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# Current Trends and Future Opportunities in Corporate Securities Issues-Shareholder Rights Plans

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January 1990

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## 1. INTRODUCTION

Shareholder rights plans or "poison pills" as they are commonly known, have very recently become a prominent feature of the Canadian business environment. The latest introduction of rights plans by Alcan Aluminium Ltd. and Placer Dome Inc. brought the number of such plans which have been introduced in Canada to sixteen. Most of the Canadian companies instituting such measures are large, widely-held corporations whose shares trade in high volumes on the Toronto Stock Exchange and elsewhere. In fact, the corporations with shareholder rights plans currently in place account for over 13% of the weighted TSE 300 index. Given the current rate at which such plans are being adopted and their increasing level of acceptance among the Canadian business community, this number will undoubtedly continue to expand, although given the limited number of widely-held public companies in Canada, one will not see the proliferation that occurred in the United States.

This paper will examine the origins and purposes of rights plans and suggest reasons why they have become so popular in the Canadian context. We will then summarize the major features of plans which have been adopted in Canada. Regulatory considerations with respect to rights plans and their justification and legality will then be examined. Finally, the effectiveness of rights plans in the Canadian context will be considered.

## 2. ORIGINS OF RIGHTS PLANS

In corporate finance, the 1980s were the decade of the corporate raider, the hostile take-over bid, the leveraged buy-out and the junk bond. Rightly or wrongly, target corporations in the United States perceived that many tactics which they considered abusive and unfair were permitted under United States law. These tactics included "street sweeps" (a rapid accumulation of shareholdings in a target corporation through open market purchases or privately negotiated acquisitions not available to all shareholders, generally occurring just after the termination of a tender offer), "greenmail" (a tactic in which an acquiror who has accumulated a large block of shares of the target corporation extracts a premium from the target corporation for the repurchase of the shares by threatening to undertake or facilitate a hostile take-over bid) and "two-tiered, front-end loaded, junk bond financed, bust up acquisitions" (an acquiror makes a tender offer for the shares of the target corporation, acquires the remaining shares of the minority who do not tender into the front end of the bid at a lower price or for different consideration, and finances the take-over through junk bonds which it eventually redeems by breaking up the corporation and selling off its assets). Such tactics led target corporations to develop numerous defensive techniques including the "poison pill".

The term "poison pill" stems from plans originally introduced in the United States, which were designed to have disastrous effects for any acquiror who attempted, by unfriendly means, to take over a target corporation which had instituted such a plan. These original plans were unwieldy and the rights were difficult to redeem. The purpose of these initial plans was to prevent a hostile take-over of the adopting corporation from succeeding and flexibility in the use of the plan was not a major consideration in their design.

These plans were first introduced in the United States in 1983 and have undergone several modifications. Originally, they were designed to combat a second stage transaction which provided minority shareholders with less or different consideration than provided on the first stage. They did so through the issuance of preferred stock or rights to shareholders which allowed shareholders to convert these securities into common shares of the entity undertaking the second stage transaction. A weakness in these initial plans was that they only worked if an acquiror decided to carry out a second stage transaction. If the acquiror was content to remain with its threshold position, the plan would have no effect. Accordingly, variations developed which included the issue of rights to shareholders, which rights could be put to the corporation at a set price in the event that a threshold percentage of shares of the corporation was acquired by one person. In such a case, the securities held by the acquiror were deemed by the plan to be void.

Eventually, the form of rights plan, as we know it in Canada, developed. Essentially, current rights plans allow shareholders of a target corporation to acquire shares of the corporation, or in some cases securities of another entity, at a substantial discount to market in circumstances involving a take-over bid or business combination which is not approved by the board of directors of the target corporation or is not otherwise exempt under the operation of the plan. The person that triggers the exercise of the rights is not allowed to exercise rights owned by that person as the plan deems that person's rights to be void. If the rights are exercised, the shares owned by the person who triggered the rights plan would be substantially diluted and the price of the corporation's shares would drop substantially. The events that allow shareholders of the target corporation to purchase shares of the target corporation or another entity at a discount are known as "flip-in" events and "flip-over" events. We will describe these in more detail when discussing the operation of Canadian plans but essentially they involve the hostile acquisition of a certain percentage of shares of the target by another person or the merging or amalgamating of the target with another person.

Following the decision of the Delaware Supreme Court in *Moran v. Household International. Inc.*, 500 A.2d 1346 (Del. 1985), which removed much of the uncertainty surrounding the ability of a board of directors to adopt shareholder rights plans, the number of plans in the United States of one form or another has proliferated to the point where there art now over 900 companies in the United States with a type of poison pill in place.

Generally, a rights plan has several main aims. First, it is an attempt by the target corporation to ensure that all shareholders are treated equally, i.e. that a bid is made for all shares at the same time. Second, it is an attempt by the corporation's board to ensure that the shareholders receive the highest price for their shares. In the United States, rights plans also force an acquiror to negotiate with the board in acquiring the corporation. As will be seen, most Canadian plans allow an acquiror whose bid meets certain conditions to put its offer directly to the shareholders without having to go through the board.

The first rights plan was not adopted by a Canadian corporation until late 1988. One of the reasons for the delay in Canadian corporations adopting rights plans was that it is much more difficult under Canadian law to carry out some of the tactics used by acquirors in the United States and accordingly it was more difficult to justify rights plans in the Canadian context. As well, the legality of rights plans under Canadian law was and is still in doubt. Finally, given that many Canadian corporations have a majority shareholder the need for plans was less acute. The delay also meant that Canadian corporations were able to profit from the U.S. experience and refinements, and as a result, the rights plans currently in effect in this country contain a much greater degree of uniformity than those in place south of the border.

The first rights plan in Canada was introduced by Inco Limited in October of 1988 amid much controversy. In the proxy circular sent to shareholders of Inco prior to the special meeting of shareholders which was called to approve the rights plan, the Board of Inco cited shareholder protection as the reason for their recommendation that the plan be adopted. The fact that shares in Inco were widely traded on the New York Stock Exchange and the resultant potential for share transactions in one country and not another and the possibility of street sweeps in the U.S. being used to acquire control of Inco was also put forth in support of the adoption of the plan.

The introduction of this plan faced great opposition from some institutional investors, who objected to the transfer of the power to make a determination on the adequacy of a take-over offer from the shareholders of Inco to the directors of the corporation. Another source of objection to the Inco plan was that the shareholder vote for approval of the plan was tied to a special one-time U.S. $10.00 dividend which was only payable upon approval of the plan. This dividend was characterized by some as a bribe to shareholders in order to gain their approval of the plan and was denounced by many observers. Institutional investors were placed in the difficult position of wishing to vote against the shareholder rights plan but at the same time being subject to a fiduciary duty to the investors whose interests they were required to maximize. Despite these objections and complaints from Inco's existing debtholders as to the amount of debt Inco was incurring, the Inco plan was approved by 72% of the corporation's shareholders. A second vote, which took place at the annual meeting and which was in the form of a shareholder proposal to have the board redeem the rights, produced a result which was materially the same, even though that vote was not tied to receipt of the special cash dividend.

The Inco plan was followed soon afterward by a plan introduced by Pegasus Gold Inc. Pegasus Gold had a majority of its shareholders in the United States and the stated rationale of this rights plan was to prevent creeping take-overs (the acquisition of a substantial number of shares in a target corporation through use of take-over bid exemptions) and street sweeps from occurring without all shareholders having the opportunity to obtain a suitable premium for any change in control.

In response to the objections with which the Inco plan had been met, the Pegasus rights plan included a "permitted bid" feature, which has become a standard component of Canadian rights plans. As we will describe later, the inclusion of a permitted bid provision allows shareholders to vote on the acceptability of a take-over offer which meets certain pre-specified criteria. This development was greeted enthusiastically by Pegasus' institutional investors, and 85% of Pegasus' shareholders voting at the meeting voted in favour of the plan.

The introduction of shareholder rights plans continued through 1989, with 12 such plans being introduced last year. These plans have been generally well-accepted by shareholders and all votes considering the adoption of such plans have approved them (with majorities reaching as high as 98%). Popular reasons put forth by target corporations for the introduction of plans have been low share prices relative to underlying corporate value, protection of shareholders from coercive take-over tactics such as creeping take-over bids or bids for less than all the shares and the lack of a major controlling shareholder. Most of the corporations adopting plans have stated that the plans have not been adopted in response to any actual or specifically anticipated acquisition proposal but rather as a precautionary measure.

## 3. OPERATION OF CANADIAN RIGHTS PLANS

### *(a) How Rights Plans Work*

Most Canadian-style plans are designed to result in all cash bids for all shares, to provide shareholders with time to evaluate the bid and to maximize the price shareholders obtain for their shares. As most Canadian plans contain permitted bid provisions which allow an acquiror to put its case directly to the shareholders, it is not possible for the board of a target corporation to use a plan to prevent an acquiror from picking up shares under the bid. The punitive effect of plans occurs as a result of shareholders of the target corporation being allowed to purchase shares in the corporation at a discounted rate (which in Canada has consistently been set at 50%) and nullifying the rights of the acquiring person, thereby significantly diluting the percentage holdings represented by any shares which the acquiror manages to obtain. The practical effect of such plans is to give the directors of a target corporation sufficient time to adequately analyze a tender offer, to negotiate with the bidder, to seek competitive bids and to otherwise employ any action which is deemed necessary. It has been said that plans provide the target corporation directors with "a shield to fend off coercive offers and with a gavel to run an auction" (*CRFT v. Federated Dept. Stores, Inc*., 683 F. Supp. 422 at 439 (S.D.N.Y. 1988)).

Shareholder rights plans which contain permitted bid provisions accomplish the dual objectives of giving the directors of target corporation leverage to combat abusive or coercive take-over tactics in order to obtain the best deal for the target corporation's shareholders while at the same time allowing shareholders to vote on take-over bids which comply with the terms of the plan. By reducing the time pressures often associated with take-over situations which occur in the absence of such plans, the directors of the target corporation are given a better opportunity to solicit or examine competing offers and to make a reasoned and informed recommendation to the shareholders whom they represent. Another argument in favour of the shareholder vote is that it eliminates the problem of the so-called "shareholder stampede" where shareholders tender into a bid not because they think it is the best bid but because they are worried about remaining as minority shareholders.

### *(b) Characteristics of Canadian Plans*

The fact that the Canadian corporate and legal communities have had the opportunity to observe the development of shareholder rights plans in the United States has resulted in a more refined form of plan in Canada and greater uniformity among the plans which have been introduced. There have also been several "made in Canada" adaptations to certain fundamental aspects of the form and operation of plans which have resulted from the different regulatory environment in this country. Major characteristics of the Canadian plans which are currently in place are summarized below.

#### *(i) Form of Security*

Shareholder rights plans are created by the entering into of a rights agreement between the corporation which is adopting the plan and a rights agent, which in Canada has consistently been a trust company. In many respects, a rights agreement is similar to a warrant indenture. Thus, the basis of a plan is contractual in nature.

The rights distributions in Canadian plans have usually taken the form of an issuance of one right for each common share issued and outstanding as at the record time (which is generally on or soon after the date of implementation of the plan). There are no actual certificates issued in respect of these rights; instead they are evidenced by a legend printed on common share certificates issued after the record time but prior to the earlier of the Separation Time (the time at which the rights detach from the common shares and become transferable in their own right) and the Expiration Time (the time at which the rights are no longer exercisable, either due to the termination of the rights pursuant to the plan or the expiration of the plan itself). The rights plans provide that certificates representing common shares that are issued and outstanding at the record time evidence one right for each common share notwithstanding the absence of the legend setting out this fact.

Variations on this format have occurred where the share structure of the adopting company required it, e.g., the corporation has more than one class of common shares or has a class of securities outstanding that is convertible into common shares. For example, the Maclean Hunter Ltd. plan provided that one right be issued in respect of each Class X and Class Y share of Maclean Hunter. This plan was announced in conjunction with the intention of the company to reclassify the outstanding Class X voting participating shares and the Class Y non-voting participating shares into a single class of voting shares on a one-for-one basis.

The Dominion Textile Inc. and Canadian Pacific Ltd. rights plans provided for the issuance of one right for each common share issued and outstanding and one convertible right for each convertible preferred share. The Dominion Textile plan entitles the holder of each convertible right to one right for each whole common share issued to the holder upon exercise of the conversion privilege attached to the preferred share. The convertible right is deemed to automatically have been converted into one right upon the conversion of the preferred share to a common share of the corporation.

The Canadian Pacific plan provides that each convertible right entitles the holder to a fraction of a right equal to the ratio of the value of a preference share to the value of a common share, as at the date immediately preceding the event giving rise to the separation of the rights. This relative value is to be determined by an internationally recognized Canadian investment dealer or investment banker taking into account the attributes of the shares and other matters considered by such dealer or banker to be relevant. Like the Dominion Textile plan, this plan provides that the conversion of a convertible right to a right is deemed to have occurred upon the conversion of the preferred share to a common share. Unlike the Dominion Textile plan, this plan provides for the issuance of fractional rights to holders who convert their preferred shares.

In all Canadian rights plans, prior to a triggering event, the rights are transferable with and only with the shares to which they are attached. After the rights have separated from the common shares, separate rights certificates are issued in respect of the rights by the rights agent which enable the rights to be transferred by themselves. The rights agent is responsible for maintaining a register which records the ownership and transfer of the issued rights.

*(ii) Length of Plan*

Nearly all of the rights plans which have been introduced in Canada have had a life of ten years from the date of implementation. The choice of this term gives the directors a sizeable time frame over which to exercise the powers which are granted to them pursuant to the rights plan while at the same time ensuring that such plans can be reviewed and altered should the needs of the corporation change. Recent plans have had express conditions in the terms of the plans stating that they are to expire on a given date unless confirmed at a meeting of shareholders prior to that time, in which case the life of the plans are extended to the standard ten years. This is because of the requirement imposed by the regulators of obtaining shareholder approval for the plan within a period of **six** months from its adoption.

There have been two exceptions to this ten year term. The shareholder rights plan introduced by Numac Oil & Gas Ltd. was adopted on July 28, 1989 and had a term which lasted until November 28, 1989 and was extendable by the Board of Directors to not later than January 28, 1990. The plan which Numac had adopted was allowed to expire on November 28 of last year, after the easing of tensions between Enfield Corp. Ltd. and Hees International Bancorp Inc. resulted in Numac allowing Hees to name two representatives to its eight member Board. Numac, which was controlled by Enfield, implemented the plan during the struggle for control of Enfield between the management of Enfield and the management of Hees. Numac president William McGregor had stated at the time of implementation of the plan that he wanted the fate of Numac to be determined through negotiations between Enfield and Hees and not by the outcome of a power struggle between the corporations. Since the reason for the introduction of the rights plan no longer existed at the time that it was up for renewal the pill was deemed to be no longer necessary.

The other exception to the ten year standard is the plan which was adopted by Aur Resources Inc. on July 19, 1989 which is not set to expire until September 30, 2004.

*(iii) Separation Time*

The Separation Time is the time at which the rights become "unstapled" from the shares to which they are attached. This date is generally set out as being on or soon after the earlier of the Stock Acquisition Date (the date at which a person becomes or announces an intention to become the beneficial owner of a percentage of shares of the corporation which is greater than the threshold percentage) and the date of commencement of, or public announcement of the intent to commence, a non-permitted take-over bid. Generally, plans provide that where a bid is abandoned, separation is deemed never to have occurred. The more recent plans contain a provision that allows the board of the target corporation, acting in good faith, to defer the Separation Time as they determine necessary. The Canadian Pacific rights plan allows the board to set a later or earlier date for the Separation Time than that which is set out in the terms of the plan. As the rights trade separately on separation, a potential acquiror cannot tender for the shares and accompanying rights but would have to tender separately for the rights. This makes it more difficult to obtain all or substantially all the rights and thus defuse the effect of the plan.

All of the most recently introduced rights plans have an eight or ten day period between the occurrence of the triggering event and the Separation Time. This is desirable from the standpoint of the directors of the target corporation, as it allows them to examine the event which has triggered the separation of the rights and to determine whether or not to waive the application of the plan provisions to any particular flip-in event or to redeem the rights. This "window period" prior to the Separation Time can be used to prevent the separation of the rights in cases where the threshold percentage level of shares has been inadvertently breached or where the directors of the target corporation have been able to come to a satisfactory arrangement with the triggering corporation. A possible downside to a redemption window is that a potential acquiror may go over the percentage threshold with the intention of putting the target corporation into play and this can result in the target being taken over, although not necessarily by the original suitor.

*(iv) Flip-in Event*

The key feature in all plans is their provision for certain events known as flip-in events which when they occur allow all rights holders, other than the person who triggers the flip-in event, to purchase common shares of the corporation at a 50% discount to market. In all of the Canadian plans introduced, the flip-in event is defined as the acquisition of beneficial ownership of voting shares of the corporation equal to or greater than a threshold percentage by a person other than the target corporation itself, or such entities such as a subsidiary of the target corporation, an employee benefit plan or trust. There is also an exception for a person who crosses the threshold percentage as a result of an acquisition or redemption by the target corporation or a subsidiary of the target corporation of voting shares of the corporation which, by reducing the number of common shares outstanding, increases the proportionate number of common shares beneficially owned by the person in question to greater than the threshold percentage.

The percentage chosen as the triggering threshold has varied from a low of ten percent for Canadian Pacific Ltd., Dofasco Inc., and Maclean Hunter Ltd. rights plans to a high of 20.5% for the Canadian Turbo Inc. rights plan (the limit of 20.5% was set to allow equity accounting for parties that wish a substantial investment in Turbo). Many of the plans have "grandfather" provisions, which prevent any shareholders who may already have holdings in excess of the threshold percentage from being deemed to be acquiring persons. Such provisions are necessary in any case where a corporation which wishes to adopt a shareholder rights plan already has a major shareholder whose holdings in the corporation surpass the threshold percentage proposed in any plan. Grandfather provisions are drafted such that the acquisition of any additional shares of the corporation (or any shares beyond an allowed additional percentage) by the grandfathered person would trigger a flip-in event.

*(v) Exercise Price Before Flip-in Event*

The exercise price for the rights on separation but prior to the flip-in event is generally set at a high level relative to the current market value of the common stock of the corporation, rendering the rights of little, if any, value. The exercise price is intended to be an estimate of the maximum trading price of the common shares during the life of the plan and is generally arrived at through consultation with the corporation's investment bankers. For instance, the pre-flip-in exercise price for the rights which attached to the common shares in the Inco plans was set at $100.00 for one common share at a time when the shares of Inco had traded on the TSE at prices between a low of $22-1/8 to a high of $42-1/2 in the previous year (on the last trading day prior to the date of the public announcement of the rights plan, the common shares of Inco were trading on the TSE at $33-3/4 per common share).

*(vi) Flip-over Event*

Almost all Canadian plans adopted to date also provide for flip-over events. Flip-over events have been rather uniformly defined in Canadian right plans. They include a transaction, or series of transactions, whereby the corporation consolidates, merges, amalgamates or is in some other way reorganized in a manner which causes the common shares of the corporation to be reclassified, exchanged, redeemed or changed in some manner. A flip-over event is also constituted by a transaction whereby the company sells, assigns, transfers, leases or in some other way deals with assets which are more than 50% (book or fair market value) of the assets of the corporation or which generated in the last fiscal year or are expected to generate in the current fiscal year more than 50% of the operating income or cash flow of the corporation. (Such assets would not necessarily meet the "all or substantially all" test under the corporation statutes, which when met requires a shareholder vote before such assets can be sold.) An exception is made where any of the above transactions occurs in connection with a wholly-owned subsidiary.

Upon the happening of a flip-over event, it is generally the case that the holders of the rights of the target corporation have the right to purchase shares of the entity (the "flip-over entity") with which the target corporation has been consolidated, merged or amalgamated (or of the merged entity) or to which the target corporation has dealt assets, equal to twice the exercise price for an amount in cash equal to the exercise price. All of the rights plans contain provisions which require the corporation to ensure that the flip-over entity complies with the flip-over provisions of the plan and will issue its shares at a discount. This includes entering into a supplemental agreement in which the flip-over entity agrees to assume all of the obligations, liabilities and duties of the corporation pursuant to the rights plan. The corporation must take all steps within its control to ensure that the flip-over entity complies with such agreement and the terms of the plan.

Not all Canadian plans have provided for flip-over events. It is questionable as to whether a target corporation gains a great deal more protection by having a flip-over event as part of the plan since the type of events that are flip-over events will not take place without the consent of the board of directors of the target corporation. That being the case, if the board approves these transactions, they would redeem the rights before a flip-over event takes place. One advantage to having a flip-over event is that any decision by the directors to redeem the rights so as to permit a flip-over event would have to be made within the parameters of their fiduciary obligations. This is particularly important if a shareholder who acquires control changes the composition of the board so as to facilitate a flip-over event.

*(vii) Redemption Rights and Waiver*

All of the rights plans provide for the redemption of the rights by the board of directors of the adopting company for no or nominal consideration. Such redemption must be made for all and not less than all rights and must be made prior to the occurrence of a flip-in event. The earlier plans generally placed a good faith requirement on the board but this has been eliminated in the more recent versions of the plans. Recent plans also have set a negligible consideration requirement (of $0.01 per right, or less) which must be paid to the rights holders in order to redeem the rights. Some plans also permit the board, until the first to occur of a flip-in event or flip-over event, to waive the application of the plan to a particular event. This provides the board with added flexibility in that it is not actually forced to redeem the rights.

*(viii) Deemed Redemption*

Most of the early plans did not have deemed redemption provisions. This type of provision provides that upon a certain percentage of common shares of the target corporation being acquired under a permitted bid (other than shares already held by the acquiror bidder), the rights are without further formality deemed to have been redeemed by the board of the target corporation. This threshold percentage ranges from 50% in the Falconbridge plan to 90% in the Domtex, Maclean Hunter, Sherritt Gordon and Pegasus plans. This type of provision operates on the theory that at a certain point in time, the directors must cease to stand in the way of an acquiror.

The argument in favour of a 50% threshold is that if a majority of the shareholders have tendered their shares, then the board should redeem the rights. The opposing argument is that if over 50% but **less** than 90% have tendered their shares such that there is still a sizeable minority, removal of the rights would allow an acquiror who has obtained over 50% of the shares to acquire more shares through a creeping take-over bid. The argument in favour of the 90% redemption threshold is that it ties in nicely with the compulsory acquisition provisions of the corporation statutes and that if an acquiror has acquired over 90% of the common shares such that it is entitled to compulsorily acquire the remainder, it should be allowed to do so without being hindered by the rights.

*(ix) Permitted Bids*

The original Inco plan did not contain a provision for a permitted bid. It was this lack of ultimate shareholder capacity to pass judgment on a bid made for all shares of the corporation which was the source of major objections to the plan. All subsequent rights plans except for the Numac plan have contained permitted bid provisions which allow acquirors to make tender offers which do not trigger the activation of the rights. In order to qualify as a permitted bid, Canadian shareholder rights plans require most or all of the following:

- The bid must be a non-exempt take-over bid in compliance with and not on a basis which is exempt from securities legislation in Canada, the United States and any other relevant jurisdiction;

- The bid must be in compliance with all other applicable laws. Some rights plans, such as the Maclean Hunter and Canadian Pacific plans, have included an explicit requirement that the bid or its consummation may not result in the target corporation being in default, or in contravention of any laws, regulations, rules, policy statements, cabinet directions or conditions of licence or franchise relating to a change of ownership or effective control of the corporation. These provisions address the special legislative regimes which these corporations operate under (the *Broadcasting Act* and the *National Transportation Act*, respectively).

- The bid must be made to all holders of voting shares and (in most recent plans) for any and all voting shares;

- Most of the earlier plans called for a fairness opinion from a nationally or internationally recognized investment dealer or investment banker with respect to the fairness of the bid and the adequacy of any non-cash consideration. Several of the more recently introduced rights plans, such as the plan introduced by Sherritt Gordon, have dispensed with this requirement. Given the time and expense involved in obtaining such an opinion, the exclusion of this requirement as a condition of a permitted bid makes the undertaking of such bids a less daunting proposition and is thus less likely to discourage such action. An additional rationale for omitting the fairness opinion is that it is perceived by some target corporations that it would not be very difficult for an acquiror to obtain an opinion that the bid is fair from a financial point of view and accordingly the requirement for a fairness opinion does not serve much of a purpose;

- The bidder must not beneficially own more than 5% of the voting shares of the corporation at the date of the bid or else be a grandfathered person (as we have discussed earlier in this paper). The idea here is not to allow the acquiror to establish a substantial foothold in the corporation before beginning its bid;

- Within a specified time, the bidder must submit a list which sets out all of the voting shares of which the bidder is beneficial owner and undertake to keep the list updated during the course of the bid;

- A condition of the bid must be that no shares will be taken up under the bid unless a resolution is passed by a majority of the votes of non-bidder shareholders voting on whether to accept the offer at a special meeting called for that purpose (earlier plans called for a majority of the votes attaching to all non-bidder shareholders rather than the majority of the votes cast at the meeting);

- The bidder must agree to pay 50% of the costs of the above meeting; and

- The bid must be open for a certain minimum period, which is generally the earlier of ten days after the above meeting or 120 days after the bid has been made (and a minimum five days after the meeting in any event).

Recent plans have added additional conditions such as the undertaking of the bidder not to acquire any additional shares of the corporation during the course of the bid other than pursuant to the bid and the requirement that a bidder provide evidence that it has obtained the financing necessary to take up and pay for the shares under the take-over bid.

This provision for a permitted take-over bid subject to conditions is virtually non-existent in the United States but has developed as a standard feature of Canadian plans. It appears to satisfy institutional investors which were upset at the lack of such a feature in the Inco plan, and in fact the Caisse de Depot, which voted against the Inco plan, indicated that it would abstain on the vote on the Dominion Textile plan which contained a permitted bid feature. A possible variation on the permitted bid plans as they currently stand would be to dispense with the shareholder vote entirely but provide that the rights must be redeemed if over a certain percentage of the shares are tendered into the bid. This type of provision was contained in the Falconbridge plan although the Falconbridge plan was somewhat unique in that it was adopted in the face of Amax's friendly bid for Falconbridge and Noranda's ongoing attempts to acquire control of Falconbridge. From the shareholder's point of view, this variation would probably not substantially lessen the protection otherwise provided to him, although it does not eliminate the problem of the so-called "shareholder stampede" referred to earlier. From the target corporation's point of view, it eliminates the additional time to search out alternatives that a vote under a permitted bid plan allows.

*(x) Exchange Option*

Most of the more recent shareholder rights plans have included an exchange option, which provides that the directors of a corporation may, at their option and at any time after a flip-in event has occurred, authorize the corporation to deliver in return for each right which is not void, debt or equity securities or other assets (or a combination thereof) having a value equal to the exercise price; or in return for the exercise price and the right, such assets having a value equal to twice the exercise price. Some plans only allow the board to utilize the exchange option where the board acting in good faith determines that conditions exist which would eliminate or otherwise materially diminish in any respect the benefits intended to be afforded to holders of rights.

### *(c) Objections to Rights Plans*

Detractors of shareholders rights plans, and there have been many, list several grounds for their objections. The major objection which is cited by such critics is that plans remove the decision as to the sale of control from the shareholders, where it belongs, and give it to the directors of a corporation. Even in cases where there are permitted bid provisions, plans are seen as discouraging bidders from attempting to acquire a given stock. Rather than facilitating an auction for the stock of a target corporation, plans are seen as potentially pre-empting such a bidding war. Critics claim that the directors of corporations which introduce such plans are attempting to entrench their positions rather than uphold the best interests of the shareholders. This view is understandable given the reality that a change in the control of a corporation will often result in the termination of the directors' positions with the company. As such, a conflict of interest exists which is bound to focus attention on the motives of boards which institute such plans.

Other criticisms of rights plans are that the share price of the adopting corporation has a tendency to decrease after the introduction of the plan (this has been the tendency in Canada, although the sample size may be too small to draw conclusions from at this point and, in any event, the price fluctuations have not been great and may be attributable to other factors) and that the plan may in fact serve to put the corporation in play.

## 4. LEGAL CONSIDERATIONS

The regulation of shareholder rights plans in Canada is within the sphere of influence of the provincial securities commissions, the listing stock exchanges, in the case of listed stocks, and the courts. We will examine each of these in turn. When we discuss the relevant judicial considerations, we will first focus on certain U.S. jurisprudence.

### *(a) Regulatory Considerations*

*(i) Provincial Securities Commissions*

There are several issues in connection with the issue of rights which the Ontario Securities Commission (the "OSC") and other provincial commissions have been called upon to consider:

***Shareholder approval***: The creation of a shareholder rights plan involves the distribution of rights to existing shareholders of the adopting corporation and in this respect it is no different than any other rights offering. As such, no shareholder approval is required under either the

*Canada Business Corporation Act* (the "CBCA") or the *Business Corporations Act, 1982* (Ontario) (the "OBCA") and rights plans may be instituted upon authorization by the board of directors of a company. This is in the fact the position in the United States where rights plans are effective upon adoption by the board of directors.

Notwithstanding the absence of this requirement at corporate law, it is an unwritten policy of the OSC that such approval be obtained. Shareholder approval of such plans is also a condition of listing on the TSE. Most Canadian shareholder rights plans have required that the approval be by a simple majority of the shareholders of the corporation, although some plans, such as the one recently instituted by Canada Packers Inc., require that such plan be ratified by a special resolution of the shareholders of the corporation requiring at least 2/3 of the votes cast at a special meeting called to consider the rights plan.

It is the position of the OSC that rights plans may be instituted by resolution of the directors of an adopting corporation so long as a shareholder meeting to approve the plan is held within a reasonable time period, which seems to be three to six months from the adoption of the plan. The OSC is also concerned that shareholders get an opportunity to pass judgment on the merits of a rights plan, and as such, appears to take the position that the shareholder vote to approve such a plan be considered independently from any other resolution. This informal policy is designed to prevent shareholders from being "bribed" into accepting a rights plan by including the plan with a package of favourable proposals.

***Prospectus exemptions***: When plans were first introduced, there was some question as to whether a prospectus was required in connection with the issue of the rights and, if not, which prospectus exemption was applicable. It now appears that the OSC is prepared to accept the proposition that the distribution of rights pursuant to a plan is not a "trade" for the purposes of the *Ontario Securities Act*. This position is in accordance with the treatment given such plans in the United States, but on the surface does not appear consistent with the position taken by the OSC with respect to traditional rights offerings.

The consequences of this view are that corporations distributing rights under a plan do not need to rely on section 71(1)(h)(i) of the *Securities Act* in order to undertake the distribution. This means that the pre-clearance procedure set up by this section is not position that the subsequent prospectus exemption commonly used for the issuance of shares upon the exercise of the rights (section 71(1)(f)(iii)) is not available. Therefore, a prospectus for the issue of shares pursuant to the plan would have to be filed should the rights ever become activated. The position taken by the OSC is difficult to justify under our reading of the statute but given that the purpose of a plan is to deter any need for it ever having to be put into use, this potential requirement should not discourage a corporation which is considering the adoption of a shareholder rights plan. The securities authorities in Quebec and Nova Scotia take the position that exemption orders are needed for the issuance of rights under rights plans applicable, but it also means that the OSC takes the and it is possible that Ontario may eventually rethink its position.

To reiterate, the above regime is premised on the assumption that shareholder approval will be obtained within six months after the adoption of a plan. As adoption of a rights plan would appear to constitute a material change in the affairs of the adopting corporation, most corporations which have adopted a shareholder rights plan have filed a detailed material change report with a copy of the plan attached as a schedule.

**National Policy No. 38**: The applicability of National Policy No. 38 should also be considered. That Policy sets out the views of provincial securities administrators with respect to defensive tactics in response to take-over bids and is applicable in all jurisdictions of Canada. The Policy states that "the primary objective of take-over bid legislation is the protection of the bona fide interests of the shareholders of the target company". In accomplishing this objective, it is stated that the rules governing take-over bids should favour neither the offeror nor the management of the target company but should instead "leave the shareholders of the offeree company free to make a fully informed decision". In order to leave a measure of discretion in the hands of securities administrators, the Policy does not set out a specific code of conduct for the directors of a target company. The Policy does, however, make note of the following factors which will affect the degree of scrutiny to which defensive tactics undertaken during the course of a bid, or immediately prior to a bid if the board of directors has reason to believe that an offer might be imminent, will be subjected:

- The presence of prior shareholder approval of corporate action (which is now required by the Ontario Securities Commission in cases where a shareholder rights plan is being introduced) will, in appropriate cases, diminish the concern of securities administrators;

- The undertaking of extraordinary corporate action including, inter alia, the granting of an option on securities representing a significant percentage of the outstanding securities of the target company;

- The effect of defensive tactics on the ability of shareholders to respond to a take-over bid or to a competing bid.

The Policy recognizes the legitimacy of many defensive tactics (which would include shareholder rights plans) which may be taken by the board of a target company in order to maximize value to shareholders in a take-over bid situation. The Policy states that, "it is only those tactics that are likely to deny or severely limit the ability of shareholders to respond to a take-over bid or a competing bid, that may result in action by the administrators".

It should also be noted that pre-bid defensive tactics may not be governed by the Policy if they are undertaken at a time when no take-over bid is imminently anticipated. Given that most plans have been introduced with no suitor on the horizon, it is our view that National Policy No. 38 is not likely to be applicable to the introduction of most plans.

The Ontario Securities Commission may still attempt to examine the actions of the directors of a target company under National Policy No. 38 in the event of a take-over bid made in the face of a previously implemented plan. At this point in time, no such take-overs have been attempted and it remains to be seen to what extent the OSC will intervene in cases where it feels the directors of a target company are not properly exercising their discretion granted under a rights plan. It is possible that that in so doing, the Commission would judge the actions of such directors in a manner similar to the way in which American courts have used the business judgment rule to review the reasonableness of directors' actions in like cases. This jurisprudence is discussed at a subsequent stage of this paper.

*(ii) Toronto Stock Exchange Requirements*

The Toronto Stock Exchange (the "TSE") constitutes a second level of regulation with respect to shareholder rights plans of corporations whose shares are listed on the TSE. The TSE takes the position that section 19.06 of the Toronto Stock Exchange General By-law applies to the distribution of rights to acquire securities. Under this section, a corporation proceeding with such a distribution must give notice to the TSE and the distribution may not proceed if it is rejected by the TSE.

The TSE has the power under section 19.06 of the By-law to require shareholder approval of a proposal if it deems such approval to be desirable, having regard to the interest of the shareholders of the corporation and the investing public. While this requirement has been redundant since the OSC stated in February of 1989 that it would also require shareholder approval of the adoption of a rights plan, it was the TSE which initially insisted that such a vote take place. When the Pegasus Gold Inc. rights plan was introduced in December of 1988, Pegasus attempted to argue that a shareholder vote for approval of the plan was unnecessary because the permitted bid provision contained in the plan allowed the shareholders to vote to redeem the rights should such a bid ever occur. This argument was unsuccessful, although the TSE did allow Pegasus to limit to some degree the shareholders who could vote on the proposal to prevent opponents of the rights plan from acquiring amounts of stock prior to the vote with the objective of defeating the adoption of the plan.

### *(b) Relevant Jurisprudence*

Many of the legal aspects surrounding rights plans in Canada are largely untested and thus can only be the subject of speculation. Conversely, there is a fairly large body of case law dealing with the legality of rights plans in the United States, which although not of a binding nature would undoubtedly have some impact on any judicial consideration of rights plans in a Canadian context. As such, it is worth undertaking a review of American jurisprudence on the subject prior to examining Canadian legal considerations with respect to such plans.

#### *(i) American Developments*

The legality of rights plans in the United States has largely been decided under state law. This has led to uncertainty with respect to the legality of rights plans because decisions considering the law of different states have come to opposite conclusions as a result of the different wording contained in their corporation statutes and state law precedents.

The *Moran* case (supra) was the first prominent American decision which gave judicial approval to a "flip-over" type of poison pill. The court, in responding to objections to the rights plan stated the following:

- Shareholder rights plans did not have the effect of preventing the success of any and all take-over bids. The rights plan did not even have the effect of preventing all hostile tender offers, as these could still be pursued using various means such as tendering with a condition that the board of directors redeem the rights, tendering with a high minimum condition of share and rights, or acquiring shares up to the threshold level and soliciting proxies for consents to remove the board and redeem the rights, as well as various other means;

- The rights plan did not have the effect of transferring all of the power to pass judgment on a take-over bid from the stockholders to the directors of the corporation. This was because the board did not have unfettered discretion in refusing to redeem the rights. The directors remained under a fiduciary duty to act in the best interests of a corporation as a whole, which would include redeeming the rights in the face of an acceptable tender offer;

- The holder of a proxy is not the beneficial owner of the voting stock and thus the plan did not unduly frustrate proxy efforts by placing a threshold percentage on the amount of shares which could be acquired by one person without triggering activation of the rights.

The court concluded that the actions of the directors in adopting the plan were within the scope of the "business judgment rule", which has developed as the yardstick by which corporate action in the United States is measured. Thus, there was a presumption that the decision to institute the plan was made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. The court also adopted the test formulated in *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946 (Del. 1985) that the directors must show that they had reasonable grounds for believing that a danger to the corporation existed and that upon reasonable investigation they believed in good faith that the institution of the rights plan was reasonable in relation to the threat posed. This was found to be the case given the facts under examination, and the directors' reasonable belief that Household was vulnerable to coercive acquisition techniques. The court also noted that the actions of the board upon the receipt of a take-over bid would be subject to the business judgment rule in the same way as were their actions upon the institution of the plan.

The decision in *Household* opened the door to the introduction of such plans in the United States. The reasoning of the Delaware Court was subsequently followed in several other state court decisions which also upheld the validity of shareholder rights plans. In *Horowitz v. Southwest Forest Industries, Inc.*, 604 F. Supp. 1130 (D. Nev. 1985), a Nevada court declined to issue a preliminary injunction preventing the Board of Southwest Forest Industries, Inc. from instituting a flip-over shareholder rights plan. The court stated that,

> "...the decision to build the value of a company from within, rather than through merger or takeover may be rational exercise of business judgment ... directors actions in averting takeovers will be upheld if reasonable and taken in good faith."

Decisions considering the laws of Michigan (*Harvard Industries, Inc. v. Tyson*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,064 (E.D. Mich., November 24, 1986) and Minnesota (*Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829 (D. Minn. 1986)) have reached similar conclusions.

A decision which reached the opposite conclusion with respect to the adoption of a flip-in/flip-over type of poison pill was *Dynamics Corp. of America v. CTS Corp.*, 805 F.2d 705 (7th Cir. 1986), wherein it was found that the adoption of a poison pill by CTS Corp. had the effect of precluding all tender offers without adequate consideration for the fairness of the tender offer. The Seventh Surrogate Court of Appeals found that the Board of CTS had failed to evaluate the tender offer of Dynamics Corp. in a "cool, dispassionate and thorough fashion", that there had been insufficient investigation by outside directors into the desirability of such a plan, and that the poison pill was triggered at a possibly premature level of ownership (which was 15%). The court stated that it did not hold that all flip-in plans which inflict a penalty based on mere ownership, or even ownership levels as low as 15%, were thereby invalid, but that for the purposes of a preliminary injunction such a flip-in plan, adopted in the heat of a proxy contest, with no identifiable threat other than the vague fears articulated to the court, was unreasonable in relation to the particular threat posed. This decision cast doubt upon the legitimacy of percentage flip-in provisions in American rights plans set at levels below that which confer effective control on the acquiror where the rationale of the adoption of the rights plan was to protect minority shareholders.

The Court of Appeals was later called upon to consider a variation on the rights plan which CTS had adopted in response to the District Court decision with respect to the original rights plan. Although the Court specifically stated that the institution of poison pills was within the power of the board of directors of a company, it noted that it was a further requirement that the institution of such measures be in the best interests of the shareholders of the corporation and not for the purposes of entrenching the management of the corporation. The case was remanded to the District Court to determine whether the exercise price and threshold percentage level which had been chosen under the plan were reasonable in the circumstances.

Recent cases have confirmed the state of the business judgment rule as it applies to rights plans. In *Washington Bancorporation v. Robert B. Washington., Jr.* (Civil Action No. 88-3111 (RCL), September 26, 1989), Judge R.C. Lamberth of the United States District Court for the District of Columbia stated that courts will generally presume that directors of a corporation have acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company and will accordingly not substitute their judgment for that of the board if the latter's decision can be attributed to any rational purpose. Judge Lamberth then went on to apply the following principle which had been set down by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co*. (supra):

> "….because of the omnipresent specter (in the context of a battle for control of a corporation) that a board may be acting primarily in its own interests, rather than those of the corporation and shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."

The Delaware Court went on to find that before receiving the shelter of the business judgment rule, directors of a target corporation who have adopted defensive measures in the face of a pending take-over bid must show that they acted in good faith and with reasonable investigation, and that the measures were reasonable in relation to the threat posed.

It appears that in recent years the case law in the United States in respect of rights plans has undergone a shift in that the real examination no longer goes to the board's ability to adopt a plan but rather to its ability to maintain a plan in place in the face of a take-over bid. To understand this development it is necessary to begin with the Delaware decision of *Revlon, Inc. v. MacAndrews & Forbes Holding,. Inc.*, 506 A.2d 173 (Del. 1986), where the court held that a court should not evaluate the wisdom and merits of a business decision unless sufficient facts are alleged with particularity that the decision was not the product of an informed, disinterested and independent board. However, once a company is "for sale" the role of the board changes from "protectors of the corporate bastion to auctioneers charged with getting the best price for stockholders at a sale of the company." The court stated that the minimum standard set by

Revlon was the most scrupulous adherence to ordinary principles of fairness in that stockholder interests are enhanced, rather than diminished, in the conduct of the auction for the sale of corporate control. This "auctioneer" theme was reaffirmed, if not strengthened, in the recent decision of the Delaware Supreme Court in *Mills Acquisition Co. v. MacMillan, Inc*., 559 A.2d 1261 (1989, Del.). As a result of these decisions, it would appear that where an auction has developed, the board may use a rights plan to obtain the highest price for its shareholders but at some point in time it will have to redeem the rights.

A boards' hands appears to have been further tied by the decision in *Grand Metropolitan plc v. The Pillsbury Company* 558 A.2d 1049 (Del. Ch.). There the board strenuously resisted Grand Metropolitan's overtures and also proposed its own restructuring. The court, in ordering the redemption of the rights, purported to apply the *Unocal* balancing test of whether the plan was reasonable in relation to the threat posed and held there was no threat to the corporate entity or other constituency. The only threat was to the shareholders who could lose the value of the Grand Metropolitan offer. The court was also influenced by the fact that 87% of the Pillsbury shares were tendered into the offer. The court therefore found that the board's decision to keep the plan in place was not protected by the business judgment rule.

At the risk of diverging too far, we should note that under U.S. law, there is still room for independent action by a board in the face of a take-over bid even in the face of the auction cases as evidenced by the recent decision of the Delaware court in paramount *Communications. Inc. v. Time. Inc*. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch.).

Some U.S. courts have also considered the discriminatory aspects inherent in rights plans in that the acquiror is excluded from participating in the plan. For an examination of the manner in which U.S. courts have dealt with the discrimination argument generally, reference can be made to *Providence and Worcester Co. v. Baker* 378 A.2d 121 (Del. 1977) (upholding discriminatory charter provisions), *Asarco, Inc. v. Court* 611 F. Supp 468 (D.N.J. 1985) (invalidating an issue of blank cheque preferred stock as being discriminatory), *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.* 618 F. Supp 407 (S.D.N.Y. 1985) (invalidating blank cheque preferred stock), *Amalgamated Sugar Co. v. NL Industries* (S.D.N.Y. 1986) (holding a rights plan to be ultra vires the corporation statute) and *The Bank of New York Co. Inc. v. Irving Bank* 536 N.Y.S.2d 923 (N.Y. Sup. ct, 1988) aff'd (N.Y. App. Div. Oct. 4, 1988) (holding that a flip-in plan discriminates among shareholders). The chief argument against the plan violating the corporation statutes because of the discriminatory feature is that any restrictions are restrictions upon holders of the securities and not restrictions on the securities themselves. The chief argument in favour of the view that the plan violates the statute is that there is in reality restrictions on the securities and in any event, equality among security holders of the same class is a basic concept of corporate law and any plan which excludes an acquiror violates this principle.

In summary, the following factors have been considered in judicial decisions regarding the legality and/or proper exercise of rights plans the United States:

- State of incorporation: Decisions applying the law of Colorado, New Jersey, Wisconsin and New York have found certain types of plans or provisions thereof to be in violation of the corporate statutes of those states. The principal objection has been to threshold triggering provisions, on the grounds that such provisions illegally discriminate among in shareholders. On the other hand, cases considering the law of Michigan, Minnesota, Nevada and the pivotal state of Delaware have all upheld, or alluded to, the legality of such plans and provisions.

- Circumstances surrounding adoption of plan: The trend of American decisions indicates that shareholder rights plans are less likely to be struck down by the courts if they are adopted at a time when no specific take-over offers are pending. The motives of directors come under much greater scrutiny when plans are adopted in response to an existing tender offer. The rationale behind this principle is that the adoption of a plan is supposed to be as a result of the careful deliberation of the board of directors of a company after a reasonable examination of the business climate and the circumstances of the corporation. American courts have been more likely to find that this is the case where the directors are not operating under the present threat of a hostile offer.

- Threshold percentage chosen: The Court of Appeals in the CTS case stated that "there must be evidence justifying setting the triggering percentage below the level that would give a minority shareholder an actual legal right to block decisions taken by the majority". The court did not state that all threshold percentages which were lower than 50% would be found to be invalid, but did call for evidence from the adopting corporation to justify the percentage which had been chosen as the triggering percentage.

- Circumstances surrounding the use of the plan: Plans have been looked upon favourably in instances where they have been used in order to maximize shareholder wealth by facilitating an auction for the stock of the target company. However, in instances where the board of a target company has not been seen as being receptive to any tender offers, courts have been unwilling to uphold such plans.

- Most importantly and as emphasized previously and demonstrated by Pillsbury, the focus in American litigation over plans has been away from their institution and towards the exercise by directors of the powers of redemption granted under such plans. This provides an additional element to the application of the business judgment rule. As will be seen when examining the principles likely to be applied by Canadian courts, it can be expected that authorities in this country will also be willing to conduct this sort of examination should a plan be challenged in the face of a take-over bid.

In short, it now appears likely that the directors' actions in introducing a plan will be upheld under the laws of most states as coming within the business judgment rule. It appears equally likely that at some point in time a court will call upon a board of directors to redeem the rights in the face of a bid, particularly where a majority of the shares have been tendered into the bid on the theory that the shareholders have spoken. This will particularly be the case where a court decides that the corporation is in the auction mode.

*(ii) Canadian Developments*

As at this date, there has not been any Canadian judicial consideration of the legal validity of shareholder rights plans. In fact, there has been only one action initiated against a rights plan in Canada. This stems from the recent nature of shareholder rights plan in this country and generally the greater reluctance of Canadians to litigate. We will now consider the issues raised by the introduction of rights plans in Canada and the basis for the one current action challenging a rights plan.

The first issue to consider is whether directors have the power to issue rights. This in turn raises the question of the directors' fiduciary duty to the corporation. Section 122 of the CBCA provides that, "every director and officer of a corporation in exercising his powers and discharging his duties shall act honestly and in good faith with a view to the best interests of the corporation; and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances". The OBCA contains a similar provision. These sections codify the long-standing duty of loyalty, good faith and avoidance of conflict of interest which a director owes to a corporation. Directors' actions must be taken on a disinterested and impartial basis and must be based on a reasonable belief and for a rational business purpose.

The situation is complicated by the "proper purpose" test that has been adopted in certain Canadian cases. This test is based on the reasoning that powers granted to directors under corporate legislation are granted for particular purposes and such powers may only be exercised if the directors' primary purpose in exercising the power is the purpose for which the power was granted. Applying this test, some courts have held that the only proper purpose for issuing securities is to raise capital. A typical statement is Lord Wilberforce's observation in *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, (1974] 1 All E.R. 1126 (P.C.) that the ability of directors to:

> "use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred on them."

If one takes this statement at face value, directors could never issue rights under a rights plan. The "proper purpose" test was in fact adopted by the trial division of the Nova Scotia Supreme Court in *Exco Corp. v. Nova Scotia Savings & Loan Co.* (1987), 35 B.L.R. 149.

The "proper purpose" test appears to be somewhat of an anachronism, and given the "best interests of the corporation" standard set out in the corporation statutes for the exercise of directors' duties, it can be strongly argued that it has little place in modern Canadian law.

This view is reinforced in certain decisions where Canadian courts have upheld the validity of defensive measures in take-over bids situation where the directors of a target corporation believe on reasonable grounds that such measures are in the best interests of the shareholders. In *Teck Corp Ltd. v. Millar* (1972), 33 D.L.R.(3d) 288 (B.C.S.C.), Justice Berger of the British Columbia Supreme Court upheld the issuance of a block of shares which was designed to dilute the majority holding which had been accumulated by an acquiror corporation. Justice Berger stated that,

> .. . the directors (of a corporation) ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is

> taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorized as improper".

This case was applied by the Ontario High Court in *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd*. (1986), 59 O.R. (2d) 255, which was affirmed by the Ontario Divisional Court.

Although authorities in Canada have been inconsistent, many recent decisions (with the notable exception of *Exco*) have adopted a modified business judgment rule rather than the less flexible proper purpose test. Under this test, if a court finds that the directors of a target corporation acted in good faith, upon a reasonable apprehension that a potential take-over bid might not be in the best interests of the corporation and its shareholders, and such belief was based on a reasoned evaluation of all relevant information and advice, the directors would be justified in responding to their apprehensions by instituting a defence which was reasonable relative to the harm threatened by the potential take-over bid.

It should be emphasized that even if the business judgment rule is applicable to the introduction of a shareholder rights plan, a foundation must be laid for its use. Accordingly, a board considering the adoption of a rights plan must consider whether it has reasonable grounds to believe that a danger may exist to corporate policy and effectiveness of the corporation or to the interest of its shareholders in the event of a take-over bid. In that respect, the board must consider whether the rights plan is a reasonable response in relation to the threat, if any, posed to the corporation or its shareholders. The board of directors must also consider other available alternatives to protect the interests of the corporation and its shareholders, including the possibility of not taking any action at all. The rights plan, when adopted, should also be approved by the independent members of the board so as to avoid allegations of managerial entrenchment. Finally, to demonstrate that it took into account the proper considerations in adopting a rights plan, the board should consult with its investment bankers, particularly with respect to the possible effect that implementing a rights plan or taking other defensive actions would have on the value and trading price of the securities of the corporation.

Assuming then that the introduction of a rights plan could be upheld as coming within the ambit of the directors' business judgment, the key issue then becomes whether Canadian corporate statutes permit a company to discriminate between shareholders by deeming an acquiror's rights to be void, or whether such provisions are illegal as has been held in certain of the American cases.

The issue of equal treatment of shareholders has been considered in Canada in cases which did not involve a shareholder rights plan. In *Bowater Canadian Ltd. and R.L. Crain Inc*. (1987), 62 O.R.(2d) 752 (C.A.), the articles of incorporation of R.L. Crain Inc. provided for the issue of special common shares which entitled the initial holder to ten votes per share, but the number of votes attached to each share decreased to one vote per share upon the transfer of the special common shares. In upholding the trial court finding that this "step-down" provision was invalid, the Court of Appeal agreed that subsection 24(4) of the CBCA should be interpreted in accordance with the general principles of corporate law with the result that the rights which are attached to a class of shares must be provided equally to all shares of that class. This interpretation was founded on the principle that rights, including votes, attach to the share and not to the shareholder. The court cited subsection 24(5) of the *Alberta Business Corporations Act*, 1981, c. B-15, as reflecting what it took to be the applicable principle of corporate law. This section provides that if a corporation has more than one class of shares, the rights of the holders of the shares of any class are equal in all respects.

Section 24 of the CBCA was also examined in *Jacobsen v. United Canso Oil & Gas Ltd*. (1980), 113 D.L.R. (3d) 427 (Q.B.). The case involved a corporate by-law which restricted the voting rights of shareholders to a maximum of 1,000 votes regardless of the number of shares held. The Court found that the by-law contravened the provisions of the CBCA and was thus invalid since where a corporation has only one class of shares the rights of the holders thereof must be equal in all respects and only when there is more than one class of shares may different rights, privileges, restrictions and conditions attach to various shares.

Given these cases and the conflicting American decisions on point, it is unclear how a Canadian court would deal with the issue of whether or not shareholder rights plans improperly discriminate among shareholders. It is possible to argue that both the Bowater and United Canso decisions deal with the issue of discrimination between shares, while a rights plan is created through a contract and the issuance of rights. Since the rights are issued equally to all shareholders upon the institution of the plan and discrimination can only occur at a later date and only through the privileges attaching to the issued rights, the target corporation could argue that the provisions of the CBCA are not applicable.

An acquiror would no doubt argue that the discrimination with respect to the exercise of the rights is solely on the basis of shareholdings in the corporation and thus there is discrimination between shares. An acquiror could also argue that the discriminatory regime which is set up by a rights plan is contrary to the spirit of the corporate legislation. As well, even if on a technical reading of the statute a rights plan may not offend section 24 as rights are not shares, an acquiror would be able to buttress the discrimination argument through use of the oppression section, as we will allude to shortly. As we have noted, many of the objections to the Inco plan have been addressed in subsequent rights plans, but the shareholder discrimination issue remains relevant to the flip-in/flip-over type of plan which has become the Canadian prototype.

The oppression remedy found in the CBCA and the OBCA may also be used to attack a plan. Under this section, a complainant may apply to a court where the business affairs of the corporation have been conducted or the powers of the directors of the corporation have been exercised in a manner that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, any securityholder, creditor, director or officer. The court to which such an application is made is given a wide discretionary power in making an order to rectify the matters complained of.

This remedy is conceivably available both upon the institution of a rights plan and at the time of a take-over bid. In the first instance, the application could be made by any of the shareholders or creditors of the corporation, including a shareholder, if any, against whom the plan is directed. For example, if a shareholder acquired 18% of the shares and a rights plan was subsequently adopted with a 20% threshold, it would not be difficult for that shareholder to argue that the plan was directed against him, discriminates against him and was designed to prevent him from acquiring further shares of the corporation. Other shareholders could argue that the plan is oppressive in that it might prevent a bid for the corporation being made. The showing of oppressive conduct upon the institution of a rights plan may be difficult for a complainant other than a large shareholder who can allege that the plan is directed against him since there is conflicting evidence as to the effects of such plans. There have been many cases where plans have increased the price which an acquiror has paid for the shares of a corporation and this could be offered in support of the adoption of such a plan. The corporation could also point to shareholder approval of the plan and the effect of section 242 of the CBCA which provides that shareholder approval of the actions of the directors of a corporation, while not decisive, is a factor to be taken into account in deciding whether or not a course of action is oppressive.

In the second instance, an application would most likely be made by the bidder shareholder, or a shareholder who wishes to force the directors of the corporation to redeem the rights pursuant to the terms of the plan. A bidder shareholder would likely argue that the corporation's conduct was oppressive as it discriminated against him and impedes his ability to make or complete his bid. The counterargument is that the corporation's conduct is directed against him qua bidder and not qua shareholder and that the oppression section only covers actions directed against him qua shareholder. In fact, this argument was raised in *Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd.*, (supra). A successful oppression action would also be less likely where a bidder purchased his shares after a plan was in place.

In terms of how a court would apply the oppression remedy to the exercise of powers granted under a rights plan, it is probable that an examination of the operation of the plan and/or the directors' exercise of power under the plan would involve many of the same issues as the breach of fiduciary duty question. No doubt as well, a Canadian court would consider and be influenced by U.S. jurisprudence such as *Pillsbury*. In any event, despite the uncertainty over this issue, the plan would still produce delay and thus maintains its desired deterrent effect. Shareholder approval of the adoption of the plan is unlikely to be extended to excuse conduct of this type which occurs at a subsequent date.

The lone Canadian attack on the adoption of a rights plan has been by the Caisse de Dépot et Placement du Quebec with respect to the shareholder rights plan introduced by Inco. The Caisse is attempting to have Inco's plan struck down on the basis that the CBCA does not authorize the implementation of such a plan. The arguments raised by the Caisse are many of the ones cited above and the provisions of the CBCA which the Caisse cites in its claim are:

- section 24, which provides, inter alia, that where a corporation has only one class of shares, the rights of the holders thereof are equal in all respects (the Caisse claims that Inco's plan is in violation of the spirit of this section);

- subsection 49(9), which prohibits any restriction on the issue, transfer or ownership of the shares of a corporation which are or were a part of a distribution to the public and remain outstanding (the Caisse claims that the plan restricts all three of these actions);

- section 102, which states that the directors of a corporation shall manage the business and affairs of a corporation (the Caisse claims that the power conferred by this section does not include the power to place limits on the percentage of shares which one shareholder may acquire);

- subsection 48(3), which declares that a security is a negotiable instrument.

The key issue in the litigation should be the discrimination point.

One final point we should note is that the Inco litigation will no doubt take years to resolve and until it is resolved, the plan remains in effect. Therefore absent a person challenging the plan bringing an injunction application, the introduction of a plan will buy time for a target corporation.

## 5. EFFECTIVENESS OF RIGHTS PLANS

In summary, we should make it clear that U.S. experience and jurisprudence has demonstrated that a rights plan will not generally prevent the ultimate acquisition of a corporation in the face of a persistent suitor. For example, *Grand Metropolitan* was eventually able to acquire *Pillsbury* after a prolonged struggle even in the face of a rights plan. The rights plan did result in Grand Metropolitan having to eventually increase its offer price but not by a very large percentage.

A rights plan would be even less likely to prevent the acquisition of a corporation in the Canadian context given that almost all Canadian rights plans contain permitted bid provisions which allow an acquiror to put its case directly to the shareholders of the target corporation. Accordingly, the current type of rights plan in Canada, to the extent they are not challenged by an acquiror in the courts, are generally effective in allowing a target corporation's board of directors to obtain a bid for all shares made to all shareholders at a price which is obviously acceptable to the shareholders. This was the effect of the rights plan adopted by Falconbridge which, coupled with a friendly bid by Amax, caused Noranda to make a bid for all shares and abandon its creeping acquisition strategy. Rights plans in Canada may also provide the board of the target with the added benefit of having additional time to consider alternatives to the acquiror as a result of the shareholder vote needed to consider the permitted bid.

The other point that should be emphasized in connection with the effectiveness of rights plans in Canada is that they may not even serve the aims described above. An aggressive acquiror who decides to fight a rights plan in court would have a good argument that they offend the provisions of the corporation statutes or that in not redeeming the rights in the face of a bid, the directors have not satisfied the business judgment rule. As well, an acquiror who does not wish to make a permitted bid may be able to use the compulsory acquisition provisions of the CBCA or OBCA to eliminate the rights if it tenders for the rights and receives over 90% of the rights. It is therefore possible to argue that the protection provided by rights plans is somewhat illusory in the Canadian context.

| Rights Plan | Form of Security |
|---|---|
| Inco | One Right for each common share issued and outstanding prior to the earlier of the Separation Time and the Expiration Time |
| Pegasus | Same as Inco |
| Agnico | Same as Inco |
| Aur | Same as Inco |
| Turbo | Same as Inca |
| Numac | Same as Inco |
| Falconbridge | Same as Inco |
| Domtex | One Right for each common share issued and outstanding prior to the earlier of the Separation Time and the Expiration Time and one Convertible Right for each convertible preferred share issued and outstanding at the Record Time |
| Finning | Same as Inca |
| Can. Pack. | Same as Inco |
| Maclean | One Series X Right for each Class X Share and one Series Y Right for each Class Y Share for all Class X and Class Y Shares issued and outstanding prior to the earlier of the Separation Time and the Expiration Time |
| Sherritt | Same as Inco |
| Dofasco | One Right for each voting share (includes convertible preferred shares) issued and outstanding prior to the earlier of the Separation Time and the Expiration Time. |
| Can. Pacific | One Right for each common share and one Convertible Right for each convertible preferred share for all common and convertible preferred shares Issued and outstanding prior to the earlier of the Separation Time and the Expiration Time. |
| Al can | Same as Inco |

| Rights Plan | Length of Plan |
|---|---|
| Inco | 10 years from October 3, 1988 |
| Pegasus | 10 years from December 5, 1988 |
| Agnico | 10 years from May 10, 1989 |
| Aur | To September 30, 2004 |
| Turbo | 10 years from July 26, 1989 |
| Numac | Expired November 28, 1989 (could have been extended by Board to not later than January 28, 1990) |
| Falconbridge | 10 years from August 1, 1989 Domtex 10 years from August 9, 1989 |
| Finning | 10 years from September 13, 1989 |
| Can. Pack. | To February 28, 1990, unless confirmed at a meeting of shareholders by special resolution - if confirmed, 10 years from September 29, 1989 |
| Maclean | 10 years from October 25, 1989 |
| Sherritt | 10 years from November 23, 1989 |
| Dofasco | 10 years from November 24, 1989 |
| Can. Pacific | 10 years from December 5, 1989 |
| Alcan | 10 years from December 14, 1989 |

| **Rights Plan** | **Separation Time** |
|---|---|
| Inco | Earlier of:<br><br>(a) Stock Acquisition Date (first date of public announcement that person has acquired beneficial ownership of shares in company greater than threshold percentage);<br><br>(b) 10th day after commencement of (or public announcement of intent to commence) non-permitted takeover bid |
| Pegasus | 8th day after earlier of:<br><br>(a) Stock Acquisition Date;<br><br>(b) Commencement of (or public announcement of intent to commence) non-permitted takeover bid OR later date as determined by Board |
| Agnico | Same as Inco |
| Aur | Earlier of:<br><br>(a) Stock Acquisition Date:<br><br>(b) $8^{th}$ day after commencement/announcement of non-permitted takeover bid. |
| Turbo | Same as Pegasus |
| Numac | Earlier of:<br><br>(a) Flip-in date (10th day after Stock Acquisition Date);<br><br>(b) 10th day after commencement of (or public announcement of intent to commence) non-permitted takeover bid |
| Falconbridge | Same as Pegasus |
| Domtex | Same as Inco |
| Finning | Same as Aur |
| Can. Pack | Same as Pegasus |

| | |
|---|---|
| Maclean | Same as Pegasus |
| Sherritt | Same as Pegasus |
| Dofasco | 10th day after earlier of:<br>(a) Stock Acquisition Date;<br>(b) commencement/announcement of non-permitted takeover bid for 10% (or more) of voting shares |
| Can. Pacific | 10th day after earlier of:<br>(a) Stock Acquisition Date;<br>(b) commencement/announcement of non-permitted takeover bid<br>OR later or earlier date as determined by the Board acting in good faith |
| Alcan | Earlier of:<br>(a) 10th day after Stock Acquisition Date;<br>(b) 10th day (or earlier/later date as established by Board prior to Stock Acquisition Date) after commencement/announcement of non-permitted takeover bid |

| **Rights Plan** | **"Flip-in" Event** | **Exercise Price before "Flip-in" Event** |
|---|---|---|
| Inco | Person acquiring beneficial ownership of 20% or more of voting shares (other than the corporation or a subsidiary or by way of a decrease in total number of shares) | $100 for I common share |
| Pegasus | Person acquiring beneficial ownership of 10% or more of voting shares (same exceptions as Inco, plus employee benefit plans, trusts and permitted bids excluded) | $50 for 1 common share |
| Agnico | Same as Inco (exceptions similar to Pegasus) | $80 for I common share |
| Aur | Person acquiring beneficial ownership of 15% or more of voting shares (exceptions similar to Pegasus) | $60 for 1 common share |
| Turbo | Person acquiring beneficial ownership of 20.5% or more of voting shares (exceptions similar to Pegasus) | $3 for 1 common share |
| Numac | Person acquiring beneficial ownership of 10% or more of voting shares (exceptions similar to Pegasus) - Flip-in date occurs 10 days after public announcement of flip-in event | $30 for 1 common share |
| Falconbridge | Same as Aur | $100 for 1 common share |
| Domtex | Same as Inco (exceptions similar to Pegasus) | $60 for 1 common share |
| Finning | Same as Aur | $50 for 1 common share |
| Can. Pack | Same as Pegasus | $50 for 1 common share |

| **Rights Plan** | **"Flip-in" Event** | **Exercise Price before "Flip-in" Event** |
|---|---|---|
| Maclean | Same as Pegasus | \$60 for series X Right,<br>\$60 x <u>Mkt.price of Class Y Shares</u><br>Mkt.price of Class X Shares<br>for Series Y Right |
| Sherritt | Same as Inco (exceptions similar to Pegasus) | \$41 for 1 common share |
| Dofasco | Same as Numac | \$100 for 1 common share |
| Can. Pacific | Same as Pegasus | \$85 for 1 common share |
| Alcan | Same as Inco (exceptions similar to Pegasus) | \$100 for 1 common share |

| Rights Plan | "Flip-over" Event" |
|---|---|
| Inco | (A) Transaction (or series thereof) whereby company consolidates, merges, amalgamates, etc. causing common shares to be changed, reclassified, exchanged, redeemed, etc.; or<br><br>(B) Transaction whereby company sells, assigns, transfers, leases, etc. assets.<br><br>(i) which are more than 50% of assets Nook or fair market value); or<br><br>(ii) which generated in last fiscal year or are expected to generate in current fiscal year more than 50% of operating income or cash flow of company and its subsidiaries (taken as a whole) other than to wholly-owned subsidiary |
| Pegasus | Same as Inco |
| Agnico | Same as Inco except corporation in whose capital Agnico holds more than 5% of voting shares also modifies paragraph (A) (i.e. in addition to wholly-owned subsidiary) |
| Aur | Same as Inco |
| Turbo | None |
| Numac | Same as Inco except "wholly-owned subsidiary" does not modify paragraph (A) |
| Falconbridge | Same as Inco |
| Domtex | Same as Numac |
| Finning | Same as Inco |
| Can. Pack. | Same as Inco |
| Maclean | Same as Inco |
| Sherritt | Same as Inco |
| Dofasco | Same as Inco (but applying to any and all voting shares) |
| Can. Pacific | Same as Inco |

| | |
|---|---|
| Alcan | Same as Inco |

| Rights Plan | Redemption Rights | Deemed Redemption |
| --- | --- | --- |
| Inco | Board at its option and acting in good faith can terminate all (but not less than all) Rights prior to Flip-in event | None |
| Pegasus | Board at its option for all Rights prior to Flip-in event at $0.01 per Right | 90% of common shares acquired under Permitted Bid (other than shares already held by bidder) |
| Agnico | Same as Inco | None |
| Aur | Same as Inco (but without good faith requirement) | None |
| Turbo | Same as Pegasus but at a price of $0.0001 per Right | None |
| Numac | Board at its option can terminate all Rights prior to Flip-in date | None |
| Falconbridge | Same as Pegasus | 50% of common shares taken up and paid for under Permitted Bid (other than shares already held by bidder) |
| Domtex | Board acting in good faith prior to a Flip-in event may at its option redeem all Rights and Convertible Rights at a price of $0.01 per Right | Same as Pegasus |
| Finning | Same as Inco | Same as Falconbridge |
| Can. Pack. | Same as Turbo | Same as Falconbridge |
| Maclean | Same as Pegasus but at a price of $0.001 per Right | Same as Pegasus but with percentage applying to both Class X and Class Y shares as separate classes |
| Sherritt | Same as Pegasus | Same as Pegasus |
| Dofasco | Board at its option can terminate all Rights prior to a Flip-in Event or a Flip-over Transaction or Event | None |

| Rights Plan | Redemption Rights | Deemed Redemption |
|---|---|---|
| Can. Pacific | Same as Domtex but at prices of $0.01 per Right and $0.001 per Convertible Right | Same as Pegasus |
| Al can | Board acting in good faith prior to a Flip-in or Flip-over event may at its option redeem all Rights at a price of $0.01 per Right | None |

| | |
|---|---|
| Inco | None |
| Pegasus | (a) Non-exempt takeover bid in compliance *with B.C. Securities Act* and the *1934 Exchange Act* ("EA") and all other applicable laws; |
| | (b) made to all holders of voting shares wherever resident; |
| | (c) circular to be accompanied by opinion of nationally/internationally recognized dealer/banker re: fairness of bid; |
| | (d) bidder must submit list re: beneficial ownership of voting shares; |
| | (e) no shares taken up unless approving resolution passed by majority of votes attaching to shares held by non-bidder; |
| | (f) bidder to commit to pay 50% of cost of holding shareholder meeting to consider bid; and |
| | (g) bid cannot expire until earlier of: (1) 10 clear business days after the above meeting; or (ii) 120 days after bid (minimum 5 days after meeting in any event) |
| Agnico | (a) Non-exempt takeover bid in compliance with the *Ontario Securities Act* ("OSA") and all other applicable laws; and |
| | (b) (b) Pegasus subparagraphs (b), (c), (d), (e), (f) and (g) |
| Aur | (a) Agnico subparagraph (a) and Pegasus subparagraphs (d), (a), (f) and (g); |
| | (b) made to all holders of voting shares in Canada (and in U.S. If U.S. shareholders hold 20% or more of voting shares); |
| | (c) fairness opinion from independent Canadian investment dealer/banker |
| Turbo | (a) Agnico subparagraph (a) and Pegasus subparagraphs (b) and (d); |
| | (b) majority vote at shareholder meeting must only be of votes cast, not votes outstanding; |
| | (c) bidder must pay Turbo $250,000 within 2 days of bid to cover expenses of meeting, etc.; and |
| | (d) bid cannot expire until earlier of: (1) 10 clear business days after shareholder meeting; (ii) 90 days after bid (minimum 5 days after meeting in any event) |
| Numac | None |

| | |
|---|---|
| Falconbridge | Non-exempt takeover bid pursuant to OSA and EA made to all shareholders for all outstanding common shares |
| Domtex | (a) Non-exempt takeover bid in compliance with OSA, EA and other applicable laws; b made to all holders for any and all voting shares;<br><br>(b) made to all holders for any and all voting shares;<br><br>(c) bidder does not beneficially own more than 5% of voting shares (or is a grandfathered person); and<br><br>(d) Pegasus subparagraphs (c), (d), (f) and (g) and Turbo subparagraph (b) |
| Finning | (a) Pegasus subparagraphs (a), (d), (e), (f) and (g) and Domtex subparagraphs (b) and (c); and<br><br>(b) no shares taken up if Board determines that agreements/relations with suppliers w 11 be adversely affected |
| Can. Pack. | Takeover bid made (by a person who does not own more than 5% of common shares) for all outstanding common shares in compliance with applicable laws and under which no shares may be taken up prior to close of business on December 15, 1989 |
| Maclean | (a) Agnico subparagraph (a), Domtex subparagraph (b) and Pegasus subparagraphs (c)-(g); and<br><br>(b) bid must not affect compliance with laws, policies, etc. re: ownership restrictions (eg. *Broadcasting Act*) |
| Sherritt | Domtex subparagraphs (a) and (b), Turbo subparagraph (b) and Pegasus subparagraphs (f) and (g) |
| Dofasco | Same as Domtex except majority vote at shareholder meeting must be of non-bidder votes outstanding and the bidder must demonstrate the ability to pay/deliver any cash/non-cash consideration. |
| Can. Pacific | Same as Domtex except: (a) only time limit on bid is 5 days after shareholders meeting; (b) bid must not affect compliance with laws, policies, etc. re: ownership restrictions (eg. *National Transportation Act*); and (c) bid must provide evidence as to ability to pay consideration required to take up shares |
| Alcan | (a) Domtex subparagraphs (a) and (b), Pegasus subparagraphs (c), (d) and (f) and Turbo subparagraph (b);<br><br>(b) bidder owns 5% or less of voting shares as at date of bid, and has not disclosed any intent related to control of Alcan while owning greater than 5% of the then outstanding voting shares at any time in the year preceding the bid;<br><br>(c) bid cannot expire earlier than 10 business days (and shares must be taken up and paid for within 20 business days) after shareholder meeting and<br><br>(d) circular must state that the necessary financing has been obtained and that no share will be acquired during bid except pursuant thereto |