

TABLE OF CONTENTS

<i>Preface to the First Edition</i>	iii
<i>Preface to the Second Edition</i>	vii
<i>Table of Cases</i>	xxi

CHAPTER 1: Introduction 1

CHAPTER 2: Debt and Equity: The Financial Building Blocks 5

2.1 Introduction	5
2.2 The Basic Sources of Cash for Business	6
(a) External and Internal Cash Source	6
(i) Internal Sources of Cash	7
(A) Trade Credit	7
(B) Accruals	8
(C) Retained Earnings	10
(ii) External Sources of Cash	10
2.3 Debt and Equity: The Fundamental Building Blocks	10
(a) Introduction	10
(b) Some Preliminary Concepts	18
(c) Priority: Debt ranks ahead of Equity	25
(i) Restrictions on Return of Capital to Shareholders at Common Law	26
(ii) Reduction and Return of Capital and Shareholder Distribu- tions under Corporate Statutes	28
(d) Debtholders earn interest, and have a legal right to earn interest payments; equityholders may receive dividends unless and until they are “declared” by a corporation	31
(i) Interest on Debt	31
(ii) Dividends	31

Table of Contents

(A) Can directors consider prospective future cash flows for purposes of the s. 42(a) test?	39
(B) What is meant by the phrase “realizable value”? . . .	39
(C) When must the corporation meet the solvency test? At the time the dividend is declared? At the time the dividend is paid? Or at both times?	42
(e) Retraction Privileges	45
(i) Overview	45
(f) Tax Treatment: Interest Paid on Debt is Tax Deductible. Dividends Paid on Shares Are Not	49
(g) Upside Potential: Debt Offers a Maximum Fixed Return; Equity May Offer the Possibility of Unlimited Upside	50
(i) Basic Principle	50
(ii) Preferred Shares as “Equity”	52
(h) Voting Control: Equityholders have Greater Power and Influence over Corporate Management	57
(i) Debtholders Enjoy Contractual Rights. Equityholders are Protected by the Fiduciary Obligations Imposed upon a Corporation’s Directors	59
(j) Final Note on Debt vs Equity Comparison	64
(k) Debt: A Closer Look	65
(i) Negotiated Loans versus Market Instruments	65
(A) Collateral Security	65
(B) Loan Covenant Pattern	72
(C) A Digression: Why Secured Lending?	75
(ii) Market Instruments: Bonds, Debentures, Notes, Commercial Paper	77
(A) Debt Securities	77
(B) Trust Indentures	80
(C) Debenture Features	82
(iii) Interest	86
(A) Effective Annual Interest Rate	86
(B) The <i>Interest Act</i>	88
(C) Criminal Rate of Interest	93
(D) Benchmark Interest Rates and the LIBOR Scandal	103

Table of Contents

(l) Equity: A Closer Look	106
(m) Classes of Shares	110
2.4 Conclusion	113
 CHAPTER 3: An Introduction to Elementary Finance and Financial Theory	115
3.1 Of Buffet and Bumble Bees	115
3.2 Financial Theory and Financial Practice: Carts and Horses	118
(a) Square One: Elementary Capital Budgeting and Valuation Methods	118
(i) IRR and NPV	119
(A) Time Value of Money	121
(B) Net Present Value	122
(C) Internal Rate of Return (IRR)	128
(D) Brief Comparison of NPV and IRR	131
(E) Recent Research	132
(b) Simple Bond and Share Valuation	133
(i) Bond Pricing	133
(ii) Simple Share Valuation	136
(A) Preferred Shares	137
(B) Common Shares	139
(c) From Financial Valuation to Financial Theory	141
3.3 Financial Theory	145
(a) Introduction	145
(b) Efficient Market Theory	145
(i) What does “efficiency” mean?	146
(ii) History of Efficiency Market Theory	147
(iii) Development of the Efficient Market Hypothesis	149
(iv) Efficient Market Hypothesis and the Law	154
(A) Securities Legislation	154
(B) The Courts	156
(C) Summary	161
(c) The M-M (Modigliani and Miller) Proposition	161
(d) Portfolio Theory	165

Table of Contents

(e) The Capital Asset Pricing Model	167
(f) Option Pricing Theory	169
(g) Arbitrage and the Law of One Price	170
(i) The Law of One Price	171
(ii) Interest-Rate Parity Theorem and Covered-Interest Arbitrage	172
(iii) Covered-Interest Arbitrage and Weak Currency Financing	175
(A) Introduction	175
(B) Interest Parity and Income Tax	176
(C) Shell Canada — A Case Study	177
(D) Trial Decision	182
(E) Federal Court of Appeal	184
(F) Supreme Court of Canada	185
(v) Limits to Arbitrage	187
3.4 Conclusion: Corporate Financing -A Dynamic Subject	189

CHAPTER 4: Creating and Issuing Financial Claims: Public Offerings and Private Placements 191

4.1 Introduction	191
4.2 History and Philosophy of Securities Regulation	191
(a) Securities	191
(b) English Developments	192
(c) US “Blue Sky” Legislation	199
(i) “Blue Sky”	199
(d) U.S. Federal Securities Legislation: The American Disclosure Model.....	202
(i) Background	202
(ii) Merit Review/Disclosure Debate.....	207
(iii) The 1933 Act	208
(iv) Ontario’s Securities Laws	210
4.3 Public Offering Process	213
(a) Growing Interest in Capital Markets	213
(b) Sources of Funds	214
(c) Public Offering vs. Private Placement Securities	214

Table of Contents

(d) Going Public: The Initial Public Offering	215
(e) The Advantages of Going Public	216
(f) The Disadvantages of Going Public	217
(g) The IPO: Process and Issues	219
(i) Engaging the Underwriter	220
(A) Overview	220
(B) Underwriters' Commissions	224
(ii) Drafting the Prospectus/Due Diligence/Liability for Misrepresentation	224
(iii) Pricing issues	226
(iv) Green Shoe Options/Market Stabilization	227
(v) Escrow and Lockup Arrangements	228
4.4 Exempt Distributions (Private Placements)	229
4.5 Recent Reforms	231
4.6 Conclusion	234
 CHAPTER 5: Financial Innovation and Financial Engineering:	
Derivatives	235
5.1 Introduction	235
5.2 Derivatives and Financial Innovation	237
(a) Introduction	237
(b) What is a Financial Innovation?	238
(c) The New Wave of Financial Innovation	239
5.3 Derivatives in the News	241
(a) Early 1990s	241
(b) Long-Term Capital Management	243
(c) U.S. Financial Regulatory Reform	245
(d) The Financial Crisis and its Aftermath	252
5.4 Understanding Derivatives	252
(a) The Building Blocks of Derivatives	253
(i) Forward	253
(A) A Forward Example	254
(ii) Futures	255
(iii) Options	256

Table of Contents

(A) An Option Example	256
(B) Put and Call Options	258
(C) Option Payoffs	259
(D) Option Styles	264
(E) Put-Call Parity	264
(iv) Swaps	269
(A) A Swap Example	269
(B) Notional Amounts and Netting	271
(C) Uses of Swaps	272
(D) Standardization of Swaps Agreements	272
5.5 Derivatives: Legal and Public Policy Implications	272
(a) Integrity of Financial Reporting	273
(i) Non-Financial Firms	273
(ii) Financial Firms	275
(iii) Risk of Business Losses or Business Failures	275
(b) Derivatives and Corporate Governance	277
(i) Market Risk	282
(ii) Credit Risk (or Default Risk)	282
(iii) Operational Risk	283
(iv) Legal Risk	283
(c) Derivatives Dealers Responsibility to Clients	287
(d) Derivatives and the New Financial World Order	288
5.6 Recent Regulatory Initiatives	291
(a) Introduction	291
(b) International Developments	292
(c) Canadian Legislative and Regulatory Initiatives	294
(i) Early Initiatives	295
(ii) Quebec Derivatives Regulation	297
(iii) Post-Financial Crisis Regulatory Proposals	297
5.7 Conclusion	299
 CHAPTER 6: Mergers and Acquisitions	 301
6.1 Introduction	301
(a) Mergers, Consolidations, Amalgamations	301

Table of Contents

(b)	Delaware (“Three-Cornered”) Amalgamation	303
6.2	Why Companies Merge	303
(a)	The Simple Answer: To (Attempt to) Increase Shareholder Value	303
(i)	A Theoretical Explanation for Mergers	306
(ii)	Some Specific Explanations for Pursuing Mergers	307
(A)	Diversification of a corporation’s businesses aimed at making the corporation’s earnings less vulnerable to downturns in a particular business operation	307
(B)	Reduction of Costs (or increase of revenues) Through Vertical or Horizontal Integration	308
(C)	Realization of Synergies	309
(D)	Increasing Market Share	310
(E)	Acquiring Technology, Intellectual Property or “Know How”	310
(F)	Increasing Earnings Per Share	311
(G)	Bargain Hunting	313
(H)	Roll’s Hubris Theory	313
(I)	Pressures of Economic Forces and Globalization	314
6.3	Merger Waves	314
6.4	Asset versus Share Sales	315
6.5	Structuring a Significant Share Acquisition	316
(a)	Amalgamation	316
(i)	Amalgamating Corporations Incorporated in Different Jurisdictions	316
(A)	Amalgamation Agreement	317
(B)	Shareholder Meeting(s)/Information Circular	318
(C)	Shareholder Approval	320
(D)	Articles of Amalgamation	326
(E)	Dissent and Appraisal Rights	326
(b)	Capital Reorganization	328
(c)	Statutory Plan of Arrangement	329
(i)	Introduction	329
(ii)	Court Approval	330
(iii)	Advantages of Arrangements	331

Table of Contents

(A) Court Sanction/Certainty	331
(B) Flexibility	331
(C) U.S. Securities Laws Advantages	332
(D) Tax and Other Technical Advantages	333
(iv) Obstacles to the Plan of Arrangement Structure	333
(A) Solvency of Applicant	333
(B) The Fairness Hearing — A Two-Edged Sword	334
(C) Fairness Opinions	334
(D) Dissent and Appraisal Rights	335
(E) Arrangements and Take-over Bids	335
6.6 Take-over Bids	336
(a) Introduction	336
(b) Corporate Law	338
(c) U.S. Tender Offers vs. Canadian Take-over Bids	338
(i) Take-over Bid Defined	339
(d) Exempted Take-over Bids	342
(i) Normal Course Purchase Exemption	342
(ii) Private Agreement Exemption	342
(A) Why Restrict Control Premia At All?	345
(iii) Non-Reporting Issuer Exemption	350
(iv) Foreign Take-over Bid Exemption	351
(v) <i>De Minimis</i> (fewer than 50 Shareholders) Exemption	352
(e) The Formal Bid Procedure	353
(f) Anatomy of a Hostile Take-over Bid	359
(g) Protection of the Rights of Target Company Shareholders	363
(h) Delaware Take-over Law	365
(i) Unocal/Unitrin “Enhanced Judicial Scrutiny”	365
(ii) Revlon Duty	368
(iii) Entire Fairness	371
(iv) Revlon and Unocal in Canada	372
(A) General Role of Directors of Target: No Express Unocal Test	372
(B) Revlon Duties and Canadian Take-over Law	375

Table of Contents

(i) Poison Pill Plans	385
(i) Poison Pill Cases (Pre-2007)	387
(ii) More Recent Poison Pill Cases	393
(i) Do Poison Pills Prevent “Coercive Bids”?	394
(A) Do Poison Pills Lead to Higher or Lower Shareholder Value?	400
(B) Other Justifications for Canadian Poison Pills	404
(C) The Legality of Poison Pills	405
(D) Poison Pill Plans and Institutional Shareholders	407
(j) Post-Bid Squeeze-Out (or Squeeze-in) Transactions	408
(i) Compulsory Acquisition	408
(ii) Post-Bid Business Combinations (or Going-Private Transactions)	410
6.7 Shareholder Approval of Major Share Acquisitions	411
6.8 Conclusion	412
 CHAPTER 7: Securitization	415
7.1 Introduction	415
7.2 Basic Steps	416
7.3 Why Securitize at all?	421
7.4 Key legal Issues: True Sale and Bankruptcy Remoteness	423
7.5 Securitization: Comments and Criticisms	427
7.6 Recent Legislative and Regulatory Developments	430
7.7 Securitization and Covered Bonds	431
7.8 Conclusion	433
 CHAPTER 8: Financial Statements and Auditors	435
8.1 Introduction	435
8.2 Financial Statements	436
(a) The Balance Statement or Statement of Financial Position	437
(i) Dual Aspect Concept	438
(ii) Accounting Values Not Market Values	439

Table of Contents

(iii) Some Valuable Assets Never Appear on the Balance Sheet	440
(iv) Balance Sheet is a “Snapshot” — Good for Date of Issue Only	441
(v) The Challenge of “Off Balance Sheet Items”	441
(b) Income Statement/Statement of Comprehensive Income	443
(i) Manipulating or “Managing” Accounting Earnings	445
(c) Cash Flow Statement (or Statement of Changes in Financial Position)	449
8.3 The Role of Auditors and Accountants	449
(a) The Legal Duty of Auditors	449
(i) What is an “auditor”?	449
(ii) What is an “accountant”?	450
(iii) What sort of review do auditors perform?	454
(A) Audit Engagement	455
(B) Review Engagements	457
(C) Compilation Reports	460
(b) Who, as a matter of law, is entitled to rely upon an auditor’s report?	460
(i) Introduction	460
(ii) Haig v. Bamford	460
(iii) Hercules Managements Ltd. v. Ernst & Young	462
8.4 Conclusion	466
CHAPTER 9: Canadian Financial Institutions and Exchanges — From Pillars to (Trading) Post	467
9.1 Introduction	467
9.2 A Brief Overview of Canadian Financial Institutions: The Traditional Four Pillars	467
(a) Overview	467
(b) Banks	469
(i) What is “banking”?	470
(ii) Restrictions on Banks’ Powers	472
(iii) Banks, Trusts and Insurance Companies	475
(iv) Prudential Regulation	476
(A) Capital Adequacy Rules	476

Table of Contents

(B) Systemically Important Financial Institutions	479
(c) Securities	480
(d) Insurance	483
(e) Trust Companies	484
9.3 The Role of Canadian Securities Exchanges	484
(a) Introduction	484
(b) Stock Exchanges	486
(c) Overview	487
(d) The Origin of Stock Exchanges	487
(e) Types of Stock Markets: Order-Driven and Quote-Driven	489
(i) Order-Driven Markets	489
(ii) Quote-Driven Markets	490
(f) The Role of the Stock Exchange	490
(g) The Integrity of the Stock Exchange	491
(h) The Regulation of Canadian Stock Exchanges	493
(i) Canadian Stock Exchanges	495
(i) Introduction	495
(ii) The Development and Consolidation of Canada's Stock Exchanges	497
(A) Background	497
(B) The 1999 Realignment of Canada's Stock Exchanges	499
(C) Subsequent Consolidations and Ownership Changes	499
(D) Trade New World: Alternative Trading Systems	502
(j) Importance of Securities Markets	506
9.4 Conclusion	507
Index	509