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UPDATE ON TAKE-OVER BID DEFENSIVE TACTICS LAW AND REGULATION IN CANADA – THE SECURITIES AND CORPORATE DISCONNECT CONTINUES

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> "… in our view, *Neo* does not stand for the proposition that the Commission will defer to the business judgment of a board of directors in considering whether to cease trade a rights plan, or that a board of directors in the exercise of its fiduciary duties may "just say no" to a take-over bid."

the Ontario Securities Commission in Re Baffinland Iron Mines Corporation (December 2010)

> "In Canada, it has been clear since *Teck* that where directors have carried out reasonable enquiries to inform themselves as to where their company's best interests lie and are *bona fide* of the belief, based on reasonable grounds, that a proposed takeover will run contrary to those interests, they are entitled to use their powers to take defensive measures."

the British Columbia Court of Appeal in Icahn Partners LP v. Lions Gate Entertainment Corp. (May 2011)

Introduction

In a two-day span in October 2011, two Canadian securities commissions released their written decisions to allow shareholder rights plans (poison pills), which had been challenged by hostile take-over bidders, to remain in place for a specified time period following which they would be cease traded. In both cases, *Re Mosaid Technologies Incorporated* in Ontario and *Re Afexa Life Sciences Inc.* in Alberta, the reasons for the decisions made no mention of the pronouncements on directors' fiduciary duties contained in the reasons of the Supreme Court of Canada in the 2008 case of *BCE Inc. v. 1976 Debentureholders*. These omissions served, along with the earlier commentary of the Ontario Securities Commission (OSC) in *Baffinland* quoted above, as additional confirmation that *BCE* would not play a role in the outcome of poison pill hearings, at least for the time being. This was the case despite an earlier, opposite indication from the OSC in *Re Neo Material Technologies Inc.* in 2009.

As a result, there continues to be a fundamental disconnect between corporate law and securities regulation in this area. The incongruity is perhaps best illustrated by the decisions of the British Columbia Securities Commission and the courts in two separate matters involving the 2010 take-over bids for Lions Gate Entertainment Corp. by Icahn Partners LP and its related entities, as described later in this article.

In November 2011, at a conference presented by the OSC called "OSC Dialogue 2011", an OSC staff member disclosed that the OSC staff was considering proposing a change to the

approach of the Canadian securities regulators to their regulation of take-over bid defensive tactics, as currently set out in their National Policy 62-202. The change would give greater weight to prior shareholder approval of a poison pill, allowing a poison pill to be used as a "just say no" defence to a hostile take-over bid if shareholders had approved the pill and certain other conditions were met, even if the shareholder approval did not take place during the hostile bid. The change has not been formally proposed and the positions of the other Canadian securities regulators on the subject are not yet known.

Background – Poison Pill Regulation

In the 1980s, the Canadian securities regulators adopted a policy statement, now called National Policy 62-202 – *Take-over Bids – Defensive Tactics* (NP 62-202), which took the position that shareholders should have the right to decide whether to accept a take-over bid and that the take-over target's directors should not interfere with that right. From 1991 to the present, NP 62-202 has been the basis of numerous challenges of poison pills before the securities regulators in conjunction with hostile take-over bids. Until 2007, all of the hearings from those challenges resulted in a decision that the poison pill would be cease traded either immediately or within a short period of time to give the target time to obtain a superior transaction for the shareholders.

In 2007, the Alberta Securities Commission (ASC) in *Re Pulse Data Inc.*, and in 2009 the OSC in *Neo*, each allowed a poison pill to remain in place indefinitely after the target's shareholders approved the poison pill during the hostile bid. In 2010, the British Columbia Securities Commission (BCSC) in *Re Icahn Partners LP and Lions Gate Entertainment Corp.*, explicitly refused to follow the ASC's and OSC's departure from the previously established practice, and took the traditional position that a poison pill could only be used, if at all, to provide a limited additional amount of time for a target to find a superior transaction for shareholders, regardless of whether shareholders approved the poison pill during the hostile bid. Since the Lions Gate poison pill was not being used for that purpose, the BCSC cease traded the pill despite the fact that a shareholder vote on the poison pill had been scheduled to take place a week after the hearing. An appeal of the BCSC's decision was dismissed by the British Columbia Court of Appeal.

Then the OSC in its 2011 decision in *Mosaid*, while considering, as a "particularly important factor" in its decision, the fact that the shareholders of the target approved the poison pill during the hostile take-over bid, nevertheless allowed the poison pill to remain in place for only a specified amount of time. As a result, there is a lack of clarity as to whether, and in what circumstances, shareholder approval of a pill during a hostile bid might be available to a target in Ontario as a strategy to permit it to fend off the bid indefinitely, or for as long as the target's directors consider reasonably necessary to obtain a better transaction for shareholders.

The Relevance (or Non-Relevance) of *BCE* to Poison Pill Decisions

In 2008, the Supreme Court of Canada decided in favour of BCE Inc. in a challenge by holders of debentures of a BCE subsidiary who opposed a plan of arrangement proposed by BCE. The case did not involve a poison pill or securities law, but certain comments made by the court in its reasons regarding the duties of corporate directors were notable when contrasted with NP 62-202. In particular, the court stated the following:

> The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation.

> … There is no principle that one set of interests – for example the interests of shareholders – should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way.

While the result of the subsequent OSC poison pill hearing in *Neo* may have turned on the fact that shareholders had approved the poison pill during the hostile take-over bid, the following commentary in the *Neo* reasons was perhaps even more noteworthy at the time than the decision itself:

> We also defer to the comments of the Supreme Court of Canada in *BCE* where the Court noted:
>
> > What is clear is that the *Revlon* line of cases [in the United States] has not displaced the fundamental rule that the duty of directors cannot be confined to particular priority rules, but is rather a function of business judgment of what is in the best interest of the corporation, in the particular situation it faces….
>
> We are bound by this principle as a matter of law, and have a duty to apply it in cases such as these.
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> … Pala submits that the *only* proper use of a shareholder rights plan in the face of a take-over bid is to allow a board of directors sufficient time to seek out alternative bidders. Consistent with the Supreme Court's statements in *BCE* and the established body of corporate case law it is our view that, shareholder rights plans *may* be adopted for the broader purpose of protecting the long-term interests of the shareholders, where, in the directors' reasonable business judgment, the implementation of a rights plan would be in the best interests of the corporation. [Emphasis in original.]

However, the BCSC in *Lions Gate* and the OSC in *Baffinland* declined to interpret the *Neo* commentary as justifying a "just say no" take-over defence.

Non-Poison Pill Defensive Tactics

A poison pill conveniently entails the threat of an issuance of shares in the future, making it a simple matter for the securities regulators to assert themselves in this area through their cease trade powers. But if an alleged take-over defensive tactic either does not involve an issuance of securities (e.g. the sale or optioning of a key asset) or is comprised of an immediate issuance of shares rather than a threatened one (so that the issuance has already taken place before it comes under consideration by a securities regulator), the remedy available to the regulators is not as obvious. The BCSC found itself faced with the latter situation in July of 2010 when Icahn Partners LP and its related entities (the Icahn Group) applied to the BCSC for relief pursuant to NP 62-202 in connection with a share issuance by Lions Gate Entertainment Corp. to an investment fund related to a Lions Gate director.

This time the BCSC, which had previously followed the traditional bidder-friendly path taken by the securities regulators in cease trading the Lions Gate poison pill, dismissed the Icahn Group's application without formal reasons. The press release issued by the BCSC announcing its decision included the following comment:

> In dismissing the application, the panel noted that the Court is the most efficient forum to resolve the issues, and said that a temporary order is not necessary in the public interest at this time.

The decision to defer to the court was of interest for a number of reasons. The Icahn Group alleged that the share issuance was intended to impede the group's planned second take-over bid for Lions Gate. NP 62-202 explicitly refers to an issuance of securities representing a significant percentage of a company's outstanding securities as an example of a transaction that can come under scrutiny under the policy. (Lions Gate's share issuance represented approximately 12% of the outstanding common shares of Lions Gate after giving effect to the issuance.) In fact, in the 1980s when NP 62-202 was first adopted (as National Policy No. 38), poison pills had not yet found their way to Canada, and an issuance of shares to a party friendly to the target company had been the most common Canadian take-over defensive tactic.

Of greater significance, the deferral by the BCSC to the court meant that NP 62-202 would play no role in the matter. The Lions Gate court proceeding was an oppression action and, not surprisingly, the British Columbia Supreme Court, which heard the case, focused on *BCE*, other court precedents and the business judgment rule, without paying any heed to NP 62-202.

The court took particular note of the 1972 decision of the same court in *Teck v. Millar*, in which a share issuance to defeat an attempt to gain control of the company was held to be justifiable if the directors of the target company reasonably believed, in good faith, that depriving the hostile suitor of control would be in the best interests of the company. In Lions Gate's case, the board of directors acknowledged that, while the primary purpose of the transaction was to deleverage the company (the issued shares replaced company debt), a secondary purpose was to dilute the Icahn Group's holdings and thereby impede a take-over bid by the Icahn Group. The court regarded both purposes as having been reasonably held by the board to be in the best interests of Lions Gate.

Following the principles set out in *BCE,* the court dismissed the oppression action. While it was not entirely clear what the outcome would have been without the deleveraging element, indications are that the result would have been the same in light of the favourable references to *Teck v. Millar* by the court, and subsequently by the British Columbia Court of Appeal in its reasons for dismissing the Icahn Group's appeal.

Comment

It has been suggested in a number of circles that the securities regulators should revoke NP 62-202 and leave disputes involving take-over defensive tactics to the courts. The disconnect between the approaches of the courts and securities regulators, and to a certain extent among the securities regulators themselves, are among the reasons cited for the desirability of this change. The question has also been raised as to whether the limited resources of the securities regulators should be devoted to this area. In fact, the OSC's own "Five Year Review Committee", in its 2003 report, expressed its concern that poison pill hearings "consume considerable resources and entail significant cost."

To date, the securities regulators have not demonstrated an inclination to abandon the field. Assuming that this continues to be the case for the foreseeable future, the proposal currently under consideration by the OSC staff would at least partially address the concerns that have been raised. The proposal essentially gives greater recognition to the following existing passage from NP 62-202:

> …the Canadian securities regulatory authorities wish to advise participants in the capital markets that they are prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns.

Many poison pills are approved by shareholders before a specific take-over bid is launched or threatened, but in those circumstances securities regulators have never considered the previous shareholder approval to be determinative as to whether a pill should be cease traded once a hostile bid has materialized. Shareholder approval of a pill prior to a bid has only been one of a number of factors the regulators have taken into account in deciding whether to cease trade the pill immediately or within a limited period of time.

Having regard to the passage from NP 62-202 quoted above, one might question whether the use of a poison pill by a target company to "just say no" to a hostile take-over bid is "abusive of shareholder rights" if the target's shareholders have previously approved a poison pill with knowledge that it could be used in future for that very purpose. In the reasons for its 2009 decision in *Re 1478860 Ltd. and Canadian Hydro Developers, Inc.*, the ASC, while not permitting the poison pill in question to remain in place indefinitely (a result not requested by the target in any event), described the significance of prior shareholder approval of the pill as follows:

> The Plan was adopted by the Hydro Board and approved by Hydro shareholders in advance of the Bid – indeed, in advance even of TAC's initial approach to Hydro. We attached considerable importance to this.
>
> We considered that at the time the Plan was put to a shareholder vote – in April 2008 – Hydro shareholders had, and exercised (to the extent they wished to), the opportunity to make a decision, in advance, relating to take-over bids. We noted the solid (over 70%, as mentioned) support given to the Plan by the Hydro common shareholders who voted on it. Clearly the votes were cast in light of the information about the Plan set out in the Hydro Meeting Circular. We concluded that the Hydro shareholders gave their approval with knowledge of the disclosed key terms of the Plan, such as the 60-day minimum duration of a "Permitted Bid".
>
> In our view, therefore, it followed that Hydro shareholders can fairly be presumed to have made an informed decision that would have the effect of impeding a take-over bid that (like the Bid) was not a "Permitted Bid"… This presumption implied also that Hydro shareholders knew and accepted the risk that a potential non-Permitted Bid – even a highly attractive one – might be blocked by the Plan.

Following on this logic, if non-conflicted shareholders periodically approve a poison pill with knowledge, from the management information circular, that the pill could in future be used as a "just say no" take-over defence, it would appear to be reasonable for the securities regulators to allow the pill to stand in accordance with that vote in the event of a subsequent hostile bid. This change of approach would provide a much-needed enhanced level of clarity in the capital marketplace as to the practical effect of a poison pill, in addition to meaningfully contributing to regulatory efficiency.