securities regulatory authorities propose two new approaches to the regulation of shareholder rights plans – a clash of philosophies

introduction

On March 14, 2013, each of the Canadian Securities Administrators ("CSA")[1] – which includes the Autorité des marchés financiers ("AMF") – and the AMF[2] issued alternative proposals to revamp the regime regulating rights plans in the context of defensive tactics. The AMF proposal went further in advocating a new approach to regulating all defensive tactics, while the CSA indicated that it would address other defensive tactics as part of an ongoing CSA review.

After approximately 27 years of regulating defensive tactics under National Policy 62-202 – Take-Over Bids – Defensive Tactics ("NP 62-202") and its predecessor,[3] it is now very likely that the CSA will adopt a more uniform and dramatically different approach to

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[1] *Proposed National Instrument 62-105 Security Holder Rights Plans*, CSA Notice, (2013) 36 OSCB 2643 (14 March 2013).

[2] *An Alternative Approach to Securities Regulators' Intervention in Defensive Tactics*, AMF Consultation Paper (14 March 2013).

[3] *Take-Over Bids – Defensive Tactics*, OSC National Policy Statement No 38, 9 OSCB 4255 (1986), repealed by 20 OSCB 3525 (1997).

the regulation of rights plans. We note that the AMF has indicated that it intends to implement whichever rule or policy is ultimately adopted by the CSA.

The historical decisions of securities regulators under NP 62-202 and the recent proposals of the CSA and the AMF reflect three philosophical approaches to the regulation of rights plans in the context of defensive tactics:

- the position that the only legitimate purpose of a rights plan is to allow a target board to seek an improved or alternative offer, as each shareholder has an absolute right to accept or reject a bid (represented initially by the decision of the Ontario Securities Commission ("OSC") in *Canadian Jorex Ltd., Re*[4] and more recently by the majority decision of the British Columbia Securities Commission ("BCSC") in *Icahn Partners LP v. Lions Gate Entertainment Corp.*[5]). As a result, Canadian securities regulators have typically been willing to cease trade rights plans of target companies within 45 to 60 days following the launch of a hostile bid, thereby ensuring that shareholders have the right to tender to a bid. The customary effect of this approach is that the target company is forced into a process which, depending on the time available to the target prior to expiry of the initial bid as well as market and specific industry conditions, usually results in a sale by auction;

- the approach adopted by the CSA proposal that recognizes that a rights plan may be adopted for broader, longer-term purposes when approved by a majority of shareholders (represented to some extent by NP 62-202 itself, which provides that "shareholder approval of corporate action would, in appropriate circumstances, allay" concerns that actions of a board are abusive of the capital

[4] (1992), 15 OSCB 257. The first securities regulatory decision under the predecessor to NP 62-202 which ruled that a rights plan should be cease traded.

[5] 2010 BCSECCOM 432 [*Lions Gate*].

markets;[6] and also represented by the decisions of the OSC in *Neo Material Technologies Inc., Re*,[7] the Alberta Securities Commission in *Re Pulse Data Inc*.[8] and the minority reasons of the BCSC in *Lions Gate*[9]);[10] and

- the AMF proposal that may be considered to be board-centric or corporate-centric, whereby regulators would defer to the decision of a target board in responding to a takeover bid provided that the board has in place appropriate safeguards to manage conflicts of interests (reflected in United States jurisprudence[11] and the even

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[6] *Notice of National Policy 62-202 and Rescission of National Policy Statement No 38 Take-Over Bids – Defensive Tactics*, 20 OSCB 3525 (1997).

[7] (2009), 32 OSCB 6941 [*Neo Material*].

[8] 2007 AB ASC 895 [*Pulse Data*].

[9] 2010 BCSCECCOM 494.

[10] See Paul D. Davis & Stephen Genttner, "Time to Update Policy on Defensive Tactics" (March 2011).

[11] Under Delaware law, a board must take an "active and direct role in the sale process." Delaware has a three tier system of review for director decision-making: (i) the business judgment rule; (ii) enhanced scrutiny where directors face potentially subtle structural or situational conflicts that are not sufficient to trigger an entire fairness review, but do not comfortably permit expansive judicial deference; and (iii) entire fairness: *In re Del Monte Foods Company Shareholders Litigation* (2011), 25 A.3d 813 (Del Ch). Courts will apply the business judgment rule in the context of a takeover bid, which provides that there is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Where the actions taken are defensive, the directors must meet a heightened standard of scrutiny by demonstrating "reasonableness" and "proportionality": *Unocal Corporation v Mesa Petroleum Co* (1985), 493 A.2d 946 (Del Sup Ct). In determining whether a defensive response falls within the range of reasonableness, courts generally consider whether it is a statutorily authorized form of business decision which a board may routinely make in a non-takeover context, and as a defensive response, whether it was limited and corresponded to the degree or magnitude of the threat. If the court concludes that the measures are proportionate to the threat, the board's actions are entitled to review under the traditional business judgment rule and the burden of proof will shift to the plaintiff, who must demonstrate "by a preponderance of the evidence that the directors' decisions were primarily based on: (i) perpetuating themselves in office; (2) some other breach of fiduciary duty such as fraud, overreaching, lack of good faith; or (3) being uninformed": *Unitrin, Inc v American General Corp* (1994), 651 A.2d 1361 ¶ 45 (Del Sup Ct). Entire fairness is a two party inquiry into fair dealing and fair price; the entire fairness doctrine will be applied in transactions where: (i) directors stand on both sides of the

more deferential approach of the Supreme Court of Canada in *BCE Inc. v. 1976 Debentureholders*[12]).

In moving away from the first approach, the CSA and the AMF proposals would provide directors and shareholders of public companies with greater flexibility in negotiating with hostile bidders or simply defeating hostile takeover bids.

CSA proposal

The key aspects of the CSA proposal are as follows:

- rights plans will be effective when adopted by the board of directors but must be approved by security holders within 90 days from the date of adoption or, if adopted after a takeover bid has commenced, within 90 days from the date of commencement of the bid,
- to remain effective, rights plans must be approved annually by majority vote of shareholders,
- material amendments to rights plans must be approved by security holders within 90 days of the date of adoption of such amendments,

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transaction; (ii) directors of the company own significant non-majority stakes of the company's voting shares and have personal interests that significantly diverge from those of other equityholders; or (iii) a majority of the board is materially interested in the transaction. To demonstrate fair dealing, directors must show the lack of any process flaws that would likely lead to an unfair result. In determining fair price, a board should seek an opinion as to whether the transaction was fair to the affected shareholders: *In re Tele-Communications, Inc Shareholders Litigation*, 2005 WL 3642727 (Del Ch). A board with a conflicting self-interest must demonstrate that the transaction was entirely fair to the shareholders: *In re Southern Peru Copper Corporation Shareholder Derivative Litigation* (2011), C.A. No. 961-CS (Del Ch).

[12] The Supreme Court held that as long as the directors' decision is found to have been within the range of reasonable choices that they could have made in weighing conflicting interests, the court will not go on to determine whether their decision was the perfect one (2008 SCC 69 ¶ 112).

- rights plans must be able to be terminated by shareholders at any time by majority vote,
- shares held by a bidder and its joint actors are to be excluded from a security holder vote to adopt, maintain, amend or terminate a rights plan,
- a rights plan cannot be triggered as a result of a shareholder vote,
- if a rights plan is waived or modified with respect to a takeover bid (regardless of whether the takeover bid is a takeover bid commenced by a takeover bid circular), it must be waived or modified with respect to any other takeover bid, and
- enhanced disclosure will be required at the time of adoption and material amendment of a rights plan.

The impact of the CSA proposal would be dramatic:

- Historically, rights plans issued by Canadian public companies have been "permitted bid" plans which allow for takeover bids to proceed without the target board's approval and without triggering the rights plan provided that the bid remains open for a minimum period (usually 60 days), a majority of the target's shares held by independent shareholders are tendered to the bid and if a majority of such shares are tendered, the bid is extended by at least an additional 10 days so as to provide other shareholders with an opportunity to tender to the bid. It is not clear why issuers should wholeheartedly continue with this approach, notwithstanding any objections proxy advisory firms may have. With the requirement for annual shareholder approval after a rights plan has been initially approved by shareholders, and the ability of shareholders to revoke rights plans prior thereto, it is not clear why a permitted bid exemption would be necessary. In any event, if the CSA proposal is implemented, we would expect that the minimum period during which a "permitted bid" would be required to remain open would be increased from 60 to 90 days.

- The CSA recognizes that, as a result of its proposal, disputes related to rights plans should rarely be brought before a securities regulatory authority. This should result in a higher level of certainty in the market than is currently the case, as securities regulatory authorities have recently taken conflicting views on when a rights plan "should go" and in some instances[13] whether it "should go" at all. Nevertheless, the CSA notes that the securities regulators may intervene if a target issuer engages in conduct that undermines the principles underlying the proposed rule or there is a public interest rationale for the intervention not contemplated by the proposed rule.

- We expect that there would be an increase in proxy fights in connection with takeover bids, more akin to the current situation in the United States.

- While litigation before securities regulatory authorities may diminish, there is little doubt that litigation before the courts related to proxy solicitation/fights would increase.

- Under the current regime, rights plans generally only remain in place for 45 to 60 days following a hostile bid. Under the CSA proposal, one would expect that right plans would remain in place for a minimum period of 90 days and shareholders together with the board of an issuer may well be able to "just say no." At a minimum, boards would be provided with more time to canvass and consider alternatives.

AMF proposal

The basic elements of the AMF proposal are as follows:

- Provided that the board has in place appropriate safeguards to manage conflicts of interest (such as the establishment of a committee of independent directors being advised by independent financial and legal advisors), deference will be given to the

[13] See *Neo Materials, supra* note 7; *Pulse Data, supra* note 8.

decision of a board, absent unusual circumstances that demonstrate an abuse of shareholders' rights or that negatively impact the efficiency of capital markets.

- Takeover bids will be required to provide for a minimum tender condition similar to that currently required for permitted bids under rights plans in Canada; that is, shares will not be permitted to be taken up under a takeover bid unless more than 50% of the outstanding securities owned by shareholders, other than the offeror and those acting jointly or in concert with the offeror, have been tendered and if such condition is met, the bid will be required to be extended for an additional 10 days following the public announcement that such condition has been met.

  The AMF proposal is an unambiguous rejection of NP 62-202, and its impact would be to give boards significantly more flexibility. The AMF proposal would allow boards to fully consider the long-term interests of a corporation and, subject to the ability of shareholders to persuade the board otherwise or to simply remove a sufficient number of directors, a board of a target issuer would at least in theory be able to "just say no." We note however that the protection of investors and fostering fair and efficient markets and confidence in the markets are the overlying principles that securities regulatory authorities consider in connection with the exercise of their public interest discretion and power to cease trade rights plans. The regulators' focus will continue to largely be on the impact that a decision of a board would have on the capital markets or shareholders. Accordingly, while a target board could follow a proper process, and reach a decision consistent with the exercise of its fiduciary duties, such decision could still be challenged as impacting negatively on the efficiency of the capital markets or possibly as effecting an abuse of security holders' rights. As a result, it may well be that additional criteria will be required to be enumerated in order to ensure that the AMF's corporate/board centric approach is effective.

Put another way, if a board of a target issuer determines, after adopting and adhering faithfully to a pristine process, that it should "just say no" and this goes on for several months, what would the AMF do? It is interesting to note that a senior representative of the AMF in a discussion of the impact of the AMF proposal was recently quoted as saying: "This does not mean in my mind that a board would be in a situation to just say no and just say no forever."[14] Market participants may well need additional guidance in order to better understand on what basis regulators would cease trade a rights plan under the AMF proposal or, in other words, when would "unusual circumstances" occur that would require the imposition of a cease trade order.

conclusion

The AMF specifically notes that its consultation paper seeks to provide a forum for discussion on the issues relating to the regulation of defensive tactics. This presents a unique opportunity to market participants and practitioners to shape a key aspect of the regulation of the capital markets. The CSA and the AMF have each requested comments in writing by June 12, 2013, and we would encourage clients who wish to comment to contact one of the writers of this bulletin or any other member of the firm's Capital Markets and M&A group.

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[14] Jeff Gray, Canada's Securities Regulators Plan a More Potent Poison Pill (February 2013).

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.