Pill-Popping: Hostile Takeovers and Securities Regulation in Ontario

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"*There seems to be some perverse human characteristic that likes to make easy things difficult*." - Warren Buffett.

Securities regulation in Canada, with its 13 different securities jurisdictions, is sometimes politely referred to as a "*mosaic*". A mishmash might be a more apt description. There is perhaps no area of securities regulation that exemplifies this concept better than the treatment of hostile takeover bids and the resulting adoption of shareholder rights plans, or "*poison pills*," by target companies. Conflicting decisions by Canadian regulators and courts regarding the adoption of poison pills and directors' duties in Canada have done little to assist us.

Target companies involved in a hostile takeover bid may employ a poison pill to dilute the price of their shares, rendering the takeover unprofitable unless the company or its shareholders approve the bid. For example a company may pass a resolution such that a poison pill is triggered once a single shareholder acquires 20 per cent of the issued and outstanding shares of the company, at which point, all *other* shareholders will have the ability to buy new issues of shares at a discount (sometimes called a "*flip-in*").

In Ontario, as in the rest of Canada, both the regulators and the courts exercise jurisdiction over disputes arising from hostile takeover bids and the adoption of poison pills. The result is that the target board in Ontario may be left to fight a battle on two fronts: (a) applications before the Ontario Securities Commission (OSC) to either prevent the bidder from buying more shares of the target company, or to prevent the target company from issuing new shares to dilute their value; and (b) applications before the Superior Court of Justice, most often the commercial list in Toronto. How can the board of directors of a target company manage the risk?

1. AVOID LITIGATION IF YOU CAN

The best strategy is always to take pro-active steps to avoid litigation. If you are on the board of directors of the target company and you are considering defensive strategies to a takeover bid (including the adoption of a poison pill), this means that you should:

(a) set up an independent special committee to consider the takeover bid;
(b) arm the committee with the tools that it needs to make recommendations that are in the best interests of the company and the stakeholders, including hiring outside experts and advisors, if necessary;
(c) obtain informed shareholder approval if the committee recommends that a poison pill or defensive strategy be adopted. Where prior approval of the poison pill or defensive strategy is not possible, subsequent ratification from the shareholders should be sought as soon as possible.

Unlike the United States, where courts will allow a board of directors to "*just say no*" to a hostile takeover bid, the traditional rule in Ontario has been that poison pills were permissible only to the extent that they were a short-term measure used to facilitate an auction for other bids. Recent decisions by the OSC, including its 2009 findings in *Neo Materials Technologies Inc*., have called this traditional rule into question. It appears that the adoption of a poison pill on an indefinite basis is now possible, though more likely to attract scrutiny from the OSC. As a board of directors of a public company, your primary concern is to act in the best interests of the company. However, in order to prevent a successful attempt to block you from adopting a poison pill, your recommendations and actions should also take into consideration the best ways to maximize shareholder value. Attempts to entrench either the board of directors or current management through the adoption of poison pills are not likely to succeed.

2. FIGHTING A WAR ON TWO FRONTS

Unfortunately, experience tells us that no matter how careful you are, you may still end up in litigation. This is particularly so if you adopt a poison pill to defeat a takeover bid. The prevailing view is that the OSC has the expertise necessary to deal with disputes arising from mergers and acquisitions but, increasingly, parties are also looking to the expertise of the judges for guidance.

If you are the target in a hostile takeover bid, you may apply to the OSC for relief under the *Ontario Securities Act*, to prevent a takeover bid from proceeding where a person or company has failed to comply with the provisions of the *Act*. More commonly, however, it is the bidder in a hostile takeover that will apply to the OSC to prevent the target company from adopting the poison pill. The bidder may also make an application to a court to, among other things, allege that the board of directors of the target company breached its fiduciary duties by recommending to the shareholders of the company that they vote to approve the adoption of the poison pill.

The problem for all concerned is that the decisions of the OSC and the courts are often at odds: while the OSC tends to view the dispute through the prism of shareholder choice and value maximization, the courts will tend to review the target board's actions in terms of their fiduciary obligations to the corporation and what is in the best interests of the corporation.

What is best for the shareholder today is not always what is best for the corporation over time and legal practitioners have argued for more consistency in dealing with the inevitable disputes that arise between target boards on the one hand and bidders and other shareholders on the other. Rather than relying on the conflicting decisions of Canadian regulators and courts, and forcing boards of directors to fight a war on two fronts, it has been suggested that we should adopt a model similar to that in the United States, where such disputes are typically dealt with by specialized judges in traditional courts.

Until then, the reality is that boards of directors that chose to adopt defensive tactics during takeover bids will be subject to scrutiny by both the OSC and the courts.