Revue de droit de l'Université de Sherbrooke

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Volume 21, Number 1, 1990

URI: https://id.erudit.org/iderudit/1108582ar
DOI: https://doi.org/10.17118/11143/13435

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Publisher(s)

Revue de Droit de l'Université de Sherbrooke

ISSN

0317-9656 (print)
2561-7087 (digital)

Explore this journal

Cite this article

Bernier, J.-F. (1990). SHAREHOLDERS' RIGHTS PLANS - THE POISON PILL IN THE U.S. AND CANADA: BACKGROUND AND LEGAL CONSIDERATIONS. *Revue de droit de l'Université de Sherbrooke*, *21*(1), 123–207. https://doi.org/10.17118/11143/13435

Article abstract

In anticipation of the Quebec Superior Court's ruling on the Caisse de dépôt et placement's judicial challenge to the first Canadian prescription of the "Poison Pill" defense mecanism by Inco Ltd.'s board of directors in late 1988 to alter unwelcomed take-over attempts, the author examines, in the first part of his study, the origin and the various legal considerations surrounding the U.S. developped remedy. In the second part, the author focuses on the prevailing Canadian legal environment from both a corporate and securities standpoint to question the legal validity of the "Poison Pill" in light of its growing popularity as the medication of choice for Canada's directors who whish to insure their preservation of corporate control.

SHAREHOLDERS' RIGHTS PLANS - THE POISON PILL IN THE U.S. AND CANADA: BACKGROUND AND LEGAL CONSIDERATIONS

par Jean-François BERNIER*

In anticipation of the Quebec Superior Court's ruling on the Caisse de dépôt et placement's judicial challenge to the first Canadian prescription of the «Poison Pill» defense mecanism by Inco Ltd.'s board of directors in late 1988 to alter unwelcomed take-over attempts, the author examines, in the first part of his study, the origin and the various legal considerations surrounding the U.S. developped remedy. In the second part, the author focuses on the prevailing Canadian legal environment from both a corporate and securities standpoint to question the legal validity of the «Poison Pill» in light of its growing popularity as the medication of choice for Canada's directors who whish to insure their preservation of corporate control.

En prévision de la décision que doit rendre la Cour supérieure du Québec au sujet de l'action de la Caisse de dépôt et placement en contestation de la première «pilule empoisonnée» canadienne qu'a administré le Conseil d'administration d'Inco Ltd. à la fin de 1988 aux éventuels initiateurs d'une prise de contrôle, l'auteur examine, dans la première partie de son étude, l'origine et le contexte juridique de ce recours né aux Etats-Unis. Dans la seconde partie, l'auteur porte son attention sur les facteurs juridiques du point de vue des sociétés et des valeurs mobilières qui prévalent au Canada et remet en cause la légalité de la «pilule empoisonnée», à la lumière de sa popularité croissante comme remède de choix pour les administrateurs canadiens qui désirent conserver le contrôle de leur société.

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1. INTRODUCTION

The take-over phenomenon, in recent years, has generated the transfer of control of some of America's largest corporations and has literally affected the whole capital market system. The price tag on the RJR Nabisco transaction, close to $25 Billions (U.S.) has opened the door to take-overs of considerable magnitude. Considering that Bell Canada Enterprises, one of the few publicly-held Canadian companies without a dominant shareholder, could be taken over for less than $12 Billions (Can.), the Canadian financial community is thus watching U.S. developments in take-over defense strategies with great interest[1]. Therefore, it is interesting and relevant to examine, in this context and from a canadian perspective, the various take-over bid defensive measures which have proliferated in recent years in the U.S.

One U.S. Court has commented that contests for corporate control are being «waged with the intensity of military campaigns and the weaponry of seemingly bottomless bankrolls»[2].

The retiring Chairman of the U.K. take-over panel which plays the regulatory role of British take-over bids recently commented that take-overs are: «currently a high profile activity, attracting not only the involvement of businessmen, of bankers and of investors, but one that has increasingly become the stuff of political controversy and public curiosity. [Take-over bids] raise issues of economic efficiency, management responsibility and personal ethics that can have consequences for those who do not own the companies concerned: employees, customers, sometimes the regions in which the target company operates»[3].

In North America, take-over bids have become the most common transactions in corporate control and, their proliferation has brought about the development of new strategies to both facilitate take-over attempts and defend against them.

An increasing number of take-over bids are being resisted by the directors of the target companies who have developed a wide range of

1. «Inco's move started wheels turning in Canadian boardrooms» The [Toronto] Globe and Mail (12 December 1988) B17.
2. *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F. 2d 255, (1984), 258.
3. «The Right Way To Regulate The Market», The [London] Economist (23-29 September 1989) 21.

defensive measures against such unsolicited take-over bids[4]. An examination of the arsenal of defensive measures available to the management of a target company[5] and of the debate over the propriety of such defensive measures as a means of corporate control is however beyond the scope of the present study.[6]

4. The term «take-over bid» is used interchangeably throughout the present text with its American equivalent, «tender offer». The term «take-over bid» is defined in the *Québec Securities Act*, R.S.Q., c. V-1.1, as amended, at s. 110 as an offer to purchase for cash voting or equity securities of a company whereby the person proposing the bid would obtain or increase his interest of 20% or more of the outstanding securities of that class of securities at the date of the offer to purchase. The term "tender offer" is not defined by American federal legislation and as a result, U.S. Courts have formulated their own definition. See for example *S.E.C. v. Carter Hawley Hale Stores, Inc.*, 760 F. 2d 945 (1985) where the court found that the existence of a tender offer is determined by the following factors: (1) active and widespread solicitation of public shareholders for shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed maximum number of shares to be purchased; (6) offer open only for a limited period of time; (7) offeree subjected to selling pressure; and (8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of a large amount of a target's securities.
5. For general comments on various defensive measures see L. Serafini, «Survol des tactiques défensives» in *Meredith Memorial Lectures* (Cowansville, éd. Yvon Blais, 1987) 141. See also W.F. Brown, «Corporate Defenses to Takeover Bids» (1970) 44 *Tulane L. Rev.* 517; S.L. Hayes and R.A. Taussig, «Tactics of Cash Takeover Bids» (1967) 45 *Harv. Bus. Rev.* 135; E.C. Schmults and E.J. Kelly, «Cash Takeover Bids - Defense Tactics» (1967) 23 *The Business Lawyer* 115; D.S. Bradshaw, «Defensive Tactics Employed by Incumbent Managements in Contesting Tender Offers» (1969) 21 *Stan. L. Rev.* 1104; S.A. Hochman and O.D. Folger, «Deflecting Takeovers: Charter and By-law Techniques» (1979) 34 *The Business Lawyer* 537; G.C. Lynch and M.I. Steinberg, «The Legitimacy of Defensive Tactics in Tender Offers» (1979) 64 *Cornell Law Rev.* 961.
6. There is wide array of literature on this subject. See F.H. Easterbrook and D.R. Fischel, «The Proper Role of a Target's Management in Responding to a Tender Offer» (1981) 94 *Harv. L. Rev.* 1161; F.H. Easterbrook and D.R. Fischel, «Takeover Bids, Defensive Tactics and Shareholders' Welfare» (1981) 36 *The Business Lawyer* 1733; F.H. Easterbrook and D.R. Fischel, «Auctions and Sunk Costs in Tender Offers» (1982) 35 *Stan. L. Rev.* 1; M. Lipton, «Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel» (1980) 55 *N.Y.U.L. Rev.* 1231; R.J. Gilson, «A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers» (1981) 33 *Stan. L. Rev.* 819; R.J. Gilson, «The Case Against Shark Repellent Amendments: Structural Limitations on The Enabling Concept» (1982) 34 *Stan. L. Rev.* 775; R.J. Gilson, «Seeking Competitive Bids versus Pure Passivity in Tender Offer Defense» (1982) 35 *Stan. L. Rev.* 51; L.A. Bebchuk, «The Case for Facilitating Competing Tender Offers» (1982) 95 *Harv. L. Rev.* 1028; L.A. Bebchuk, «The Case for Facilitating Competing Tender Offers: A Reply and Extension» (1982) 35 *Stan. L. Rev.* 23; L. Lowenstein, «Pruning Deadwood in Hostile Takeovers: A Proposal For Legislation» (1983) 83 *Columbia Law Rev.* 249; E.F. Greene and J.J. Junewicz, «A Reappraisal of Current Regulation of Mergers and Acquisitions» (1984) 132 *U. of Penn. L. Rev.* 647; Matheson and Norberg, «Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities» (1986) 47 *U. of Pitt. L. Rev.* 407.

Instead the following study will examine in detail the background and the various legal considerations behind one of the newer mechanisms designed to alter unwelcomed bids euphemistically known as the Shareholders' Rights Plan. Since its creation in December 1982 by take-over lawyer Martin Lipton[7], the poison pill has made its way into the corporate landscape of close to 1,000 American companies. In Canada, dozens of companies have adopted or announced their intention to implement a shareholders' rights plan.

Such a mechanism was conceived to respond to a less regulated mergers and acquisitions environment in the U.S. that allows such things as «two-tier front-end loaded junk bond financed bust-up acquisitions», «street sweeps» and «greenmail»[8].

What was thus needed was a defensive strategy which would: (i) discourage coercive or unfair hostile offers; (ii) delay a bidder in order to provide the target with an opportunity to encourage a competing offer or to structure a competing transaction (i.e. a recapitalization, a leveraged buy-out or an offer from a «white knight»); (iii) avoid the sale of «crown jewels», the bust-up of the target or other destructive defensive strategies prevalent in the U.S.[9]

Poison pill plans are designed to be used as a dilatory tactic, hence providing the target's board of directors with the necessary leverage to negotiate a more favourable arrangement by forcing a hostile bidder to come to the bargaining table[10]. They are now the predominant and most

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7. The Poison Pill was originally conceived in connection with El Paso's defence strategy against a hostile take-over bid from Burlington and Northern Railroad. See J.G. MacIntosh, «The Poison Pill; A Noxious Nostrum for Canadian Shareholders» (1989) 15 *Can.Bus.L.J.* 276, n.l.
8. See G. Coleman, «Poison Pills in Canada» (1989) 15 *Can.Bus.L.J.* 1 at 3 (explaining the meaning of these respective terms as a «two-step transaction where an acquiror makes a cash take-over bid for over 50% of a target company's shares followed by a second-step merger where the remaining shareholders are squeezed out at a lower-valued consideration (hence the «front-end loading»). The transaction is financed with high-yield junior debt («junk bonds») to be paid off (or down) by the sale of assets or subsidiaries of the target (the «bust-up») after the merger is completed». A «street sweep» is the rapid accumulation of a huge block of stock accumulated in one day on the open market by corporate raiders in the U.S. «Greenmail» is blackmail of a higher financial order and works as follows: a significant number of shares of a company is acquired in the market. The acquiror then threatens a take-over bid or a proxy fight in order to force the company to buy the shares back at a premium. See also text, *infra*, section 4.2(B)(2): Justifying the implementation of a shareholders' rights plan: Regulatory Issues.
9. J.E.A. Turner, «Inco Limited - The First With A Pill», (Tory, Tory, Deslauriers & Binnington; Toronto, November 25, 1988) [unpublished].
10. H.T. Lacroix, «Reflections on Poison Pills in Canada», (Colloque sur les mesures défensives en matières d'offres publiques d'achat, Quebec City, 25 September 1989) [unpublished].

effective defensive strategy available to U.S. corporations and they come in a variety of forms which will be discussed in the following pages[11]. But, whichever particular forms are adopted, the basic objectives of such plans are to deter abusive take-over tactics by making them unacceptably expensive to the prospective acquirors and, to encourage an open negociation with the board of directors of the target company by making the rights issued pursuant to the plan redeemable.

Ideally, poison pill plans will be designed to achieve a balance that will not entrench inefficient management but that will eliminate the most egregious of the take-over abuses without interfering with the day-to-day operations of the companies which adopt them.

In November 1985, the Delaware Supreme Court[12] upheld the original «Flip-over» plan as being authorized under the Delaware state corporate laws and governed by the Business Judgment Rule thereby providing legal support for adoptions of poison pill plans and opening the door to further variations of such plans.

Poison pill plans were first developed to deal with the then current two-tier, front-end loaded tender offer and related techniques. They accomplished this by providing the target's shareholders with rights, that would have to be assumed by a raider in a second-step merger, to buy the corporate raider's common stock at half of its market price. The raider was thus faced with unacceptable dilution unless it either offered a price that was sufficient to attract the tender of substantially all of the shares and the rights or negotiated a merger at an acceptable price according to the target's board of directors so that the rights were redeemed and thereby removed as an impediment for the acquiror.

Following the Delaware Supreme Court's decision, many companies adopted plans with «Flip-in» provisions providing that, upon an acquiror

11. See text, *infra*, section 2.2: Poison Pill Features.
12. *Moran v. Household International, Inc.*, Del. Supr., 500 A. 2d 1346 (1985) aff'g Del. Ch. 490 A. 2d 1059 (1985) [hereinafter *Moran*]. See also text, *infra*, section 3.3(b)(ii): *Moran v. Household International Inc.* The Poison Pill was however originated by Lenox Inc. and Bell & Howell Co. See *Brown-Forman Distillers Corp. v. Lenox Inc.*, No. 83-2116 (D.N.J. June 20, 1983) and *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip.op., (Del. Ch. Aug. 25, 1983). See also, No. 7278, slip.op., (Dec. 13, 1983) (defendant Bell & Howell Co.'s motion to dismiss for failure of plaintiff to join indispensable parties denied). Because of the procedural posture of these cases (injunctive relief to block the implementation of a poison pill plan) they did not contribute to the determination of the ultimate legality of poison pill plans.

crossing a certain triggering threshold (usually 20%), all the other target's shareholders are given the right to purchase additional shares of the target at half price.

Unlike the basic Flip-over plan, this type of plan obtained mixed results in the courts, even though it provided a greater protection against take-over abuses. The effectiveness of the Flip-in is dependent upon its discriminatory feature. Without this feature, the Flip-in would not result in dilution for the acquiring company since it would be able to buy additional shares on the same basis as the other shareholders.

Nonetheless, in the U.S., legal experts recommend to their clients the adoption of this type of plan but they include in such special shareholders meeting procedures to approve such a feature in order to meet any judicial concerns about legality.

Furthermore, in the recent take-over contest involving Federated Department Stores, the U.S. District Court for the Southern District of New York, applying Delaware law, refused to enjoin a Flip-in plan notwithstanding its discriminatory feature[13].

The Delaware Supreme Court's decision in *Moran* also estab-lished that the adoption of a shareholders' rights plan, notwith-standing its features, had no effect whatsoever on the fiduciary standards to be followed by a board of directors responding to a subsequent take-over bid. In the event of a specific take-over bid, the plan and its operation will have to be assessed according to the response that the board decides to be appropriate based on the advices given at that time by the company's investment banker and legal counsel.

Such judicial warning, that the legal validity of a poison pill plan will be examined by the courts as a corporate policy matter, has been carried out as subsequent court decisions began to chip away at the Delaware Supreme Court's decision and shifted the judicial focus from the «validity» of a poison pill plan per se to its «operation» bringing about complex tests and uncertainty for legal and financial advisers both in the U.S. and Canada. Even though U.S. courts have sanctioned the adoption of certain poison pill plans as defensive measures, such plans have been and will continue to be the object of continuous litigation and the validity of a

13. *C.R.T.F. Corp. v. Federated Dep't Stores Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (C.C.H.) ¶¶ 93,680 (S.D.N.Y. Mar. 18, 1988); 683 F. Supp. 422 (S.D.N.Y., 1988).

particular poison pill plan will be the centre of further judicial consideration and in-depth scrutiny.

The poison pill's popularity in the U.S. market, which affects Canadian international investors, together with its potential use by Canadian firms, make it an important defensive tactic to be considered by Canadian companies, advisors and regulators[14].

However, there are evident difficulties arising from the transplantation of foreign solutions to Canadian problems[15].

We will thus try to examine these issues facing the Canadian legal adviser by trying to transpose an American mechanism in our own legal and regulatory context. In the first part of our study, we will focus on the U.S. situation in order to understand the history of the shareholders' rights plan as pertaining to its intent and purpose in detail to better analyze, in the second part, the possible transplantation, north of the border, of such a defensive measure considering our own legal climate and corporate governance situation.

2. AN OVERVIEW OF POISON PILLS

2.1 **Definitions**: Many authors and legal scholars have attempted to give a definition of a poison pill rights plan[16]. The definition of the Office of the Chief Economist, Securities and Exchange Commission is probably the one that best describes the scope of such a plan[17]. There are actually two definitions:

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14. J.M. Stransman and R. Wildeboer, *Poison Pills: Background and Legal Considerations*, Toronto (October 1988) [unpublished].
15. See C. Jordan, «U.S. Takeover Defences - In The Canadian Context» (1988) 2 *R.I.B.L.* 205.
16. See for examples, S.S. Dawson, R.J. Pence and D.J. Stone, «Poison Pill Defensive Measures» (1987) 42 *The Business Lawyer* 423, who give a general definition of a poison pill as generically referring to «various defensive measures adopted by boards of directors in response to takeover attempts or in advance of possible takeover attempts that can cause severe economic repercussions in an acquirer or potential controlling person». See also R.G. Clemens, «Poison Debt: The New Takeover Defense» (1987) 42 *The Business Lawyer* 747, who defines the term «poison pill» as describing «Rights or warrants granted to stockholders by a target company that become exercisable if a raider obtains a specified percentage of the target's shares and are designed to have unpalatable consequences for the raider».
17. See Office of the Chief Economist, Securities and Exchange Commission, *The effects of Poison Pills on the Wealth of Target Shareholders*, (October 23, 1986) at 1.

(a) **Short Definition**:

A poison pill describes a family of shareholder rights or convertible preferred share (or debt) agreements that, when triggered by an event such as a tender offer or an actual accumulation of target stock by a potential acquiror, allows the target shareholders, other than the acquiror, to purchase additional shares (of the target or, in some cases, of the acquiror) or to sell shares to the target at very attractive prices.

(b) **Long Definition**:

A poison pill is any financial device that, when triggered by a particular action (e.g. merging a target's assets or acquiring a specified amount of a target's stock), results in one or a combination of the following:

(1) the acquiror is forced to purchase securities from the shareholders of the target firm at prices equal to or exceeding their market value;

(2) security holders of the target firm gain rights to exchange stock of the target firm for a combination of cash and securities from the target firm having a value exceeding that of the surrendered stock (the acquiror is generally excluded from the exchange);

(3) the security holders of the target firm gain rights to purchase securities from the target firm at prices below market value (the acquiror is generally excluded);

(4) the acquiror must sell its securities at prices below market value to security holders of the target firm; or

(5) the acquiror loses substantial voting power of its shares relative to other security holders of the target firm.

A shareholders' rights plan is generically called «poison pill» because if the pill is «swallowed» it is designed to economically «poison» the acquiror's take-over attempt. Besides conferring the right to purchase stock, the rights also have a «poison pill» aspect designed to deter would-be acquirors[18]. Generally, «poison pill plans are implemented through the issuance of a pro rata dividend to common stockholders of stock or rights to acquire stock and/or other securities of the issuer or, under certain circumstances, a person or group («Acquiring Person») involved in a business combination with the issuer»[19]. Poison pills are generally not exercisable until the occurence of specified «triggering events» usually defined to include a merger or other business combinations with the issuer such as the announcement or commencement of a tender offer for a specified percentage of the issuer's capital stock or the accumulation of a specified per-centage of the issuer's capital stock[20]. The poison pill plan will usually exclude the Acquiring Person from the exercise of such rights. «Typically, poison pill rights are redeemable by the issuer at a nominal price at least until a triggering event occurs»[21].

A typical poison pill plan works as follows: a company issues rights pursuant to a Rights Agreement between the company and a trust company acting as rights agent on behalf of the company. The rights are distributed as a dividend to all common stockholders of the company and, until the happening of a triggering event[22], trade together with the common shares and are represented by common share certificates. They are valid for a predetermined period which is usually ten years and have a «strike price» that is relatively high to make the rights virtually worthless (for example $ 100 compared to a $ 25 market price). Because the rights are «out of the money» they do not dilute earnings per share or otherwise alter the company's capital structure. The «strike price» is also known as the «exercise price» at which the registered stockholder may purchase one common share from the company. The rights carry no vote and are redeemable at a nominal amount by the board of directors before and, in some cases, for a short period after the triggering event to allow the directors to negociate an acceptable deal for all shareholders.

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18. See D.S. Newman, «Delaware Serves Shareholders The "Poison Pill": Moran v. Household International, Inc.» (1986) 27 *Boston College Law Review* 641 at 644.
19. See Dawson, Pence and Stone, *supra*, note 16 at 423.
20. *Ibid.*
21. *Ibid.* at 424.
22. Some rights agreements refer to a triggering event as the «Separation Time» - for upon the occurence of a triggering event the rights separate from the underlying stock and become separately exercisable.

The triggering events may vary according to the type of plan involved. Usually a triggering event will be the acquisition by a third party of a given percentage (usually 20%) or more of the voting or equity securities (common shares to remain in conformity with securities legislation definition of a take-over bid) or upon the announcement of an offer to purchase sufficient shares to give the purchaser a given percentage (at least 30%) of the outstanding common shares of the company.

Upon the happening of the earlier of these events, the rights separate from the common shares to which they were formerly attached, rights certificates are issued and distributed to shareholders and the rights become separately tradeable and exercisable.

A triggering event will carry various consequences according to the type of plan involved. A different type of plan will carry with it different features to which we now turn our attention[23].

2.2 **Poison Pill Features:** Five basic versions of poison pills[24] have been introduced since their creation[25].

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23. See R. Wilderboer, «The Poison Pill Playground: The Search For A Proper Decision Rule», LL.M. Thesis, 1987 [unpublished]. Virtually all descriptions in legal literature focus on types of *plans*. This is somewhat misleading, as hybrid plans can and have been developed. Thus it would be more correct to speak in terms of pill *features*. Our discussion will describe pills in terms of plans, but the plan referred to will be dominated by a certain feature. It is the dominant feature that will determine the characterization of the plan, at 27. For examples of hybrid plans see the outline on poison pills prepared by Jim Freund and Eric Cochran of Skadden, Arps, Slate, Meagher & Flom of New York for the Practicing Law Institute's 20th Annual Institute on Securities Regulation.
24. See P.J. Thompson, «Shareholder Rights Plans: Shields or Gavels» (1989) 42 *Vanderbilt Law Review* 173 at 181, n. 45 stating that «very similar to poison pills, "poison" securities are becoming an increasingly popular defense» and citing Clemens, «Creating Financial Perils for Hostile Acquirors» 22 *Mergers & Acquisitions*, Nov.Dec. 1987, at 27 (discussing «poison preferred» and «poison debt»); The Debt Repellent 22 *Mergers & Acquisitions*, Jul.-Aug. 1987, at 21-22 (noting companies implementing poison put options).
25. See Dawson, Pence and Stone, *supra*, note 16 detailing the various types of poison pill plans available.

(a) **Convertible Preferred Stock Dividend Plan**

This type of plan also referred to as the «Poison Pill Preferred»[26] forms the basis of the first poison pill plan introduced by Lenox Inc. in June 1983. The mechanism of which is as follows:

The preferred stock is issued as a pro rata dividend to all holders of the target company's common stock. The preferred stock carries with it the typical features attributable of such stock. However the poisonous effect is contained in the special redemption and/or conversion features.

These features are designed to ensure that shareholders receive a «fair price» and/or to allow them to retain their interest after an acquisition has been consummated.

The redemption feature would be triggered at some point (e.g., thirty days) after an acquiror has accumulated a defined percentage of the stock. The convertible preferred stock could then be redeemed, at the option of the holder, at the redemption price specified in the plan. However, the acquiror would not be permitted to participate in any issuer redemption of poison pill stock.

The price, which is very similar to a «fair price» in a fair price provision[27], is determined through a formula provided in the plan, which usually reflects the average price for the issuer's common stock over a specified period of time (usually the price would be set at the highest price paid by the acquiror for the issuer's common or preferred stock during the preceeding year). The redemption price would be equal to the tender offer price if the acquiror proceeded via the tender offer process.

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26. See Note, «Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred» (1984) 97 *Harv. L. Rev.* 1964.
27. For a detailed illustration of the «fair price» provision designed to assure those stockholders who do not tender their shares in a take-over bid that they will not be subsequently squeezed out at unfavourable prices, see Hochman and Folger, *supra*, note 5 at 553ff. See also E.J. Kelly, «The Origin and Development of the Fair Price Clause» (1987) 15 *Securities Regulation Law Journal* 267.

However, the exercise of this redemption privilege is not triggered immediately on the stock acquisition date and the redemption privilege is made subject to suspension for a period of time in the event of a publicly announced intention to consummate certain business combinations. The acquiror can thus avoid the redemption provisions and this is where the conversion feature comes into play. The plan provides for the avoidance of the redemption privilege by giving the acquiror an option to complete certain defined business combinations such as a second-step merger followed by the issuance of securities that have an economic value to the stockholder in the acquiror or surviving entity which is equal to the value prescribed by the conversion provisions. Business combinations are also usually defined to include transfers of all or substantially all of the issuer's assets, reorganization or common stock reclassifications.

In the event of such business combinations, the terms of the convertible preferred shares require that provisions be made in the merger agreement to allow for the conversion into an equivalent amount, such as determined by the plan, of voting stock in the acquiror or surviving entity. The issuer would not be allowed to enter into any of these business combinations unless the acquiror agreed to comply with the terms set out in the plan.

The effect of these plans depends upon whether a business combination involving the issuer is consummated. The redemption and conversion privileges block the acquiror on two fronts; if the acquiror acquires a stock position but no business combination is consummated, the issuer's equity capital would become depleted by the payment to stockholders of the «fair value» through redemption of the preferred stock upon demand by the holders thereof. The acquiror would then be left with a target in a weakened financial position. If, on the other hand, a business combination is consummated to avoid the triggering of the redemption privileges then the acquiror will trigger the conversion privileges (of the preferred stock of the issuer into voting stock of the acquiror) bringing about a dilution of the acquiror's existing shareholders position.

The poisonous effect of these provisions should not, however, be exaggerated. Evidence has showed that a conversion privilege can easily be avoided. If the acquiror is an individual, the dilution will not cause him prejudice. A publicly held corporation, with a wide share distribution and managed by de facto groups will not fear dilution either.

Redemption features may also be of limited appeal since most corporate statutes impose solvency tests to be met before redeeming stock. Also, a company may be restricted by creditors via covenants to proceed to such stock redemption.

Three of the four companies that have adopted this type of plan were eventually taken over[28] and no companies were reported to have adopted any version of these plans since 1983[29].

(b) **Flip-over Plan**

Poison pills with Flip-over provisions are usually modeled on the plan considered by the 1985 Delaware Supreme Court decision in *Moran v. Household International Inc.*[30]. A Canadian commentator has referred to this type of plan as the «first generation poison pill»[31].

The typical Flip-over plan works as follows: the company issues as a pro rata dividend one right or warrant per common share to purchase a percentage of common or preferred stock of the issuing company. The rights or warrants generally have a fixed-term existence (generally, ten years) and are redeemable by the issuer for a nominal amount[32] prior to the occurence of a triggering event. The rights are initially traded with the underlying common stock and cannot be exercised. They usually carry typical preferred share provisions and their exercise price (or «strike price») for the acquisition of the issuer's stock will be set at a level that is «out of the money», bearing no relation to the

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28. Ganek, «Five Decisions That Shook the World of M & A» [1986] Am. Law 9 at 10.
29. Office of the Chief Economist, Securities & Exchange Commission, «A Study on the Economics of Poison Pills», [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (C.C.H.) ¶¶ 83,971 (March. 5, 1986).
30. *Supra*, note 12.
31. Coleman, *supra*, note 8 at 2.
32. In *Moran*, the rights were redeemable by the board of directors for $.50 per right, *supra*, note 12 at 1349.

issuer's longterm value over the life of the plan in order to make the rights virtually worthless when issued[33].

When a triggering event occurs, the exercise terms of the rights change and they become very valuable. Upon the occurence of such a defined triggering event, the rights become separable from the common stock and exercisable. The separation time typically occurs upon the acquisition of 20% of the issuer's common stock by any single entity or group and/or upon the announcement of a tender offer for 30% of the issuer's common stock. At that time, the rights usually become non-redeemable.

Upon the further occurrence of a defined «merger event», each right would «flip-over», becoming a right to purchase shares of common stock of the acquiror or of the merged entity which at the time of the merger would have a market value of twice the exercise price of the right therefore al-lowing the rightsholders to purchase shares at half price. For example, if the issuer's shares are trading or have a market value of $ 25 per share while the exercise price is $ 100, the holder of each right is entitled to purchase $ 200 worth of the common stock (8 shares) of the surviving entity for $ 100, immediately making $ 100 per right (a 50% discount).

This result is achievable only where an arrangement is en-tered into between the target and the acquiror (such as a merger or sale of assets)[34]. If the acquiror engages in defined «self-dealing transactions»[35], then the rightsholders, other than the acquiror, are entitled to purchase common stock of the issuer at half price (the «Flip-in»).

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33. The *Household pill* was designed to provide for the newly issued rights to be immediately exercisable to purchase 1/100 share of new preferred stock for $ 100. The «unit» of preferred stock usually being equivalent in economic terms to one share of common stock, therefore, if at the date of issuance such common stock traded at $ 25 per share, the worthlessness of the rights prior to a triggering event is thus obvious. *Ibid.*
34. See Coleman, *supra*, note 8 at 2.
35. Examples of self-dealing transactions include: issuance of capital stock of the issuer in exchange for the transfer of assets by the acquiror; purchase or sale of assets of the issuer on terms less favourable than the issuer could have obtained in arm's length negociations; the receipt by an acquiror of excessive compensation or additional benefits from the issuer; reducing dividends and a reclassification or recapitalization of the issuer's stock to increase the proportionate interest of the acquiror. See Dawson, Pence and Stone, *supra*, note 16 at 428.

Finally, the plan also provides that the issuer shall not engage in transactions that will trigger the Flip-over or Flip-in features unless there are adequate provisions made to honour the rights.

The Household-type plan works as follows: if an announcement of a tender offer for 30% of Household's common shares is made, the rights are issued and are immediately exercisable to purchase 1/100 share of new preferred stock for $ 100 and are redeemable by the board of directors for $ .50 per right. If 20% of Household's common shares are acquired by anyone, the rights are issued and become non-redeemable. In such event, they are exercisable to purchase 1/100 of a share of preferred stock.

If a right is not exercised for preferred stock, and thereafter, a merger or consolidation occurs, the rightsholders can exercise each right to purchase $ 200 worth of the common stock of the tender offeror for $ 100.

This has the effect of substantially diluting the equity of the acquiror and dramatically increasing the effective cost of the takeover for the acquiror thereby giving Flip-over provisions significant deterrent effect.

Finally, the bidder also has to contend with what has been termed the «Grossman Hart» problem[36] for the Flip-over plan provides great incentives for the shareholder to refrain from tendering before receiving the gains provided by the rights in the event of any «merger event» or «self-dealing transaction». To get those rights off the market before the second stage, the acquiror must then offer exorbitant prices because of their very high potential value in the second-stage transaction. Either way, the merger or self-dealing transaction becomes prohibitively expensive, wiping out potential gains to the bidder and effectively precluding a hostile bid[37].

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36. See S.J. Grossman and O.D. Hart, «Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation» (1980) 11 *Bell Journal of Economics* 42.
37. Wilderboer, *supra*, note 23 at 34.

(c) **Percentage Based Flip-in Rights Plan**

Poison pill plans with Flip-in provisions consist essentially of a standard Household-type Flip-over rights plan with additional Flip-in features. The *Household* plan contained a self-dealing Flip-in whereby in the event of an acquiror of 20% of the common stock engaging in certain defined selfdealing transactions, the holder of a right, except the acquiror, would be permitted to purchase stock and/or debt of the issuer at a 50% discount.

A stronger form of Flip-in provision is one that is triggered upon the mere accumulation of a specified percentage of the issuer's stock. This form is known as the Percentage Based Flip-in or Ownership Flip-in. A Canadian commentator has referred to this type of plan as the «second generation pill»[38]. In a Flip-over plan where an acquiror would accumulate stock of the issuer but would not engage in a merger event or a selfdealing transaction with the issuer, such acquiror would avoid both the Flip-over and the Flip-in provisions[39].

Because the Flip-over provision does not operate unless the bidder attempts to acquire all the issuer's common stock by a merger or by some other type of business combination, Flip-over pills do not prevent all-cash tender offers for all of the issuer's shares or open-market purchases of a controlling interest in the issuer. It is to fill this gap that the Flip-in provisions were added to Flip-over plans.

In the Percentage Based Flip-in plan, defined «selfdealing» is not required and the rightsholder is entitled to purchase common stock of the issuer at a discount upon the mere accumulation by the acquiror of a specified percentage of issuer stock.

The Percentage Based Flip-in plan has become, because of the greater potency and incentive it provides the acquiror to negotiate

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38. See Coleman, *supra*, note 8.
39. James Goldsmith used a creeping acquisition strategy to avoid the Flip-over rights and to take control of Crown Zellerbach. Goldsmith eventually acquired over 50% of Crown Zellerbach's shares on the open market and took control of the board of directors. See *Crown Zellerbach Corp. v. Goldsmith*, 609 F. Supp. 187 (D.C.N.Y. 1985). See also «Goldsmith's Move on Crown Zellerbach Prompts "Poison Pill" Potency Questions», The Wall St. J. (16 May 1985) at 8.

with the issuer's board of directors, the most frequently adopted form of plan in the U.S.

(d) **Back-End Plan**

This type of plan also known as a Note Purchase or «Put» plan involves the issuance of rights as a pro rata dividend to all common stockholders of the issuer, to tender («put») their common stock to the issuer for a specified amount of cash or a package of securities (debt securities, preferred stock or a combination thereof) worth more than current market price following the occurence of a specified triggering event.

The rights are not unlike those involved in other poison pill plans (they carry no voting right and they are redeemable for a nominal sum until they become effective) except that they do not separate from the underlying common stock. This type of plan is similar to a Flip-in, but uses an automatic self-tender rather than an automatic new issue of stock to dilute an acquiror's holdings[40].

Typically, the triggering event is the acquisition of a given percentage of the issuer's capital stock. The rights then become non-redeemable and exercisable by all common stockholders except the acquiror, through the tendering of their common stock to the issuer. However, the rights do not separate from the underlying stock. If the take-over is successful, the effect of the Back-End plan is to require the acquiror to buy out the remaining shareholders at a price established by the issuer's management.
The Back-End discount is usually less than the 50% discount available to rightsholders with Flip-over plans[41]. The value of the securities package or Back-End price may be intended to reflect the high end of the long-term realizable value of the issuer over the duration of the plan. Although many variations are available, a fixed dollar value will be chosen to project the impression that the board of directors of the issuer has made a definite assessment as to the long-term «fair» value of the issuer's stock to its stock-

40. See Office of the Chief Economist, *supra*, note 29 at 88, 045.
41. Back-End values typically exceeded market prices by 8 to 92%. See Office of the Chief Economist, *supra*, note 17 at 14.

holders. A fluctuating Back-End price would undermine the credibility of that proposition[42].

The effects of the Back-End plan are very similar to those emanating from the Flip-over plans inasmuch as the acquiror's equity position in the issuer is diluted even through an open market stock purchase which is an important advantage over Flip-over plans with Flip-in added features. In a Back-End plan, the dilutive effects can occur without a merger or a selfdealing transaction.

Many variations of Back-End plans are available[43]. However, because Back-End plans, upon the occurrence of a triggering event, involve an exchange offer that is not open to all shareholders, they are similar in financial effects to discriminatory self-tender offers and may be illegal under the Securities Exchange Act of 1934. They are thus unpopular in the U.S. because of such suspect legal status[44].

(e) **Voting Rights Plan**

Defensive measures with voting provisions involve the issuance of a pro rata dividend to all common stockholders of the issuer of securities having special voting powers. Voting plans are directly aimed, not at diluting an acquiror's economic investment, but at his exercise of control[45].

There are various forms of voting rights plans. In one version, the issuer issues preferred stock[46] that grants «supervoting» privileges[47] to all common stockholders except the acquiror under

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42. Wildeboer, *supra*, note 23 at 37.
43. For examples of different variations of Back-End plans, see Dawson, Pence and Stone, *supra*, note 16 at 429.
44. The Delaware Supreme Court in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, Del. Supr., 506 A. 2d 173 (1986), while not directly confronting the legality of a note purchase plan (or Back-End plan) stated *in dicta* that Revlon's plan, which provided note purchase rights to all shareholders except Pantry Pride, was not unlawful. The court concluded that Revlon's board had the power to adopt such a plan if plausibly related to the goal of shareholders wealth maximization. However, the Securities and Exchange Commission (S.E.C.) has indicated that it views such plans as the equivalent of an issuer tender offer. Thus, plans which discriminate against acquiring persons would be prohibited under the «all-holders rule» enunciated by the S.E.C. whereby an issuer tender offer must be open to all security holders of the same class at the highest price paid to any other security holder. See Rule 13e-4(f) (8) under the Securities Exchange Act of 1934, 15 U.S.C. s. 78a et seq.
45. Wilderboer, *supra*, note 23 at 38.
46. See Dawson, Pence and Stone, *supra*, note 16 at 430.
47. See *Asarco Inc. v. M.R.H. Holmes A. Court*, 611 F. Supp. 468 (D.C.N.J. 1985).

specified circumstances for the purpose of severely diluting the voting power of said acquiror seeking control.

Under another version, common stockholders are issued securities with voting rights that increase with the length of time the securities are held[48], «preventing those shareholders who sell their stock to the bidder from transferring full voting power»[49]. Also the securities may carry reduced voting privileges for a specified period following their transfer.

2.3 **Concluding Thoughts**

There are thus numerous combinations possible and new forms of poison pill plans are yet to be invented[50]. The decision to adopt a shareholders' rights plan, the feature(s) to be incorporated into the plan and the timing of its adoption will depend on various considerations such as the different impacts of pill features. With the exception of voting rights plans, general provisions are found scattered throughout the different types of plans[51], such as the redemption provisions. Many plans provide the issuer's board of directors with a redemption «window» of a specified number of days after the pill has been triggered. Other redemption provisions have been inserted. For example, if an acquiror reduces his holdings below a predetermined level in transactions that do not involve the issuer, the redemption provisions may be reactivated. As the board of directors controls the redemption, issuer's management and directors become important players in the take-over bid process.

Another provision generally encountered is commonly called the «out» price provision. For example, a triggering event will be deemed not to occur, if a bidder makes a cash tender offer for all the issuer's outstanding common shares at a specified minimum price.

48. See Dawson, Pence and Stone, *supra*, note 46 at 430.
49. See Thompson, *supra*, note 24 at 187.
50. For a detailed exposure on recent U.S. developments and variations in poison pill technology such as the «Adverse Person Flip-in» adopted in 1987 by Boeing in response to a bid by Mesa Limited Partnership to acquire 15% of Boeing's common stock, the «Shareholder Approval Provisions», the «Interim Safeguard» plans, the «Value Assurance» plans and other variations, see the outline on poison pills prepared by Jim Freund and Eric Cochran of Skadden, Arps, Slate, Meagher & Flom of New York, *supra*, note 23.
51. Wilderboer, *supra*, note 23 at 39.

The «out» price will be set at a premium to market price but reflective of the long-term value of the shares of the company[52].

Poison pill plans may provide strong anti-take-over consequences. A plan may be put in place to cause the potential acquiror massive dilution of his economic investment if he reaches a certain threshold of ownership in the issuer of rights (the «target»).

The above-detailed features vary in form but have the same «poisonous» effect for the acquiror. Whether the securities involved in the Rights Agreement are common, preferred or debt, the consequences will be the same.

The pertinent distinctions that are worth evidencing at this time are the discriminatory effect and the severity of a particular type of plan.

First, all poison pill plans are discriminatory. By their very nature, even Flip-over provisions cannot include the defined acquiror, since all Flip-over plans contain a self-dealing Flip-in feature that excludes the acquiror. Such a feature is designed to prevent said acquiror from engaging in defined self-dealing transactions which do not require a contract between the latter and the issuer. If pills were not discriminatory, they would void the purpose they were intended for and all that would happen upon a triggering event is a massive stock split[53].

As per the severity, it appears that since all pills are re-deemable by the board of directors of the rights issuer, the final issue is whether or not the board redeemed the rights[54]. How-ever, it is easily evidenced that poison pill plans that give issuer's shareholders, other than the defined acquiror, the right to purchase securities at a 50% discount will be judged more severe than other plans which act as fair price amendments when massive dilution is absent.

Because all poison pill plans are discriminatory and severe, they encourage the potential acquiror to negociate a deal with the issuer's

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52. See *Dynamics Corp. of America v. C.T.S. Corp.*, 805 F. 2d 705 (7th Cir. 1986).
53. Wilderboer, *supra*, note 23 at 43.
54. *Ibid.* at 44.

management, rather than with the shareholders who usually have the final say in a corporate control decision[55].

Finally, it should be emphasized that shareholders' rights plans do not foreclose all hostile tender offers and make a corporation take-over proof. They simply raise the costs of a nonnegotiated transaction[56]. The acquiror can make a tender offer for all of the issuer's outstanding shares and rights subject to a condition that a very high number of shares and rights be ten-dered in order to reduce the dilutive effects of a plan. The acquiror can also accumulate stock just below the trigger level and use the proxy process either to pass a resolution calling for the redemption of the rights or to replace the issuer's board and then redeem the rights[57].

In the following section we will examine the emphasis given to the above detailed features and the close scrutiny of said features' severity and poisonous effects by the American courts in their judicial enquiry into the validity of shareholders' rights plans from a corporate law standpoint.

3. THE JUDICIAL ASSESSMENT: American Caselaw

3.1 Introduction

Because of their potential effectiveness and controversial nature, judicial review as pertaining to the merits of poison pill plans in the U.S. is abundant. We will therefore review, for the purpose of this study, only the relevant caselaw and analyze the main factors which influence U.S. courts in determining the legal validity of such plans.

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55. The legality of such a transfer of authority will be more fully developed in section 3 where we will analyze the various court decisions concerning the legal validity of poison pill plans in the U.S.
56. See Fleischer and Golden, «Poison Pill» *Nat'l L.J.* (Feb. 24, 1986) at 17.
57. The Delaware Supreme Court, in upholding the *Household* plan, demonstrated that the plan did not prevent stockholders from receving tender offers and that Household was not take-over proof by giving examples of how it would be possible to circumvent the plan. See *Moran, supra*, note 12 at 1354.

The poison pill first attracted judicial attention in the battle for control of Lenox Inc.[58] After Brown-Forman Distillers Corporation announced a cash tender offer for all of Lenox Inc.'s shares, Lenox Inc.'s board adopted a poison pill plan[59]. Brown-Forman Distillers Corporation sought a temporary restraining order to challenge the pill. The district court refused to grant the order on the ground that such a defensive tactic was not clearly in conflict with shareholders' interest[60].

The second judicially considered pill was in *National Education Corp. v. Bell & Howell Co.*[61] where plaintiff, National Education Corp. (NEC), sought a preliminary injunction to prevent Bell & Howell from issuing rights under the plan. The Chancery Court concluded that there was not sufficient demonstration of success of prevailing on the merits at a final hearing. The injunction was denied and the parties settled out of court[62].

In both above mentioned situations there was little if any discussion as to the merits of the rights plan. The Delaware Supreme Court, in *Moran v. Household International Inc.*[63] was thus the first to be called upon to review the legality of a rights plan. It found the «adoption» of the pill was a valid exercise of the directors Business Judgment Rule[64].

However, the court warned that the «use» of a given plan will be assessed when and if the issue arises[65]. Consequently, the legal roles for using the pill remain obscure.

The judicial enquiry into the validity of a shareholders' rights plan will involve focusing on two main litigious issues: a) whether the plan unlawfully discriminates against the acquiror; and b) whether the adoption or implementation of the plan consti-tutes a breach of fiduciary duty by the company's board of directors in view of certain procedural and substantive standards established by recent court decisions.

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58. *Brown-Forman Distillers Corp. v. Lenox Inc., supra*, note 12. See also S. J. Scherer, «Delaware Supreme Court ingests a bitter pill: Moran v. Household International, Inc., 500 A. 2d 1346 (Del. 1985)» (1987) *Cincinnati Law Review* 873 at 875.
59. Scherer, *Ibid.*
60. *Ibid.*
61. See *supra*, note 12.
62. Bell & Howell Co. ended up buying off National Education Corp.
63. *Supra*, note 12.
64. See *infra*, section 3.3: Fiduciary Duties of Directors - The Business Judgment Rule Cases.
65. See *supra*, note 12 at 1357.

3.2 **The Discrimination Cases**

A typical poison pill plan provides that the acquiring shareholder who triggers the exercise of the rights is excluded from the full exercise of those rights. Such discriminatory treatment among shareholders may be found unlawful or unauthorized[66].

Virtually all corporate statutes provide that all shares must be identical within the same category. Strangely and interestingly, courts which have considered pills that discriminate against shareholders within the same category have reached different conclusions.

Generally, poison pill plans do not discriminate between shares themselves. It is the shareholder triggering the exercise of the rights who is discriminated against for he is the only one excluded from the benefits that other shareholders are entitled to receive.

In *Providence & Worchester Co. v. Baker*[67] (hereinafter *Providence & Worchester*), the Delaware Supreme Court held that the principle, that there cannot be discrimination between shares, does not forbid discrimination based on the holder of the shares. The court stated that the restrictions were «limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock per se»[68].

66. In the U.S., shareholder approval of the issuance of the rights is not required by law. See however, *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407 (D.C.N.Y. 1985) where a New York court applying Delaware law invalidated a time-phase plan as improperly discriminating both as to voting and as to transferability. The court stated *inter alia* that «change in corporate structure of great magnitude requires stockholder approval under DEL CODE ANN. tit. 8, s. 202(b) 1985» which provides that «no restriction [so imposed on the *transfer* of shares] shall be binding [...] unless the holders of the securities are parties to an agreement or voted in favor of the restriction.» [Emphasis added]
67. 67 Del. Supr., 378 A. 2d 121 (1977), rev'g Del. Ch., 364 A. 2d 838 (1976).
68. *Ibid.*, at 123.

This line of reasoning has been accepted by courts interpreting the laws of the following states: Indiana[69], Michigan[70], Minnesota[71] and Delaware[72].

However, this approach has not been accepted by courts interpreting state laws of New Jersey, Colorado, Wisconsin and New York. It is thus fair at this time to conclude that the legality of a poison pill plan depends to some extent on the state of incorporation of the company adopting the plan. The discrimination issue has been at the heart of a number of decisions invalidating poison pill plans. The decisions finding illegal discrimination are usually grouped into the three following categories: economic effect, transferability and voting[73].

The two principal cases in the first category are *Amalgamated Sugar Co. v. NL Industries Inc.*[74], (hereinafter *Amalgamated Sugar*) and *Bank of New York Co. Inc. v. Irving Bank Corp.*[75], (hereinafter *Irving Bank*).

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69. See *Dynamics Corp. of America v. C.T.S. Corp., supra*, note 52, where the Seventh Circuit held that discriminatory pills comply with Indiana's antidiscrimination statute, which requires identical rights within a share class, because discriminatory pills only discriminate among shareholders, not among shares. See also L. J. Slania, «Dynamics Corp. of America v. C.T.S. Corp.: Posner's Plan for Poison Pills» (1987) *Wisconsin Law Review* 711 at 732 making an interesting argumentative nuance by commenting that «if a poison pill plan singled out a shareholder and stripped its shares of rights which other shares had, that would be discrimination between «shares» and therefore forbidden. But if a poison pill plan was designed to strip the rights from any shareholder if that shareholder acquired a certain percentage of stock, that would be discrimination between «shareholders» and therefore allowed».
70. *Harvard Industries v. Tyson*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (C.C.H.) ¶¶ 93, 064, 95,294 (E.D. Mich. Nov. 25, 1986).
71. *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 847-48 (D. Minn. 1986), aff'd in part and vacated in part on other grounds 811 F. 2d 414 (8th Cir. 1987).
72. It is not certain that Delaware law would follow the reasoning set forth in *Providence & Worchester* for a Delaware Court has never addressed the problem of discrimination directly. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, supra*, note 44 [hereinafter *Revlon*], the court stated *in dicta* that *Revlon*'s Note Purchase Plan, which provided note purchase rights to all shareholders, except the person whose 20% stock accumulation triggered the rights, was lawful discrimination. The plan was held valid on the ground that there was a reasonable purpose for such corporate measure. The *Moran* decision is not controlling law for it did not examine the discriminatory effect of the Household pill finding the Flip-over provision to be non-discriminatory by its very nature. See *infra*, note 78. See also *Unilever Acquisition Corp. v. Richardson-Vicks, Inc., supra*, note 66, and accompanying text.
73. This distinction is evidenced by one particular author, see e.g., Wildeboer, *supra*, note 23 at 59.
74. 644 F. Supp. 1229 (S.D.N.Y. 1986) aff'd 825 F. 2d 634 (2nd Cir. 1987).
75. Transcript of Oral Opinion (N.Y. Sup. ct. July 6, 1988), aff'd, No. 34386 (N.Y. App. Div. Oct. 4, 1988).

In *Amalgamated Sugar*, the target, NL Industries (NLI), adopted a Household-type pill. After NLI refused to redeem the rights, Amalgamated Sugar triggered the rights and sought injunctive relief in order to enjoin NLI's pill. The injunction was granted by the District Court of New York which held the NLI plan, and in particular the Flip-in provision, to be ultra vires as a matter of New Jersey law. Amalgamated Sugar's main argument was that the plan discriminated among shareholders of the same class or series in violation of the New Jersey's Business Corporations Act[76]. The court agreed with Amalgamated Sugar's pretentions and held that the Flip-in provision, by diluting only the acquiring shareholder's holdings, created an illegal disparity of treatment among shareholders. The court rejected NLI's argument that the rule in *Moran v. Household International Inc.*[77] should apply on the ground that the Household pill only contained a Flip-over provision which is no discriminatory by nature[78]. The court placed importance on the severity of the discriminatory effect of the NLI's plan and emphasized the fact that «no one in his right mind will ever tender».

In *Irving Bank*, the Bank of New York (BNY) brought a motion seeking a preliminary injunction enjoining Irving Bank (IBC) from enforcing the Flip-in provision of its rights agreement that was adopted by the board of IBC, on May 19, 1988. BNY sought a conclusion that the Flip-in amendment was ultra vires as a matter of New York law.

Section 501 of the *New York's Business Corporation Law*[79] directs that all shares in the same class shall be equal.

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76. N.J. STAT. ANN. § 14A: 7-1 (West 1969).
77. *Supra*, note 12.
78. See text, *supra*, section 2.3: Concluding Toughts. It is submitted that all pills are discriminatory and must be so to attain the results that they are created to achieve. The *Household* pill did contain a self-dealing Flip-in provision but in the court's view, one reason why the *Household* pill was held legal was that it left a strategic gap in the target's defense against a potential take-over bid. The *Household* pill was a «first generation pill» and if no defined merger event or self-dealing transactions occurred than neither the Flip-over nor the Flip-in provision would be triggered. The Flip-in plan in *Amalgamated Sugar* was a «second generation pill» and contained a «percentage-based trigger» and the only accumulation of stock to a given percentage was sufficient to trigger the poisonous effect of the pill. No «merger event» or «self-dealing transaction» were needed.
79. N.Y. Bus. Corp. Law § 501(c). Section 501(c) states that «subject to the designations, relative rights, preferences and limitations applicable to separate series, each share shall be equal to every other share in the same class». Transcript of Oral Opinion at 8.

Following *Amalgamated Sugar*[80], the Supreme Court of New York held that the express prohibition against discrimination in s. 501(c) may not be avoided by using a provision in the company's certificate of incorporation. It stated that s. 501(c) was intended «not to prescribe a distinction between shareholders[81]» and rejected the principle set out in *Providence & Worchester*[82].

In the second discrimination category concerning restrictions as to the transferability of the stock, the leading case is *Minstar Ac-quiring Corp. v. AMF, Inc.*[83] (hereinafter *Minstar*) where the District Court for the Southern District of New York, interpreting New Jersey law, enjoined a rights plan which provided that only shareholders who had originally received the rights to dividends would be allowed to exercise the conversion privilege set forth in the rights plan.

In *Minstar*, the board's goal was to ensure that nontendering shareholders would receive a fair value for their shares in the event of a hostile take-over. The plan provided for the distribution of a dividend in the form of a right to exchange, upon a defined triggering event, their shares for subordinated debentures. The rights were not transferable. The shareholders could not trade these rights without the underlying stock nor transfer them separately after the occurrence of the triggering event.

The court thus enjoined the plan on two basis. Firstly, the fact that only those shareholders who held their shares as of the date of the distribution were permitted to convert their shares effectively divided the common stock into two classes and thus created discrimination between holders of the same class. Secondly, the nontransferability constituted an illegal restraint on the alienability of the underlying stock[84].

In the third discrimination category concerning restrictions as to voting, two cases stand out in importance. The first, interpreting New Jersey law and the second, interestingly interpreting Delaware law where discrimination has usually been allowed[85]. In *Asarco Inc. v. M.R.H.*

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80. *Supra*, note 74.
81. Citing approvingly the New York Court of Appeals in *Febland v. Two Trees Management Co.*, 66 N.Y. 2d, 556 which had previously judicially considered s. 501(c) of N.Y. Bus. Corp. Law.
82. See *supra*, note 67.
83. 621 F. Supp. 1252 (D.C.N.Y. 1985).
84. *Ibid.* at 1257-1259.
85. See *supra*, note 72.

Holmes A. Court[86] (hereinafter *Asarco*) a New Jersey court applying New Jersey law held in favor of the plaintiff that it was impermissible to have different rights within a single class of stock. According to the court, New Jersey corporate law did not grant the board of directors the authority to reapportion the voting powers of stockholders within the same class.

In *Asarco*, the board's plan provided for the issuance of a dividend consisting of preferred stock to common stockholders. The rights would be triggered if a person acquired 20% or more of voting stock of Asarco while the acquiror would be the only one prevented from exercising the increased voting power.

In *Unilever Acquisition Corp. v. Richardson-Vicks Inc.*[87], a New York court interpreting Delaware law invalidated a time-phase voting plan on the basis that it was improperly discriminating both as pertaining to voting and transferability. The new class of preferred stock, adopted in the middle of a take-over fight, provided for different voting rights within the same class of stock dependent upon the time the stock was acquired and the duration that it was held.

The court noted that under Delaware law, a change in corporate structure of this importance required shareholders approval which had not been obtained[88] and indicated that Richardson-Vicks Inc.'s certificate of incorporation explicitly provided that «[a]ll shares of any one series of preferred stock shall be identical with each other in all respects»[89].

The court also distinguished the *Unocal* findings[90] on the ground that discriminating against a renowned «greenmailer» was permissible but that the facts in the present situation were different.

86. *Supra*, note 47.
87. *Supra*, note 66.
88. *Ibid.* at 410.
89. *Ibid.*
90. *Unocal Corp. v. Mesa Petroleum Co.*, De. Supr., 493 A. 2d 946 (1985) [hereinafter *Unocal*].

Colorado law[91] and Wisconsin law[92] have also been judicially interpreted to forbid unlawful discrimination between shares of the same class.

Under Delaware, Indiana, Michigan and Minnesota law[93], discrimination has been allowed in light of the Delaware Supreme Court finding in *Providence & Worchester*[94]. Said discrimination can be a factor that may influence a court's decision as to whether a target's board breached its fiduciary duty in adopting a certain type of poison pill plan[95].

It is interesting to note that both Ohio[96] and Wisconsin[97] have modified their state corporation laws to expressly permit directors of target companies to issue rights which do not allow the holder of a determined percentage to exercise said rights hence permitting discrimination among shares of the same class or series.

3.3 Fiduciary Duties of Directors - The Business Judgment Rule Cases

(a) The Business Judgment Rule in the context of ordinary business decisions: The «Traditional» Rule

The U.S. courts may invalidate a poison pill plan if the issuer's directors are found to have breached their fiduciary duties by either adopting the plan or by deciding to redeem the poison pill rights once a take-over bid is launched.

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91. See *Spinner Corp. v. Princeville Development Corp.*, No. 86-0701 (D. Hawaii 1986) where the U.S. District Court for the District of Hawaii, applying Colorado law, enjoined the Flip-in feature of the plan but refused to enjoin the Flip-over provision.
92. See *R.D. Smith & Co., Inc. v. Preway, Inc.*, 644 F. Supp. 868 (W.D. WIS. 1986) where a preliminary injunction was denied on the grounds of failure to demonstrate irreparable harm. The court found that plaintiff had demonstrated a likelihood of success on the merit that a discriminatory pill was unlawful by applying Wisconsin corporate law. The court compared Preway's plan with the plan in *Amalgamated Sugar* and found them to be substantially similar and followed *Amalgamated Sugar's* application of New Jersey law which «does not allow directors to circumvent the anti-discrimination statute».
93. See *supra*, notes 69-72.
94. See *supra*, note 66 and accompanying text.
95. Thompson, *supra*, note 24 at 199.
96. OHIO REV. CODE ANN § 1701.16 (Anderson Supp.1987).
97. WIS. STAT. ANN § 180.155 (West Supp. 1988).

As fiduciaries to the corporation and its shareholders directors have a duty to act with due care and in good faith. As such, corporate directors enjoy the protection of the Business Judgment Rule which is a Common Law doctrine that, at least outside the realm of tender offers[98], insulates managerial decisions from judicial scrutiny[99]. The Business Judgment Rule is a presumption which provides that: in making a business decision, the directors of a corporation acted on an informed basis, in good faith and with the honest belief that the action taken was in the best interests of the company[100].

The Business Judgment Rule consists of the five following elements having to be satisfied for the Rule to apply[101]:

«(1) the directors exercised a business judgment, in that there was an affirmative act by the directors as opposed to inaction (although a conscious decision to refrain from acting may be a valid exercise of business judgment);

(2) the directors did not have a personal interest in the challenged directorial action[102];

(3) the directors made a reasonable effort to ascertain and consider all information relevant to their action;

(4) the directors acted with the belief that their action was in the best interests of the corporation and its shareholders; and

(5) the directors' action did not constitute gross overreaching or abuse of discretion.»

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98. See *Unocal, supra*, note 90 at 946 which stated *inter alia* that «the Business Judgment Rule, including the standards by which the conduct of a board of directors is judged, is applicable in the context of a takeover.»
99. Easterbrook and Fischel, «The Proper Role of a Target's Management in Responding to a Tender Offer», *supra*, note 6 at 1194-1195.
100. *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. Supr. 1984). See also D. Block, N. Barton and S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers* (Clifton, N.J.: Prentice Hall, 1987).
101. Block, Barton and Radin, *Ibid.* at 9-17. See also M. St-Patrick Baxter, «The Fiduciary Obligations of Directors of a Target Company in Resisting an Unsolicited Takeover Bid» (1988) 20 *Ottawa L. Rev.* 63 at 68.
102. Directors are only precluded from making money at the expense of the corporation. See *Cheff v. Mathes*, 199 A. 2d 548, 554 (Del. 1964) [hereinafter *Cheff*], stating that «the mere fact that some [...] directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder».

Unless a plaintiff, challenging the directors' decisions, can rebut this presumption and show evidence that the directors had a disqualifying self-interest in the transaction, the courts will refrain from reviewing the substance of the decision[103]. Judicial inquiry ends when the directors demonstrate that they have taken the procedural steps necessary to guarantee informed decisions.

The «Traditional» Business Judgment Rule recognizes that ordinary business decisions are better made in the boardroom than in the courtroom. However, in take-over cases, instead of automatically applying the «Traditional» Business Judgment Rule, courts have begun to scrutinize very carefully whether the directors of a corporation implementing a take-over defense mechanism have respected their fiduciary duties toward the corporation and its shareholders. Some authors have suggested that the Business Judgment Rule has no place in the context of corporate control for such transactions involve inherent conflict of interest between the directors' loyalty to shareholders interests and their own desire to retain control[104].

(b) The Business Judgment Rule in the context of corporate control decisions : The «Modified» Rule

Two important characteristics distinguish corporate control decisions from ordinary business decisions[105]. First, corporate control decisions affect shareholders' interests in making personal investment decisions that each shareholder has an interest in making independently without relying on their directors[106]. Second, is the inherent conflict of interest that directors, especially inside or management directors, face when confron-

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103. Some commentators have suggested the following justifications for the Business Judgment Rule: first, the Business Judgment Rule allows directors the freedom to formulate effective corporate policy. Second, the Business Judgment Rule encourages competent people to become directors by alleviating their fear of personal liability for honest mistakes in judgment. Third, the Business Judgment Rule relieves courts of the burden of second guessing complex corporate decisions, a task for which courts often lack the necessary expertise, information and time. The Business Judgment Rule thus articulates the principle that although shareholders have a right to expect their directors to exercise due care and undivided loyalty to the corporation, they cannot expect directors to guarantee the success of their decisions. See Notes, «Exclusionary Tender Offers: A Reasonably Formulated Takeover Defense or a Discriminatory Attempt to Retain Control?» (1986) 20 *Georgia Law Review* 627 at 658, n. 139.

104. See Gilson, «A Structural Approach to Corporations: the Case Against Defensive Tactics in Tender Offers» *supra*, note 6 at 821-831.

105. See Notes, «False Halo: The Business Judgment Rule in Corporate Control Contests» (1988) 66 *Texas Law Review* 843 at 848-849.

106. *Ibid.* at 848.

ted by a take-over attempt[107]. Directors may be inclined to resist a take-over bid to preserve control[108].

The *Cheff* case[109] involved a corporation purchasing its own shares as a defensive tactic against a minority shareholder interested in gaining control of the corporation to liquidate its assets. The *Cheff* case followed the reasoning of *Bennett*[110] in which the requirement that directors in a struggle for control bear the initial burden of proving that their actions have a proper business purpose was first formulated.

The *Cheff* court noted that where there is a struggle for control, «directors are of necessity confronted with a conflict of interest, and an objective decision is difficult»[111]. The board had to demonstrate that it had sincerely believed that buying out the dissident shareholder was «necessary to maintain what the board believed to be proper business practices»[112].

However, the traditional discretion afforded to directors was not altered for if directors carry a burden of proof, their decision will not be modified «even though hindsight indicates the decision was not the wisest course»[113]. The court found that the board's decision was an informed one and should be given deference.

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107. *Ibid.* at 849.
108. See *Bennett v. Propp*, 187 A. 2d 405, 409 (Del. 1962) [hereinafter *Bennett*]. «When a threat to control is involved», the Delaware Supreme Court felt that «directors are of necessity confronted with a conflict of interest». Thus, the burden of proof «should be on the directors to justify such a purchase as one primarily in the corporate interest». See also *Cheff, supra*, note 102 at 554 citing *Bennett* approvingly and the dissenting opinions in *Johnson v. Trueblood*, 629 F. 2d 287 (1980) and *Panter v. Marshall Field & Co.*, 646 F. 2d 271 (1981) [hereinafter *Panter*] where majority opinions applied the sole or primary motive test and evoked strong dissentions. See particularly the dissenting opinion of Cudahy J. in *Panter* criticizing the majority for providing target directors with a virtually «irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion», at 299.
109. *Supra*, note 102.
110. *Supra*, note 108.
111. *Supra*, note 102 at 554, citing *Bennett*.
112. *Ibid.*
113. *Ibid.*

The *Cheff* court formulated a policy conflict/primary purpose test[114] whereby the directors satisfy their burden of proof by showing good faith and reasonable investigation; «the directors will not be penalized for an honest mistake of judgment, if the judgment ap-peared reasonable at the time the decision was made»[115]. *Cheff's* motive analysis thus gave target companies directors large discretion to block take-over bids that lasted for two decades until the Delaware Supreme Court moved toward a standard of judicial review in a trilogy of decisions handed down in 1985 and early 1986[116] which contemplated a genuine effort to distinguish defensive tactics that might benefit shareholders from suspect tactics designed to entrench management.

These decisions strengthened the *Cheff* standard by imposing a second step requiring the defensive tactics to face proportionality review. Defensive measures must be «reasonable in relation to the threat posed»[117] notwithstanding the motives of their authors.

(i) **Unocal Corp v. Mesa Petroleum Co.**[118]

In *Unocal*, the Delaware Supreme Court imposed the enhanced duty, on a board of directors facing a take-over bid, to satisfy the initial burden of proving the reasonableness of its decision to oppose the bid:

> «Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there

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114. R.J. Gilson and R. Kraakman, «Delaware's Intermediate Standard for Defensive Tactics: Is there Substance to Proportionality Review?» (1989) 44 *The Business Lawyer* 247 at 249.
115. *Supra*, note 102 at 555.
116. The Second Circuit Court of Appeals in *Norlin Corp. v. Rooney, Pace, Inc., supra*, note 2 was actually the first court to question the application of the Business Judgment Rule under *Cheff's* policy conflict/primary purpose test. Applying New York law, the court found self-dealing on the part of the Norlin board. Plaintiffs made a prima facie showing that the Norlin directors breached their fiduciary duty of loyalty by adopting a defensive take-over tactic designed to perpetuate the board's control over the corporation. Given this initial demonstration of self-dealing or bad faith is demonstrated, «the duty of loyalty supersedes the duty of care, and the burden shifts to the directors to "prove that the transaction was fair and reasonable to the corporation"», at 265. The court thus superimposed the duty of loyalty onto the Business Judgment Rule by requiring the board to establish the «independent» legitimacy of the actions taken instead of the more easily met «legitimate» business purpose of the *Bennett* and *Cheff* era.
117. *Unocal, supra*, note 90 at 955.
118. *Ibid.* at 946.

> is an enhanced duty which calls for judicial examination of the threshold before the protections of the business judgment rule may be confered.
>
> [...]
>
> In the face of this inherent conflict, directors must show that they had reasonable grounds for believing that a *danger to corporate policy and effectiveness existed* [...].
>
> However they satisfy that burden «by showing *good faith and reasonable investigation*[119] [...]» [Emphasis added]

To come within the ambit of the Business Judgment Rule, the defensive measure [here a self-tender offer] must also be reasonable in relation to the threat posed[120].

Once the board of directors meets these requirements, the Business Judgment Rule will receive application to protect the board's defensive measure.

The court thus engaged in a thorough review of the directors' decision making process and motives. Since the court was con-vinced that the board had taken adequate steps to ensure an informed business judgment, the court deferred without an extensive examination of the defensive measure[121].

(ii) **Moran v. Household International Inc.**[122]

The *Moran* decision followed the *Unocal* analysis in the first judicial test of the poison pill. The Delaware Supreme Court upheld a decision rendered by the Chancery Court on the grounds that the adoption of Household's shareholders' rights plan under which shareholders had the right to purchase $200 worth of the acquiror's stock for $100 in the event of a take-over was a «legitimate exercise of business judgment by Household»[123].

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119. *Ibid.* at 954-955.
120. *Ibid.* at 947.
121. In *Unocal* the court was impressed by the fact that outside directors met separately with accountants and lawyers to consider the tender offer before voting to approve the defensive measure. The approval of outside directors created a sufficient presumption that the measure was fair enough for the court to decline further scrutiny.
122. *Supra*, note 12.
123. *Ibid.* at 1348.

In *Moran*, the court extended the *Unocal* analysis to a situation in which the board of directors took action even though no actual tender offer had been made. The suit to invalidate the plan was not filed by a bidder but by a dissenting board member and Household shareholder. The court concluded that the board did not breach any fiduciary duties[124] and found that the directors had reasonable grounds for believing Household was vulnerable to bust-up take-overs and coercive acquisition techniques, and that the shareholders' rights plan was a reasonable defensive mechanism.

However, because the poison pill defensive measure resulted in transferring power from the shareholders to management, the *Moran* court exhibited more interest than it had in *Unocal* in both the merit of the directors' evaluation of the threat and the reasonableness of the defensive measure.

The court noted that the board's ability to satisfy the initial burden of proof was materially enhanced by the fact that a majority of the board consisted of outside, independent directors[125]. A decision by a board composed of a majority of outside directors rein-forces the presumption that said board acted in good faith.

The court also expressed the view that, because the directors were not acting under the pressure of a hostile tender offer but pursuant to a reasonable and informed[126] analysis of the issues, application of the Business Judgment Rule was even more appropriate[127].

In upholding the poison pill plan, the court noted that when a bidder actually presents a tender offer and requests the board to redeem the rights, the board will be under the same fiduciary duty to base its redemption decision as when it decided to adopt the plan. The decision

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124. Before addressing the fiduciary duty issue, the court found that (1) the Delaware General Corporation Law gave the board the power to implement the pill. *Ibid.* at 1351-1353. (2) Shareholder approval was not necessary to implement the pill because it dit not change Household's fundamental structure pointing out that the rights inhibited but did not preclude a hostile bid, at 1354. (3) The pill did not restrict a shareholder's ability to conduct a proxy context, at 1355.

125. *Ibid.* at 1356.

126. The Court applied the standard set out in *Smith v. Van Gorkom*, Del. Supr., 488 A. 2d 858 (1985) where one of the issues in the case was whether the board had approved the transaction on an informed basis and where the Delaware Supreme Court held that the board had breached its duty of care even though the transaction involved a substantial premium to market price.

127. *Supra*, note 12 at 1350.

whether to redeem the poison pill plan will be eva-luated under the same criteria that were originally used by the court to evaluate the board's initial decision to adopt the plan[128].

The Delaware Supreme Court even though it held as valid the «adoption» of a poison pill, warned that the «use» or «operation» of a pill may not be treated equally:

> «While we conclude for present purposes that the Household directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders [citations omitted]. Their use of the Plan will be evaluated when and if the issue arises»[129].

The issue did arise in the Revlon take-over bid by Pantry Pride[130].

(iii) **Revlon Inc. v. MacAndrews & Forbes Holdings Inc.**[131]

The Delaware Supreme Court found that Revlon Inc. (Revlon), who was the subject of a tender offer by Pantry Pride, had an informed basis for believing that the offer was inadequate, that it would be financed by «junk bonds» and that if the offer were successful, it would probably lead to the eventual break-up of the corporation.

The court thus found that the poison pill was initially justified to strengthen Revlon's bargaining power. The focus of the court was thus on the pill's use or operation.

The Revlon board also entered into a «lock-up» option and a no-shop agreement with a «white knight». The court found that such an agreement was not protected by the Business Judgment Rule since by granting a «lock-up» option the board commits itself to a break-up and sale of the company's assets which is inconsistent with the preservation rationale behind the initial adoption of the poison pill plan.

The enjoinment of the «lock-up» option is relevant to the study of poison pills for, the use of defensive measures to prevent a sale of the

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128. *Ibid.* at 1354.
129. *Ibid.* at 1357.
130. *Revlon, Supra*, note 44.
131. *Ibid.*

corporation is improper and the court held that once the corporation is for sale, the directors' duty changes «from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company»[132].

The court found that the no-shop clause effectively prohibited negotiations with all other prospective acquirors, thereby impeding the competing bidding process[133]. The «lock-up» option allowed the «white knight» to acquire two of Revlon's lucrative divisions at a price $100-$175 million below its appraisal value[134]. The court found that it stiffed the bidding process between the «white knight» and Pantry Pride to the detriment of the shareholders[135]. As auc-tioneers, directors have a duty to maximize the company's sale price; therefore, defensive tactics must be designed to obtain the highest price possible for the stockholders[136].

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132. *Ibid.* at 182.
133. *Ibid.* at 184.
134. *Ibid.* at 178.
135. *Ibid.* at 184. The court stated that no interests other than those of the shareholders can be considered when there is an active bidding process in progress. The court also noted that a «lock-up» provision is not illegal *per se*; some «lock-ups» benefit the sharehol-ders by inducing a bidder to compete for control of the company. Such tactics are harmful, however, where the plan *precludes* bidders from competing, at 183. [Emphasis added]
136. *Ibid.* at 182. Two subsequent decisions have reaffirmed and expanded the *Revlon* principle. See *Edelman v. Fruehauf Corporation*, 798 F.2d 882 (6th Cir. 1986) and *Freedman v. Restaurant Associates Industries Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (C.C.H.) ¶ 93, 502 (Del. Ch. 1987). But see *Buckhorn, Inc. v. Ropak Corporation*, 656 F. Supp. 209 (S.D. Ohio 1987) where the Southern District Court of Ohio limited the scope of the *Revlon* principle by holding that the target board's authorization of management to explore a variety of defensive measures, including the possible sale of the company, did not establish the board's duty of auctioneer. In *Ivanhoe Partners v. Newmont Mining Corporation*, Del. Supr., 535 A. 2d 1334 (1987) the Newmont directors entered into a standstill agreement with a third party to avoid Ivanhoe's hostile take-over attempt. The court concluded that *Revlon* did not apply because the board did not «sell» the corporation for the third party only acquired a minority position from private sellers and did not gain control of the corporation's board. See also B. Reder, «the Obligation of a Director of a Delaware Corporation to Act as an Auctioneer» (1989) 44 *the Business Lawyer* 275 interpreting *Revlon* to the effect that the board should become an auctioneer only when it is clear that the target is to be broken up and its effectiveness destroyed. In *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988) the United States District Court of Delaware expanded the reach of the *Revlon* principle in recognizing that a change in control through recapitalization may be equivalent to a «sale» and trigger the directors duty to obtain the highest price possible for the shareholders. The Recapitali-zation Plan included a Poison Pill Plan and an Employee Stock Ownership Plan that had the effect of ensuring American Standard Management's control over a majority of the common stock of the company. It was held that the change in control amounted to a sale. The duty of directors to act as auctioneer is also evidenced in *C.R.T.F. Corp. v. Federated Dep't Stores, supra*, note 13 where the United States District Court for the Southern District of New York observed that even during an auction, a poison pill plan

Thus, when a board adopts an anti-take-over measure, there must be some «rationally related benefit accruing to the shareholders»[137]. Therefore, when a sale is inevitable, the enjoinment of the poison pill plan is also inevitable for the courts believe that the director's duty is to obtain the best price for the shareholders. If the pill is aimed at preventing a prospective acquiror to make a bid, then the board will breach its fiduciary duty to act as a neutral auctioneer.

The *Revlon* court thus applied an enhanced duty of loyalty giving controlling importance to the best interests of the shareholders once an auction begins.

With the added emphasis on «reasonableness», has come an increased scrutiny into the directors' duty of care[138]. Cases dealing with a proper decision-making process criteria were subsequently established[139]. The battle for control of CTS Corp. by Dynamics Corp. of America illustrates this.

«provides the directors with a shield to fend off coercive offers and with a gavel to run an auction», at 98, 120. In *City Capital Associates v. Interco Inc.*, Del. Ch. 551 A. 2d 787 (1988) Chancellor Allen commented that *Revlon* should not be read as requiring a board to «shop» or conduct an auction process every time a merger agreement is entered into. The board's duty is to probe the market for alternative transactions in order to satisfy the obligation to act in an «informed manner». The board's fiduciary obligations can thus be satisfied with more latitude, in ways other than by acting as auctioneers in the traditional way.

137. *Revlon, supra*, note 44 at 176.

138. See Easterbrook and Fischel, «The Proper Role of a Target's Management in Responding to a Tender Offer» *supra*, note 6 observing that when directors are looking at a conflict of interest situation such as a defensive measure to a take-over bid and its use, the directors' skills are not the issue, it is the directors temptation for self-dealing which the courts must enquire and therefore the proper criterion should be whether the directors satisfied their fiduciary obligation of loyalty to the corporation and its shareholders.

139. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986) where the United States Court of Appeals for the Second Circuit considering whether a target board had adequately informed itself before adopting a defensive tactic found that in the particular facts of the case, (e.g., a management led buy-out) the directors should have been more suspicious of management's motives and had a duty to scrutinize further into the fairness of the financial and legal advisors recommendations and proceed to a reasonable investigation. The court rejected the argument that directors had an absolute right to rely on advisors. The director's had failed to satisfy their fiduciary obligation of due care. See *contra Horwitz v. Southwest Forest Industries, Inc.*, 604 F. Supp. 1130 (D. Nev. 1985).

(iv) **Dynamics Corp. of America v. CTS Corp.**[140]

In the litigation concerning the take-over bids of Dynamics Corporation of America for CTS corporation, the Illinois courts, applying Indiana law, considered the legality of two poison pill plans adopted by CTS.

A) Dynamics I:

Applying the standards of director's conduct established by the Delaware Courts in *Unocal, Moran* and *Revlon*[141], the district court found that CTS directors breached their fiduciary duties in adopting the poison pill plan. Three main factors led to the court's conclusions.

1. The district court first considered the procedure followed by the directors in adopting the plan. The court found that the directors paid little attention to the fairness of the tender offer for the shareholders[142] and were more interested in finding out about other possible tactics.

   The court noted that, as opposed to the *Unocal* situation[143] where the directors each met separately with independent financial and legal advisors before rejecting the bid, the CTS outside directors have not referred to any independent investigation[144].

2. The district court second consideration concerned the «proportionality» requirement as set out in *Unocal*. The court concluded that the plan was preclusive as opposed to deterring so that all

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140. The litigation went as follows; in *Dynamics Corp. of America v. CTS Corp.*, 637 F. Supp. 406 (N.D.Ill. 1986), the district court of Illinois issued a preliminary injunction to enjoin a CTS poison pill. In *Dynamics Corp. of America v. CTS Corp.*, 794 F. 2d 250 (7th Cir. 1986) the Seventh Circuit on appeal, affirmed the district court's decision. These decisions are henceforth referred to as *Dynamics I* and *Dynamics I-A*. The board of CTS, after *Dynamics I*, implemented a second poison pill which was not enjoined by the district court in *Dynamics Corp. of America v. CTS Corp.*, 638 F. Supp. 802 (N.D.Ill. 1986). Dynamics still sought an injunction, and appealed to the Seventh Circuit in *Dynamics Corp. of America v. CTS Corp.*, 805 F. 2d 705 (7th Cir. 1986), henceforth referred to as *Dynamics II* and *Dynamics II-A*. These cases, and others involving the same parties, deal also with issues other than poison pill plans.
141. See *Dynamics I* at 409-411.
142. *Ibid.* at 412ff. The board spent 15 minutes considering the offer. See *infra*, note 44.
143. *Supra*, note 90 at 950.
144. *Dynamics I, supra*, note 140 at 411. The court still reached such a conclusion even though a CTS «Internal Key Management Group» had analysed the Dynamics bid.

bids would be defeated and not merely coercive ones[145] and was thus unreasonable under the *Unocal* «proportionality» test. The court determined that the board adopted the Flip-in provision with the primary objective of defeating Dynamics bid[146].

3. Finally the district court held that CTS Flip-in provision had to be based on an evaluation of the company's true value. The 15% trigger was evidently designed to hamper Dynamics efforts to solicit proxies[147].

B) Dynamics I-A:

The Seventh Circuit Court of Appeals affirmed the district court decision in *Dynamics I* and proceeded to review the policy considerations involved in the adoption of a poison pill plan. The Seventh Circuit seemed genuinely troubled by CTS's financial advisor's lack of independence and objectivity. Indeed, the financial advisor's bonus seemed to vary according to the opinion he would render to CTS's board.

Concerning the reasonableness of the defensive measure, the court stated that such a measure must be «plausibly related to the goal of stockholder wealth maximization»[148]. The Seventh Circuit concurred with the district court on its conclusions concerning the 15% trigger but held that the percentage level of a trigger alone is not determinative of the validity of the plan. The individual circumstances surrounding the adoption of the pill are critical to the propriety of the boards actions. It was also concerned with the $80 million, high-interest debt that would accrue if the rights were issued, therefore increasing the risk of insolvency[149].

C) Dynamics II:

A second poison pill plan was put in place to conform with the strictures of the Seventh Circuit opinion in *Dynamics I-A*. Again the

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145. *Ibid.* at 418.
146. *Ibid.* at 413.
147. *Ibid.* at 418. The court held that «for purposes of a preliminary injunction, that such a flip-in plan, adopted in the heat of a proxy contest, with no identifiable threat other than the vague fears articulated here, is unreasonable in relation to the particular threat posed.»
148. *Dynamics I-A, supra*, note 140 at 256.
149. *Ibid.* at 258-259.

district court had to consider the plan but did so, this time, in light of the Seventh Circuit's comments on the first pill. It held that the pill was properly put into place and did not enjoin CTS's second pill.

D) Dynamics II-A:

The Seventh Circuit, on appeal, this time found three main problems with the second pill.

1. The compensation arrangement with CTS's financial advisor caused the court to doubt the objectivity that is necessarily required from an independent financial advisor in tender offers situations[150].

2. The second pill's trigger was set at 28% which was at a level below CTS's control percentage. If such an increased level would not interfere with proxy contests, the court stated that any trigger set below the necessary level needed to exercise control of the corporation had to be justified by adequate evidence[151].

3. Finally, the Seventh Circuit was concerned that if a trigger price («exercice price») was set too high above market or intrinsic value, it would prevent tender offers in general and go against the purpose of selling to the highest bidder[152] for no person would dare submit a bid in such a situation.

The Seventh Circuit analyzed the method used by the CTS board to determine the trigger price which, in its opinion, is highly relevant to the issuers duty of reasonableness and good faith»[153].

(v) **Conclusion:**

Even though the Illinois Seventh Circuit is applying the Business Judgment Rule standard, it seems to have less faith in management decisions than did the Delaware Supreme Court in *Unocal* and *Moran*.

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150. *Dynamics II-A, supra*, note 140 at 710.
151. *Ibid.* at 712.
152. *Ibid.* at 714-715.
153. *Ibid.* at 714

This lack of confidence is evidenced by the careful scrutinizing involved in reviewing the procedure adhered to by company boards in implementing a defensive measure against a tender offer.

The Delaware Court of Chancery in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*[154] argued that the proportionality test set out in *Unocal* and *Moran* was more than a threshold standard and, indeed, constituted a regulatory test by which management would be forced to justify its choice of defensive actions by reference to the amount of coercion associated with a particular bid[155].

The Illinois courts, in studying the facts in the *Dynamics* situation, have certainly demanded justifications as to the CTS's board process in adopting their poison pill plans.

If some commentators[156] and courts have in the past claimed that the Business Judgment Rule was a necessary doctrine because courts were ill equipped to analyse complex business transactions, the courts in *Dynamics* have certainly demonstrated that the need for such pretentions need reconsideration.

Even though the substance of the decision is left in the hands of management, the decision-making process consists in a series of complex business and financial issues to be considered which are of great substance in themselves. The courts, when analyzing the «reasonableness» of a defensive tactic are making business judgments and second guessing complex corporate decisions even though courts usually contend that they are ill equipped to do so. It becomes harder and harder to justify the Business Judgment Rule in take-over situations when courts keep imposing on directors duties of care and loyalty for every move they make[157]. The «Modified» Business Judgment Rule is very deserving of its name for it leads a court into a detailed situational analysis of all the

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154. Del. Ch., 519 A. 2d 103 (1986).
155. Gilson and Kraakman, *supra*, note 114 at 254-255.
156. See *supra*, notes 101-103.
157. See Easterbrook and Fischel, «The Proper Role of a Target's Management in Responding to a Tender Offer» *supra*, note 6 at 1196 where the respected academic commentators recognized that «Many business decisions are made on the basis of suggestive but inconclusive information. Rational shareholders would not have it otherwise, however, for their welfare is maximized by decisions that yield the highest profits net of the costs of gathering information and making the decisions».

circumstances surrounding the implementation and operation of a shareholders' rights plan[158].

4. The Canadian Context

4.1 Introduction

On December 9, 1988, a majority[159] of Inco Ltd. shareholders have approved the company's controversial recapitalization plan in a vote that will have far-reaching implications for Canadian com-panies who wish to defend themselves against take-over bids[160].

The recapitalization plan consisted in the payment of a special cash dividend of $1.05 billion (U.S.) representing $10 per common share and the introduction of a shareholders' rights plan which became effective on October 3, 1988 subject to shareholders' approval[161].

The Caisse de Dépôt et Placement, a major Inco Ltd. shareholder[162], has filed a suit in the Québec Superior Court[163] to have the rights plan declared null and void as contrary to Canadian corporate law[164]. The Caisse's court challenge represents a monumental fight for the rights of all shareholders[165]. At issue: are poison pills in the best interest of

158. For a detailed study on the role that courts should play when defensive measures are subject to legal challenge see R. C. Brown, «The Role of the Courts in Hostile Takeovers» (1989) 93 *Dickinson Law Review* 195.
159. At a special meeting of more than 400 Inco shareholders, representing 75 million of the company's 105 million shares outstanding, 72 percent voted in favor of the recapitalization plan. See J. McNish, «Inco majority opts for poison pill» The [Toronto] Globe and Mail (10 December 1988) B1; see also L. Dingwall, «Inco win pushes pill option» The [Toronto] Financial Post (10-12 December 1988) 1.
160. The writer wishes to acknowledge the involvement of the Toronto office of Stikeman, Elliott and particularly of Mr. Edward Waitzer who represented a number of major Inco shareholders in opposing the October 3, 1988 recapitalization plan and has remained an active commentator of the poison pill in Canada. He remains, along with Mr. Rob Wildeboer also of the Toronto office of Stikeman, Elliott to whom the writer wishes to express his gratitude for supplying with important research material on the poison pill plan, infinitely better versed in the subject than is the present writer.
161. See *Inco Material Change Report* (3 October 1988) at 1.
162. The Caisse de Dépôt et Placement owns over 3,200,000 common shares of Inco representing 3% of the outstanding common stock.
163. (December 5, 1988), No. 500-05-013354-889.
164. See text, *infra*, section 5: Concluding Toughts: The Inco Pill.
165. S. Foerster, «Pass the pills for a vote, please, and hold the sugar» The [Toronto] Financial Times of Canada (19 December 1988) 40.

shareholders or do they represent an act of entrenchment by management[166]?

The Québec Superior Court has not yet rendered its decision and in anticipation thereof, the debate will remain theoretical. However, there are various legal and regulatory issues affecting shareholders' rights plan in Canada and in Québec which we will try to disclose in the following pages.

4.2 **The Canadian Take-over Bid Regime**

In the U.S., shareholders' rights plans were developed as a response to very a different regulatory environment than the one pre-vailing in Canada[167], where securities laws are structured to ensure that all public shareholders are treated fairly and receive the same consideration for their shares in a take-over bid context.

The Provincial securities dispositions and, in particular those contained in the Québec Act, will be examined in greater detail in the following pages[168]. However, the legal and regulatory regime that prevails in Canada entails us to proceed with the following preliminary questions;

1) Are shareholders' rights plans *sustainable* from a Canadian Corporate Law standpoint?

2) Are shareholders' rights plans *necessary* from a Canadian Securities Law standpoint?

A) **Corporate Law Regime**

Several corporate law issues arise when a shareholders' rights plan is adopted by the directors of a Canadian corporation such as the board's authority to issue securities, to declare dividends (all poison pill plans involve the issuance of a pro rata dividend to the common stockholders), to allow shareholders to purchase shares at a discounted price (usually

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166. *Ibid.*
167. See text, *infra*, section 4.2(b)(2): Justifying the implementation of a shareholders' rights plan: Regulatory Issues.
168. See text, *infra*, section 4.2(b): Securities Law Regime.

50%), to redeem securities, to impose restriction on the ownership and issue of shares, to create a disparity of rights between holders of the same class, to decide who may hold a certain level of ownership in the outstanding equity securities of the corporation.

Each of the above-mentioned issues has to be examined specifically and individually if we are to sustain the validity of poison pill plans from a Canadian corporate law standpoint. If we answer affirmatively to the legality question concerning each of these issues, then and only then will we be able to address the matter of justification as a question of necessity in a regulatory context.

It should be noted, however, that some corporate law issues may be justified by specifically referring to the regulatory environment «gaps» which may help justify certain corporate law breaches and thus legally sustain the validity of poison pills in Canada.

(i) **The Issuance of Securities**

The issuance of poison pill securities has to be authorized by corporate statute. The board of directors has a general power to issue securities under its broad power to manage the affairs of the company[169] or the corporation[170].

The board of directors may issue certificates, warrants or other evidences of conversion privileges, options or rights to acquire securities of the corporation[171]. The articles of incorporation may also authorize the directors to issue a class of shares in one or more series and determine the rights, privileges and restrictions attached thereto[172].

169. *Companies Act*, R.S.Q. c. C-38, s. 123.72 [hereinafter cited as Q.C.A.].
170. *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 102 [hereinafter cited as C.B.C.A.]. The term «corporation» will be used throughout the text whether referring to a Québec «company» or a Federal «corporation» for simplification purposes.
171. Ss. 29 C.B.C.A., 123.12(7) and 123.102 Q.C.A.
172. 27 C.B.C.A. and ss. 48(2), 123.6, 146(3) Q.C.A. Also known as blank-cheque stock provisions, they allow the board of directors to fix by resolution the term of such stock. These provisions are designed to provide flexibility for the directors to issue securities without having to obtain shareholder approval. Because there are no restrictions in corporate statutes as to the directors authority to issue blank-cheques securities, it is possible to conclude that the issuance of poison pills securities, even though not issued for financing purposes, may be permitted under the C.B.C.A. and the Q.C.A.

Finally, the board of directors may issue debt obligations of the corporation[173].

It thus seems that corporate statutes do not contain any disposition to the effect that poison pill securities issuance is limited. We will however discuss the judicial consideration of the board of directors power to issue securities in greater detail as we will analyze the directors duties in deflecting take-overs in Canada[174].

(ii) **Declaration of the dividend**

Shareholders' rights plans as we have previously noted contain different features[175]. Virtually all rights plans involve the issuance of a right as a pro rata dividend.

Under corporate law statutes, directors have a wide discretion in declaring dividends. A board of directors may pay a dividend by issuing shares of the corporation[176]. The board may also pay a dividend in money or property[177].

The only statutory limit imposed on directors is the solvency tests designed to protect the corporation's creditors[178].

(iii) **The Discounted Shares**

Some shareholders' rights plans allow rightsholders to purchase shares at a discount (usually half the market value).

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173. S. 189(1)(b) C.B.C.A. and ss. 77, 123.6, 169 Q.C.A.
174. See text, *infra*, section 4.2(a)(vi): Fiduciary duties of Canadian directors in a take-over context.
175. See text, *supra*, section 2.2: Poison Pill Features.
176. S. 43(1) C.B.C.A. and ss. 81, 123.6, 173 Q.C.A.
177. S. 43(1) C.B.C.A. and ss. 80 para. 3, 123.29, 172 Q.C.A.
178. S. 42 C.B.C.A. and ss. 123.70-71 Q.C.A.

Corporate law statutes usually provide that directors may determine the consideration for the share[179]. The consideration does not have to reflect fair market value[180].

Theoretically, it would seem that directors could issue discounted shares as in the case when the rights are triggered upon the accumulation by a third party of a percentage of company stock and allows the rightsholders, other than the third party acquiror, to buy shares of its stock (Flip-in) or of the acquiror or merged entity (Flip-over) at a discount.

(iv) **Redemption of Shares**

Some shareholders' rights plans allow the rightsholders to cause the issuing corporation to redeem their shares (e.g. convertible preferred rights plan and note purchase plans)[181] at favourable prices.

A board of directors will not be authorize to redeem securities if certain solvency guidelines are not met[182]. Also, creditors may impose covenants to this effect in various debt agreements with the debtor corporation.

(v) **Discrimination**

We have already stated that shareholders' rights plans are discriminatory, for the acquiror who reaches a certain threshold of participation in the target's capital structure is the only one prevented from exercising the rights to acquire more shares at a discount and consequently suffers massive dilution of his equity participation.

The discrimination issue is probably the most critical to the legal validity of a shareholders' rights plan under Canadian corporate law[183].

In a number of U.S. cases, shareholders' rights plans have been held invalid on the basis that, from a corporate law standpoint, a corporation

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179. S. 25(1) C.B.C.A. Under the Q.C.A., the share capital of a company may consists of par value stock. It is to be noted that there has been judicial hostility in the past towards the issuance of stock at a price below par. See *North-West Electric Co. v. Walsh*, (1898) 29 S.C.R. 33 and *Ooregum Gold Mining Co. v. Roper* [1892] A.C. 125 (House of Lords).
180. S. 25(3) C.B.C.A.
181. See text, *supra*, section 2.2: Poison Pill Features.
182. See s. 36 C.B.C.A. and s. 123.54 Q.C.A.
183. S. 24(3) C.B.C.A.

may not discriminate against a particular shareholder based on the identity of that shareholder[184].

In *Bowater Canada Limited v. R. L. Crain Inc.,*[185] the Ontario Court of Appeal considered a decision of McRae J., of the Ontario Supreme Court, where a provision in the articles of incorporation of a C.B.C.A. corporation purported to reduce the ten voting rights per share attaching to one class of shares to one vote per share when such stock was transferred out of a family control block.

The Ontario Court of Appeal upheld McRae J.'s decision who stated that «this interpretation is founded on the principle that votes attach to the shares as opposed to the shareholder [...] present corporate law cannot tolerate the result that the rights of a share depend on the identity of the shareholder»[186].

It would thus appear that the principle to the effect that there cannot be discrimination between shares extends to discrimination based on the identity of the holder[187].

A commentator has suggested an argument to the effect that a rights plan is created under a rights agreement which constitutes a contract between the issuer and a trustee acting as agent of the rightsholder and corporate law principles applicable to a class of shares do not limit the flexibility available in establishing rights by private agreement[188].

A second argument that can be made is that rights are issued as a pro rata dividend and as such, are distributed to *all* shareholders. It is only when an acquiror reaches a certain level of ownership of common

184. See text, *supra*, section 3.2: The Discrimination Cases.
185. (1988), 46 D.L.R. (4th) 161; (1988), 62 O.R. (2d) 752 (C.A.); (1987), 26 O.A.C. 348 (Ont. C.A.), aff'g McRae J., unreported judgment, S.C.O. January 23, 1987.
186. *Ibid.*, S.C.O. January 23, 1987 at 7.
187. See also *Jacobsen v. United Canso Oil & Gas Ltd.* (1981),113 D.L.R. (3d) 427, [1980] 6 W.W.R. 38, (1980) 11 B.L.R. 313 (Alta. Q.B.) [hereinafter cited to B.L.R.] where the court held invalid a corporation by-law provision restricting to 1,000 the number of votes regardless of the number of shares held by a shareholder as contrary to subs. 24(3) of the C.B.C.A. The court stated that «[...] if voting rights are to vary, separate classes of shares must be created so that *the different number of votes can be attached to the shares themselves and not to the holders*», [Emphasis added] at 319.
188. Coleman, *supra*, note 8 at 10.

stock of the issuer that such acquiror is discriminated against. The acquiror is the only shareholder whose rights become null and void.

However, there have been situations where corporations have issued rights or stock options to certain officers that become null and void in circumstances such as leaving the corporation's employment.

The only difference between such a situation and a shareholders' rights plan is that in the latter situation the rights are issued to *all* shareholders.

However, in anticipation of judicial ratification of such arguments, it remains to be ascertained whether the necessary discriminatory effects of a shareholders' rights plan can be sustained under Canadian corporate law.

(vi) Fiduciary duties of Canadian directors in a take-over context.[189]

Despite the high take-over activity of recent years, very few Canadian courts have proceeded to a judicial consideration of the validity of take-over defensive measures. Courts are therefore lacking in Canadian precedent and will be forced to turn to other jurisdictions for judicial support. It is noted by certain legal scholarss[190] that Canadian courts will thus focus on the wealth of U.S. case law to assist them in their difficult task of deciding the validity of both the adoption of a defensive measure and of its operation.

(a) The Proper Purpose Doctrine

The Proper Purpose Doctrine is a statement developed by the courts to the effect that directors, in carrying out their functions, must exercise

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189. It is to be noted that the legal relationship between a corporation and its directors is governed, in Québec law, by a different set of rules from those existing elsewhere in Canada. In Québec, a director is not a fiduciary as in other provinces but a mandatary of the corporation he represents. See s. 123.83 Q.C.A. The rules of civil law mandate (A. 1701-1761 C.C.) are completed by the duties which flow from the position of director (e.g. the institutional theory has allowed for the imposition on a director of the duty of independence which does not exist as a rule of civil law mandate and which in common law stems from the general duty of good faith imposed on fiduciaries generally). Also, A. 1710 C.C., which reads, in part: Art. 1710. The mandatary is bound to exercise, in the execution of the mandate, reasonable skill and all the care of a prudent administrator ... embodies the duty of care which also serves as the legal basis for the imposition of the duty to act «bona fide» in the best interest of the corporation and the duty to act for a proper purpose. A comparative analysis of common law fiduciary duties and civil law mandatary roles of directors is beyond the scope of the present study and for the purpose of the subject treated herein, we will assume that the same legal consequences will prevail. The main difference, between the two systems of law for our purpose, is that the standard of conduct imposed by Common Law courts on directors is based on a subjective criterion. However, since the enactment of s. 122 C.B.C.A. this distinction is now obsolete. The second distinction is that from a corporation law standpoint, Québec directors are mandataries of the corporation and owe no special duty to the shareholders. It may thus be more difficult to justify adopting a defensive measure if it is not in the best interest of the corporation but is only aimed at the protection of the shareholders from coercive maneuvers in certain circumstances. The other difficulty that directors have to overcome is that their duties differ when examined from a securities law perspective, where in Canada such rules are designed to give sovereignty to the shareholders. In the event of a take-over bid defense decision, where both corporate and securities legislation contain dispositions to regulate take-over bids, the Québec director is faced with uncertainty as to what is duties entail.

190. See B. Welling, *Corporate Law in Canada: The Governing Principles* (Toronto: Butterworths, 1984) at 714-15.

their powers in what they consider is in the best interests of the corporation, and for a proper purpose and not for any collateral purpose[191].

The proper purpose analysis is applied to the primary or sub-stantial purpose of the directors in exercising their discretion. This entails that an improper secondary purpose will not cause to invalidate the board's decision[192].

In Canada, the leading authority with respect to the application of the proper purpose doctrine is probably the case of *Bonisteel v. Collis Leather Co. Ltd.*[193] where the directors of Collis Leather Co. Ltd. issued authorized shares to existing shareholders for the purpose of diluting the plaintiff's equity from a majority position to a minority position.

Rose J. held that even if the share issuance was believed by the directors to be in the best interest of the company[194], the evidence showed that the purpose of the defendant directors in all they did was to deprive the plaintiff of the controlling position which he had acquired[195].

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191. See *Re Smith and Fawcett, Ltd.*, [1942] Ch. 304 at 306. The proper purpose doctrine (also known as the collateral purpose rule) involves ascertaining what is a proper purpose for the exercise of a particular directorial power and whether that purpose was present in that particular case. Proof concerning these questions is difficult, since the intentions of the directors have to be examined along with the other circumstances of the case. As noted by Professor Iacobucci, the idea that every power has certain proper purposes has become much less emphasized since corporate statutes require directors to act in good faith in the best interests of the corporation (see s. 122 C.B.C.A.). Courts may thus be more likely to judge directors' conduct by the standard of «the best interests of the corporation», and thus will look more to the particular act and the particular circumstances of the case, rather than relying on preconceived judicial notions of what constitutes a proper exercise of a given power. See F. Iacobucci, «The Exercise of Directors' powers: The Battle of Afton Mines» (1973) 11 *Osgoode Hall L.J.* 353 at 365, n. 35.

192. See St-Patrick Baxter, *supra*, note 101, at 77 n. 71 citing *Harlowe's Nominees Pty. Ltd. v. Woodside (Lakes Entrance) Oil Co.* (1968), 121 C.L.R. 483 at 493.

193. (1919), 45 O.L.R. 195 (H.C.).

194. In this particular case, the general manager, who was largely credited for the company's financial success, threatened to leave his position if plaintiff acquired control of the company.

195. In *Spooner v. Spooner Oils Ltd.* [1936], 2 D.L.R. 634, [1936], 1 W.W.R. 561 (Alta. S.C.A.D.) [hereinafter cited to D.L.R.] Harver C.J.A. toned down this principle at 635-636 in stating that «...when an issue of shares by the directors for the purpose of giving control cannot be deemed to be intended to be in the best interest of the shareholders generally but on the contrary appears to be intended to accomplish some other purpose, then it constitutes a breach of trust on the part of the directors who occupy a fiduciary position in which they must act *bona fide* for the interests of the general body of shareholders. It is simply an instance of the act of the directors being at variance with this duty. *There is nothing in the authorities cited that would stand in the way of [...] giving someone control of the company if the directors honestly believed on reasonable grounds that it was for the interest of the company that this should be done*».

In the English decision in *Hogg v. Cramphorn Ltd.*[196], a company was the subject of a hostile bid for its ordinary and preferred shares. The directors responded by establishing a trust for the benefit of the company's employees and allotted shares to the trust, nominating themselves as trustees to secure a position that would enable them to purchase said shares. The trust was set up to purchase the shares with funds loaned by the company.

Buckley J. held that the directors had done so to ensure that the bidder could not achieve a majority position and that this exercise of the directors power to allot shares was for an improper purpose. Buckley J. reached this conclusion even though evidence showed that the directors had acted in good faith, believing they were serving the best interests of the company[197].

(b) **Teck Corp. v. Millar**[198]

The facts of the *Teck* case are very unusual and at the same time very important in understanding the logic behind Mr. Justice Berger's judgment in this landmark decision on Canadian directors' fiduciary duties in a take-over situation. A careful description of said facts is thus required.

Defendant Chester Millar (Millar) was president and a director of Afton Mines Ltd. (Afton), a junior mining company. Millar became interested in some mining claims relating to a copper property, the development of which became the central issue in this case.

Said claims were acquired by a syndicate led by Millar and subsequently transferred to Afton.

[Emphasis added]

196. (1963), [1967] 1 Ch. 254, [1966] 3 All E.R. 420 [hereinafter *Hogg* cited to Ch.].

197. *Ibid.* at 265-266. Buckley J. stated that «The power to issue shares was a fiduciary power and if, as I think, it was exercised for an improper motive, the issue of these shares is liable to be set aside.», at 269. Buckley J. also cited approvingly *Punt v. Symons & Co. Ltd.*, [1903] 2 Ch. 506 at 516-517 where Byrne J. first made the statement that the power to issue shares was given to the directors primarily to enable them to raise capital, but then went on to say that there might be occasions when the directors might fairly and properly issue shares for other reasons.

198. (1973) 33 D.L.R. (3d) 288, [1973] 2 W.W.R. 385 (B.C.S.C.) [hereinafter *Teck* cited to D.L.R.].

Afton, lacking the financial clout to carry-on an extensive drilling program sought to interest a major mining company to provide capitals for the development of a particular property. Such development agreements between «majors» and «juniors» are frequent in the mining industry, whereby the major will generally extract a bonus involving equity interest either by way of shares in the company or by an interest in the mining property itself.

Millar decided that the best thing for Afton would be to sell some of its shares to a «major» to raise sufficient money for drilling requirements without giving up control of the company. Millar eventually approached Placer Development Ltd.'s Canadian subsidiary Canadian Exploration Ltd. (Canex). An agreement providing for the sale of shares to Canex at a price of $3.00 per share was entered into between Afton and Canex, giving the latter a right of first refusal on any future financing.

In the meantime, plaintiff Teck Corporation Limited (Teck), another «major», had notified Millar of its interest in developing the Afton property. However, Teck did not enjoy an excellent reputation in the industry, neither did it possess Canex's record of successful ventures. Millar did not think Teck had the expertise that Canex had and chose to deal with Canex even though Teck was willing to pay 4.00 $ per share.

Having failed to make a deal with Afton, Teck began buying shares of Afton on the market. Millar, knowing that Teck was buying more Afton shares and was coming close to obtaining con-trol, entered into a second agreement with Canex under which Canex would be fully responsible for the exploration and development of the property. Canex would receive 30% of the outstanding shares of Afton thereby reducing Teck's participation in Afton from 50% to approximately 35%.

Teck brought a derivative action alleging inter alia that the share issuance was made for an improper purpose.

Berger J. dismissed Teck's action and refused to follow the reasoning of *Bonisteel*[199] and *Hogg*[200]. Even though the directors' agreement with Canex involved the issuance of shares that caused the dilution of Teck's equity position, the evidence showed that the primary purpose of the

199. See *supra*, note 193.
200. See *supra*, note 196.

directors was the development of the copper property in the best interests of Afton and not a desire to defeat the control position of Teck.

The issuance of shares to Canex was incidental and an inevitable result flowing from arrangements of such kind, especially since «majors» usually require a 50% equity participation.

The facts of the *Teck* case showed that the main issue was who should get the ultimate development contract and not who should control Afton.

Berger J. placed the burden of proof on the plaintiff to show that the directors had no reasonable grounds for believing that a take-over by Teck would cause damage to the interests of Afton and its shareholders. He thus adopted the following test:

Directors may adopt an anti-take-over measure if: (i) they act in good faith; and (ii) they decide, on reasonable grounds, that the take-over will cause substantial damage to the company's interests[201].

Commenting on the *Hogg*[202] decision and the directors' power to issue shares, Berger J. said that «The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose, it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers»[203].

The *Teck* case is a clear break from the prevailing English law proper purpose doctrine and is a definite attempt to follow the U.S. Business Judgment Rule as interpreted by the Delaware Supreme Court in *Unocal* and *Moran*. The only difference is that Berger J. places the burden of proof on the plaintiff instead of on the directors. The *Teck* test is similar to the U.S. «Traditional» Business Judgment Rule that applies upon evaluating business decisions other than corporate control decisions.

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201. See *supra*, note 198 at 315-316.
202. See *supra*, note 196.
203. *Supra*, note 198 at 312.

It has been previously noted[204] that in situations where a conflict of interest arises such as when directors have to respond to a take-over bid, the U.S. Courts apply the «Modified» Business Judgment Rule and the directors assume the burden of showing good faith and reasonable investigation in using their discretion to implement a take-over defense measure.

However, we must bear in mind that the facts in the *Teck* case were rather unusual[205]. The issuance of shares was not immediate but was to be effected after other parts of the agreement were carried out. Teck took control in the interim period and ousted Afton's directors. This attitude of the directors added to the presumption that they acted in good faith for the best interests of the company[206].

The *Teck* case, notwithstanding the immense take-over activity of recent years, has been subject to judicial consideration in Canada in only two subsequent cases; *Re Olympia & York*[207] and *Exco*[208]. It is still unclear whether *Teck* presently represents the state of Canadian corporate law.

In *Howard Smith Ltd. v. Ampol Petroleum Ltd.*[209], the Judicial Committee of the Privy Council distinguished *Teck* on its facts, which demonstrated that the primary purpose of the Afton directors was to act in the best interests of the company. In *Howard Smith*, the Privy Council reaffirmed the proper purpose doctrine in deciding that the sole purpose of the directors was to dilute the majority to enable the minority to advantageously dispose of their shares to an offeror[210].

The Privy Council thus referred to *Teck* without disapproval. Other decisions have approved Berger J.'s reasoning in *Teck*[211].

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204. See text, *supra*, section 3.3(b): The Business Judgment Rule in the context of corporate control decisions: The «Modified» Rule.
205. See Iacobucci, *supra*, note 191 at 372, n. 64.
206. *Ibid.*
207. *Re Olympia & York Enterprises and Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254, 37 D.L.R. (4th) 193 (H.C.). [hereinafter *Re Olympia & York* cited to O.R.].
208. *Exco Corp. Ltd v. Nova Scotia Savings & Loan Co.* (1987), 78 N.S.R. (2d) 91, (1987) 35 B.L.R. 149 (S.C.T.D.) [hereinafter *Exco* cited to B.L.R.].
209. [1974] A.C. 821, [1974] 1 All.E.R. 1126 (P.C.) [hereinafter *Howard Smith* cited to All.E.R.].
210. *Ibid.*, at 1135.
211. See *Olson v. Phoenix Industrial Supply Ltd. et al* (1984) 9 D.L.R. (4th) 451, (1984) 26 B.L.R. 183 (Man. C.A.) [hereinafter cited to B.L.R.] where the court held that directors were entitled to issue shares if it was in the best interests of the company. The court followed *Teck* and allowed a share issuance to force a change of control insisted on by

(c) **Re Olympia & York**[212]

The Ontario courts increased the scope of management discretion in *Re Olympia & York* in implementing a defensive strategy to thwart a take-over attempt.

Curiously, Montgomery J.'s decision did not take into consideration the three landmark U.S. decisions rendered in 1985 and 1986 by the Delaware Supreme Court and establishing the «Modified» Business Judgment Rule as the proper judicial test to be applied in corporate control situations[213].

The facts are as follows. Gulf Canada Corporation (Gulf), a subsidiary of Olympia & York Enterprises (Olympia), launched a take-over bid for Hiram Walker Resources Ltd. (Hiram Walker). The target board of directors rejected the offer and entered into a contract with Allied-Lyons PLC to sell Hiram Walker's liquor division. Hiram Walker set up a subsidiary (Fingas) with Allied-Lyons PLC to make a competing bid for the company at a higher price than that offered by Gulf. Gulf and Olympia & York applied for an interlocutory injunction arguing that the target's directors attempted to entrench themselves by manipulating corporate assets without shareholder approval.

Montgomery J. held that the board had not breached its fiduciary duties and acted in good faith on the advice of its investment bankers for the sole purpose of maximizing shareholders' value[214].

The court reached this decision by only considering the chief executive officer and one director's affidavits. The court did not take into account the U.S. decisions to the effect that when the sale of company

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company creditors as a condition of allowing further credit. The fact that the directors were also shareholders and made a decision which could benefit them personally if the shares gained value was not sufficient ground for disallowing the issuance, at 191. See also *First City Financial Corp. Ltd. v. Genstar Corp.* (1981), 33 O.R. (2d) 631 (H.C.).

212. See *supra*, note 207.

213. *Unocal Corp. v. Mesa Petroleum, supra*, note 90; *Moran v. Household Int'l, Inc., supra*, note 12 and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., supra*, note 44. See text, *supra*, section 3.3(b)(iii): Revlon Inc. v. MacAndrews & Forbes Holdings Inc.

214. *Supra*, note 207 at 270.

assets becomes inevitable, the directors duty of auctioneers is triggered and the sole consideration is maximizing shareholders' wealth[215].

The court was very interested in the procedure used by Hiram Walker to achieve the desired result. The Fingas subsidiary served as a vehicle to reduce corporate taxation by $300 million and funnel $2 billion of the sale of assets proceed to purchase 50 million of the 103 million common shares of Hiram Walker at a higher price than the Gulf and Olympia bid.

Montgomery J., accepting Berger J.'s reasoning in *Teck*, stated that it would have been a breach of the directors' duty to the shareholders since it had reasonable grounds to believe that the intrinsic value of the company's stock was higher than the offered price.

(d) **Exco Corp. v. Nova Scotia Savings & Loan Co.**[216]

Exco Corp. (Exco) made a tender offer to obtain control of Nova Scotia Savings & Loan Co. (NSS&L) and was at that time already owner of 49% of NSS&L common stock accumulated from various individuals.

In order to thwart Exco's bid, the directors of NSS&L set about finding a rival bidder more to their liking.

Considering Exco's already important equity position, finding a «white knight» to make a competing bid required diluting Exco's holdings. Halifax Developments Holdings Ltd. (HDHL) agreed to act in such manner when the directors of NSS&L issued sufficient shares to HDHL and other related parties to reduce Exco's position to approximately 34%.

Richard J. held that in so doing, NSS&L's directors actions were in breach of the directors' fiduciary duty because the shares were issued for an improper purpose[217]. The sole purpose of the share issuance had been to waterdown Exco's 49% participation to 34%[218]. This represented the exercise of a fiduciary power for an improper purpose.

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215. See *Revlon, supra*, note 44. See also *Hanson Trust PLC v. ML SCM Acquisition, Inc., supra*, note 139.
216. See *supra*, note 208.
217. *Ibid.*, at 230-233.
218. *Ibid.*, at 232.

Richard J. stated that the directors power to issue shares «must be exercised in the best interests of the company and not for any collatteral purpose»[219].

Richard J. devised his own test to discover if corporate directors had breached their fiduciary duty which, in a refinement proposal from Berger J.'s test in *Teck*, aimed at distinguishing from the directors primarily motivated by self-interest from the directors that are motivated by the best interest of the corporation. It also attempted to balance the conflicting interests of the directors, the company, and the shareholders.

The test to be applied is thus the following: (i) «directors must be able to show that the considerations upon which the decision to issue was based are consistent only with the best interests of the company and inconsistent with any other interests; [and (ii)] this burden ought to be on the directors once a treasury share issue has been challenged»[220].

Richard J. applied such a test to the facts and concluded that the directors were in breach of their fiduciary duty. He thus refined the proper purpose doctrine that was more or less set aside by Berger J. in *Teck*[221].

Richard J. also commented the approach of Berger J. in *Teck*. He held that, contrary to the factual situation in *Teck*, there was no management decision at stake but only two groups of shareholders fighting it out. The directors of NSS&L in acting one-sidedly without proper business reasons to do so, breached their fiduciary duty to the company. As Richard J. stated, «in effect, Berger J. found that this was a good business decision for [Afton] and with that conclusion I agree»[222].

According to Richard J. the *Teck* case should be confined to its very particular facts.

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219. *Ibid.*, at 258.
220. *Ibid.* at 261.
221. See B. Welling, *supra*, note 190. The author, after discussing the *Teck* decision concluded that : «to summarize, there is no proper purpose doctrine», at 150.
222. *Exco, supra*, note 208 at 259.

(e) **Conclusion:**

The *Exco* decision has revived the proper purpose doctrine with a reinforced fiduciary duty. Richard J.'s test also draws nearer the U.S. «Modified» Business Judgment Rule by placing the burden of proof on the targets directors[223].

The problem with the proper purpose doctrine, as with any other motive-minded test, is in its difficulty of application because it is almost impossible to isolate «the» primary purpose of a board of directors which is nothing less than the sum of every purpose of every directors.

Also, most corporate statutes confer to the directors' powers in broad terms without specifying the purpose of a given directorial grant[224].

Berger J.'s test in *Teck* was probably more in tune with modern company law when he stated that if the purpose of the directors is not to serve the company's interests, then it is an improper purpose[225].

The proper purpose doctrine, if it is to apply in modern Canadian corporate law of take-overs, should probably use a more objective criterion considering both the wording of the statutes conferring directorial powers and also the conflict of interests situation face by company directors in responding to a take-over attempt.

As one commentator mentioned[226], one of the problems with Richard J.'s test in *Teck*, which requires that directors decisions should be consistent only which the best interests of the company, is that no defensive measure adopted by directors are inconsistent with self-interest since if successful, such a measure will necessarily preserve the directors' position. Sometimes a board may consider a bid to be unfair or not in the best interests of the company and either refuse the offer[227] or use a

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223. See *Cheff, supra*, note 102 and *Bennett, supra*, note 108.
224. See s. 122 C.B.C.A. which reads, in part: 122. (1) [*Duty of care of directors and officers*] Every director and officer of a corporation in exercising his powers and discharging his duties shall (a) act honestly and in good faith with a view to the best interests of the corporation; and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. (...)
225. See *Teck, supra*, note 198 at 312.
226. St-Patrick Baxter, *supra*, note 101 at 88.
227. It has been suggested that a board of directors can just say no to a bidder if the board proceeds in good faith and on reasonable grounds to come to such a conclusion that the bid is inadequate. This approach has been named the «Nancy Reagan defense» by U.S. securities lawyers because of the First Lady «just say no» anti-drug efforts.

defensive measure to thwart a hostile bid. Such a measure will necessarily be consistent with the interests of the company but also with the interests of the directors.

Under Richard J.'s test, directors will be put in the impossible situation of proving that it is not in their interest to remain as directors[228].

Richard J. did recognize the conflict of interest situation that is inherent in the take-over context, by shifting the burden of proof to the target directors but did not distinguish between inside and outside directors[229].

It is difficult to conclude with certainty on the fiduciary obligations of directors in the take-over context because the Canadian courts have failed to develop a consistent judicial framework and as Richard J. himself stated, this area of corporate law is in «a morass of conflicts and inconsistencies»[230] which future judicial consideration will hopefully clarify.

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228. See St-Patrick Baxter, *supra*, note 101 at 88. The present writer's opinion is to the effect that Richard J.'s words cannot and should not be interpreted quite that literally. The words «only the best interest of the company» cannot be interpreted to exclude other interests such as the directors' or the shareholders'. They should be interpreted to mean that only the best interest of the company will be taken into consideration when courts will have to determine the legality of a given defensive measure. The words «inconsistent with any other interests» should be followed by the words «that are *inconsistent* with any other interests of the company.» So as to not exclude the possibility that a board's decision may also be in the best interest of other constituencies.

229. *Ibid.* at 90, where the commentator opines that Richard J.'s test fails in not recognizing the distinction between «inside» and «outside» directors. (management directors as opposed to non-management directors). According to Mr. St-Patrick Baxter, a board of directors composed of a majority of outside directors should not be subject to the same burden of proof. He however recognizes the possibility of a conflict of interest and therefore turns to the U.S. «Modified» Business Judgment Rule in the case of outside directors. In the author's opinion, the U.S. «Modified» Business Judgment Rule as developed in *Unocal, Moran* and *Revlon* which imposes on the directors the initial burden of proving that «(1) they had reasonable grounds for believing that the take-over bid presented a danger to corporate policy and effectiveness or would result in substantial damage to the company's interests; (2) their decision to resist the take-over bid and their defensive measures were the result of an informed business judgment based on an evaluation of all material information; and (3) the defensive measures adopted were a reasonable response to the threat posed by the take-over bid», will permit a balance to be «reached between the protection of the interests of the corporation and the presumption of good faith and due inquiry that the law affords the business judgment of disinterested directors», at 92.

230. See *Exco, supra*, note 208 at 256.

At this point in time it is difficult to conclude that a shareholders' rights plan is sustainable from a corporate law standpoint because the issue has never been directly presented for judicial inquiry. Also, the few Canadian decisions addressing the fiduciary duties of directors and how to dispatch them[231] in resisting unsolicited take-over bids failed to give us the necessary consistency to opine on the legal validity of poison pill plans.

However, we may conclude that Canadian courts are unlikely to proceed to a detailed fact-study and modify directors' business judgment once an appropriate purpose has been established. Canadian courts look at the directors decision from a broader point of view by inquiring into their principal purpose. On the other hand, U.S. courts are narrower in their examination and inquire into the reasonableness of directors' decision, taking business decisions from the boardroom to the courtroom at the same time, a judicial step that the Canadian courts are obviously and rightfully hesitant to emulate.

A possible explanation might rely on the fact that Canada's legal and regulatory securities environment which we will now examine is very different from the one actually prevailing in U.S., which, it must be concluded, is more deserving of judicial intervention.

B) **Securities Law Regime**

In this section, we will try to analyze the prevailing securities law issues that pertain to the establishment of a shareholders' rights plan in Canada.

In the first part of this section, we will focus on the regulatory issues arising in connection with the implementation per se of a plan by a Canadian issuer.

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231. For a list of guidelines to be followed by directors in satisfying their fiduciary obligations in resisting an unsollicited take-over bid, see St-Patrick Baxter, *supra*, note 101 at 104-114 and H.J. Knowles, «Individual Involvement in the Take-Over Process» in *Meredith Memorial Lectures* (Cowansville: Yvon Blais, 1987) 1. See also F. Iacobucci, «Planning and Implementing Defences to Take-over Bids; The Directors' Role» (1980-81) 5 *Can.Bus.L.J.* 131. For an american view see M. Lipton, «Takeover Bids in the Target's Boardroom» (1979) 35 *The Business Lawyer* 101. See also Matheson and Norberg, *supra*, note 6.

In the second part of this section we will try to establish the regulatory issues that are most likely to justify such implementation by focusing on the differences in the regulatory environments in Canada and in the U.S.

1. Implementation of a shareholders' rights plan: Regulatory Issues

In the U.S., the operation of poison pill plans has not received the scrutiny that they are likely to receive in Canada. The Federal Securities and Exchange Commission has been impeded in its regulation efforts by the assertion of state jurisdiction over the corporate governance aspect of corporate take-overs. However, Canadian securities regulators will not hesitate to scrutinize what may be identified as corporate law matters when certain measures are likely to affect, in an adverse way, the integrity and efficient functioning of capital markets in Canada[232].

Various securities issues arise when a company's board of directors are considering the adoption of a poison pill plan such as the necessity of obtaining prior shareholders' approval, the Canadian stock exchanges' listing requirements, disclosure and prospectus requirements among others.

(i) Shareholders Approval

In Canada, all that is expressly required to implement a shareholders' rights plan is the authorization of the corporation's board of directors. There are no specific provision of corporate or securities law statutes or regulations that requires shareholders' approval prior to the plan's implementation.

However, the Ontario Securities Commission (OSC) has indicated that it would oppose the implementation of a rights plan if a majority of the issuer's shareholders did not approve of such a plan[233]. This approach

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232. In the «Canadian Tire» dispute, the Ontario Securities Commission issued a cease trading order after deciding that the take-over bid was abusive and in conflict with public interest even though no specific regulatory provision had been violated. See *Cdn. Tire Corp. v. C.T.C. Dealer Holdings Ltd.*, (1987), 10 O.S.C. Bulletin 509.

233. See Ontario Securities Commission: Blanket Orders, Interpretation, Notes and Notices, Notice re: *Regulation of Target Company Defensive Tactics*. See also D. Westell, «OSC makes clear it wants shareholders to approve poison pills.» The [Toronto] Globe and Mail (9 February 1989) B14. However, in the case of Numec Oil & Gas Ltd., the poison pill plan has been put into place without a shareholder vote. Because the

is consistent with paragraph 3 of National Policy No. 38[234] which is to the effect that prior shareholder approval of a take-over defense measure would, in appropriate cases, allay Canadian securities administrators concerns that such measure may be abusive of shareholders' rights in specific cases[235].

a) **National Policy 38**[236]

In 1973, the Ontario Select Committee on Company Law recommended a legislative change similar to Rule 38 of the United Kingdom City Code on Take-overs and Mergers which prohibits inter alia company directors from taking certain defensive measures in the event of a take-over attempt without the approval of a majority of the company shareholders in a general meeting[237].

National Policy 38 is the result of provincial securities commissions' efforts to regulate, without prohibiting, company's defensive measures in such a way that the target companies shareholders' interests are maximized[238].

National Policy 38 operates as a result-oriented policy[239] with an emphasis on shareholder access to the take-over bid decision[240]. In this sense corporate directors who act in good faith to deter a potential acquiror may very well be in breach of regulatory standard of conduct if the take-over bid is defeated and the target company shareholders lose the opportunity to make the take-over bid decision[241].

Numec pill is to expire after six (6) months, securities regulators decided a shareholder vote was not required. See also D. McMurdy, «Firms Arm to Fend Off Predators» The [Toronto] Financial Post (12-14 August 1989) 1 at 4.

234. National Policy No. 38 - Take-over Bids: Defensive Tactics (1986) 9 O.S.C. Bulletin 4255 [hereinafter *National Policy 38*].

235. In the case of Inco Ltd's plan, the board of directors has determined that it would not proceed with the recapitalization plan without shareholders approval, even though shareholders approval is not required by law, because of the significant financial implications of such recapitalization. See *supra*, note 161 at 8.

236. See *supra*, note 234. National Policy Statements are applicable throughout Canada.

237. F. Iacobucci, *supra*, note 231 at 161.

238. S.M. Beck and R. Wildeboer, «National Policy 38 as a Regulator of Defensive Tactics» in *Meredith Memorial Lectures* (Cowansville: Yvon Blais, 1987) 119 at 120.

239. *Ibid.* at 133-34.

240. *Ibid.* at 134.

241. This view is similar to the English Courts approach in *Hogg, supra*, note 196 where it was held that, notwithstanding the board of directors' good faith in believing that the issuance of shares was in the best interests of the target company, the proper purpose doctrine should apply and that the fiduciary power to issue shares was not intended to be used to dilute a majority holder.

However, given the result orientation of National Policy 38, directors who adopt a defensive tactic that ends up defeating a take-over bid, would not be in breach of the policy if the purpose of the adoption was to provide the target company's shareholders with a better deal[242].

Securities commissions will consider a rights plan acceptable when adopted prior to a take-over bid and when shareholder approval has been obtained. However the commissions will also examine the operation of a rights plan in the context of a particular bid to determine its conformity with the provisions of National Policy 38[243]. The review process will thus be very similar to the U.S. courts' approach where rights plans have usually been held valid upon adoption but very carefully scrutinized to determine the propriety of their operation[244].

National Policy 38 «addresses a significant gap left by the le-gislative process on the one hand, and the periodic and often confusing judicial review of defensive tactics on the other»[245]. It reflects an attempt to ensure that shareholders have a say in the disposition of their ownership rights in a company[246].

However, securities commissions should not intervene too hastily when shareholders have approved of the board's conduct. Regulators are cognizant of shareholders incapacity to properly protect them-selves through the use of the voting process and for such reasons, shareholders ratification will not automatically subdue regulatory concerns about defensive measures[247].

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242. It is to be noted that such a situation would require careful analysis. See also *Teck, supra*, note 198.
243. National Policy 38 is drafted to apply to post-bid defensive measures primarily for there is a presumption that measures undertaken during the course of a bid are destined to entrench management. Certain commentators have stated that National Policy 38 should not be read as an indication that securities regulators have no concerns about pre-bid tactics. Such measures may have consequences that, in certain circumstances, are more abusive than post-bid tactics. It is virtually certain that securities commissions will closely scrutinized poison pill plans. See Beck and Wildeboer, *supra*, note 238 at 136.
244. See *Moran, supra*, note 12. In the U.S. it has been held that a poison pill plan may be used to spur on a bidding contest or to effectively block a take-over bid. (see *Revlon, supra*, note 44 and *Dynamics Corp. of America v. C.T.S. Corp., supra*, note 52).
245. Beck and Wildeboer, *supra*, note 238 at 137.
246. *Ibid.*
247. *Ibid.* at 135-136.

There is little indication as to how a securities commission would apply National Policy 38 in a given fact situation. It may be appropriate to design a rights plan to meet certain regulatory concerns which are likely to be raised. A rights plan should be tailored to ensure that the target company's shareholders receive adequate consideration for their shares instead of discriminatorily penalizing one particular shareholder who reaches a determined level of participation in the company's stock[248].

Securities commissions are however provided with no effective legal remedy in the event that a defensive measure is in breach of National Policy 38. The commissions do not have the authority to require a board of directors to redeem the rights in order to allow the shareholders to have the final word in disposing of their stock[249].

Even though National Policy 38 has not been a significant factor in influencing legal advice as to the appropriateness of a particular defensive measure, it would be appropriate for a company's board of director to consider the regulatory response before proceeding with a shareholders' rights plan[250].

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248. Pegasus Gold Inc. which was the second Canadian company to adopt a poison pill plan, has anticipated such a regulatory concern. Pegasus' plan differs from Inco Ltd.'s in that it contains a «permitted bid» provision which allows target shareholders at a meeting initiated by the acquiror to veto, by majority vote, the directors decision to reject the bid under certain circumstances. In the U.S., recent variations of poison pill plans include what is referred to as «Value Assurance» plans. Mayflower Group Inc. in its defense of a hostile take-over bid by Laidlaw Transportation Ltd. sought to protect shareholders from both an inadequate bid and a subsequent failure of management to raise stock price should the offer be defeated by ensuring *inter alia* that shareholders received the difference between the offer price and the market price of the company's shares during a specified period subsequent to the withdrawal of the offer.

249. It has been suggested that a securities commission could, in theory, arrive at a similar position by removing the prospectus exemption otherwise available to the target company, by refusing to issue a final receipt for a prospectus or by refusing to allow the issued securities to be traded in the Commission's province regardless of the target company's jurisdiction of incorporation. See (OSC) Notice re: Regulation of Target Company Defensive Tactics, *supra*, note 233. See also s. 71 of the *Ontario Securities Act*, R.S.O. 1980, c. 466 as amended [hereinafter the O.S.A.] and s. 52 of *Québec Securities Act.*, R.S.Q., c. V-1.1 [hereinafter the Q.S.A.].

250. See *supra*, note 235.

b) **Stock Exchanges Rules**

Every company that has securities listed on the Montreal Exchange (ME)[251] and/or the Toronto Stock Exchange (TSE)[252] must give immediate notice to the relevant exchange of each proposed issue of securities, with the exception of non-convertible debt securities. In both the ME[253] and the TSE[254], the exchanges acceptances may be conditional on shareholders approval if, in their opinion, the proposed transaction may materially affect the actual control of the company and has not been negociated at arm's length or, is of such a nature as to make shareholder approval desirable considering the interests of the company, the shareholders and the investing public.

In the case of the ME, it may, if it deems it appropriate, require that the vote of shareholders *interested* in the proposed transaction not be counted in the determination of shareholders *approval* to the proposed transaction[255].

The *Southam*[256] and *Canada Malting*[257] cases both involved rapid share issuances without the approval of shareholders to non arm's length parties following rumours that the companies could be subject to takeover attempts.

In both these cases, the TSE and the OSC did not intervene to uphold the rights of shareholders under the Toronto Stock Exchange's By-Law 19.06 even though there was sufficient evidence to suggest that the share issuances acted as defensive measures for the purpose of retaining control.

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251. S. 9156A of Rule Nine of the Montreal Exchange: *Listing and Delisting of Securities*.
252. S.19.06 of Part XIX of Toronto Stock Exchange General By-Law. The TSE's Filing Committee ordered Pegasus Gold Inc. to submit its rights plan to a mandatory shareholder approval. See H.D. Whyte, «Pegasus Poison Pill requires approval» The [Toronto] Financial Post (8 February 1989) 14.
253. *Ibid.*, note 251, ss. 9156A(1), 9156A(2).
254. *Ibid.*, note 252, ss. 19.06(1), 19.06(2).
255. *Ibid.*, note 251, s. 9156A(3).
256. *In the Matter of Torstar Corporation and Southam Inc.* (1986) 9 O.S.C. Bulletin 3088.
257. *In the Matter of Canada Malting Co. Limited* (1986) 9 O.S.C. Bulletin 3566; *Re Canada Malting Co.; Re Molson Companies Ltd. and Ogilvie Mills Ltd.*, (1986) 33 B.L.R. 1 [hereinafter cited to B.L.R.].

i) Southam

Southam's major field of business activity is rooted in the information sector, most notably newspaper publishing. During the summer of 1985, the board of directors of Southam received notice from the financial advisors of the company that a take-over bid was imminent[258]. Southam's board feared that a break-up of the company was not in the best interest of the public and contrary to «the Southam Publishing Company philosophy»[259].

Southam thus entered into an agreement with Torstar, a company also involved in newspaper publishing, where Southam would sell some of its unissued common shares to Torstar, therefore increasing Torstar's participation in Southam to 20%. Pursuant to the agreement, Torstar then acquired an additional 5% on the open market. A ten year standstill agreement was entered into in which Torstar agreed to vote its shares in favour the directors that were nominated by the Southam family.

The issuance of shares was done without shareholder approval, in breach of the Toronto Stock Exchange By-Law 19.06. However, the TSE considered the transaction to be a private placement that did not require shareholders approval unless more than 25% of a corporation's equity was involved[260].

The OSC did not overturn the TSE's approval of the transaction because sanctions such as delisting, cease-trade orders or retroactive shareholders' approval would unfairly prejudice innocent shareholders who invested in Southam and/or Torstar during the period between the date of issuance of the Southam shares and the date of the administrative hearing.

The OSC however sanctioned both companies directors by preventing them from dealing in the Ontario capital market for six months[261].

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258. *Supra*, note 256 at 3095.
259. *Ibid.* at 3103-3105.
260. Toronto Stock Exchange Company Manual (1986), s. 620.
261. See *Certain Named Directors of Torstar Corporation and Southam Inc.* (1986) 9 O.S.C. Bulletin 3031.

ii) **Canada Malting**

Following rumours of a take-over attempt on Canada Malting Co. Limited, the board of directors authorized, without shareholders approval, a private placement share issuance to the company's two largest shareholders; Molson's Breweries and Labatt's Breweries allowing them to raise their stake in Canada Malting Co. Limited from 28.3% to 39.7%.

The TSE accepted the notice of the share issuance without shareholder approval because it considered that the Canada Malting Co. Limited issuance of shares did not materially affect control of the company even though two large shareholders had increased their ownership by more than 11%.

The OSC accepted that the transaction was non arm's length because both shareholders already controlled Canada Malting Co. Limited. The OSC decided that even though the control position was consolidated «there was no material change in their relationship to Canada Malting»[262].

The TSE's position in both cases is irreconciliable with the wording of its own policies and such position stands to deny shareholders of the opportunity to obtain a control premium[263]. The TSE failed to avail itself of rules specifically designed to permit the shareholders to decide whether managerial entrenchment affects their right to make the investment decision of receiving a premium for their shares in the event of a take-over that harms their personal interests[264].

c) **Securities Commissions Policies**[265]

The Québec Securities Commission Policy Statement No. Q-17 and Ontario Securities Commission Policy No. 1.3 require that a company, that is a reporting issuer, obtains the approval of minority shareholders in order to create and issue a class of equity shares (i.e. shares that carry the right to participate to an unlimited degree in earnings of the company and

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262. *Supra*, note 257 at 17.
263. L. Grafstein, «Whose Company Is It, Anyway? : Recent Developments in Canadian Takeover Law» (1988) 46 *U.T. Fac. L. Rev.* 522 at 540.
264. *Ibid.* at 536.
265. Although securities commissions policy statements do not have the force of law and are not intended to have such effect, we will nonetheless discuss them in the present text since securities commissions usually expect issuers to comply to such policies. (See s. 2 of Policy No. 1.1 - O.S.C. Policy Statements - General).

in its assets upon liquidation or winding-up) which do not carry a voting right at least equal to the right to vote attached to the shares for any other class[266].

Shareholders' rights plans that have such features as a voting rights plan[267] involve the use or creation of restricted shares as above-defined.

ii) **Prospectus Requirements**

Under both Ontario[268] and Québec[269] securities laws, a prospectus has to be prepared by a company that intends to make a distribution of securities[270]. In both provinces, exemptions from prospectus requirements are available to a company which issues subscription[271], conversion or exchange[272] rights relating to the company's securities to its securities holders. The securities issuance, upon the exercise of said rights, is also exempted from prospectus requirements[273].

However, such prospectus exemption is circumscribed by Uniform Act Policy No. 2.05[274] and OSC Policy No. 6.2[275]. Such a limitation is also evident under the Québec regulatory scheme[276].

The limitation comes from the obligation of the issuing company, in the event of a «rights offering», to prepare an offering notice containing

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266. Québec Securities Commission Policy Statement, August 26, 1986, no. Q-17: *Restricted Shares*, s. 1.
267. See text, *supra*, section 2.2(e): Voting Rights Plan. See also ME Policy I-10, *infra*, note 289.
268. S.52(2) O.S.A.
269. S.11 Q.S.A.
270. SS. 1(1)(11), 1(1)(42) O.S.A., s. 5 Q.S.A, for definitions.
271. S. 71(1)(h)(i) O.S.A., s. 52(1) Q.S.A.
272. S. 71(1)(h)(ii) O.S.A., s. 52(1) Q.S.A.
273. S. 71(1)(f)(iii) O.S.A., ss. 52(1), 52(4) Q.S.A.
274. Uniform Act Policy No. 2-05: *Applications under sections 34(1)14 and 71(1)(h) of the Securities Act by a company wishing to sell additional securities to its security holders*. The wording of the policy text however leads to the conclusion that the rights offering exemption is intented to be available to traditional rights offering established for financing purposes. (See e.g., s.4 which requires *inter alia* that a brief statement of the purposes for which the additional funds are required.
275. Ontario Securities Commission Policy No. 6.2: *Rights offering*. (Addendum to Uniform Act Policy No. 2-05, *Ibid.*).
276. See s.53 Q.S.A. See also ss.107, 108, 112, 113 and 114 of the *Regulation Respecting Securities* (Québec) [c. V-1.1 r. 1] [hereinafter *Québec Regulation*]. S. 108(4)b) of the *Québec Regulation* requires information concerning the proposed use of the funds obtained to be included in the offering notice required by s.53 Q.S.A. The comments concerning Uniform Act Policy No. 2-05 apply also here. See *supra*, note 274.

current and sufficient information concerning business affairs of the company. Said notice must be made available to the persons contemplated by the distribution so that securities holders are adequately informed of the terms and conditions of the offer before the company accepts any undertaking on their part[277].

Considering these regulatory dispositions, it remains to be ascertained whether prospectus exemption dispositions are intended to apply in the event of a distribution of rights pursuant to a shareholders' rights plan. Under the OSA, it may be easier to interprete these dispositions to apply in such a case for, under Ontario law, a prospectus is required only when there is a «distribution» of securities which is premised upon the existence of a «trade» which in turn is premised upon a disposition of a security for «valuable consideration»[278]. Since no valuable consideration is paid upon the issuance of rights in a traditional offering but only upon exercise of said rights, we may thus argue in favor of the application of the prospectus exemption dispositions to the initial distribution of rights pursuant to a shareholders' rights plan[279].

Upon the exercise of the rights, prospectus exemption for the issuance of shares is evidenced by dispositions in both Ontario and Québec legislations[280].

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277. These limitations to prospectus exemption would evidently not apply in the event of a stock-dividend distribution plan such as a convertible preferred stock feature in a shareholders' rights plan. The issuance of convertible securities under such a plan would benefit from prospectus exemption since such a «rights offering» would not be established for financing purposes. See s. 71(1)(f)(i) O.S.A., ss. 52(2) and 53 Q.S.A.

278. See ss. 1(1)(11), 1(1)(42) O.S.A.

279. The initial distribution of rights will thus not be considered as a «distribution» of securities within the meaning of the O.S.A. and most Canadian securities legislations which are tailored on the Ontario legislation. Henceforth, the OSC's position is to the effect that a rights offering pursuant to a shareholders' rights plan will ordinarely be prospectus exempted without any necessity for the issuer to apply for an exempting order so long as shareholders' approval of the plan is obtained. In Québec, the initial distribution of rights, notwithstanding the absence of «consideration», will however be considered a «distribution» of securities within the meaning of the Q.S.A. and an application to the Québec regulator for an exempting order is advisable. The Nova Scotia Registrar of Securities has also rejected the OSC position notwithstanding the definition of «distribution» pursuant to the Nova Scotia Securities Act which is identical to that of the O.S.A. and considers the implementation of a shareholders' rights plan to effect a «distribution» of securities. See C.S. Reagh, «Nova Scotia: Poison Pills» The Canadian Senior Executives' Legal Alert, Vol. 8, No. 10, at 114 (January 1990).

280. *Supra*, note 273.

In the event of a shareholders' rights plan that contains a Flip-over feature permitting rightsholders to acquire shares of an unrelated company at a discount, it seems doubtful that a prospectus exemption would be available upon the issuance of shares by the unrelated company.

Considering the wide residual jurisdiction of securities commissions to intervene when rights are issued improperly, some uncertainty remains as to prospectus exemption at this time[281].

(iii) **Disclosure Requirements**

It is a cornerstone principle of securities regulation that all persons investing in securities have equal access to information that may affect their investment decisions[282]. Therefore, a material change report should be prepared and a press release distributed disclosing the substance of the change when a shareholders' rights plan is adopted[283]. This should be done even though studies have showed that a rights plan is not likely to have a significant influence on the value or market price of the securities of the rights issuer[284].

For companies whose securities are listed on the ME and/or the TSE, prompt notice of each proposed material change in the business or affairs shall be given to the proper exchange[285].

Companies will also give prompt notice to the proper exchange of any action with respect to dividends or allotment of rights for subscription to shares or other securities[286]. For companies listed on the TSE, such notice shall also be given to the shareholders[287].

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281. In the Inco Ltd. situation, the OSC did not consider that the original distribution of the rights required a prospectus to be prepared. However, Inco Ltd. undertook to file a prospectus upon the exercise of the rights agreeing that the exemption provided for in s. 71(1)(f)(iii) O.S.A. would not apply, though no order for the removal of the exemption set forth in s. 71(1)(f)(iii) O.S.A. has been issued. It would be proper to consider that a prospectus will be required upon the rights becoming exercisable. See J.E.A. Turner, *supra*, note 9 at 30-32.
282. National Policy No. 40: Timely disclosure [hereinafter National Policy 40].
283. See ss. 74(1) O.S.A., 73 Q.S.A. See also *Ibid.*, National Policy 40 which establishes a non limitative list of developments to be disclosed including, *inter alia*, changes in an issuer's issued capital, stock splits, changes in share ownership that may affect control of the issuer, changes in capital structure.
284. See Study by the Office of the Chief Economist, *supra*, note 17.
285. *Supra*, note 251, s. 9153 ME, *supra*, note 252, s. 19.09 TSE.
286. *Ibid.*, ss. 9162, 9163 ME, s. 19.15 TSE.
287. *Ibid.*, s. 19.15 TSE.

(iv) **Listing Requirements**

The majority of shareholders' rights plan allow for the issuance of rights which initially trade with the issuer's common stock. The rights will normally be listed on the proper exchange, as will the underlying securities[288].

Since typical rights plans provide that rights issued thereupon usually have a term of ten years, they resemble warranty or option securities. These securities are generally exercisable over a longer period than is normally associated with rights, therefore it may be advisable to refer to the stock exchange provisions concerning warrants[289].

(v) **The Discounted Shares**

Some shareholders' rights plan allow rightsholders to purchase shares of the issuer (Flip-in) or of an unrelated company (Flip-over) at a discount. Both the ME and the TSE have adopted policies concerning maximum discounts in certain circumstances[290] that cannot exceed 10% - 25% depending on the market price of the issuer's securities at the time of the granting of the options.

The policy statements are applicable to stock options, stock purchase plans or share issuances which are used as incentives or compensation mechanisms for persons who provide services for listed companies as employees or otherwise[291]. The policy statements are not directed at options granted for the purpose of a distribution of securities either publicly or otherwise[292].

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288. See ss. 9163, 9164 ME, s. 19.15 TSE. See also ss. 638-653 Toronto Stock Exchange Company Manual (1986).
289. See Rule 9 ME, *Ibid.* ss. 654-668. ME Policy I-10: *Take-Over Bid Protective Provisions For Restricted Shares* provides *inter alia* that the exchange will not accept for listing classes of restricted shares that do not have take-over bid protection provisions («coattails») to ensure that the holders of restricted shares are not prevented from participating in a take-over bid on an equal footing with the common shareholders.
290. See ME Policy I-1: *Employee Stock Options, Stock Purchase Plan And Options For Services* and *TSE Policy Respecting Employee Stock Option And Stock Purchase Plans, Options For Services And Related Matters*.
291. *Ibid.*, s.1 ME, s.1 TSE.
292. *Ibid.*

However, the policies state that the proper exchange may, in certain circumstances, consider it appropriate to apply the rules set out therein to other types of transactions[293].

(vi) **Issuer Bid Requirements**

In some shareholders' rights plans such as note purchase plans and convertible preferred stock plans with special redemption fea-tures, the rightsholder is entitled to tender his stock to the issuer for a determined consideration. The issuer, by acquiring securities issued by it, thus proceeds by way of an issuer bid.

Both the OSA and the QSA provisions concerning issuer bids receive application upon the exercise of the rights[294]. If the number of securities deposited in response to the issuer bid is greater than the number that the issuer is willing to acquire, he shall reduce the number of securities deposited by each holder in proportion with the number of securities deposited by each security holder[295] (Pro rata take-up) unless an exemp-tion is available[296].

2. **Justifying the implementation of a shareholders' rights plan: Regulatory Issues**

The creation of shareholders' rights plans was prompted by a significantly different regulatory environment than the actual legislative scheme prevailing in Canada where coercive take-over bids are not permitted. Maneuvers such as two-tier front-end acquisitions and greenmail are common in the U.S. but specifically regulated against in Canada. The poison pill was also designed to give man-agement a sufficient time-frame to negotiate an acceptable deal for the shareholders thus avoiding unfair tactics such as a street sweep[297].

Canadian statutory rules regulating take-over bids form a comprehen-sive code. All purchases made by an offeror must proceed by way of the procedures stipulated in the relevant securities statute unless the

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293. *Ibid.*, see also Québec Securities Commission Policy Statement, (October 30, 1986), No. Q-3: Options, s. 1.
294. S. 88(1) O.S.A., s. 147.19 Q.S.A.
295. S. 94(7) O.S.A., s. 147.2, 147.20 Q.S.A.
296. S. 92(3) O.S.A., s. 147.21 Q.S.A.
297. See *supra*, note 8.

transaction may be brought within the extent of an exemption from the rules[298].

The rules are intended to protect investors, while balancing the goals of maintaining confidence and neutrality between the offerors, the offeree company management and competing offerors.

They are designed to give the offeree shareholders sufficient time to digest the notice of the bid and their directors response to it; seek advice, and respond to the offer, thereby mitigating the pressure created by the offer of a premium price and the limited time frame in which to consider the offer.

The rules also counterbalance the offeror's informational advantage by requiring the disclosure of all relevant facts known to the offeror, as well as the offeror's intentions concerning the target company if should the offer succeed.

In effect, the rules require that all shareholders have an equal opportunity to participate when a take-over bid is made. It is thus obvious that the regulatory environment of the U.S. which prompted the creation of the poison pill is quite unregulated in comparison to Canada where the rules are designed to protect against most of the coercive situations which may occur in the U.S.[299] In 1965, the Kimber Committee stated that the primary objective of the [Canadian] take-over bid laws should be the protection of the bona fide interests of the shareholders of the offeree company[300].

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298. One of the exemptions provided by s. 119 Q.S.A. is for offers made through the facilities of a recognized stock exchange. Equivalent exemptions exist in other provinces' rules.

299. See for examples s. 141 Q.S.A. restricting market acquisitions during the course of a bid; s. 142.1 Q.S.A. integrating pre-bid purchases made within 90 days prior to a formal offer by requiring that the subsequent offer be made at a consideration at least equal to the consideration paid in connection with the pre-bid purchase; s. 144 Q.S.A. prohibiting post-bid acquisitions for 20 days following the expiration of the bid; s. 145 Q.S.A. requiring that identical consideration be paid to all shareholders in connection with a bid and prohibiting private agreements that would create disparity among shareholders; s. 147.4 Q.S.A. prohibiting the offeror from acquiring securities for a period of 21 days following the date of the bid; ss. 147.19, 147.23 Q.S.A. prohibiting private purchases by a corporation of its own shares. See also *Québec Regulation* ss. 183ff. regulating going private transactions by providing that a valuation of the offeree issuer must be made unless an exemption is obtained from the Commission.

300. Report of the Attorney General's Committee on Securities Legislation in Ontario, para. 3.10 (1965). See also National Policy 38, *supra*, note 234.

If an offer is made to all security holders through a stock exchange recognized by the securities commissions it will be exempted from the procedural steps stipulated in securities statute. However, the offer will have to comply with the stock exchanges rules[301]. These rules and regulations arose as a result of a number of apparent abuses of the exemption which permits an offeror to make an «exempt offer» through the facilities of a stock exchange. If the stock exchange rules are not complied with, the offer will not be considered to be exempted.

On September 1, 1989, Canadian stock exchanges have implemented new rules designed to ensure that shareholders receive full or fair value for their stock in the event of a take-over bid[302]. Under the new stock exchange rules, the holder of 20% or more of the outstanding shares of a listed company is limited to acquire 5% of additional outstanding shares in a twelve months period. The previous rules allowed the purchase of an additional 5% in 90 days[303].

These amendments to the stock exchange rules impose obligations on the offeror who proceeds with a stock exchange take-over bid that may prove to be equally (if not more stringent) than the statutory procedure[304]. The offeror must file a notice of a stock exchange take-over bid with the proper exchange and with the proper securities commission(s) after acceptance by the exchange that contains material information about the

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301. See *supra*, note 298. See also ME Policy I-12: *Stock Exchange Take-Over Bids and Issuer Bids*; Montreal Exchange Rule Twelve: *Stock Exchange Take-Over Bids and Issuer Bids* [hereinafter R12]. See also ME Policy I-10, *supra*, note 289.
302. See D. Slocum, «Crackdown on creeping take-overs» The [Toronto] Globe and Mail (6 September 1989) B1.
303. *Supra*, note 301. R12 of the Montreal Exchange has been revised as at September 1, 1989 to reflect provincial securities regulators concern that an investor could gradually accumulate shares in a target company in the open market without making an offer to all shareholders and thus avoid the take-over bid premium. S.12001(1)q) of R12 defines a stock exchange take-over bid as a take-over bid made through the facilities of the exchange *other than a normal course purchase*. The latter is also defined at s. 12001(1)r) as a «take-over bid» and therefore applies to outstanding purchasers that hold or would hold after the purchases at least 20% of the outstanding shares (10% if in the case of a company incorporated under the *Canada Business Corporations Act*). Until September 1, 1989, an exempted *normal course purchase* was defined as a purchase of such a number of a class of securities that, together with all other purchases in the preceding 90 days, constituted no more than 5% of the securities outstanding. As at September 1, 1989, the time frame was extended from 90 days to twelve months.
304. See *Ibid.*, ss. 12002(8), 12002(9) providing that the offeror must provide the shareholders of the target company with information on the terms of the offer by the filing of a notice with the exchange to be sent to each registered holder of the class of securities that is the subject of the bid in Canada. The offeror must also offer the same conditions to all holders of securities of that class and is prohibited from making any agreement that would have the effect of creating disparity among shareholders.

take-over bid that will help the shareholders in their decision-making process[305]. Also, all Canadian stock exchanges have established an uniform twenty-one days minimum period for all take-over bids to provide more time for a competing offer to be put forward[306].

Considering these regulatory rules, the question that arises at this time concerns the effective need for a defensive measure such as a shareholders' rights plan in Canada. Coercive and unfair take-over tactics such as evidenced in the U.S. market place are evidently regulated against here.

However, from a target company perspective, there are plausible reasons for implementing a shareholders' rights plan. It will not only discourage hostile bids but it will also provide the board of directors of the target company with more time to react by forcing the bidder to negotiate an acceptable deal for all shareholders[307]. The general argument in favor of shareholders' rights plans is that current securities laws give the offeror an advantage because a company board can seldom respond to an offer rapidly because the laws do not allow directors sufficient time

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305. See *Ibid.*, s. 12003 which requires, *inter alia*, information regarding plans of the offeror to liquidate the target, to sell, lease or exchange all or substantially all of the target's assets or to make any major change in the business, operations or corporate structure of the target. See also s. 12003(o) which requires information regarding the financial resources of the offeror including the source of funds to be used to pay for securities tendered to the bid and the terms of any financing obtained.

306. See *Ibid.*, s. 12005 providing that the book for receipt of tenders may not be opened until the morning of the twenty-first clear trading day after acceptance of the notice. The former time period was eleven trading days.

307. In the 1988 Nova Corp. (Nova) take-over attempt of Polysar Energy & Chemical Corp., (Polysar), Polysar's shareholders ended up receiving a premium of 200% over market value due to a by-law provision that, although not a poison pill, operated just like one by restricting voting ownership in Polysar to 25%. Formerly Canada Development Corp., a Federal government-controlled company, Polysar's by-laws included an old government provision giving the Polysar board the power to remove the voting rights and dividends entitlements of any person who tried to purchase 25% or more of Polysar. Through a tender offer of $14 per share, Nova increased its holding in Polysar to a maximum of 25%. The 25% rule permitted the Polysar board to orchestrate a $10 per share dividend to force Nova to increase its bid for the rest of Polysar stock. The Polysar board circumvented the 25% rule by selling the company's assets to Nova earning shareholders $14.50 in cash plus half a Nova share for each share of Polysar for a total value of about $21. Considering the $10 per share dividend, Polysar's shareholders received $31 per share, a 200% premium from the $ 14 per share initial offer. See T. Corcoran, «Poison Pills can raise shareholders' values» The [Toronto] Financial Post (19 October 1988) 13. See also J. Daly, «The Final Victory, Falconbridge may prove to be too expensive» Maclean's (2 October 1989) 40-41, where Falconbridge's poison pill plan partly contributed to increase shareholders' value by forcing Noranda to increase its bid from $23 to $37 per share in a year.

to deal with take-over offers or with the arrival of an unfriendly suitor in order to get a better deal for the shareholders[308].

Another argument in favor of shareholders' rights plans is the protection of a Canadian issuer which may be subject to U.S. style abuses when a large volume of trading of its shares occur on the U.S. stock exchanges. Since Canadian regulators have no direct authority to regulate take-over activities occurring in the U.S., a Canadian issuer cannot be assured that Canadian regulators will impose Canadian standards on transactions occurring outside of the country and a U.S. defense mechanism may be then a justified solution. Indeed, effective control can be acquired from institutional shareholders or arbitrageurs in a matter of hours[309]. «Because of subsequent rule changes, a Canadian offeror would now be unable to carry out a U.S. street sweep for a Canadian company»[310]. A non-Canadian offeror would likely be exempt from Canadian regulators intervention for jurisdictional reasons[311].

Other arguments in favor of supporting the shareholders' rights plans utility in Canada exist. For example, a private purchase from not more than five holders by way of a block purchase at less than a 15% premium above market price would not trigger the take-over bid provisions[312]. Also, most provincial legislation allow purchases of up to 5% of a company's shares in any 12 months period without any restriction on the accumulated total[313]. A widely held company could gradually become a controlled company[314].

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308. In the case of the Inco Ltd. plan, both Canadian and U.S. shareholders need protection. At the time of the implementation of the Inco Ltd. plan, the time period of a take-over bid during which a competing offer could be put forward was eleven days. The Inco Ltd. board felt that this time frame may be insufficient and leave U.S. shareholders in the cold. The time period has since September 1, 1989 been increased to twenty-one days. See *supra*, note 306. See also *Inco Material Change report, supra*, note 161 at 3.

309. In 1979, Edper Equities Ltd. raised its interest in Brascan Ltd. to 33% from 5% in two days through purchases on the American Stock Exchange.

310. See Coleman, *supra*, note 8 at 4. See also s. 113 Q.S.A. stating that a take-over bid will be subject to the Part IV of the *Québec Securities Act* if the offeror intends to acquire securities from at least one security holder having a connection with Québec by his address, his residence or by his presence in the territory at any time during the bid.

311. Coleman, *Ibid.*

312. See s. 123 Q.S.A.

313. See s. 120 Q.S.A. See also *supra*, note 303.

314. See T. Corcoran, «Should Canadian Pacific take a poison pill» The [Toronto] Globe and Mail (2 August 1989) B2.

In Canada, nearly all publicly-held companies have majority shareholders and so do not need to formulate defensive measures at all. However, because of regulatory «gaps» between the U.S. and the Canadian legislation, a rights plan may be an adequate remedy to ensure that American and Canadian shareholders receive a fair value for their stock. Indeed, when a lot of shareholders are American and the company trades in the U.S., shares can be gathered quickly. At the same time, a slow stockpilling of shares in Canada is possible.

5. Concluding Thoughts: The Inco Pill

As the foregoing discussion has attempted to indicate, while there may exist solid reasons for a Canadian corporation to implement a shareholders' rights plan or poison pill, one has to bear in mind that the Canadian legal and regulatory environment differs significantly from that of the U.S. where the poison pill was originally conceived.

A board of directors would act recklessly if it were to import into Canada take-over bid defensive measures such as the shareholders' rights plan without careful and detailed scrutiny of the U.S. practices.

While shareholders' rights plans and related restructuring are common in the U.S., they are a relatively new phenomenon in corporate Canada. Much of the Canadian financial and legal community took notice when Inco Ltd. («Inco»), a widely held Canadian nickel producer, announced its adoption of a shareholders' rights plan on October 3, 1988 becoming the first Canadian corporation to adopt a poison pill defensive measure.

The Caisse de Dépôt et Placement, a major shareholder of Inco, has filed suit in Québec Superior Court seeking to have Inco's plan ruled illegal. The fundamental issue being whether or not an issuing company may, from a corporate law standpoint, discriminate against a shareholder who reaches a certain level of ownership in the common stock of the company by diluting his position and thus making a take-over prohibitively expensive. The lawsuit also argues that the rights plan transfers the right of the shareholders to evaluate the tender offer to the board of directors.

Inco announced its plan on October 3, 1988 after the company substantially increased its current cash generation and earning capabilities after achieving an improved competitive position within the nickel industry which benefited from a fundamental improvement in 1988.

However, while the price of Inco common shares had risen during 1988, the board of directors felt the stock was undervalued and did not adequately reflect the quality of the company's assets and improved position in the nickel industry therefore making Inco a likely take-over target.

The board of directors of Inco decided to proceed to a recapitalization plan to reduce this value gap by providing an immediate cash return to the shareholders while also maintaining financial flexibility.

The Inco board decided to recapitalize and pay its shareholders a (U.S.) $10 dividend per share but feared that such a substantial dividend would promote heavy trading of Inco stock with many investors selling out to avoid the tax consequences of the dividend payment. Such intense trading would provide an ideal opportunity for a U.S. acquiror to proceed to a street sweep on the U.S. stock exchanges leaving Canadian shareholders in a minority position.

The Inco board also feared it could not adequately protect its U.S. shareholders because a Canadian acquiror could proceed to a tender offer on a Canadian exchange and exclude all non-Canadians from the offer considering the relatively brief time frame allowed for a tender offer under Canadian securities laws. U.S. shareholders could be excluded from participating in a tender offer that would have considerable value.

Therefore, to protect its recapitalization and its broad-based shareholder pool, Inco's board of directors adopted a shareholders' rights plan.

The rights were issued pursuant to a Rights Agreement between Inco and a trust company acting as rights agent. The shareholders' rights plan is fairly conventional. The rights contain both a «Flip-in» and «Flip-over» feature, which allow shares of Inco or of another person to be purchased at a discount in certain circumstances and which account for the rights dilutive effect.

The Flip-in feature operates in the event that a defined «Acquiring Person» acquires over 20% of the issued and outstanding common shares of Inco. Shareholders, other than the Acquiring Person, will be entitled to receive at the then current exercise price of the rights that number of common shares having an aggregate market price on the stock acquisition date equal to twice the exercise price. The rights will thus allow common shares of Inco to be purchased at a 50% discount.

The Flip-over feature operates in the event of (i) a transaction in which Inco consolidates with, amalgamates with or enters into an arrangement with any other person and in connection therewith, all or part of the outstanding common shares are changed in any way or converted into or exchanged for shares or other securities or cash or any other property or (ii) a transaction or series of transactions in which, directly or indirectly, Inco or one or more of its subsidiaries sells or otherwise transfers assets aggregating more than 50% of the assets or generating more than 50% of the operating income or cash flow of Inco and its subsidiaries to any other person (other than Inco or one or more of its wholly-owned subsidiaries).

If such events occur, the rights plan states that provision shall be made so that each holder of a right again has the right to receive, upon the exercise thereof at the then current exercise price of the right, that number of shares of common stock of the person engaging in the Flip-over transaction or event having an aggregate market price on the date of consummation of such transaction or event equal to twice the exercise price. Inco shareholders are thus allowed to purchase shares of the other person at a 50% discount.

Inco's board of directors is given the option at any time prior to the occurrence of a Flip-in event to elect to terminate the rights. Such termination option exists in order to permit the board to negotiate with a potential acquiror before a Flip-in event occurs and to terminate the rights if the board determines that a fair price will be paid to all shareholders.

Inco's board of directors is also given the option after a Flip-in event has occurred, if it determines that conditions exist which would eliminate or otherwise materially diminish the benefits intended to be afforded to the holders of rights, to issue or deliver in return for the exercise price, either debt or equity securities or other assets having a value equal to twice the exercise price or without charge, debt or equity securities or other assets having a value equal to the exercise price.

Before adopting its shareholders' rights plan, Inco's board of directors decided to consult the OSC to obtain the regulatory agen-cy's approval. Shareholders approval was the OSC's main concern and consequently Inco proposed to put its recapitalization plan to a shareholder vote and pledged to dismantle the pill if shareholders voted against the plan.

The OSC did not address the merits of Inco's rights plan. It did put the board of directors of Inco on notice that it would be examining management's actions closely and would intervene after the pill was implemented if it deemed it necessary in circumstances where the plan would be utilized to the detriment of Inco's shareholders or in an otherwise abusive manner[315].

The most important aspect of the Canadian regulatory environment is thus the apparent requirement of shareholders approval for implementing a rights plan.

However, it is difficult to take a conclusive learning from the Inco situation in anticipation of the Québec Superior Court decision on the legality of the plan. In Canada, corporate law issues, particularly regarding discrimination inherent in any rights plan may be resolved differently than in the U.S. where despite the inherent discrimination, courts upheld rights plans similar to Inco's saying such would provide directors with a shield to fend off coercive offers and with a gavel to run an auction[316].

A Canadian court, when asked to decide on the legality of a shareholders' rights plan will be asked to critically examine other important issues such as valuation evidence to determine whether or not a rights plan was deployed in the best interests of the shareholders. Since courts have limited expertise in matters that relate to business judgment and valuation, it can be affirmed with relative certainty that courts should refrain from intervening when shareholders approval of the plan has been obtained considering the matter relates to an economics issue rather than a corporate governance one[317]. Shareholders' approval should inevitably influence the court in finding against an allegation of oppression. A court

315. In contrast, Vancouver based Pegasus Gold Inc. adopted a shareholders' rights plan on December 1, 1988 without offering to put the plan to shareholders or obtaining prior approval of its provincial securities commission in British Columbia. The Toronto Stock Exchange, where Pegasus' stock is traded did intervene however and ordered Pegasus' board of directors to submit the rights plan to a shareholder vote at its following annual meeting. See *supra*, note 248. Pegasus Gold Inc.'s plan differs from Inco's in that it contains a special «permitted bid» provision granting shareholders greater rights and less discretion to the board in the face of a take-over bid. Therefore, the plan attempts to comply with the concept of shareholder approval required by the Ontario Securities Commission for the Inco plan by including a provision under which certain bids would be put to a shareholder vote before the rights are exercised.

316. See *C.R.T.F. Corp. v. Federated Dep't Stores, supra*, note 13.

317. See *supra*, note 3 at 22 «It seems clear that takeover battles should be decided on the basis of economics, not legalism. Put another way, shareholders surely know their own interests better than any judge can».

may however hold that while the creation of a rights plan is not oppressive, the operation of the plan, in particular circumstances may affect shareholders' rights in an oppressive manner[318].

A Canadian court should also intervene if it has any doubts about the use of a rights plan and force the redemption of the rights in order to insure that the final question of whether the company should be sold be left in the sole hands of the owners of said company[319].

Considering the inherent risk that the integrity of the company's board of directors decision-making process may be compromised by motives of self-entrenchment in the adoption and/or the operation of the rights plan, a heightened standard of review is thus suggested.

Shareholder wealth maximization, which should be the ultimate justification for a shareholders' rights plan is likely to be incorporated in the courts standard of review.

In Canada, there is relatively less take-over litigation than in the U.S. While different in details, both countries regulatory systems, reflecting the uniform character of the take-over bid as a legal institution, are necessarily analogous. It is thus to our advantage that we can benefit from the massive quantity of thoroughly analyzed U.S. cases.

Will the Canadian courts defer to actions taken by securities regulators having regard to their statutory mandate and their expertise in the matter or will they address the issue head on and turn the poison pill into a placebo?

It is to be hoped that a clear judicial framework will be developed in Canada in the area of take-over defences and will delineate reasonable

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318. Under s.241 of the C.B.C.A, a complainant may apply to a court for an order varying or setting aside a transaction or contract to which a corporation is a party if, *inter alia*, any act of the corporation 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 security holder. See *Re Sabex Internationale Ltée*, (1979) 6 B.L.R. 65 (Qué. S.C.) where Gonthier J. held a right offering dilutive effects to be oppressive to minority shareholders' rights.

319. It is to be noted that no U.S. company with a poison pill plan has ever allowed the rights to be exercised. Poison pill plans have always been used as a means to negotiate with an acquiror.

and clear boundaries of legitimate activity and determine the available recourses when such limits are transgressed.

Hopefully the Québec Superior Court's decision in the Inco case will provide the Canadian legal community with these much awaited guidelines.