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Fiduciary Out Provisions: An Unnecessary Standard in Canada

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INTRODUCTION

In negotiating an agreement[2] for the acquisition of a public company, some of the most heavily negotiated terms are a host of provisions generally referred to as "deal protection provisions". These provisions are designed to increase the likelihood of success for the purchaser since it is impossible for the target board to bind the public company's shareholders and thereby guarantee that the agreed upon transaction will close. In this paper, we will focus primarily on those aspects of deal protection provisions which are generally referred to as "fiduciary out" provisions. These provisions allow a target board to terminate a merger agreement with a purchaser in the event an unsolicited, *bona fide* superior proposal is received from a third party after the signing of a merger agreement.

Based on our experience and a review of various studies with respect to public company M&A transactions,[3] fiduciary out provisions are standard in Canada and are included in a significant majority of merger agreements in the U.S.[4]

It may be surprising to a Canadian lawyer who is starting his or her M&A practice to learn that there is a dearth of jurisprudence on the need to include fiduciary outs in Canadian merger agreements. In fact, the genesis of including fiduciary outs in merger agreements in almost every public company acquisition in Canada stems from decisions of the Delaware courts, including the much criticized decision of the Delaware Supreme Court in *Omnicare, Inc. v. NCS Healthcare, Inc.*[5]

In this paper, we will submit that a Canadian target board, particularly in the context of an uncontested transaction, can agree to the demands or requests of a purchaser to not include fiduciary out provisions in a merger agreement in return for appropriate consideration, without breaching its fiduciary duty or engaging in oppressive conduct, so long as the merger agreement permits the target board to change its recommendation in suitable circumstances. We will conclude that the practice that has developed in Canada is not based on Canadian law (and may not even be supported under Delaware law) and is overly restrictive.

Part I of this paper provides some definitions for key terms used in the deal protection context and reviews typical deal protection provisions. Part II outlines the Delaware jurisprudence which we view as relevant to having a better understanding of whether fiduciary out provisions are required, including a review of the *Omnicare* decision and the key cases that have considered that decision. Part III considers the duties of directors and the standards of review applicable in the Canadian context, as well as key cases on the subject matter. Part IV examines the application of Canadian jurisprudence to the fiduciary out issue, and also considers whether certain other exceptions to deal protection provisions are required. Finally, Part V offers our conclusion.

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[1] The views expressed in this paper are those of the authors and should not be attributed to McMillan LLP. This paper was prepared with the assistance of Sean Coughlin and Allison Vale, each of whom is an articling student of McMillan LLP; and Josh L. Freedman, Shahram Khalili, William Lee, Mikolaj Niski and Valenteena Suvaminathan, each of whom is a summer student. We would also like to thank Paul Collins and Bernhard Zinkhofer, partners of McMillan LLP, for reviewing and commenting on this paper.

[2] In the context of a takeover bid for a Canadian company, these are usually referred to as support agreements, and in respect of plans of arrangement they are referred to as arrangement agreements. In this paper, we will refer to all such agreements as merger agreements.

[3] Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Fifth Annual Edition* (2013); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Sixth Annual Edition* (2014); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Seventh Annual Edition* (2015); American Bar Association, *2013 Canadian Public Target M&A Deal Points Study (For Transactions Announced in 2011 and 2012)* [ABA Study].

[4] *Ibid,* ABA Study.

[5] 818 A.2d 914 (Del. 2003) [*Omnicare*].

PART I – GLOSSARY OF DEAL PROTECTION TERMS

As there are no clear definitions for certain key terms frequently used in the context of deal protection provisions, the following is a list of definitions for the terms used in this paper, which generally reflect industry standards.

Standstill and "don't ask, don't waive" provision: A standstill agreement prohibits a person from engaging in various actions relating to the acquisition of control of the target company, such as buying shares or seeking to influence or change management or the board of the target. It is customary in an auction process to have all participants sign standstill agreements (as part of a confidentiality agreement) in order to control the process and ensure that participants put forward their best offer within the process. A previously common element of standstill agreements is a "don't ask, don't waive" provision, which prohibits a prospective purchaser from publicly or privately requesting a waiver of the standstill agreement.

No-shop/non-solicit covenant: A no-shop or non-solicit covenant restricts a target company from, directly or indirectly, soliciting competing bids, providing information to other potential bidders or negotiating with other potential bidders, after it has signed a merger agreement with a purchaser. The covenant also frequently requires the target to enforce existing standstill agreements.

Go-shop: A go-shop clause provides a target company with a defined period of time, prior to the imposition of the no-shop, to actively seek and solicit competing offers, after it has signed a merger agreement with a purchaser.

Window shop: A window shop is an exception to the no-shop clause, which allows the board of the target company to discuss and negotiate with prospective purchasers certain unsolicited proposals and to furnish them with non-public information. The information cannot be provided to the prospective purchaser without the prospective purchaser entering into a confidentiality/standstill agreement on terms no more favourable to it than those entered into by the target and the purchaser. Practically all merger agreements contain a window shop exception.

No-talk: A no-talk clause prohibits the target from providing information to, or entering into discussion with, potential third party bidders, and therefore prevents a window shop clause.

Superior proposal: A *bona fide* unsolicited acquisition proposal that is received from a third party after execution of the merger agreement that the target board determines, after obtaining financial and legal advice, would, if consummated, result in a transaction more favourable, from a financial point of view, to the shareholders of the target than the transaction provided for by the merger agreement.

Matching right: A matching right provision provides the purchaser with an opportunity to amend and improve its offer before the target's board of directors accepts, or changes its recommendation in favour of, a superior proposal put forward by a third party.

Force-the-vote: A "force-the-vote" provision is a deal protection provision requiring a target board to submit the purchaser's negotiated transaction to a shareholder vote and not terminate the merger agreement, notwithstanding there being a superior proposal and the target board changing or withdrawing its recommendation in favour of the merger agreement.

Fiduciary out: A fiduciary out provision allows a target board to terminate a merger agreement, prior to approval of the agreement by its shareholders, if an unsolicited, *bona fide* superior proposal is received from a third party that did not result from a breach of the merger agreement. This right to terminate by the target is usually only available if the target accepts the superior proposal and pays a break fee to the purchaser.

Break fee: A fee payable by the target to the purchaser (usually 3-4% of transaction value) on the exercise of the fiduciary out by the target, or the termination of the merger agreement by the purchaser under certain limited circumstances.

While deal protection provisions are found in almost all public company merger agreements in Canada, the board of directors of a target must carefully consider the impact of the provisions on its ability to discharge its fiduciary duties and meet its legal obligations. In Canada, deal protection provisions typically start with an unequivocal and broad no-shop clause. A no-shop clause typically includes a provision preventing the target board from changing its recommendation to shareholders in favour of the agreed upon transaction and a covenant of the target board to publicly confirm its previous recommendation if an acquisition proposal is publicly made by a third party bidder. Notwithstanding such an all-encompassing no-shop, deal protection provisions in Canada usually include a series of exceptions:

- The first principal exception is typically the window shop clause. In order to avail itself of this clause, the target board needs to conclude that the proposal that forms the basis of discussions under a window shop clause constitutes, or is reasonably expected to lead to, a superior proposal. In addition, the target needs to enter into a confidentiality/standstill agreement with the third party and provide notice to the purchaser of these matters.

- If the target believes that the proposal from the third party is a superior proposal and its actions will be consistent with, or are necessary to properly discharge, its fiduciary duties, the target may enter into an agreement with the third party or approve or recommend the proposal from the third party, provided that the purchaser is provided a matching right—usually of a duration of a few business days.

- Before, or contemporaneously with, the entering into of the agreement with the third party, the target must exercise the fiduciary out and terminate the merger agreement and pay the applicable break fee to the purchaser.

PART II – DELAWARE JURISPRUDENCE

A. Standards of Judicial Review for Actions of Directors

In order to understand the implications and importance of the applicable Delaware jurisprudence, it is necessary to first review the standards of judicial review in Delaware with respect to the actions of directors of a corporation. Under Delaware law, the board of directors of a corporation owes the fiduciary duties of care and loyalty to the corporation and its shareholders. Should a plaintiff in a judicial proceeding contest the actions of a board, the Delaware courts will refer to established precedents on how to judicially scrutinize the decisions of the board. There are three levels of judicial scrutiny that a court will apply depending on the circumstances: (1) the business judgment rule; (2) enhanced scrutiny; and (3) entire fairness.

1. The business judgment rule

The business judgment rule is a standard that underlies the judicial review of all actions of a board of directors. This rule mandates that courts accord a high degree of deference to the decision making process of a board and refrain from examining the substance of a board's decisions, provided that the decisions are supported by a rational business purpose. The intent of the business judgment rule is to encourage directors to use their business judgment to take the risks necessary for the success of the corporation while providing them with comfort that they will not be held personally liable for losses as a result of taking those risks.[6]

The business judgment rule has been defined by the Delaware Supreme Court as "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."[7] A court will not interfere with the decision of a board under the business judgment rule if the decision can be "attributed to any rational business purpose".[8] In the event that a plaintiff brings an action against a board relating to an act or omission of the board, the onus rests on the plaintiff to prove that the conduct of the board is either

[6] *In re The Goldman Sachs Group, Inc. Shareholders Litigation,* C.A. No. 5215-VCG, 78 (Del. Ch. 2011).
[7] *Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984) [citations omitted].
[8] *Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del. 1971).

grossly negligent or breaches the board's fiduciary duty of loyalty.[9]

2. Enhanced scrutiny

In addition to the business judgment rule, Delaware courts will review the actions of a board with enhanced or intermediate scrutiny when such board uses defensive measures in the context of a hostile takeover or in certain other limited circumstances, including in evaluating deal protection provisions. The two principal cases establishing an enhanced or intermediate standard of review are *Unocal*[10] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[11]

The enhanced scrutiny standard was articulated in 1985 by the Delaware Supreme Court in the *Unocal* case, which addressed the range of reasonable defensive measures available to a board when facing a hostile takeover. The standard articulated in *Unocal* requires that when a board of directors applies defensive measures to thwart or stall a hostile takeover, the directors must address the "omnipresent spectre" of their conflict of interest, since their actions may have the result of entrenching the management of the company.[12] If a plaintiff brings an action against a board of directors in relation to defensive measures that the board took in light of a hostile takeover scenario, the court employs a two-stage analysis. At the first stage, the burden of proof rests with the directors to show that "[i]n the face of [their] inherent conflict … they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[13] At the second stage, the board must prove that the actions they chose were objectively proportionate to the threat perceived. This is a factual analysis done by the courts and, if the test is met, the board of directors will gain the protection of the business judgment rule and the burden will shift to the plaintiff to prove a breach of fiduciary duty.

In the seminal decision of the Delaware Supreme Court in *Revlon*, the Delaware Supreme Court held that, in the event of a change of control or sale of a corporation initiated by a target, the intermediate scrutiny standard also requires the board to maximize the sale price of the enterprise. In applying the first stage of the *Unocal* standard in a sale of a business initiated by the board, the board cannot argue that it is concerned with threats to the long-term corporate strategy of the company, since it has abandoned that strategy in favour of an immediate sale. As a result, the duty of a board "changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[14] Therefore, "[s]elective dealing to fend off a hostile but determined bidder was no longer a proper objective."[15]

In such circumstances, the focus is entirely on maximizing the price that may be obtained by the shareholders of the target. For example, in *Revlon*, since the board embraced the inevitability of a sale of the company, the Court determined that the concern for non-stockholders was no longer appropriate. While the decision in *Revlon* acknowledged that *Unocal* provided for the consideration of other constituencies, such as noteholders, the Court held that the consideration of other stakeholders did not apply where the company is put up for auction.[16] Thus, according to the *Revlon* decision, when a company is facing an inevitable change of control or sale, the stockholders' interests are paramount and the board of directors must be free to negotiate with any party in order to fulfill its fiduciary duty to obtain the most value for stockholders.

Since *Revlon*, the jurisprudence has focused on defining when the heightened *Revlon* duty applies in considering a transaction that may constitute a change of control or sale of the company. If the company finds itself within the realm of *Revlon*, the duties of its directors are relatively clear: they must maximize stockholder value above all other considerations. However, the *Revlon* duty does not arise simply because a company is "in play";[17] *Revlon* is not implicated when a board engages in a market-check but does not initiate an auction and the deal does not involve a change in control.[18] The *Revlon* duty is triggered only if there is a sale of control or in other words a loss of the control premium. For example, in *In*

[9] See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) [*Unocal*].
[10] *Ibid.*
[11] 506 A.2d 173 (Del. 1986) [*Revlon*].
[12] *Ibid* at 954.
[13] *Ibid.*
[14] *Ibid* at 182.
[15] *Ibid.*
[16] *Ibid* at 183.
[17] *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009).
[18] See *Arnold v. Society for Savings Bancorp Inc.*, 650 A.2d 1270, 1289 (Del. 1994).

re Synthes Inc. Shareholder Litigation,[19] the Delaware Chancery Court held that a merger consideration consisting of 65% stock and 35% cash did not trigger the *Revlon* duty because the stock portion was stock in a company (Johnson & Johnson) whose stock was held in a large, fluid market. This concept is premised on the belief that there is no loss of the control premium to the target stockholders because the control premium is diffused in the market and represented in the resulting value of the merged corporation's stock. Therefore, the control premium will be present in the resulting combined corporation's stock, which the stockholder will still hold. Furthermore, if the target corporation has a controlling stockholder and the change of control is simply between the incumbent controlling stockholder of the target and a new controlling stockholder of the bidder, then there is no change of control and *Revlon* is not triggered.[20] However, if the stock-for-stock transaction results in a shift of control to the acquirer's single controlling shareholder, then the *Revlon* duty is triggered.[21]

If *Revlon* applies, the directors are obligated to maximize the short-term value for their stockholders by exercising their business judgment, but there is "no single blueprint" as to how that must be accomplished.[22] *Revlon* does not require a perfect decision, but a reasonable decision.[23] Directors may choose to perform an auction, a broad market check, or implement a go-shop provision. A board that has "impeccable knowledge" of the target's business and markets may also ignore a market check process and still be considered to have acted reasonably.[24] In fact, the Delaware courts have ruled that a board may engage in a "viable passive check" post the merger agreement—such as providing for a full window shop/fiduciary out in a merger agreement where the shareholders are provided with a "fully informed, uncoerced opportunity to vote to accept the deal"—and this will not violate the board's *Revlon* duties.[25] The Delaware Chancery Court has noted that the enhanced judicial scrutiny under *Revlon* is not a license for courts to second-guess the reasonable, but debatable choices that directors make in good faith.[26]

3. Entire fairness

The "entire fairness" standard is the most rigorous standard of review applied by Delaware courts with respect to the examination of the actions of a board of directors. This standard is generally applicable where the board has an interest on both sides of a transaction, has an interest opposite from the stockholders or a majority of the board is interested in the transaction.[27] If plaintiff stockholders bring a claim, the burden rests with the director defendants to prove the entire fairness of the transaction.

The Delaware Supreme Court stated that "fairness", in the context of a merger to which the entire fairness standard applies, concerns the "fair dealing and fair price" of the transaction.[28] The analysis of fair dealing involves a consideration of "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[29] The analysis of fair price concerns itself with the "economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[30]

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[19] 50 A.3d 1022, 1047 (Del. Ch. 2012) [*Synthes*].
[20] See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989) [*Time*].
[21] See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 47–48 (Del. 1994) [*QVC*].
[22] *Barkan v. Amsted Industries, Inc.*, 576 A.2d 1979, 1286 (Del. 1989).
[23] *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1385–86 (Del. 1995) citing *QVC, supra* note 21 at 45–46.
[24] *In re OPENLANE, Inc. S'holders Litig.*, No. 6849-VCN, 14 (Del. Ch. 2011) [*OPENLANE*].
[25] *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust*, C.A. No. 9980-VCN, 3 (Del. Ch. 2014).
[26] *In re Toys "R" Us, Inc. Shareholders Litigation*, 877 A.2d 975, 1000 (Del. Ch. 2005) [Toys "R" Us].
[27] *In re Tele-Communications case S'holders Litig.*, C.A. No. 16470, 18-19 (Del. Ch. 2005).
[28] *Kahn v. Lynch Communication Systems Inc.*, 638 A.2d 1110, 1114 (Del. 1994) citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).
[29] *Ibid* at 1114-15.
[30] *Ibid*.

As a result of the recent *Kahn v. M&F Worldwide Corp.* decision, the entire fairness standard will not apply when a controlling stockholder attempts to perform a cash-out merger of the minority stockholders, so long as the merger is preconditioned on a series of structural devices to ensure an uncoerced and informed transaction, including approval by independent directors and disinterested informed shareholders.[31]

B. *Omnicare*

With the standards of review in mind, we now turn to *Omnicare* and the reasons for the rare 3-2 split decision of the Supreme Court of Delaware.

1. The *Omnicare* decision

a) Facts

In late 1999, NCS Healthcare, Inc. ("**NCS**") began to experience financial difficulty and started exploring strategic transactions to address the problem.[32] On July 20, 2001, Omnicare, Inc. ("**Omnicare**") sent NCS a written proposal to acquire NCS in a bankruptcy asset sale subject to satisfactory completion of due diligence. This initial proposal provided only a small recovery for NCS' creditors and no recovery for NCS' stockholders. NCS pressed Omnicare to propose a merger transaction, but Omnicare responded that it was only interested in an asset sale in bankruptcy. The proposal was never accepted by NCS.[33]

NCS contacted Genesis Health Ventures, Inc. ("**Genesis**") regarding a possible transaction with NCS. In June 2002, Genesis proposed a stock-for-stock merger that would take place outside the bankruptcy context, provide full recovery for NCS' creditors and possibly provide NCS stockholders with some recovery. Genesis made it clear that if it were to engage in any negotiations with NCS, it would not do so as a "stalking horse".[34] At Genesis' request, NCS executed an exclusivity agreement and the two entities further negotiated the merger agreement.[35]

On July 26, 2002, Omnicare faxed a letter to NCS outlining a proposed acquisition of NCS outside the bankruptcy context, conditioned on completing its due diligence. The letter suggested a transaction that paid NCS' creditors in full and provided NCS' stockholders more recovery than Genesis' proposal.[36] On July 27, 2002, Genesis proposed substantially improved terms. In return, Genesis stipulated that the transaction had to be approved by midnight the next day.[37] After receiving legal and financial advice, the board of directors of NCS concluded that, in balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's proposal, the only reasonable course of action was to approve the Genesis transaction. On July 28, 2002, the board agreed to the terms of a merger with Genesis.[38]

Pursuant to the terms of the Genesis merger:

(i) the NCS board agreed to a force-the-vote provision whereby NCS agreed to submit the merger agreement to NCS' stockholders for a vote regardless of whether the board continued to recommend the merger;

(ii) two stockholders of NCS, who held a majority of the voting power, agreed unconditionally to vote all of their shares in favour of the Genesis merger (the "Voting Agreement"); and

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[31] C.A. No. 6566, 15 (Del. 2014) [*MFW*]. But see *In re Dole Food Co. Inc., Stockholder Litigation*, C.A. No. 8703-VCL (Del. Ch. 2015) [*Dole*]. In *Dole*, even though the cash-out merger proposal was conditioned on the factors set out in MFW, the factual presence of fraud by the President and General Counsel (who was the "right hand man" of the controlling shareholder/proposed acquirer) by purposely depressing Dole's stock price and providing false information to the special committee while giving the controlling shareholder more accurate financial information and advising him on his negotiations with the special committee, in combination with the controlling shareholder's unwillingness to sell shares which rendered the go-shop provision "cosmetic", was sufficient to maintain the standard of review as entire fairness as opposed to the business judgment rule.

[32] *Ibid* at 920.

[33] *Ibid* at 920-921.

[34] *Ibid* at 921.

[35] *Ibid.*

[36] *Ibid* at 922.

[37] *Ibid* at 925.

[38] *Ibid.*

(iii) Genesis provided a window shop provision to NCS, but NCS was not allowed to terminate the merger agreement even if it changed its recommendation in favour of a superior proposal received pursuant to the window shop provision.[39]

On July 29, 2002, Omnicare faxed NCS a conditional proposal accompanied by a draft merger agreement, which provided significantly more consideration to the NCS shareholders than under the Genesis merger agreement. On August 1, 2002, Omnicare filed a lawsuit attempting to enjoin the Genesis merger agreement and announced its intention to launch a tender offer for the NCS shares.[40]

On October 6, 2002, Omnicare committed itself irrevocably to a transaction with NCS. The board of NCS then withdrew its recommendation that the stockholders vote in favour of the Genesis merger. However, the board was still required to submit the Genesis merger to a stockholder vote and the existence of the Voting Agreement predetermined the success of the Genesis merger.[41]

b) Court of Chancery of Delaware decision

The lower court held that a stock-for-stock merger, pursuant to which the stockholders receive shares of an issuer without a controlling shareholder, did not trigger *Revlon* duties because it would not result in a change of control.[42]

Since *Revlon* did not apply, the Court started with the procedural presumption that the directors had acted with due care, loyalty and in good faith. The Court held that the plaintiffs had not shown a reasonable likelihood that the NCS board failed to properly discharge its fiduciary duties in connection with the Genesis merger. The Court further stated that the NCS board pursued a rational process, in good faith and without self-interest. Additionally, the Court held that the board was adequately informed of all material information reasonably necessary to make its decisions. Thus, the board met the business judgment standard.

The Court then reviewed the deal protection provisions under *Unocal*.[43] The Court concluded that the merger agreement was not "an unreasonable 'lock-up' of the Genesis transaction", as it was the only transaction that was "reasonably available to them".[44] The Court refused to hold that relief was available to the plaintiffs under the *Unocal* standard.

c) Majority decision of the Supreme Court of Delaware

The majority decision assumed that the business judgment rule applied to the decision by the board of NCS to merge with Genesis.[45] However, in relying on *Paramount*, the majority held that defensive devices that protect a merger agreement are subject to a *Unocal* analysis.[46] The Court reasoned that since such defensive devices seek to protect the merger agreement so as to protect the will of the board, the conflict of interest required enhanced judicial scrutiny under *Unocal*.[47]

[39] *Ibid* at 925-926.
[40] *Ibid* at 926.
[41] *Ibid* at 927.
[42] *In Re NCS Healthcare, Inc., Shareholders Litigation,* 825 A.2d 240, 254-255 (Del. Ch. 2002) [*NCS*].
[43] *Ibid* at 261, citing *Unocal,* supra note 9.
[44] *NCS, supra* note 42 at 262-63.
[45] Supra note 9 at 929.
[46] *Ibid* at 931.
[47] *Ibid* at 930-31.

The majority held that the NCS board did not satisfy the two-stage *Unocal* test. First, the board must demonstrate that they had reasonable grounds for believing a threat to the corporation existed. The board identified the threat as the possibility of losing the Genesis deal and being left with no comparable alternative deal at a time when the company was in financial difficulty.[48]

Second, the board must demonstrate that their defensive devices were reasonable in relation to the threat posed. This inquiry involves a two-step analysis: the board must establish that the defensive devices were not coercive or preclusive "*before* the focus shifts to the 'range of reasonableness' in making a proportionality determination."[49] The majority found that the deal protection devices coerced the consummation of the Genesis merger and precluded the consideration of any superior transaction. Thus, in the absence of an "effective fiduciary out clause", the defensive measures were both preclusive and coercive in the sense that they accomplished a *fait accompli*.[50] The combination of a force-the-vote provision, the Voting Agreement and the absence of an effective fiduciary out clause made it "mathematically impossible" and "realistically unattainable" for any other proposal to succeed.[51] Accordingly, the defensive devices were not within a reasonable range of responses to the perceived threat of losing the Genesis merger because they were preclusive and coercive.[52]

Alternatively, the Court argued that the deal protection provisions were invalid due to how they operated in preventing the board from exercising its fiduciary duties:

> The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced. Genesis anticipated the likelihood of a superior offer after its merger agreement was announced and demanded defensive measures from the NCS board that *completely* protected its transaction. Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer. By acceding to Genesis' ultimatum for complete protection *in futuro*, the NCS board disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e. receipt of a subsequent superior offer.
>
> …
>
> Any board has authority to give the proponent of a recommended merger agreement reasonable structural and economic defenses, incentives, and fair compensation if the transaction is not completed. To the extent that defensive measures are economic and reasonable, they may become an increased cost to the proponent of any subsequent transaction. Just as defensive measures cannot be draconian, however, they cannot limit or circumscribe the directors' fiduciary duties. Notwithstanding the corporation's insolvent condition, the NCS board had no authority to execute a merger agreement that subsequently prevented it from effectively discharging its ongoing fiduciary responsibilities.[53]

According to the majority, instead of agreeing to the absolute defence of the Genesis merger from a superior offer, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders in the event the Genesis merger became an inferior offer.[54]

d) Dissent of the Supreme Court of Delaware

In a strongly worded dissent, Chief Justice Veasey stated that fiduciary duty cases are inherently fact-intensive and therefore unique.[55] Chief Justice Veasey reasoned that the majority adopted a rule of law that imposed a prohibition on the NCS board's ability to act in concert with controlling stockholders to lock up a merger,[56] and noted that the defensive

[48] *Ibid* at 935.
[49] *Ibid* at 932 [emphasis in original].
[50] *Ibid* at 935.
[51] *Ibid*.
[52] *Ibid*.
[53] *Ibid* at 938 [citations omitted, emphasis in original].
[54] *Ibid*.
[55] *Ibid* at 939.
[56] *Ibid* at 942-43.

devices were not an isolated board action.[57]

Chief Justice Veasey found that the NCS board satisfied *Unocal*. There was a reasonably perceived threat that NCS did not have a better option to pay off its creditors, cure insolvency and provide some payment to stockholders. Further, the board's actions were reasonable in response to that threat because the Genesis merger was the "only game in town"[58] to satisfy creditors and benefit the stockholders. The defensive devices were not coercive because the two controlling shareholders had already entered into the Voting Agreement. Moreover, the defensive devices were not preclusive because there was no other bid to preclude at the time.[59]

Further, the board's good faith decision must be subject to a real-time review of the board actions before the Genesis merger was made. The process leading to the lock-up reflects a quintessential, disinterested and informed board decision reached in good faith. Going into negotiations with Genesis, the NCS board had only found one other potential bidder, Omnicare. The initial Omnicare proposal would not have paid off all the creditors and would have provided no recovery to stockholders. When the board entered into the Genesis merger agreement, the Genesis merger appeared to be the only value-enhancing transaction available.

If the NCS board would have insisted in including a fiduciary out, or if the two controlling shareholders had not agreed to the Voting Agreement, there would have been no Genesis deal. As a matter of business judgment, the risk of negotiating with Omnicare and losing the Genesis transaction, at that point, outweighed the possible benefits of Omnicare's uncertain proposal at the time. A lock-up permits a target board and a bidder to exchange certainties. Certainty itself has value. Any bright-line rule prohibiting lock-ups could, in like circumstances, chill otherwise permissible conduct.

An absolute lock-up is not a *per se* violation of fiduciary duty. As part of the negotiations, Genesis made it clear that a "fiduciary out" was not acceptable. A fiduciary out is a contractual provision that can be negotiated. Chief Justice Veasey noted that there is no authority to support the majority's holding that such a negotiated provision, if implemented in an agreement, is invalid per se where there is an absolute lock-up.[60]

In support of Chief Justice Veasey's dissent, Justice Steele found that the Court "should not encourage proscriptive rules that invalidate or render unenforceable pre-commitment strategies negotiated between two parties to a contract who will presumably, in the absence of conflicted interest, bargain intensely over every meaningful provision of a contract after a careful cost benefit analysis."[61]

2. Basis of the decision by the majority of the Supreme Court in *Omnicare*

In light of the fact that the Delaware Supreme Court has not revisited *Omnicare*, the decision arguably remains good law in Delaware.[62] The decision of the majority in *Omnicare* appears to stand for two propositions: (1) a public company board must not agree to or enter into a merger agreement which, in effect, makes a transaction a *fait accompli*; and (2) a public company board must not provide deal protection provisions without obtaining a fiduciary out.

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[57] *Ibid* at 944.
[58] *Ibid* at 943.
[59] *Ibid* at 943.
[60] *Ibid* at 945.
[61] *Ibid* at 948.
[62] However, *Omnicare* has been rejected in California. In *Monty v. Leis,* 93 Cal App 4th 1367, 123 Cal Rptr 3d 641 (Cal Ct App 2011), the shareholder plaintiff argued, among other things, that the board of the target company breached its fiduciary duty by failing to include a fiduciary out provision. The Court of Appeal of California declined to follow *Omnicare* and cited *Jewel Companies, Inc. v. Pay Less Drug Stores Northwest,* 741 F 2d 155 (9th Cir 1984) [*Jewel*], as a better authority. In *Jewel*, the Court held that a board of directors may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers. The Court in *Monty* cited *Jewel* for its reasoning that an exclusive merger agreement may be necessary to secure the best offer for shareholders of a firm. Further, the Court emphasized that the agreement was formed at a single point in time and the board of the target made their decision based on the information available at that moment. The Court ultimately refused to set aside the transaction.

Since *Omnicare*, there has been a debate as to the significance of this decision and its rulings.[63] In light of the dissent, it is not surprising that there has been severe academic criticism of this decision.[64] However, there has also been strongly worded criticism of this decision in the Chancery Court.[65] For example, in June 2005, in *In re Toys "R" Us, Inc. Shareholder Litigation*,[66] Vice Chancellor Strine, as he then was, criticized *Omnicare* as representing "an aberrational departure from [the] long accepted principle" that, when examining the reasonableness of deal protection measures taken by a board, "the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections."[67] Also, in June 2008, Vice Chancellor Lamb, in *Optima International of Miami, Inc. v. WCI Steel, Inc.*, stated that "it's really not my place to note this, but *Omnicare* is of questionable continued vitality."[68] Furthermore, the decision has not been relied upon to render an agreement, or a provision thereof, unenforceable.

Moreover, the Chancery Court has, through a series of decisions, sought to significantly limit the application of *Omnicare*. Nevertheless, in reviewing these decisions it is important to consider that in none of these decisions was there a superior proposal before the court as in *Omnicare*.

C. Limiting the Application of *Omnicare*

Fiduciary outs are so frequently used that they appear to be *de rigueur* in the realm of public company M&A transactions. It is therefore surprising that the *Omnicare* case has not been relied upon. The Delaware Chancery Court has skirted *Omnicare* in the following key ways: (i) ignoring the alternative conclusion of the Delaware Supreme Court in *Omnicare* that fiduciary outs are necessary; (ii) allowing *fait accompli* transactions that use "sign and consent"[69] within a short period of time after the execution of the merger agreement; and (iii) allowing "ratchet back support agreements" to lower the votes subject to a voting agreement below a majority level if the target board recommends a superior proposal. Each of these issues will be examined in our review of three Delaware Chancery Court decisions.

1. *Orman v. Cullman*[70]—Ignoring the alternative finding in *Omnicare*

In *Orman*, the transaction in question was a merger between Swedish Match AB ("**Swedish Match**") and General Cigar Holdings, Inc. ("**General Cigar**") that would result in Swedish Match owning 64% of General Cigar and members of the Cullman family owning 36%, while the Cullmans retained voting and day-to-day control of General Cigar post-merger.

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[63] See e.g. Sean J Griffith, "The Omnipresent Specter of Omnicare" (2013) 38 J Corp L 753; Alexander B Johnson and Roberto Zapat, "Optima is Optimal: Sidestepping Omnicare in Private Company M&A Transactions", Deal Points: The Newsletter of the Committee on Mergers and Acquisitions, American Bar Association (2009).

[64] See e.g. Daniel C Davis, "Omnicare v. NCS Healthcare: A Critical Appraisal" (2007) 4 Berkeley Bus LJ 177; Sean J Griffith, "The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare" (2004) 29 Iowa J Corp L 569.

[65] See also *Wavedivision Holdings, LLC v. Millennium Digital Medial Systems, LLC*, C.A. No. 2993-VCS (Del. Ch. 2010), wherein the agreement in question contained a no-solicitation with no fiduciary out provision. The target, Millennium Digital Medial Systems, LLC ("**Millennium**"), attempted to justify its repeated breaches of the no-solicitation in favour of Wavedivision Holdings, LLC ("**Wave**") by arguing, among other things, that the no-solicitation could not be enforced as a matter of law because doing so would have forced the management committee of Millennium to breach its fiduciary duties to its creditors. The Court of Chancery of Delaware, in noting that the management committee had the full support and approval of the creditors, rejected this argument and noted that "despite the existence of some admittedly odd authority on the subject, it remains the case that Delaware entities are free to enter into binding contracts without a fiduciary out so long as there was no breach of fiduciary duty involved when entering into the contract in the first place" (*ibid* at 38). The Court held that Millennium did indeed breach the no-solicitation provision and that Wave was entitled to damages.

[66] *Toys "R" Us, supra* note 26.

[67] *Ibid* at 1016.

[68] C.A. No. 3833-VCL, 127 (Del. Ch. 2008) (Transcript).

[69] Pursuant to Section 228 of the *Delaware General Corporate Law*, the requisite majority shareholders may approve a merger transaction that requires shareholder approval by written consent in lieu of a shareholders' meeting, so long as consent in writing for the action is signed by the requisite number of votes to authorize the transaction. There is no prior notice required when requesting consent. Accordingly, a board of a Delaware target may act with controlling or majority shareholders to execute a merger agreement and simultaneously obtain shareholder approval through written consent and for all practical purposes complete a merger on a timely basis. In Canada, the final approval under an arrangement or amalgamation would have to be obtained at a shareholders' meeting. It should be noted however that, like in the U.S., shareholders in Canada can agree to irrevocable lock-up agreements or voting agreements, whereby they can agree to support a transaction regardless of future events, including the emergence of a superior proposal.

[70] C.A. No. 18039 (Del. Ch. 2004) [*Orman*].

In connection with the merger, Swedish Match required that the Cullmans enter into a voting agreement pursuant to which they would agree not to sell their shares and to vote their shares in favour of the merger and against any alternative acquisition proposal for a period of 18 months following any termination of the merger.

The merger agreement contained the following key provisions:

(i) General Cigar agreed to a force-the-vote provision whereby General Cigar agreed to submit the merger agreement to its stockholders for a vote regardless of whether the board continued to recommend the merger.[71]

(ii) Swedish Match provided a window shop provision to General Cigar, but General Cigar was not allowed to terminate the merger agreement even if it changed its recommendation in favour of a superior proposal received pursuant to the window shop provision.[72]

The Cullmans agreed to vote their Class A shares *pro rata* in accordance with the vote of the Class A public shareholders, which effectively gave the public shareholders a veto over the merger (i.e. approval by a "majority of the minority" was required in order for the merger to proceed). At the shareholders' meeting, the public shareholders overwhelmingly approved the merger.

In responding to the application of *Omnicare* to the facts of the case, the Court noted that the transaction was not a *fait accompli* as the General Cigar public shareholders had the right to veto the transaction:

> Because General Cigar's public shareholders retained the power to reject the proposed transaction with Swedish Match, the fiduciary out negotiated by General Cigar's board was a meaningful and effective one — it gave the General Cigar board power to recommend that the shareholders veto the Swedish Match deal. That is to say, had the board determined that it needed to recommend that General Cigar's shareholders reject the transaction, the shareholders were fully empowered to act upon that recommendation because the public shareholders (those not "locked-up" in the voting agreement) retained the power to reject the proposed merger.[73]

The Court held that the approval of the minority shareholders was not "impermissibly coerced", notwithstanding that another bidder was highly unlikely to appear during the 18 month period during which the Cullmans agreed to vote against any alternative acquisition proposal.[74] Finally, the so-called "meaningful and effective"[75] "fiduciary out" negotiated by General Cigar was substantially similar to the form of "fiduciary out" in *Omnicare* which the Supreme Court found to be inadequate (i.e. the provision that did not allow the target to terminate the merger agreement upon either the existence of a superior proposal it wished to accept or a change of recommendation of the board).

2. The *OPENLANE* decision—sign and consent

On September 30, 2011, Vice Chancellor Noble issued an opinion in *OPENLANE*[76] that confirmed the permissibility of using a "sign-and-consent" exception. In *OPENLANE*, the directors of OPENLANE, Inc. ("**OPENLANE**"), who beneficially owned approximately 60 percent of the company's outstanding shares, retained a financial advisor to reach out to a limited number of potential strategic acquirers in anticipation of a decline in business. Following discussions with a number of interested parties, OPENLANE and KAR Auction Services, Inc. ("**KAR**") signed a merger agreement. The merger agreement contained the following key provisions:

(i) A full no-solicitation clause, without a window shop or any form of fiduciary out.

(ii) A provision granting the OPENLANE board the right to terminate the agreement without penalty in the event the consent from a majority of OPENLANE shareholders

[71] General Cigar Holdings Inc., Definitive Proxy Statement, Annex A: Merger Agreement (April 10, 2000) 26-27.
[72] General Cigar Holdings Inc., Definitive Proxy Statement, Annex A: Merger Agreement (April 10, 2000) 36-37.
[73] *Ibid* at 21.
[74] *Ibid* at 24.
[75] *Ibid* at 21.
[76] *OPENLANE, supra* note 24.

was not delivered within 24 hours of signing the merger agreement.[77]

The next day, a majority of OPENLANE's common and preferred shareholders signed a written consent approving the merger. A shareholder of OPENLANE brought a class action lawsuit on the basis that the board breached its fiduciary duties by failing to undertake an adequate process contrary to *Revlon* and by agreeing to improper deal protection devices contrary to *Omnicare*. The Court ultimately declined to grant a preliminary injunction to enjoin the merger.

In addressing the plaintiff's claim for inadequate process under *Revlon*, the Court found that the board possessed impeccable knowledge of the company's business and held that the actions of the board were "a reasonable effort by a highly competent board to maximize shareholder value"[78] and that they acted reasonably "in light of the then-existing circumstances".[79]

In response to the plaintiff's claim for improper deal protection, the Court applied the two-prong *Unocal* test. With respect to the threat identified by the board, the Court noted that "there were few suitors for OPENLANE and that if OPENLANE waited for too long to consummate a transaction its business could significantly decline."[80] As for the second prong of *Unocal*, the Court distinguished the case from *Omnicare*, in which the merger was declared "an impermissible '*fait accompli*'".[81] Further, with respect to the provision of consents by a majority of OPENLANE shareholders, the Court stated that "[the] Merger Agreement neither forced a transaction on the shareholders, nor deprived them of the right to receive alternative offers" and rejected the plaintiff's argument on the preclusive or locked-up nature of the merger agreement.[82]

Unlike in *Omnicare*, where the merger agreement was found to be a *fait accompli*, the Court found that there was no evidence of the execution of a shareholders' voting agreement as part of the merger. Furthermore, the fact that the OPENLANE board could terminate the agreement if the company's shareholders did not consent to the merger within 24 hours of signing the merger agreement effectively made the no-solicitation clause in the merger agreement a defensive device that was of "little moment".[83]

The Court also held that, even though *Omnicare* may be read to require a fiduciary out in every merger agreement, enjoining a merger without a fiduciary out when no superior offer has emerged would be a "perilous endeavor".[84]

Critics of the *OPENLANE* decision argue that the quick sign-and-consent strategy is both coercive and preclusive. A structure that places an enormous amount of pressure on selling shareholders is coercive because purchasers typically negotiate for the right to terminate the agreement without penalty in the event the consent is not delivered within the prescribed time. Likewise, the sign-and-consent structure is preclusive of second bids by design as it renders the transaction practically immune to a topping bid once the consent is delivered.[85]

Nevertheless, the *OPENLANE* structure seems to be considered and employed as a viable tactic to preserve a certain level of transactional certainty while avoiding a breach of *Omnicare*. For example, the agreement of the Starbucks Corporation's $620 million acquisition of Teavana Holdings in 2012 allowed Starbucks to terminate the agreement if the required shareholder consent was not received by 6 a.m. the day after signing.[86] Other deals in the same year, including Thoma Bravo's $1.1 billion acquisition of Deltek, Bayer's $1.2 billion bid for Schiff Nutrition and Genesee & Wyoming's acquisition of RailAmerica, also employed the similar form of the sign-and-consent structure.[87] It has also been documented that four deals in

[77] *Ibid at 6.*
[78] *Ibid* at 20.
[79] *Ibid* at 15
[80] *Ibid* at 23.
[81] *Ibid* at 24, citing *Omnicare, supra* note 5.
[82] *Ibid* at 26.
[83] *Ibid.*
[84] *Ibid* at 27 n 53. We would note that this argument is somewhat difficult to follow. It may be that the Court has suggested that merger agreements without fiduciary outs are voidable in circumstances where there is a superior proposal.
[85] Brian J.M. Quinn, *Omnicare: Coercion and the New Unocal Standard,* 38 J. Corp. L 385, 846 (2013).
[86] Steven M. Davidoff, Doing the Shareholder Sidestep, *The New York Times,* Dec. 6, 2012, available at <http://dealbook.nytimes.com/2012/12/06/doing-the-shareholder-sidestep>.
[87] *Ibid.*

2013 used the sign-and-consent structure.[88]

3. *Synthes*: Ratchet Back Support Agreements

In *Synthes*, the plaintiff shareholders brought a claim for breach of fiduciary duty in connection with a merger between Synthes, Inc. ("**Synthes**") and Johnson & Johnson ("**J&J**") pursuant to which J&J would pay the consideration with a mix of 65% stock and 35% cash. Wyss, the Chairman of the board of Synthes, was also the controlling shareholder of Synthes. The merger agreement contained key deal protection provisions:

(i) Synthes board agreed to a force-the-vote provision whereby Synthes agreed to submit the merger agreement to its stockholders for a vote, regardless of whether the board continued to recommend the merger.

(ii) J&J provided a window shop provision to Synthes, but Synthes was not allowed to terminate the merger agreement even if it changed its recommendation in favour of a proposal received pursuant to the window shop provision.[89]

Accordingly, the merger agreement did not contain a fiduciary out. In addition, the controlling stockholders of Synthes, who held 48.83% of the Synthes' shares in the aggregate, agreed to vote 37% of the outstanding shares in favour of the merger; however, if the Synthes board changed its recommendation in favour of a superior proposal, the shares subject to the voting agreement would be reduced to 33% from 37% (the "**Synthes Voting Agreement**").

The Court held that, since the control of the corporation would remain post-merger in a large and fluid market, *Revlon* did not apply (i.e. a change of control would not occur). In response to arguments that the deal protection provisions were problematic, the Court observed that the level of shares subject to the Synthes Voting Agreement were less than a majority and would decline if there was a superior proposal. The Court then concluded by noting its reluctance to second guess decisions of a board undertaken in the context of a robust auction:

> This court should be particularly reluctant to deem unreasonable a board's decision to use deal protections as part of the negotiating strategy to pull the best bid from the final bidder or bidders who emerge from an open process on the theory that some party that has already had a chance to make a real bid without having to hurdle any deal protection barrier at all will somehow come to a different realization of the company's value, or that some unexpected bidder will emerge from an unexplored and overlooked dusty corner of our well-scoured capital markets. That sort of tactical judgment is freighted with none of the concerns about disloyalty that animate *Unocal* and *Revlon*, and is one that courts are ill-equipped to second guess as unreasonable. For that reason, this court has made clear that when there has been a "good faith negotiation process in which the target board has reasonably granted [deal] protections in order to obtain a good result for the stockholders, there [are] no grounds for judicial intrusion.[90]

D. "Don't Ask, Don't Waive" Cases

We review briefly below decisions of the Delaware Chancery Court relating to the legality of "don't ask, don't waive" provisions. We consider this relevant since the impact of "don't ask, don't waive" provisions could be greater in preventing superior proposals than a lack of a fiduciary out, and therefore the analysis may prove helpful to the conclusions reached herein.

In *In Re Complete Genomics, Inc. Shareholder Litigation*,[91] the board of Complete Genomics Inc. ("**Genomics**") entered into confidentiality agreements with nine potential bidders. One of these agreements contained a "don't ask, don't waive" provision. In this case, in November 2012, Vice Chancellor Laster compared a "don't ask, don't waive" provision to a bidder-specific no-talk clause and reached the conclusion that it is impermissible as it has "the same disabling effect as the no-talk clause".[92] He added that this "impermissibly limit[s] its [the board's] ongoing statutory and fiduciary obligations to properly evaluate a competing

[88] The Window-shop Exception in "Openlane" Deals, Thomson Reuters (Jan. 22, 2014), <http://us.practicallaw.com/9-554-3323>.
[89] *Ibid* at 1030.
[90] *Ibid* at 1049 citing Toys "R" Us, supra note 26 at 1021.
[91] C.A. No. 7888-VCL (Del. Ch. 2012) [Genomics].
[92] *Ibid* Part II at 18.

offer, disclose material information, and make a meaningful merger recommendation to its stockholders."[93]

As a result, the Court preliminarily enjoined Genomics from enforcing the "don't ask, don't waive" provision that it had entered into with one of the potential bidders.[94]

Less than a month later, the Court of Chancery *In re Ancestry.com Inc.*[95] expressed disagreement with the conclusion of the *Genomics* ruling. In this case, the board of directors of Ancestry.com Inc. ("**Ancestry**") approved a merger agreement with Permira Advisers, LLC ("**Permira**") who were the winners of an auction initiated by Ancestry. As a part of the initial auction process, at least 11 parties entered into confidentiality agreements with Ancestry that included a standstill provision as well as "don't ask, don't waive" provisions.[96] Following the public announcement of the merger, several Ancestry public shareholders filed a suit alleging a breach of fiduciary duties by the directors of Ancestry and seeking to enjoin the upcoming shareholder vote on the Permira merger.[97]

The Court held that "don't ask, don't waive" provisions are not *per se* invalid. Chancellor Strine, as he then was, acknowledged that the provisions are tools that are designed to serve a value-maximizing purpose; by forcing potential bidders to put their best bid forward during a sale auction, the eventual winner has the confidence in knowing that it won the auction, at least against the other bidders in the process. The Court did stress, however, that "don't ask, don't waive" provisions are "potent"; as a result, directors must use them consistently with their fiduciary duties and for the value-maximizing purpose for which they were designed.[98]

E. Summary

Notwithstanding the Delaware Supreme Court's alternative finding in *Omnicare* that fiduciary outs are required in deal protection provisions, no Delaware court has since followed this ruling despite numerous opportunities to do so. In fact, many of the key decisions that have distinguished *Omnicare* had before them merger agreements with no fiduciary out provisions.[99] Indeed, the difficulties with *Omnicare* also relate to the fact that the Delaware courts continue to move away from bright line tests under the enhanced scrutiny standard.

Based on our review of the Delaware decisions following *Omnicare*, it is a tenuous argument to suggest that fiduciary outs are in fact mandatory. However, no case since *Omnicare* has considered the situation where a superior proposal was received and the merger agreement did not contain a fiduciary out. We hypothesize that, even if those facts were to come before the Delaware courts again, without the application of the enhanced scrutiny standard, it would be unlikely that a court would make a finding against the target board,[100] particularly where properly informed shareholders have the right to veto or approve a transaction following the signing of the merger agreement.

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[93] *Ibid.*

[94] See also *In re Celera Corporation Shareholder Litigation*, C.A. No. 6304-VCP, 53 (Del. Ch. 2012), where the Delaware Court of Chancery held that the "don't ask, don't waive" provision effectively blocked the entities that were most likely to make competing bids from informing a target board of their willingness to bid. This increased the risk that a target board would lack adequate information to determine whether continued compliance with the merger agreement would violate its fiduciary duty to consider superior offers, thus decreasing the benefit of the fiduciary out. The Court noted that contracting into such a state could potentially constitute a breach of fiduciary duty.

[95] *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012).

[96] Ancestry.com Inc., Proxy Statement Pursuant to Section 14(a) of the *Securities Exchange Act of 1934* (Form PRE-M14A) 'Background of the Merger' section (October 30, 2012).

[97] Ancestry.com Inc., Current Report Pursuant to Section 13 or 15(d) of the *Securities Exchange Act of 1934* (Form 8-K), 'Special Factors – Background of the Merger' section (December 19, 2012).

[98] *Supra*, note 95 at 23-24.

[99] See e.g. *OPENLANE, supra note* 24, *Synthes, supra note* 19 and *Orman, supra* note 70.

[100] See the decision of the Delaware Chancery Court in *Omnicare, supra* note 5.

PART III – CANADIAN STANDARDS OF JUDICIAL REVIEW FOR ACTIONS OF DIRECTORS

In order to examine the treatment of fiduciary outs under Canadian law, we will first consider the standards of review for the actions and decisions of directors in Canada. The significant difference between the standards in Canada and Delaware will certainly inform our analysis.

A. Business Judgment Rule and the Oppression Remedy

1. Business judgment rule in Canada

Canadian courts, like their American counterparts, have adopted a posture of deference in reviewing the business decisions of a board of directors for compliance with the board's common law and statutory fiduciary duty. The business judgment rule emerges from judicial recognition that business decisions are often made in time-sensitive and information-limited contexts by individuals that possess specialized expertise and knowledge.[101] Under the business judgment rule, a court will refrain from substituting its view for that of the board or from engaging in a microscopic examination of the business decision, even if subsequent developments seem to indicate that the directors did not reach the best outcome. The court will look to determine not whether the board's decision was a perfect one, but rather, whether it fell within a range of reasonable alternatives.[102]

However, the application of the business judgment rule is not unequivocal. To attract the application of the business judgment rule, the board's decision must be made honestly, with due care and on reasonable and rational grounds.[103] To this end, the standard of conduct expected from boards may vary depending on the circumstances in which the decision is being made. For instance, in a change of control context, the fact that the board is placed in a fundamental conflict of interest with respect to the transaction means that a board is typically required to retain independent financial and legal advisors as well as establish a special committee that is tasked with responding to the bid. As Justice Blair explained in *CW Shareholdings Inc. v WIC Western International Communications Ltd.*, these measures will help the directors to "make a decision and exercise their judgment in an informed and independent way."[104]

In contrast to Delaware, there is no enhanced scrutiny or entire fairness standard for evaluating the conduct of the board of directors in Canada (see Part III-B below). As such, the board will not have the evidentiary obligation to prove the reasonableness of its conduct or that the business judgement rule should apply.[105]

2. The oppression remedy

An often used claim in Canada with respect to the conduct of directors, which is not available in the U.S., is the statutory oppression remedy. While the oppression remedy is not an alternative standard of review to the business judgment rule, it does provide another means for aggrieved stakeholders to challenge the conduct of a board of directors.

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[101] *Peoples Department Store v. Wise*, 2004 SCC 68, 3 SCR 461; *Brandt v. Keeprite Investments* (1991), 3 OR (3d) 289, [1991] OJ No 683 [*Brandt*].

[102] *Pente v. Schneider Corp.* (1998), 42 OR (3d) 177 at para 36 (ONCA).

[103] *Brandt, supra* note 101; *BCE Inc. v. 1976 Debentureholders,* [2008] 3 SCR 560, 2008 SCC 69 [*BCE*].

[104] *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998), 39 OR (3d) 755 at para 43, 160 DLR (4th) 131 (ONCA) [*CW Shareholdings*].

[105] *Ibid* at para 63.

Under section 241 of the *Canada Business Corporations Act* ("***CBCA***")[106] and its provincial counterparts,[107] a complainant may apply for an order under the oppression remedy. In seeking to ensure fairness—that is, what is "just and equitable"—the courts are conferred broad jurisdiction to enforce not just what is legal, but what is fair.[108] To this end, in considering a claim for oppression, courts should look at "business realities, not merely narrow legalities."[109]

Against this backdrop, it follows that the oppression remedy focuses on harm to the legal and equitable interests of a wide range of stakeholders affected by the oppressive acts of a corporation or its directors. Thus, in assessing a claim of oppression, courts are required to determine if the evidence supports the reasonable expectation asserted by the claimant, and in turn, whether that reasonable expectation was violated by conduct tantamount to "oppression", "unfair prejudice" or "unfair disregard" of the relevant interest.[110] In other words, to maintain a claim for oppression, the complainant must show not only the existence of a defeated reasonable expectation, but that the failure to meet that expectation involved unfair conduct and prejudicial consequences, amounting to "oppression," "unfair prejudice," or "unfair disregard" of relevant interests.[111] Thus, not every unmet expectation gives rise to a claim under the oppression remedy; the impugned conduct must be wrongful and demonstrative of the type of injury that the oppression remedy is aimed at correcting.

In deciding whether such reasonable expectation exists, the courts consider a number of relevant factors, including: general commercial practice; the nature of the corporation; the relationship between the parties; past practice; preventative steps taken; representations and agreements; and the fair resolution of conflicting interests between corporate stakeholders.[112]

The judicial treatment of the reasonable expectation factors reveals some notable differences between closely held and public corporations.[113] In the context of public corporations, representations made to stakeholders or to the public in prospectuses, offering circulars or press releases may heavily shape the reasonable expectations of parties. To wit, "[t]he public pronouncements of corporations, particularly those that are publicly traded, become its commitments to shareholders within the range of reasonable expectations that are objectively aroused."[114] Further, general industry practice may inform the courts as to the standard of conduct that one should reasonably expect from a public corporation.

The determination of whether a particular expectation is reasonable is muddied by competing stakeholder interests. However, fair treatment—the common denominator underlying oppression jurisprudence—is most fundamentally what stakeholders are entitled to reasonably expect.[115]

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[106] RSC 1985, c C-44.

[107] (AB) Business Corporations Act, RSA 2000, c B-9, s 242(1);
(BC) Business Corporations Act, SBC 2000, c 57, s 227;
(MB) The Corporations Act, CCSM c C225, s 234(1);
(NB) Business Corporations Act, SNB 1981, c B-9.1, s 166(1);
(NL) Corporations Act, RSNL 1990, c C-36, s 371(1);
(NS) Companies Act, RSNS 1989, c 81, third sched, s 5(1);
(NT) Business Corporations Act, RSNWT 1996, c 19, s 243(1);
(NU) Business Corporations Act, SNWT 1996, c 19, s 243(1);
(ON) Business Corporations Act, RSO 1990, c B16, s 248(1);
(QC) Business Corporations Act, RSQ c S-31.1, s 450;
(SK) The Business Corporations Act, RSS 1978, c B-10, s 234(1);
(YK) Business Corporations Act, RSY 2002, c 20, s 243(1).

[108] *BCE*, supra note 103 at para 58.

[109] *Ibid*

[110] *Ibid* at para 67.

[111] *Ibid* at para 89.

[112] *Ibid* at para 72.

[113] The directors of a widely held public corporation may be accorded less latitude to depart from strict formalities, as compared to the directors of a small, closely held corporation (*BCE, supra* note 103 at para 74). Similarly, relationships between shareholders based on family or personal connections may also be governed by different standards than relationships between arm's length shareholders in a widely held corporation. See *ibid* at para 75; *Tanebaum Estate* (*Trustee of*) v. *Tanjo Investments Ltd* (2009), 99 OR (3d) 196 ("there may well be a different level of form and accountability that takes place in a closely-held private family company or companies compared to that required for a widely-held public corporation" at para 56).

[114] *Themadel Foundation v. Third Canadian Investment Trust Ltd* (1998) 38 OR (3d) 749 at para 11.

[115] *BCE, supra* note 103 at para 64.

As explained by the Supreme Court of Canada in *BCE*, "the oppression remedy focuses on harm to the legal and equitable interests of stakeholders affected by oppressive acts of a corporation or its directors."[116] The oppression remedy is based on the notion that directors have an obligation to act in the best interests of the corporation, and as such, must take into account the legitimate expectations of all stakeholders who may be affected by corporate conduct. Unfairly disregarding such interests can lead to a wide array of statutory remedies under section 241 of the *CBCA*.[117]

B. Canadian Jurisprudence Relating to Enhanced Scrutiny

By 1998, the Ontario law was clear: boards had an obligation to maximize value in the context of a change of control transaction. However, to say that Ontario courts were following *Unocal* or *Revlon* would be an overstatement.

In *CW Shareholdings*, Justice Blair of the Ontario Court of Justice noted that, in upholding an option asset agreement and a break fee, "directors must exercise the common law fiduciary and statutory obligation … to act honestly and in good faith with a view to the best interests of the corporation."[118] However, he clarified that "[i]n the context of a hostile take-over bid situation where the corporation is 'in-play' (i.e. where it is apparent there will be a sale of equity and/or voting control) the duty is to act in the best interests of the shareholders as a whole and to take active and reasonable steps to maximize shareholder value by conducting an auction."[119] Justice Blair then equated this duty to what he described as the "shareholder maximization-through-auction"[120] duty articulated by the Delaware Supreme Court in *Revlon*. Turning to the bid inducements that were challenged, Justice Blair further cited *Revlon* for the proposition that the granting of an asset purchase option and break fee to a potential bidder may be a proper and acceptable measure where, in the context of the entire transaction, it serves to stimulate the auction and induce additional bids that offer superior value to shareholders.

In facilitating the auction process, the Court noted that directors must exercise their duties in a way that accounts for and minimizes, as much as reasonably possible, their inherent conflict of interest in the change of control context. Retaining independent legal and financial advisors and establishing independent or special committees are two ways a board can cope with this position of conflict. These devices enable directors to consider the circumstances with a degree of independence. Ultimately, directors "must make a decision and exercise their judgment in an informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable grounds for believing that their actions will promote and maximize shareholder value."[121]

In response to the plaintiff's argument that, on the facts of the case, the transaction should attract the "upgraded version of the enhanced scrutiny" standard of review, being the "entire fairness standard", on account of the fact that the transaction was between related parties, Justice Blair declined to impose on the directors the requirement to demonstrate the entire fairness of the transaction. Justice Blair argued that placing an evidentiary burden on directors to justify their decisions during a possible takeover went too far and was not the law in Ontario. In particular, he suggested that such an approach places the initial burden in the wrong place, which in his view, would unduly undermine the business judgment approach.

Only a few months after *CW Shareholdings*, the Ontario Court of Appeal had the opportunity to revisit *Revlon* in *Pente Investment Management Ltd. v. Schneider Corporation*.[122] In *Pente*, the controlling shareholders of Schneider Corporation ("**Schneider"**) preferred the bid of one party, Smithfield Foods ("**Smithfield**"), to another, Maple Leaf Foods Inc. ("**Maple Leaf**"), notwithstanding that the first party's bid offered lower consideration. Their preference for Smithfield was based on non-financial considerations including the fact that Smithfield would continue the operations of Schneider in a manner consistent with the controlling shareholders' wishes. Maple Leaf and several minority shareholders brought a suit alleging that the special committee failed to maximize value.

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[116] *Ibid* at para 45.
[117] *Supra note* 106, s 241(2).
[118] *CW Shareholdings*, supra note 104 at para 39.
[119] *Ibid*.
[120] *Ibid* at para 40.
[121] *Ibid* at para 43.
[122] (1998), 42 OR (3d) 177 [*Pente*].

The Court in this case, as in *CW Shareholdings*, interpreted *Revlon* to stand for the proposition that where a company is for sale, directors have an obligation to act in the best interests of the shareholders as a whole and conduct an auction. The Court explicitly rejected this interpretation of the *Revlon* duty, stating that "*Revlon Inc*. is not the law in Ontario".[123] Alternatively, it found that an auction, by facilitating a process whereby directors must act in a neutral manner towards a number of bidders, is just one method to prevent the conflicts of interest that can arise in the change of control context. In particular, given that the board had received a single offer and had no reliable grounds to determine its adequacy, a canvassing process used by Schneider to assess the adequacy of the Maple Leaf bid was appropriate in the context. However, there was no further obligation on the special committee to turn the canvass into an auction, especially since an auction risked the potential withdrawal of some of the offers. Instead, the Court favoured a *Revlon* progeny, *Paramount*, which in its view recast the obligation as a duty to seek the best value reasonably available to shareholders in the circumstances. In this case, the best transaction can be determined by factors aside from financial considerations and there is no single blueprint that directors must follow.

Turning to the special committee's rejection of the Maple Leaf offer, the Court stated that the business judgment rule applies even in the takeover context.[124] In particular, the Court found that the rejection of alternative offers is irrelevant unless any particular one "was definitely available and clearly more beneficial."[125] Due to non-financial considerations, it was unlikely the controlling shareholders would proceed with the Maple Leaf offer. As such, the Court deemed that the alternative transactions actually available to be pursued may well be limited by the company's controlling shareholders.[126]

The Court of Appeal provided some additional insight on shifting the burden onto the directors to demonstrate that corporate decisions are in the best interests of the company. It stated that the burden of proof may not always lie on the same party in a change of control context. The real question, according to the Court, is whether the board of directors of the target successfully took steps to avoid being in a conflict of interest. If so, the rationale for shifting the burden may not exist. In this case, the independent special committee addressed the conflict so there was no need to shift the burden.

Although the highest court in Ontario had accepted the principle of maximization of shareholder value in the change of control context, the key aspect of the onus shifting basis of the enhanced scrutiny standard was rejected. The law in Ontario remained much the same until the Supreme Court of Canada's pronouncements in *BCE*.

In *BCE*, the Supreme Court of Canada, in referring to its recent decision in *Peoples*, confirmed that the board's fiduciary duty is owed to the corporation, and that duty is a broad contextual concept. In a voluntary change of control situation, this raises the obvious issue of whether, as in *Revlon*, the duty is focused on only one of the corporation's stakeholders—the shareholders. The Court noted that it may "be appropriate, although *not mandatory*, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders."[127] Conflicts may arise between stakeholders, and between stakeholders and the corporation, but directors must resolve those conflicts "in accordance with their fiduciary duty to act in the best interests of the corporation, viewed as a good corporate citizen."[128] "There is no principle that one set of interests – for example the interests of shareholders – should prevail over another set of interests… [It] depends on … whether, having regard to that [particular] situation, they exercised business judgment in a responsible way."[129]

[123] *Ibid* at para 61.
[124] *Ibid* at para 38.
[125] *Ibid* at para 78.
[126] This notion was further exemplified in the trial decision, where Justice Farley found that because Schneider was known to be controlled by the Schneider family, there was never a public expectation that the corporation would be sold to the highest bidder in an auction process.
[127] *BCE, supra* note 103 at para 39.
[128] *Ibid* at para 81.
[129] *Ibid* at para 84.

The Court framed *Revlon* as suggesting that, in circumstances such as a hostile takeover bid, "shareholder interests should prevail over those of other stakeholders."[130] With regard to the role of *Revlon* in Canadian corporate law, the Court stated that it was clear that the *Revlon* line of cases did "not [displace] the fundamental rule that the duty of the directors cannot be confined to particular priority rules, but is rather a function of business judgment of what is in the best interests of the corporation, in the particular situation it faces."[131]

There can be no doubt that the enhanced scrutiny standard is not, and has never been, the law in Canada; an Ontario Court would not examine the appropriateness of a lack of a fiduciary out clause through the lens of *Unocal*. While we would argue that the value maximization principle remains an important consideration for boards in a company-initiated change of control situation,[132] any analysis as to whether a board has duly exercised its fiduciary duty in determining to not provide for a fiduciary out in deal protection provisions will likely be undertaken under the business judgement rule. We will examine this matter in more detail below, and also consider the impact of the oppression remedy on such analysis.

PART IV – IS A FIDUCIARY OUT CLAUSE REQUIRED

A. Ventas, Inc v Sunrise Senior Living Real Estate Investment Trust[133]

Notwithstanding the scarcity of Canadian jurisprudence on whether fiduciary outs are required in deal protection provisions, the Ontario Court of Appeal in *Ventas* addressed this issue in passing.[134]

In September 2006, the board of trustees of Sunrise REIT Trust ("**Sunrise**") decided to conduct a two-stage auction process for the trust's assets, reasoning that a public sale would be a strategic method of maximizing the value of the trust's units. To carry out this plan, interested parties were asked to enter into a confidentiality agreement, which contained a standstill provision prohibiting interested parties from making an offer for the Sunrise assets without the consent of the board of trustees.

Ventas, Inc. ("**Ventas**") and Health Care Property Investors, Inc. ("**HCPI**") emerged as the two surviving prospective purchasers following the preliminary round of the auction process. In the final round, HCPI withdrew from the auction and, as a result, Ventas was successful in its bid to acquire all of Sunrise's assets at a value that represented a price of $15 per unit.[135] Shortly thereafter, Ventas and Sunrise signed a merger agreement that prohibited Sunrise from soliciting further bids. This provision, however, was subject to a traditional fiduciary out.

[130] *Ibid* at para 86.

[131] *Ibid* at para 87.

[132] In the context of a sale of a public company, particularly in a contested transaction, the argument can be made that a board must continue to focus on the value maximization principle. Notwithstanding the rejection of "particular priority rules" by the Supreme Court of Canada in *BCE*, we would expect that the oppression remedy could prove to be a useful tool for shareholders in circumstances where a board undertakes a sale transaction and does not seek to obtain the best price reasonably available. To maintain a claim for oppression, the complainant must show not only the existence of a defeated reasonable expectation, but that the failure to meet that expectation involved unfair conduct and prejudicial consequences, amounting to "oppression," "unfair prejudice," or "unfair disregard" of relevant interests. In deciding whether a reasonable expectation exists, the courts are likely to consider general commercial practice and general industry practice. A shareholder can rightfully argue that in the context of a sale of the company, it reasonably expects that the company will obtain the best available price or at the very least ensure that a majority (or a majority of the minority) of the shareholders have the right to determine if they will accept the sale transaction. This is standard commercial practice and why would persons invest in equity securities – which have limited rights – unless this was the case? For this expectation to be found to be unreasonable, we would expect a public company to publicly and clearly disclose that it would be guided by other principles in a sale transaction. In circumstances where a board is faced with significant conflicts in the context of a contested transaction, and then determines to pursue a transaction with a "friendly" party, this expectation would be heightened. In terms of unfair prejudice and oppressive conduct, a board would likely be engaging in oppressive conduct if it knowingly determines to complete a transaction that does not attain the best available price for shareholders and makes that transaction a *fait accompli* so that shareholders cannot effectively block it. See also Jeremy D Fraiberg, "Fiduciary Outs and Maximizing Shareholder Value Following BCE" (2009) 48 Can Bus LJ 213 at 227-228; and J Alex Moore & William Ainley, "BCE v.1976 Debentureholders: An Unexamined Question Considered" online: Davies <http://www.dwpv.com/images/bce_v_1976_debentureholders_an_unexamined_question_considered.pdf>.

[133] 2007 ONCA 205, [2007] OJ No 1083 [Ventas].

[134] Note that the Ventas decision was rendered prior to the Supreme Court of Canada's rejection of *Revlon* in *BCE*.

[135] *Ibid* at para 3.

The merger agreement also contained a provision that required Sunrise not to fail to enforce, and not to waive, the standstill provisions in any confidentiality agreements signed with third parties. While the confidentiality agreements were largely similar, Ventas' standstill agreement was worded differently from that of HCPI in that the Ventas standstill contained a clause stipulating that the standstill ceased to apply to Ventas if Sunrise entered into a merger agreement with a third party. As a result, when HCPI proceeded to make a post-signing bid at a value representing $18 per share (or 20% higher than the price reflected in the Ventas merger agreement), it remained subject to the standstill.[136]

While the HCPI bid was undoubtedly more financially lucrative than the Ventas bid, the board of Sunrise concluded it was not in a position to determine if the bid was in fact superior because the bid contained a clause conditioning the bid on HCPI's ability to reach a management agreement with the entity that managed the properties owned or invested in by Sunrise. As a result, the parties made various applications to the Court to determine whether Sunrise could entertain the HCPI offer.

On the Court's interpretation of the provisions of the merger agreement, Sunrise was not permitted to entertain the more lucrative HCPI proposal as the covenant with Ventas to enforce any prior standstills entered into with third parties applied.

In response to the argument of the overriding importance of fiduciary out provisions in merger agreements, the Court noted as follows:

> There is no doubt that the directors of a corporation that is the target of a takeover bid — or, in this case, the Trustees — have a fiduciary obligation to take steps to maximize shareholder (or unitholder) value in the process. That is the genesis of the "fiduciary out" clauses in situations such as the case at hand. They enable directors or trustees to comply with their fiduciary obligations by ensuring that they are not precluded from considering other bona fide offers that are more favourable financially to the shareholders or unitholders than the bid in hand.
>
> It is not necessary — nor would it be wise, in my view — to go as far as HCPI suggests this court might go, and adopt the principle gleaned from some American authorities, that the target vendor can place no limits on the directors' right to consider superior offers and that any provision to the contrary is invalid and unenforceable. That is not what happened in this case.
>
> The Trustees did not contract away their fiduciary obligations. Rather, they complied with them by setting up an auction process, in consultation with their professional advisers, that was designed to maximize the unit price obtained for Sunrise's assets, in a fashion resembling a "shotgun" clause, by requiring bidders to come up with their best price in the second round, subject to a fiduciary out clause that allowed them to consider superior offers from anyone save only those who had bound themselves by a Standstill Agreement in the auction process not to make such a bid. In this case, that turned out to be only HCPI.[137]

Several important principles can be gleaned from this statement. The Court believed that the genesis of the fiduciary out is the duty to maximize shareholder value. This duty is no longer recognized in Canadian law in the consideration of a board's fiduciary duty. Further, the Court recognized that the process which led to the inability of the board to consider the superior proposal of HCPI was designed in good faith to achieve the best result for the company and therefore undertaken to comply with the board's fiduciary duty. Thus, the time to assess whether the board properly exercised its fiduciary duty is the time of the entering into of the standstill agreement or the merger agreement. Finally, the Court refused to accept a bright line test with respect to the legality of provisions which prevent boards from considering superior proposals.

[136] *Ibid.*

[137] *Ibid* at paras 53–57 [citations omitted, emphasis added].

It is our position that the enforceability of an agreement without a fiduciary out is likely far less contentious than enforcing provisions upholding standstills entered into in the course of a robust auction. The parties subject to a standstill are likely to be the parties who could put forth a superior proposal; therefore, their inability to make a counter bid is likely to be more limiting to the creation of a superior proposal. On the other hand, the lack of a fiduciary out does not prevent the making of a superior proposal. A superior proposal could be made directly to shareholders by a takeover bid, or in circumstances where a superior proposal cannot be advanced without an agreement with the target, shareholders could reject the offer made under the merger agreement with the purchaser and seek to get the board of the target to then accept the superior proposal.

B. Application of Fiduciary Duty Standard

In undertaking our review as to whether, or in what circumstances, a board can determine not to include a fiduciary out in deal protection provisions without running afoul of its fiduciary duties, we have assumed that the decision to not include a fiduciary out has been made by a committee or board of independent directors advised by independent financial advisors and legal counsel.

In returning to *BCE*, the Supreme Court of Canada held that the fiduciary duty of directors is not confined to short-term profit or value. Further, deference must be given to the decisions of directors provided their decisions are within a "range of reasonable alternatives".[138] Accordingly, where a board has exercised independent, good faith and attentive judgment, after seeking independent advice, and considering all the relevant information, and then has concluded that it is in the best interests of the corporation to conclude a merger agreement with deal protection provisions that omit a fiduciary out, we suggest that, except in very limited circumstances, the law in Ontario would uphold such a decision as not being inconsistent with the proper exercise of the board's fiduciary duty. In arriving at this conclusion, we note the practical reality that, notwithstanding the absence of a fiduciary out, shareholders still possess the right to veto a merger agreement if a superior proposal emerges.[139]

In testing this theory, we will apply it to three assumed fact scenarios:

a) Scenario 1

A special committee of the board is tasked with selling the company. This decision is disclosed publicly. The committee engages independent legal and financial advisors and opens a data room. All persons who wish to access the data room are required to sign standstill/confidentiality agreements. Initial bids are required after two months and the top two bidders advance to the final round. Eleven persons submit indicative bids and the successful finalists engage in additional due diligence and submit final bids. The winning bidder insists on a force-the-vote clause and there not being a fiduciary out, but has no concerns with the company being provided with a window shop clause and the right to change the board's recommendation if, for among other reasons, a superior proposal emerges. However, the target has no right to terminate the merger agreement upon a change of recommendation. The transaction is to be effected pursuant to a plan of arrangement and is supported by a fairness opinion obtained by the special committee. The company has no shareholders who hold more than 5% of its issued and outstanding voting shares.

[138] *BCE, supra* note 103 at para 40.

[139] As was the case in *Omnicare*, having controlling shareholders execute irrevocable support/lock-up agreements, would make a transaction a *fait accompli* and may therefore raise concerns as to enforceability of an agreement without a fiduciary out. However, Canadian jurisprudence supports the proposition that controlling shareholders can seek to defeat or complete a sale of control of a company without regard to the rights or interests of other shareholders. Also, while we acknowledge that the lack of a fiduciary out will make it less likely for a topping bid, topping bids are rare in any event even with fiduciary outs in place. See Fasken Martineau DuMoulin LLP, Canadian Hostile Take-Over Bid Study, 2015.

b) Scenario 2

A company's sole principal shareholder—holding 32% of the issued and outstanding voting shares—approaches the company with an offer to buy the shares it does not own at a 30% premium to the previous 30-day volume weighted average trading price of the shares. A special committee of the board is tasked with responding to this proposal. The committee engages independent legal advisors and two financial advisors: one to provide a fairness opinion as well as a valuation under Multilateral Instrument 61-101 – *Take-over Bids and Special Transactions* ("**MI 61-101**"), and the other to provide financial and strategic advice on the offer and alternative value enhancement strategies. The special committee negotiates an increase in the premium to 40%, and in return the principal shareholder requests and receives the deal protection provisions as outlined in Scenario 1. An agreement is reached and no disclosure is made regarding the company being for sale or the transaction until the merger agreement is signed. The transaction is to be effected pursuant to a plan of arrangement, and the consideration is supported by the independent valuation and fairness opinion. Majority of minority shareholder approval is required under MI 61-101.

c) Scenario 3

A hostile bid is made for all the shares of a company. The target responds by establishing a special committee, which engages independent legal and financial advisors and conducts an auction. The committee rejects the hostile bid as being inadequate at $10 per share. The committee negotiates with the hostile bidder who refuses to increase the bid without first getting access to the data room, but indicates it may be prepared to bid higher. However, the hostile bidder refuses to sign the form of standstill/confidentiality agreement signed by all participants in the auction. The committee concludes that the plans of the hostile bidder are "disastrous" to employees and the communities in which the company operates. After two months of negotiations with third parties through the auction process, the committee and board, on advice of independent advisors, agree to a merger agreement with a white knight, who agrees to make a takeover bid for all the shares at $12 per share. The same deal protection provisions as in Scenario 1 apply. The $12 per share offer is supported by a fairness opinion obtained by the special committee.

As a starting point, we accept that, under Ontario law, the board cannot contract out of its fiduciary duties.[140] However, the "content of this duty varies with the situation at hand."[141] In Scenario 1, the committee undertook a thoughtful process on the basis of independent advice. It is not clear how it could be argued that its determination to not insist on a fiduciary out is outside the "range of reasonable alternatives". The board would no doubt argue that it was reasonable to assume that no bidders from outside of the auction process were likely to come forward and therefore conceding to the purchaser's request to not have a fiduciary out was, from a commercial and practical perspective, of little importance and well within the range of reasonable alternatives.[142] Furthermore, superior proposals are not blocked by the absence of a fiduciary out. In Scenario 1, shareholders would be able to vote against the transaction and the transaction would be subject to court approval.[143]

[140] (ON) Business Corporations Act, *supra* note 107, s 134(3).

[141] *BCE, supra* note 103 at para 38.

[142] The decision of the Delaware Chancery Court in *Synthes* supports this analysis. See note 90.

[143] In seeking court approval of an arrangement under section 192(3) of the *CBCA*, the corporation bears the onus of demonstrating, among other things, that the arrangement is fair and reasonable (*BCE, supra* note 103 at para 137). Determining what is fair and reasonable involves two inquiries. The Court must be satisfied that first, the arrangement serves a valid business purpose and second, it adequately responds to the objections of affected parties: "It is through this two-pronged framework that Courts can determine whether a plan is fair and reasonable" (*ibid* at para 138). The focus of the second prong of the fair and reasonable inquiry is whether the objections of those whose rights are being arranged have been resolved in a fair and balanced way. Thus, the arrangement must strike a fair balance between different constituencies. In undertaking this analysis, courts have identified several indicia of fairness, such as the approval of a majority of security holders entitled to vote, the proportionality of the impact on affected parties, and the repute of the directors and advisors who espouse the arrangement and its terms. Among these factors of particular importance in support of a finding that the proposed arrangement is fair and reasonable, is a favourable vote of informed shareholders (*BCE, supra* note 103 at para 150; *Magna International Inc., Re* 2010 ONSC 4685 at paras 56, 64–66 [*Magna*]). For example, in *Magna*, the Divisional Court held that the vote could reasonably be regarded as a proxy for the substantive fairness and reasonableness of the arrangement: "It is enough if there is credible evidence that shareholders could reasonably conclude that the perceived benefits equal or outweigh the costs of the arrangement" (*ibid* at paras 57, 64). Moreover, where the corporation provides disclosure and information sufficient to permit shareholders to make an informed decision as to how to vote on the proposed transaction, a court may conclude that an arrangement is fair and reasonable "based upon a determination of the relative probable substantive costs and benefits of the proposed arrangement coupled with a favourable vote by informed shareholders resulting from a procedurally fair and reasonable process" (*ibid* at paras 65).

Further, a bright line test that requires a fiduciary out has been rejected by the Delaware Chancery Court post-*Omnicare*[144] and appears to be a test not supported by any Canadian jurisprudence. In *Ventas*, the Court accepted that the board may undertake actions to enhance value notwithstanding that its impact could, after the fact, produce a lesser value to shareholders.[145] The enforcement of a standstill against a third party making a superior proposal, as in *Ventas,* or the enforcement of a "potent" "don't ask don't waive" provision, as in *Ancestry,* strikes us as a far more difficult proposition than enforcing deal protection provisions without a fiduciary out.

It may be argued that the right of shareholders to approve a transaction should not assist the board if it has authorized a process that is otherwise flawed. After all, the board's decision to not impose a fiduciary out may lessen the chance of a superior proposal emerging. However, to the extent the shareholders are properly informed through disclosure documents and are not coerced in the voting process, the prejudice to shareholders is not evident. Also, as in *Omnicare*, a superior proposal may emerge notwithstanding the lack of a fiduciary out provision.

Scenario 2 is more problematic in that an auction process has not been undertaken. However, the consideration agreed to is supported by an independent valuation and fairness opinion. Also, the committee negotiated an increase in the consideration in return for not having a fiduciary out. Further, the transaction would be subject to both court and disinterested shareholder approval. We would expect that a court would uphold the board's decision as being clearly within the "range of reasonable alternatives". The significant block to a superior proposal is the negative control position held by the related party, not the terms of the deal protection provisions in the merger agreement.

As the board in Scenario 3 is faced with a contested transaction, a detailed factual analysis is required. In *BCE*, the Court held that the "fiduciary duty of the directors to the corporation is a broad, contextual concept."[146] As a result, the "range of reasonable alternatives" will vary "with the situation at hand".[147] We expect that the latitude given to directors would likely change depending on the nature of the conflicts facing the directors. For example, if non-independent directors are making determinations, the level of deference will likely be lowered.[148] In the circumstances of Scenario 3, where there is the "omnipresent spectre" of conflict, we would expect that, as a practical matter, less deference would be accorded to directors, without the need to adopt *Unocal*. Put another way, the "range of reasonable alternatives" should be narrowed. As a result, we would expect that in Scenario 3, a board's action will be subject to more scrutiny.

Ultimately, though, to the extent the board acted in good faith and did not believe that it could reasonably obtain a proposal from the hostile bidder that was superior to the white knight's offer without the disclosure of confidential information on a basis not reasonably acceptable to the board, then we would suggest that the board's position would be upheld. Once again, we would suggest that a critical factor is that shareholders could reject the white knight offer by not tendering to it if the hostile bidder produced a superior proposal. To the extent that the board did not enter into the merger agreement for the purpose and with the effect of thwarting a higher bid expected from the hostile bidder, or making it more difficult for such a bid to be made, we would expect that the actions of the board would withstand judicial scrutiny.

C. Application of the Oppression Remedy

A shareholder of a target company could argue that it has been oppressed by a board that has not required a fiduciary out. To maintain a claim for oppression, the complainant must show not only the existence of a defeated reasonable expectation, but that the failure to meet that expectation involved unfair conduct and prejudicial consequences, amounting to "oppression," "unfair prejudice," or "unfair disregard" of relevant interests.[149] In deciding

[144] *Toys "R" Us, supra* note 26, *Synthes, supra* note 19 and *Ancestry, supra* note 95. Also, if *Omnicare* and other Delaware decisions were to review the legality of deal protection provisions without fiduciary outs under the business judgement rule, rather than under the enhanced scrutiny standard, we expect that, under Delaware law, there would clearly be no need for fiduciary outs.

[145] Recall the Ontario Court of Appeal held that a company had an obligation to maximize value in a sale of a company.

[146] *BCE, supra* note 103 at para 38.

[147] *Ibid*.

[148] Note that the Court in *BCE* was not faced with a contested transaction for control.

[149] *BCE, supra* note 103 at para 89.

whether a reasonable expectation exists, the courts are likely to consider general commercial practice and general industry practice.

In light of the fact that it is standard practice for fiduciary out provisions to be included in merger agreements in Canada, it could be argued that it is a reasonable expectation to include such provisions. However, even if this argument is successful, it is not clear how the absence of a fiduciary out can amount to oppression, unfair prejudice or unfair disregard of relevant interests. The compensable injury which this equity relief was designed to address appears to be missing. Again, the lack of a fiduciary out does not prevent a superior proposal and in fact would add very little costs—other than the costs of delay in waiting for the vote at a shareholders' meeting assuming that the bidder did not want to or could not pursue a takeover bid made directly to the shareholders of the target—to a third party bidder. Unless a board engages in conduct that would work to significantly deter another offer or seeks to entrench itself, it is not clear how in the context of all three Scenarios the board could be subject to sanction under the oppression remedy.

We expect that although there may well be circumstances when conduct that is not a breach of a board's fiduciary duty may be held to be oppressive, it would not be with respect to the failure to include a fiduciary out.

D. If No Fiduciary Outs, What are the limits?

Our position against the need for fiduciary outs is not intended to be pro-purchaser/bidder. We are of the view that, if a target has more freedom to negotiate deal protection provisions, it can create greater value for the company and its shareholders. In any event, it is highly unlikely that targets would simply abandon fiduciary outs; for purchasers to obtain deal protection provisions without fiduciary outs, they should have to pay for that privilege.

It is noteworthy that in 2011 and 2012 in the U.S., only 50% of all merger agreements with respect to the acquisition of public companies where consideration was 100% shares had fiduciary out provisions.[150] This is presumably due to the fact that such transactions would generally not be subject to the *Revlon* duty. We would expect that the result would not be much different in Canada if companies and their legal advisors did not treat fiduciary outs as legally required or "market".

We would also expect that in negotiating a merger agreement, the target would, at least initially, insist on the inclusion of a fiduciary out in the deal protection provisions in order to force the purchaser to seek to negotiate it away and to further protect the directors and make it easier for a superior proposal to emerge.

In considering the validity of deal protection provisions that do not contain a fiduciary out, we expect that it will be more important to consider whether the remaining provisions create concerns that would tip the scales in a court's consideration of the validity of such provisions. This invites the question: how far can a target go in conceding rights in the deal protection provisions?

Within the context of deal protection provisions, a target typically has three principal rights, other than the fiduciary out or a right to terminate in limited circumstances: (i) window shop; (ii) right to change recommendation based on a superior proposal, an intervening event or to comply with its fiduciary duties; and (iii) a general right to provide disclosure based on the board's fiduciary duty or applicable legislation. As noted above, one of the principal reasons why we believe the lack of a fiduciary out is unlikely to be sanctioned as a breach of fiduciary duty or as oppressive conduct, is that a change-of-control transaction is subject to the approval of shareholders. However, if such approval was not an informed one, the risk of sanction would be significantly increased.

With perhaps unintended consequences, it would appear that more Canadian merger agreements are containing provisions that do not allow the target board to change its recommendation in favour of the merger agreement.[151] Also, the prevailing practice in Canadian merger agreements is to provide that a recommendation cannot be withdrawn unless in connection with a superior proposal. This could, for example, prevent a change

[150] ABA Study, *supra* note 3.

[151] Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Fifth Annual Edition* (2013); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Sixth Annual Edition* (2014); Blake, Cassels & Graydon LLP, *Canadian Public M&A Deal Study, Seventh Annual Edition* (2015).

in recommendation in circumstances where the target was unexpectedly awarded a large contract, thereby increasing the value of the company, or in an all-share consideration offer where a significant adverse event has occurred with respect to the purchaser.[152] In each of these circumstances, the board is agreeing to limit disclosure and its advice to its shareholders, therefore risking that shareholders will be making a decision that is not informed.

The importance of the right to change a recommendation based on changing facts (other than in response to the receipt of a superior proposal) is likely the principal reason why a majority of merger agreements in the U.S. allow targets to change a recommendation based on "intervening events", which are usually events or circumstances that are material, but unknown (or not reasonably foreseeable) when the merger agreement was signed.[153] This trend has slowly entered the Canadian M&A landscape.[154]

Vice Chancellor Strine, as he then was, at the 2006 33rd Annual Securities Regulation Institute, noted that targets need to have the right to change recommendations for material intervening events and in such circumstances they should be able to address concerns of purchasers by allowing purchasers to terminate merger agreements and receive a break fee:

> If you're going to put out a proxy statement containing a board recommendation 45 days before the vote, and there's a contract that says the board must recommend the deal unless there's a higher bid, and the board really doesn't like the deal and the reason it doesn't like the deal is because something positive happened to the target's business or "you've been … looking for some food and up from the ground came bubblin' crude" … if the board nonetheless recommends the deal, I think it's violated its fiduciary duties … I'd also say that if you are giving advice that puts the board in that predicament, I think that it's kind of dumb advice … This whole thing is better dealt with in the termination fee context, rather than in promising to tell a lie.[155]

Some have argued that disclosure could still be made that sets out the critical facts that have changed, but the target would not need to change the "official" recommendation.[156] With respect to this argument, Vice Chancellor Strine, as he then was, further stated at the 33rd Annual Securities Regulation Institute:

> For those of you who say that you can disclose all the other material facts that suggest why your recommendation is false and then supposedly recommend in favor of the deal, you might remember that a lot of stockholders actually trust you.[157]

In *Genomics*, Vice Chancellor Laster, consistent with prior decisions of Delaware courts, including *In re Compellent Technologies, Inc. S'holders Litig.*,[158] noted as follows:

> Regardless, a board does have an ongoing statutory and fiduciary obligation to provide a current, candid and accurate merger recommendation. A board has an ongoing fiduciary obligation to review and update its recommendation. That's clear from the original Van Gorkom decision. It was the explicit holding of Vice Chancellor Noble in the Frontier Oil Corp. v. Holly Corp. decision[.]
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> …

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[152] We acknowledge that in an all-share consideration transaction a diligent target should, directly or indirectly, include a clause that allows for the termination of the merger agreement if there is a material adverse change in the purchaser. However, events which may not constitute a material adverse change could nevertheless be material and thereby impact a board's recommendation.

[153] Christina M Sautter, "Rethinking Contractual Limits on Fiduciary Duties" (2010) 38:1 Fla St U L Rev 55 at 84-87.

[154] See e.g. ABA Study, *supra* note 3; Patricia A Koval, Andrew Gray & Janan Paskaran, "Fiduciary Outs Are Broadening" (January 2014),Torys: M&A Trends, online: <http://www.torys.com/insights/publications/2014/01/ma-trends-2014-fiduciary-outs-are-broadening>.

[155] Keith A. Flaum, *2007 M&A Deal Points Studies—Public Targets*, 12 No. 2 THE M&A LAW. 1 (Feb. 2008).

[156] In the context of a takeover bid, the target would be required to provide disclosure under securities regulation by the delivery of a notice of change if the information in a prior directors' circular has changed in a manner that would reasonably be expected to affect the decision of a shareholder to accept or reject an offer. See T*ake-Over Bids and Issuer Bids*, MSC, MI 62-104, s 2.11; (ON) *Securities Act*, RSO 1990, c S.5, s 94.3(1); (AB) *Securities Act*, RSA 2000, c S-4, s 175. In connection with plans of arrangement, a similar obligation in connection with management information circulars is usually imposed as part of the interim court order obtained.

[157] *Ibid*.

[158] C.A. No. 6084-VCL (Del. Ch. 2001).

> Maintaining a current and candid merger recommendation is part of the director's duty of disclosure. For that, you can see the Berkshire Realty Company case from 2002[.] … Put simply, Delaware law requires that a board of directors give a meaningful, current recommendation to stockholders regarding the advisability of a merger including, if necessary, recommending against the merger as a result of subsequent events.
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> …
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> Chancellor Allen made the same comment in his 2000 Business Lawyer article where he pointed out, "A board may not suggest or imply that it is recommending the merger to the shareholders if in fact its members have concluded privately that the deal is not now in the best interest of the shareholders."[159]

Genomics and the authorities cited above strongly support the proposition that a board has an ongoing fiduciary obligation with respect to the merger recommendation. To be clear, the quote above formed the basis of the Court's decision to hold that "don't ask don't waive" provisions are *per se* invalid, a position that was rejected by Chancellor Strine, as he then was, in *Ancestry*. However, on this matter Vice Chancellor Laster and Chancellor Strine are in full agreement.

In Canada, it is not clear how a board can properly exercise its fiduciary duty if it cannot change a recommendation which is based on facts and assumptions which are no longer true. The duty of loyalty must, at the very least, impose an obligation on the board to provide shareholders with up-to-date and truthful recommendations, particularly as it relates to the shareholders' sacrosanct right to vote. Accordingly, we would submit that a broader exception to the deal protection provisions pertaining to changing recommendations based on, at a minimum, material intervening events should be a standard clause in merger agreements. To the extent that such a right is absent from deal protection provisions, we would expect that it would be difficult for a board to successfully argue that it has met its fiduciary duty, particularly if a fiduciary out is not present. Ultimately, a target board should ensure that under the terms of a merger agreement it preserves the right to fulfill its obligation to provide a "current, candid and accurate merger recommendation."[160]

Whether it is necessary for a target to have a possibly broader right to change its recommendation if required by the board's fiduciary duties is not as clear. Providing targets with this right appears on its face to provide targets with a right that is not easily defined or subject to objective determination. It may also be suggested that the right of a target to change its recommendation if "required by the board's fiduciary duties" is equivalent to the right to change a recommendation due to material intervening events and, therefore, a clause to give effect to the former is unnecessary. This appears to explain the trend in the U.S. of the broader acceptance of the change in recommendation for intervening events clause. A target's board will no doubt be more inclined to seek the possibly broader right to change recommendations as required by the board's fiduciary duties, while purchasers will seek to limit that right to the more objective standard of material intervening events. We would expect that either clause will be sufficient, except in truly unique circumstances.

[159] *Genomics, supra* note 91 Part II at 16-17.
[160] *Genomics, supra* note 91 Part II at 16.

PART V – CONCLUSION

Based on our review of Delaware jurisprudence, and considered from a Canadian perspective with limited Ontario jurisprudence, we are of the view that a target board may legally, particularly in the context of an uncontested transaction, agree to the demands or requests of a purchaser to not include fiduciary out provisions in the deal protection provisions of a merger agreement in return for appropriate consideration. This flexibility provides a target's board with another method to extract additional consideration or privileges from a prospective purchaser for the benefit of the target.

We would also suggest that the current practice of limiting a board's right to change its recommendation is highly problematic and likely to be in breach of a board's fiduciary duty.

McMillan is a modern and ambitious business law firm serving public, private and not-for-profit clients across key industries in Canada, the United States and internationally. With recognized expertise and acknowledged leadership in major business sectors, we provide solutions-oriented legal advice through our offices in Vancouver, Calgary, Toronto, Ottawa, Montréal and Hong Kong. Our firm values – respect, teamwork, commitment, client service and professional excellence – are at the heart of McMillan's commitment to serve our clients, our local communities and the legal profession.

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