Recent Rights Plan Decisions:
Understanding the Current Fractured Landscape

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Certainty is acutely valued in the M&A context. Accordingly, an emerging schism among securities regulators in Canada in dealing with the tactical use of securityholder rights plans – known colloquially as "poison pills" – in response to take-over bids is cause for concern. In a pair of recent decisions, securities regulators in Alberta and Ontario broke from Canadian precedent by allowing target boards to effectively use poison pills to block hostile bids indefinitely. But the British Columbia Securities Commission did not follow suit in a subsequent decision. Instead it reaffirmed the more traditional approach to Canadian rights plan decisions, which had established that, in determining whether to set aside a rights plan, the question is not *if*, but *when*, the rights plan should go. All of which has bidders, target company boards and even shareholders asking, "Where do we go from here?"

THE USE OF RIGHTS PLANS IN CANADA

Rights plans are by far the most common defensive tactic employed by target companies in Canada in response to unsolicited, or "hostile," take-over bids. In general terms, rights plans operate such that a take-over bid cannot proceed without triggering massive dilution of the bidder's holdings in the target company, thereby rendering acquisition of the target company uneconomical, unless the bidder either negotiates a "friendly" transaction with the target company or complies with the terms of the rights plan by making a "permitted bid." A "permitted bid" is usually defined as one that remains open for a specified number of days (typically 60) and satisfies certain other conditions designed to ensure that shareholders are not unduly pressured into tendering their shares to the bid.

For tactical reasons, unsolicited bidders commonly decline to comply with the "permitted bid" requirements of a rights plan, opting instead to make a bid that is not a "permitted bid" but is conditional on the application of the rights plan being waived by the target board or otherwise being rendered inoperative by regulatory or judicial order. In the absence of a decision by the target board to waive the application of a rights plan to its bid, often a bidder will apply to the applicable securities commission in Canada to have the rights plan set aside. The bidder typically argues that the plan prevents target shareholders from exercising their rights to accept or reject the bidder's offer. Prior to recent rights plan decisions, targets typically countered that the rights plan provided the target board with time to fulfill its fiduciary obligations under corporate law by seeking value-maximizing alternatives for shareholders. These arguments have traditionally pitted the securities law objective of protecting the rights of target shareholders against the corporate law requirement that directors act with a view to the best interests of the corporation.

Historically, Canadian securities regulators did not explicitly advert to the fiduciary duties of directors in considering applications to have rights plans set aside. Instead, they concerned themselves primarily with the protection of the *bona fide* interests of shareholders of the target company, conceived more precisely as their right to decide, on a fully informed basis, whether to accept or reject a bid. Accordingly, regulators took the position that rights plans were permissible for the purpose of affording the target board a reasonable period of time (generally 45 to 60 days) to evaluate alternatives and pursue other transactions that could maximize shareholder value, after which time they *should* cease to operate. Indeed, until recently, securities commissions in Canada had consistently concluded that the overriding issue was not *whether* the rights plan should be terminated, but *when* it had served its purpose and ought to be set aside. This approach was supported by the pronouncements of the Canadian securities administrators in National Policy 62-202 – *Take-Over Bids – Defensive Tactics*.

NATIONAL POLICY 62-202 AND ITS HISTORICAL APPLICATION

One of the animating principles of National Policy 62-202 is that the shareholders of a target company should ultimately be allowed to make a fully informed decision in respect of any bid made for their shares. Accordingly, National Policy 62-202

makes clear that the commissions "will take appropriate action if they become aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid."

This pronouncement appears to leave no discretion for the board of a target company to use a rights plan to effectively enable a "just say no" response to a take-over bid by keeping the rights plan in place indefinitely. On the contrary, until recently, it had been understood that in every contest for corporate control there comes a time when it is no longer appropriate to use a rights plan to prevent a take-over bid from proceeding. This was the case regardless of whether shareholders had voted to approve the rights plan though notable in all of these cases was that shareholders had never voted on the rights plan during the currency of the bid. In *Chapters* [*Re Chapters Inc. and Trilogy Retail Enterprises L.P.* (2001), 24 O.S.C.B. 1657.], the Ontario Securities Commission (OSC) noted that, although evidence of shareholder support for a rights plan is relevant in determining whether the time has come for the rights plan to go, no level of shareholder support entitles a target board to maintain a rights plan in place indefinitely:

> When shareholders approve a pill it does not mean that they want the pill to continue indefinitely. A company's board of directors is not permitted to maintain a shareholders' rights plan indefinitely in order to prevent a bid's proceeding, but may do so as long as the board is actively seeking alternatives and if there is a real and substantial possibility that the board can increase shareholder choice and maximize shareholder value.

The pronouncements set forth in National Policy 62-202, and the relative uniformity with which securities commissions interpreted and applied such pronouncements, lent predictability to commission decisions regarding applications to cease-trade rights plans. This in turn fostered compromise between bidders and target boards, which were often able to reach settlement between themselves regarding whether the time had come for a rights plan to be set aside without the necessity for intervention by a securities commission.

A NEW LINE OF RIGHTS PLAN DECISIONS: *PULSE DATA* AND *NEO MATERIAL TECHNOLOGIES*

Recent decisions in Alberta and Ontario have potentially shattered the predictability formerly associated with securities commission decisions in respect of rights plans and raised doubt regarding the appropriate use of rights plans as a tactical response to an unwelcome bid.

In *Pulse Data* [*Re Pulse Data Inc.*, 2007 ABASC 895.], the Alberta Securities Commission (ASC) permitted a rights plan to continue in effect, thereby preventing an unsolicited bid from proceeding, even though sufficient time had passed for a competing bid to come forth and even though the target company acknowledged that maintaining the rights plan was not directed at gaining time to seek out alternative bidders.

The ASC attached great weight in *Pulse Data* to a shareholder meeting held after initiation of the bid (and only a week before the hearing), at which approximately 75 per cent of the company's shares were voted in favour of maintaining the rights plan. In voting to maintain the rights plan, the ASC held that Pulse Data's shareholders had made an informed decision. The ASC noted that, among the "extraordinary amount of information" that shareholders had been provided in connection with the vote was that "the Pulse Board was very confident about Pulse's future and the continued success of its business plan." Without explicitly saying so, the ASC seemed to view shareholders as having chosen to allow the board to "just say no" to the bid and continue with the existing business plan when they voted to maintain the rights plan. Notably, the ASC expressly deferred to the business judgment of Pulse Data's board, stating that it was reluctant to interfere with the board's decision, given its fiduciary duty to act in the best interest of shareholders, "particularly when that decision had very recently been approved by informed shareholders."

The OSC implicitly approved this reasoning, and cast further doubt regarding the appropriate use of rights plans as a tactical response to an unwelcome bid, in *Neo Material Technologies* [*Re Neo Material Technologies Inc.* [2009 LNONOSC 638, 32 OSCB 6941.]. Not unlike the ASC's decision in *Pulse Data*, the OSC's decision in *Neo Material Technologies* was significantly influenced by a shareholder vote to approve the rights plan in question and by a desire to show appropriate deference to the exercise of business judgment by Neo's board. *Neo Material Technologies* went even further than *Pulse Data*, suggesting that even in the absence of any real possibility of an auction, the public interest may lie in allowing a target board to "just say no" to an unwelcome bid.

The relevant facts before the OSC in *Neo Material Technologies* were straightforward. Pala Investments Holdings Ltd., the bidder, already held approximately 20 per cent of Neo's shares when it launched a partial take-over bid for a further 20 per cent of the shares (it later amended the bid such that it was for only 10 per cent of the shares). Neo had a rights plan in place when Pala's bid was commenced, but subsequently adopted a second "tactical" rights plan designed to thwart Pala's ability to complete a creeping take-over bid. A significant majority of the Neo shares were voted to retain the second "tactical" rights plan.

The OSC inferred that Neo's shareholders, by voting to maintain the second rights plan, were rejecting the Pala bid notwithstanding the absence of any indication of a competing bid. In reaching this decision, the OSC noted that although one purpose of rights plans is to allow a target company to pursue alternative value-enhancing transactions, this was not their only legitimate purpose. Specifically, the OSC, relying upon the Supreme Court of Canada's decision in *BCE Inc.* v. *1976 Debentureholders* [2008 SCC 69] regarding the business judgment rule, held that a rights plan could be used "for the broader purpose of protecting the long-term interests of the shareholders."

The OSC went on to find that it was "evident that, in the view of the Neo Board, avoiding an auction ... was in the long-term best interest of the corporation and of the shareholders, as a whole." Accordingly, the OSC concluded that it was not the time to cease trade the rights plan, based upon the reasonable business judgment of Neo's board that the rights plan was being used to protect the long-term interests of both the company and its shareholders.

RECENT DEVELOPMENTS

In combination, *Pulse Data* and *Neo Material Technologies* potentially expand the range of justifications for using rights

plans as a defensive response to take-over bids beyond simply affording the target board additional time to evaluate alternatives and pursue other transactions that could maximize shareholder value. If the target board exercises proper business judgment and can demonstrate shareholder support for a rights plan in the face of a hostile take-over bid, *Pulse Data* and *Neo Material Technologies* both suggest that a target board may be allowed to use a rights plan to effectively "just say no" to that take-over bid.

If that were the end of the story, there would perhaps be little cause for concern — at least from the perspective of target boards. (Doubtless the situation would be very troubling to potential bidders.) For, while *Pulse Data* and *Neo Material Technologies* represent a significant departure from prior rights plan decisions, they at least appear to establish a discernable new trend in rights plan jurisprudence.

Unfortunately, however, a pair of still more recent decisions has further muddied the waters and made unclear how much leeway, if any, securities commissions will grant target boards in using rights plans to permanently resist change of control transactions.

For starters, the decision of the ASC in *Canadian Hydro Developers* [1478860 Alberta Ltd. (Re), 2009 LNABASC 355, 2009 ABASC 448] has complicated matters by, on the one hand, producing an outcome that is consistent with – and, if anything, even goes beyond – *Pulse Data* and *Neo Material Technologies* while, on the other hand, appearing to retreat philosophically from the position taken by the ASC in *Pulse Data*.

As in *Pulse Data*, the ASC refused in *Canadian Hydro Developers* to set aside a rights plan that was standing in the way of a bid that the target's special committee had rejected as inadequate. In so doing, the ASC "attached considerable importance" to the fact that the plan had been approved by Canadian Hydro's shareholders in advance of the bid. Unlike *Pulse Data* and *Neo Material Technologies*, however, shareholder approval of the rights plan in *Canadian Hydro Developers* had occurred, not in the face of the bid, but over a year before the bid was commenced. There was therefore a considerably weaker basis upon which to conclude that such approval sanctioned a "just say no" response to the bid. Nevertheless, the ASC found that shareholders "had ... the opportunity to make a decision, in advance, relating to take-over bids" and, by approving the rights plan, they had knowingly "accepted the risk that a potential non-[p]ermitted [b]id – even a highly attractive one – might be blocked by the [rights plan]."

In terms of its practical implications, *Canadian Hydro Developers* appears to have gone beyond even *Pulse Data* and *Neo Material Technologies*. Allowing a rights plan to block a bid based primarily upon shareholder approval that was obtained more than a year prior to commencement of the bid comes close to an outright, albeit only implicit, rejection of the OSC's finding in *Chapters* that "[w]hen shareholders approve a pill it does not mean that they want the pill to continue indefinitely."

Yet, whatever the practical implications of *Canadian Hydro Developers*, philosophically the ASC's reasoning in the decision appears to be more closely aligned with that of traditional Canadian rights plan decisions than with the reasoning it had provided in *Pulse Data*. Indeed, rather than explicitly acknowledging the possibility of a "just say no" response to a take-over bid, as the outcome of the decision seemed to imply and as *Pulse Data* seemed to sanction in certain circumstances, the ASC expressly noted in *Canadian Hydro Developers* that shareholders "should not be denied, indefinitely, the opportunity to make decisions about their investment once their company has become the target of an acquisition proposal." Instead, to justify keeping a rights plan in place, there should be "a real and substantial possibility" that continuing the rights plan for a reasonable time could enhance the outcome for shareholders, in terms of choice or "shareholder value." The ASC was satisfied in *Canadian Hydro Developers* that the target board was actively pursuing other options that might serve its shareholders better than the unsolicited bid. Had this not been the case, it seems doubtful that the ASC, given the tenor of its comments, would have allowed the rights plan to remain in place to permanently prevent the bid and permit the target to continue to pursue its business plan. (The ASC subsequently issued an order to suspend the operation of the rights plan after the bidder extended its bid to 60 days and made a second application to have the rights plan set aside.)

A more explicit departure from the recent trend in rights plan decisions established by *Pulse Data* and *Neo Material Technologies* can be found in the April 27, 2010, decision of the British Columbia Securities Commission (BCSC) to cease-trade the rights plan adopted by Lions Gate Entertainment Corp. in response to an unsolicited take-over bid made by Icahn Partners LP and its related funds. At the time of submitting this article for publication, the BCSC had not issued its final reasons in *Lions Gate*. However, the BCSC issued summary reasons on May 6, 2010, to facilitate review by the British Columbia Court of Appeal of Lions Gate's appeal of the BCSC decision (the Court of Appeal ultimately dismissed the appeal).

Among the more interesting features of the summary reasons in *Lions Gate* is the expression by the BCSC of reservations about the *Pulse Data* and *Neo Material Technologies* decisions. Such reservations center around the "apparent departure [of those decisions] from Canadian securities regulators' view of the public interest as it relates to [rights plans] prior to those decisions." The BCSC has promised to elaborate on its reservations in its final reasons.

In the meantime, the BCSC's summary reasons indicate that the principal basis for its decision in *Lions Gate* was the view, traditionally expressed by Canadian securities regulators, that rights plans should not deprive shareholders of the opportunity to respond to a bid by tendering into it. In keeping with this view, the summary reasons reiterate a number of principles historically identified by Canadian securities regulators in determining the public interest as it relates to rights plans adopted by target companies in the context of unsolicited bids. Of particular note is the observation by the BCSC that any reluctance of regulators to interfere with a target board's discharge of its fiduciary duties in the face of an unsolicited bid is tempered by the need to protect the public interest by ensuring that shareholders ultimately have the opportunity to decide whether or not to tender into the bid.

WHERE DO WE GO FROM HERE?

Market participants will undoubtedly be looking for additional guidance from the BCSC in the final reasons it issues in *Lions Gate*. But one thing is certain: we cannot be confident that the *Lions Gate* reasons will neatly tie together past and present rights plan decisions into one coherent package. On the contrary, *Lions Gate* serves to emphasize the *lack* of coherence among the various Canadian securities commissions in the manner in which they approach applications to have rights plans set aside.

Accordingly, market participants will need to develop strategies for dealing with the emerging fractionalization among Canadian securities regulators in dealing with applications to set aside rights plans.

It may be, for example, that potential bidders will respond to that fractionalization by attempting to engage in "forum shopping" in cases where there are credible reasons for making an application to set aside a rights plan in more than one jurisdiction. Given the current status of rights plan jurisprudence, bidders are likely to see the BCSC as more sympathetic to their interests than other securities commissions. Realistically, forum shopping is likely to be available to bidders as a strategy only in rare cases.

Bidders may find it easier to attempt to shift the poison pill debate away from the securities commissions towards the courts. Arguably, courts are better positioned to consider certain legal issues not yet directly confronted in securities commission decisions in respect of rights plans. Among these issues is whether a majority of shareholders, by supporting a rights plan, should be able to restrict shareholders who do not support the rights plan from transferring their shares to a hostile bidder.

As for target boards, the current uncertainty in rights plan jurisprudence indicates that a defensive strategy of seeking shareholder approval for a rights plan in the face of an unsolicited bid is risky. Target boards should reserve this tactic only for situations where they are highly confident of securing shareholder support.

It would not be surprising if institutional investors implement policies to vote against rights plans to ensure to the extent possible that they retain the ability to make important decisions about their investments, including whether or not to dispose of such investments. Otherwise, they risk leaving such decisions to the discretion of a target board in the exercise of its business judgment.

Regardless, the manner in which market participants respond to recent and future developments in rights plan decisions promises to be as interesting as the developments in the decisions themselves.

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