner similar to the CBCA.[236] Similarly, in 2008 the CSA revised National Instrument 51-102 so that the proxy solicitation exemptions provided by securities regulators generally corresponded with corporate law.[237]

The decline in communication costs associated with reform of the proxy solicitation rules plausibly contributed to the rise of offensive shareholder activism in Canada. A 2005 *Globe & Mail* article seeking to explain the arrival of a "perfect storm of activism" by hedge

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232 Wayne D. Gray, "Corporations as Winners Under CBCA Reform", (2003) :1 39 Can. Bus. L.J. 4, 33.

233 Ernest McNee and Michael Fabbri, "Amendments to Proxy Solicitation and Information Circular Requirements Under National Instrument 51-102 - Continuous Disclosure Obligations to Come onto Force on July 4, 2008," April 1, 2008, available at http://blakes.com/in/view.asp?ID=2292 (last visited December 3, 2012).

234 Gray, "Corporations", *supra* note xx, 5.

235 Gray, "Corporations", *ibid.* 33.

236 John Tuzyk and Lelia Costantini, "Proposed Amendments To Ontario's Business Corporations Act – Implications For Public Companies", Blakes Bulletin on Securities Law, November 2006, available at http://mondaq-business.vlex.com/vid/amendments-ontario-corporations-implications-56815444 (last visited Dec. 3, 2012).

237 McNee and Fabbri, "Amendments", *supra* note xx.

funds specifically cited the CBCA deregulation as a factor.[238] The approach Jana Partners, a New York-based activist hedge fund, took when in 2012 it built up a 4 per cent stake in Calgary-based fertilizer group and CBCA incorporated Agrium Inc. and pressed for the break-up of the company, also illustrates de-regulation's impact.[239] Jana Partners worked behind the scenes for a number of months to pitch its scheme to investors before unveiling publicly its analysis of the company.[240] Jana founder Barry Rosenstein said "We've spoken to many shareholders in Canada and elsewhere and we're confident shareholders want to see value-creating change."[241] It is doubtful whether Jana Partners would have intervened in the manner it did if it anticipated having to issue a dissident proxy circular, which it likely would have been compelled to do under the pre-2001 CBCA.

4. Financing Costs

Those who believe they can generate superior risk-adjusted returns by engaging in shareholder activism but are confronted with financing costs can potentially proceed by managing an investment fund with a suitable mandate and sufficient capital.[242] The 2000s proved to be an auspicious decade for doing this. The hedge fund industry experienced explosive growth, meaning there was ample capital to fund the various investment strategies

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238 Wayne Lilley, "We're Not Gonna Take It", Globe & Mail, May 27, 2005, 54. See also Jacquie McNish, "Rosenfeld Tunes Up for More Turmoil", Globe & Mail, February 13, 2008, B9 (saying of the founder of hedge fund Crescendo "Helping him are Canadian laws which make it easier for activists to unseat or demand changes from directors through proxy battles…").

239 On Agrium's jurisdiction of incorporation, see basic corporate information available by searching Agrium Inc. under http://www.sedar.com/issuers/company_issuers_a_en.htm (last visited December 30, 2011).

240 Boyd Erman, "Jana Probes for Weakness in Agrium's Armour", Globe & Mail, October 2, 2012, B2.

241 *Ibid.*

242 *Supra* note xx and related discussion.

hedge funds pursue, including offensive shareholder activism.[243] As Peter Puccetti, chairman and chief investment officer of activist hedge fund Goodwood Inc. said in 2004, "There has been a lot of capital come into the hedge fund business, so that gives you more clout to do these sorts of things."[244]

The number of hedge funds operating globally grew from 3000 to 8000 between 1998 and 2006 and assets under management rose from US$300 billion to well over $1 trillion.[245] Though the financial crisis side-swiped the hedge fund industry, by 2012 assets under management were over $2.1 billion.[246] While these are global figures they are relevant to the rise of hedge fund activism in Canada because the protagonists have often been foreign. Only two Canadian hedge funds (Enterprise Capital Management and Goodwood Inc.) were included in a 2006 *National Post* list of the ten activist investment firms most likely to shake up corporate Canada; the remainder were American.[247]

Katelouzou's data from 2000 to 2010 on Canadian hedge fund activism reveals a similar pattern. She identified the hedge fund responsible for each of the 59 interventions involving Canadian target companies she found, including three situations where hedge funds worked in tandem.[248] Of the 62 instances where a hedge fund stepped forward, on 42 occasions the protagonist was U.S.-based and on four others the protagonist was from another

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243 Cheffins and Armour, *supra* note xx, 88.

244 Kalawsky, "Hedge", *supra* note xx.

245 Cheffins and Armour, *supra* note xx, 79, 88.

246 Cheffins and Armour, *ibid.* 93 (financial crisis); Hedge Fund Research, "Hedge Fund Assets Surge to Record in Third Quarter", press release, October 18, 2012, available at https://www.hedgefundresearch.com/pdf/pr_20121018.pdf.

247 "Activist Shareholders", National Post, July 1, 2006.

248 Katelouzou, "Hedge", *supra* note xx, 100.

foreign country.[249] Correspondingly, the dramatic growth of the hedge fund industry globally helped to set the stage for the emergence of offensive shareholder activism in Canada.

Consistent with global trends the hedge fund industry in Canada has grown substantially over the past dozen years. It has done so from a tiny base, however, as Canadian demand for hedge fund investments was at first exclusively and more recently, largely satisfied by foreign hedge funds.[250] As of 1999, only 14 hedge funds reported to and were included in a hedge fund database complied by Canadian Hedge Fund Watch and these hedge funds had just $923 million worth of assets collectively under management.[251] As of 2006, 280 hedge funds were reporting to Canadian Hedge Watch and the 117 that reported their assets under management collectively held investments worth just over $7.6 billion.[252] Still, despite the sizeable growth rate, Canada was a hedge fund laggard. Measured in relation to the size of the domestic stock market the Canadian hedge fund industry was as of 2004 only half as developed as it was in Europe and operated at one-sixth the scale of the hedge fund industry the United States.[253]

The financial crisis sideswiped Canada's hedge fund industry, replicating the global pattern. The number of hedge funds reporting to Canadian Hedge Watch fell from 353 in December 2008 to 274 in September 2009 and total assets under management among the minority of hedge funds reporting this data fell from $7.95 billion in December 2007 to $5.41 billion in March 2009.[254] One of the victims was a prominent Canadian-based shareholder

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249 Data supplied to the author by Dionysia Katelouzou.

250 Miville Tremblay, "Portrait of the Canadian Hedge Fund Industry", Financial System Review, December 2004, 41, 41.

251 Canadian Hedgewatch, January 2011, 36 (Table 1.1), 39 (Table 1.4).

252 *Ibid.*, 36 (Table 1.1), 38 (Table 1.3), 39 (Table 1.4)

253 Tremblay, "Portrait", *supra* note xx, 44.

254 Canadian Hedgewatch, *supra* note xx, 36 (Table 1.1), 38 (Table 1.3), 39 (Table 1.4).

activist, Salida Capital, the assets under management of which fell from a pre-financial crisis peak of $1.2 billion to $300 million in 2009.[255]

The Canadian hedge fund industry bounced back as the financial crisis receded, again matching global trends.[256] By the end of 2010, the number of hedge funds reporting to Canadian Hedge Watch had gone back up to 339 and the collective assets under management of $8.98 billion of the 149 hedge funds reporting exceeded pre-financial crisis totals.[257] Salida bounced back as well, if not as emphatically, as it had roughly $650 million worth of assets under management during 2010.[258]

Despite rebounding from the financial crisis, the modest scale on which the Canadian hedge fund industry has operated has likely been a check on offensive shareholder activism in Canada. Only a small minority of Canadian hedge funds are large enough to contemplate purchasing a stake of 5% to 10% in a typical company listed on the TSX.[259] This size constraint dampens offensive shareholder activism in Canada because hedge funds based in a particular country are more likely to target a company located in the same jurisdiction than a company based elsewhere. Katelouzou's research reveals the extent of home country bias affecting hedge fund activism. She reports that all 16 instances of shareholder activism carried out by Canadian hedge funds involved Canadian targets rather than any of the other 24 countries in her dataset.[260] The pattern was the same for hedge funds based in Australia,

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255 Barry Critchley, "Salida to Munch with the Oracle", National Post, July 9, 2009, FP1.

256 On the general trend, see Cheffins and Armour, *supra* note xx, 97-98.

257 Canadian Hedgewatch, *supra* note xx, 36 (Table 1.1), 38 (Table 1.3), 39 (Table 1.4).

258 Andrew Willis, "Salida Makes Move Into Private Equity", Globe & Mail, April 15, 2010, 12.

259 *Supra* note xx and related discussion.

260 Katelouzou, "Hedge Fund", *supra* note xx, 103, supplemented by data provided to the author by Ms. Katelouzou. An important qualification here is that Katelouzou did not take into account activist campaigns with targets outside the 25 countries she focused on.

Japan and South Africa.[261] It follows that while the growth of the global hedge fund industry over the past couple of decades has been conducive to hedge fund activism in Canada, the fact that large scale hedge fund operations such as West Face Capital have been exceptional by Canadian standards has meant financing costs have muted to at least some degree the impact of offensive shareholder activism on Canadian public companies. As Terence Corcoran, the *National Post* columnist observed in 2012, "Without New York, there would be no CP proxy fight."[262]

V. Conclusion

This paper has documented the emergence of offensive shareholder activism as an important Canadian corporate governance trend and has relied on the market for corporate influence heuristic to identify variables that account for its newfound prominence. To conclude the paper, the analytical framework that has been deployed will be drawn upon to speculate briefly on the future of offensive shareholder activism in Canada. The bottom line is that while hedge fund activism should remain a feature of Canadian corporate governance going forward, the modest size of the Canadian hedge fund industry will compromise its impact to some degree.

On the supply side of the market for corporate influence, while instances of offensive shareholder activism have stirred things up Canada reputedly still has a tight-knit corporate community where complacency about the quality of corporate management persists.[263] To the extent this characterization is correct, there should remain an ample number of

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Correspondingly, if a Canadian or Japanese hedge fund targeted a U.S. company, her data would not have revealed this.

261 Katelouzou, "Hedge Fund", *supra* note xx, 103, supplemented by data provided to the author by Ms. Katelouzou.

262 Terence Corcoran, "Activism Beats Governance", National Post, May 12, 2012, 21.

263 Corcoran, "Activism", *supra* note xx; Deveau, "Unwelcome", *supra* note xx; "Opalesque Round Table Series 2012: Canada", *supra* note xx, 22.

underperforming companies where change might be beneficial. Receptivity to activist initiatives among mainstream institutional shareholders should be sustained, particularly if stock markets continue to deliver mediocre post-financial crisis investment returns.[264] There is also unlikely to be a rollback of the shareholder rights Canadian law bestows that provide those inclined to engage in offensive shareholder activism with meaningful bargaining leverage.

On the demand side, the technological changes that have driven down search costs, dealing costs and communication costs in ways that have encouraged offensive shareholder activism campaigns in Canada not only should be irreversible but will probably be reinforced over time by fresh technological innovations. The situation with financing costs is somewhat more complicated. Given the home country bias that affects hedge fund activism campaigns, so long as large scale hedge fund operations such as West Face Capital remain exceptional by Canadian standards the modest financial clout of Canadian hedge funds will compromise at least to some degree the impact offensive shareholder activism has on Canadian public companies. Moreover, this obstacle to offensive shareholder activism is unlikely to disappear in the short- to medium-term. Investors in Canada who provide the main potential market for hedge fund investment tend to be conservative by nature and associate size with safety, thereby creating an inbuilt bias against Canada's numerous small hedge funds.[265] As a *Globe & Mail* journalist explained in a 2011 article:

> "There's also a chicken-and-egg conundrum. Many big pension funds or university endowments need to invest a lot of money at one time, given their own sheer size. It's hard to do that in a small hedge fund. So the funds need to get bigger before they can get bigger. 'There is a Catch-22, as many investors will not invest in Canadian hedge

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264 Erman, "Boardroom", *supra* note xx; Corcoran, "Activism", *supra* note xx.

265 "Opalesque Round Table Series 2012: Canada", *supra* note xx, 13.

> funds because it's such a small market, and it will stay a small market until more investors buy in (quoting an Ernst & Young partner specializing in hedge funds)'."[266]

The recent activism forays by Pershing Capital (CP) and Jana Partners (Agrium Inc.) indicate that American hedge funds are ready, willing and able to target major Canadian companies. Falling search costs, dealing costs and communication costs mean that for foreign – typically U.S. -- hedge funds the setting for offensive shareholder activism is considerably more propitious in Canada than would have been the case 10 or 20 years ago. A reversal of the underlying trends seems unlikely. Offensive shareholder activism correspondingly seems destined to remain a significant aspect of the Canadian corporate governance terrain going forward. Substantial growth in the prominence of hedge fund activism in Canada is, however, by no means guaranteed. This will be contingent to a substantial degree upon the Canadian hedge fund industry's ability to develop additional activist funds with sufficient financial resources to launch campaigns against Canada's larger public companies.

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[266] Boyd Erman, "Keeping Up With Jones", Globe & Mail, January 28, 2011.

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