


[✉ nmay@goodmans.ca](mailto:nmay@goodmans.ca)

Perpetual rationality

By Neill May

“Bounded rationality” is an oddly named concept. At a high level, the idea of bounded rationality is that people are limited in the actions they take by the information, time, and other resources that are reasonably available to them. My typically oversimplified recollection of the common use of the term in law school is that contracts cannot possibly or practicably provide for every eventuality. It’s a useful, consistent excuse with a fancy name. What is odd about the label is the sense that somehow rationality is being constrained, as if there is surplus rationality waiting to burst the bonds that bind it. That has not been my experience. I suppose I could take it upon myself to set about releasing that pent-up rationality on the world, but, really, who has the energy, especially when the payoffs are on TV.

The recent decision of the Alberta Securities Commission in *Re Perpetual Energy Inc.*, an action by a group of Perpetual’s convertible debenture holders against the company, brought bounded rationality to mind. The indentures governing convertible debentures are typically very detailed, and Perpetual’s indenture was no different. Nevertheless, Perpetual took actions that were not contemplated and caused some of its convertible debentures to be generally concerned about the consequences for holders of that popular form of security.

Perpetual, facing the pending maturity of its debentures and a low market price for its shares, took two steps: (i) it determined to repay its convertible debentures with shares instead of cash; and (ii) it initiated a rights offering that permitted its shareholders to purchase additional shares at a very significant discount to the share price used to repay the debentures (the debenture holders, notwithstanding that they would soon be significant shareholders because of the repayment of the debentures in shares, were excluded from the rights offering).

The purpose of the rights offering was to limit the debenture holders’ ownership of Perpetual to a fixed percentage determined not by the market but instead by Perpetual based on its own valuation of the company and the relative interests of shareholders and debenture holders. The effect of the rights offering was to effectively fix the *pro forma* allocation of the outstanding shares of Perpetual at approximately 22 per cent for the debenture holders and 78 per cent for the existing shareholders and exercising

rights holders. Without the rights offering, the shares issued to debenture holders would have represented approximately 60 per cent of the outstanding shares. This also meant that debenture holders would acquire 22 per cent of the outstanding shares for their \$35 million in debentures, while rights holders stood to receive in excess of 60 per cent of the outstanding shares for only \$25 million.

The ASC permitted Perpetual’s rights offering to proceed despite the debenture holders’ challenges. The decision in part illustrates the differences between challenging public companies’ actions in court and going to the regulators. The ASC found that Perpetual’s debenture holders were treated unfairly in the circumstances, describing the structuring of the rights offering as “troubling”; however, it concluded that “abuse” of debenture holders — the standard the regulator required to invoke its public-interest jurisdiction — was not established. The ASC also noted that if unfairness amounting to oppression could be established by the debenture holders in a commercial court, the arsenal of available remedies could more directly address the harm than the “blunt” remedies available to securities regulators (such as a cease-trade order).

The regulatory path can be appealing because it can be pursued quickly and relatively inexpensively, but the high threshold of “abuse,” as well as the limited remedies available to regulators, warrant consideration.

In spite of the result, the decision did include a caution for other issuers

considering taking similar steps in repaying their convertible debentures, noting that “a (hypothetical) future arrangement designed, and likely to thwart a negotiated bargain could well face an unwelcome regulatory response — irrespective of the outcome of this Application.”

From a bounded rationality perspective, the decision highlighted that provisions historically included in convertible debenture indentures to protect debenture holders do not address all possible transactions. In a convertible debenture offering completed shortly after the *Perpetual* decision, the indenture included new language prohibiting the issuer from initiating a rights offering or similar transaction, the terms of which are formulaically tied to a debenture repayment.

Whether this new language will become standard and fully close the gap remains to be seen. That one cannot fully close every door and anticipate every possibility is the essence of bounded rationality, and it reminds me of the old (and likely apocryphal) story of the senior parking lot company executive. The executive, the story goes, attends a meeting one day and passionately states she is very bullish about the company’s prospects. The reason for her optimism is that, having parked at one of the company’s non-machine-operated lots on a Sunday, the attendant had insisted on payment even when the executive identified herself as the most senior officer of the company. The executive noted that the commitment demonstrated by the attendant would put the company in good stead. After a moment of awkward silence in the meeting room, one of the attendees advised the executive that there was no company attendant present at the lot on Sundays. You cannot plan for everything. In the meantime, be careful where you park as there are apparently untapped reservoirs of rationality lying about. **CL**

Neill May is a partner at Goodmans LLP in Toronto focusing on securities law, with an emphasis on M&A and corporate finance. The opinions expressed in this article are those of the author alone.