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A U.S./Canadian Dialogue About the Current State of Poison Pills

By Lawrence A. Hamermesh and Pierre-Yves Leduc

Canada and the United States have both developed case law pertaining to poison pills, which are the most common defense for a board facing a hostile bid. Comparing the two countries' jurisprudence suggests that a poison pill defense is significantly more effective in the United States. The following fictitious case study reveals how the two countries differ on the extent to which a target company board can rely on a poison pill to deter a hostile bid.

Easytarget Inc. is an American semiconductor chip maker incorporated in Delaware. Its shares of common stock are trading on NASDAQ at $26 per share. Easytarget's board of directors recently reconfirmed its long-standing strategic plan to consolidate numerous smaller players in the industry, enabling it to challenge certain dominant competitors. Easytarget is widely held, except for one institutional shareholder that holds 12 percent of its outstanding stock. DynamicGiant, a dominant player in the semiconductor industry, has announced its intention to launch a bid to acquire all of the shares of common stock of Easytarget at a price of $34 per share, conditional upon a minimum tender of 50 percent of the outstanding common stock.

The consensus of Easytarget's board is that DynamicGiant's bid does not reflect an adequate premium for the control of Easytarget and fails to compensate its shareholders for the value of Easytarget's growth prospects. Easytarget's board seeks advice on whether and to what extent Delaware law and U.S. federal securities laws permit the poison pill to prevent DynamicGiant from consummating its bid. The board has indicated that Easytarget's annual shareholders meeting will be held within the next four months. Three board members of Easytarget are Canadian residents, and are asking if, and how, our answers would differ if Easytarget were instead subject to Canadian corporate and securities laws.

Delaware Yankee: When the Delaware Supreme Court upheld the poison pill in 1985, it left open the question of when the directors' fiduciary duties would require them to eliminate the poison pill and permit a hostile bid to proceed. There is a range of potential justifications for maintaining poison pill defense. Let's start by examining the least controversial one: deterring a two-tier, front-end loaded bid that is structurally coercive, and prevents effective voluntary shareholder choice in responding to the hostile offer. There has never been any question in Delaware that this is a legitimate use of the poison pill. At least partly for that reason, however, we don't see any such hostile bids, as we did back at the time the poison pill was first developed.

Canadian's response: In Canada, the two-tier, front-end loaded bid has not been used, simply because regulations adopted by provincial securities commissions require that the per share consideration in a second step transaction is at least equal in amount and form to the consideration received by tendering shareholders.

Delaware Yankee: In Delaware it became clear soon after 1985 that boards could deploy the poison pill to permit them to develop alternative transactions — restructurings, and not just white knight competitive bids — that might result in greater value to stockholders than the hostile bid. So at the very least, Easytarget's board can maintain the poison pill for a considerable time — there's no set limit — while searching for potentially superior transactions. Within reason, the timetable and content of that search is up to the board's business judgment. Once the process concludes, however, and the board presents its preferred transaction to the stockholders, it

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is the stockholders who will have the final say, either by tendering shares or voting on a proposed transaction; the poison pill falls by the wayside.

Canadian's response: Canada's approach is a lot friendlier to the unfriendly bidder. Canadian securities commissions have used their public interest jurisdiction to regulate poison pills based upon guidelines they adopted in 1986 (referred to as National Policy 62-202) dealing with defensive measures in face of a takeover bid. According to that policy, "public interest lies in allowing shareholders of a target company to exercise one of the fundamental rights of share ownership — the ability to dispose of shares as one wishes." Nevertheless, Canadian regulators have through numerous poison pill cases confirmed that a poison pill plays a legitimate function by giving management of target companies more time than the minimum prescribed by law (currently 35 days from the launch of the bid) to explore alternatives that would maximize shareholder value. But unlike Delaware's approach, that value maximization process has been narrowly interpreted by case law to be limited to finding alternative superior bids. Any other transactions not offered to shareholders, such as the sale of assets and issuance of additional shares, would, in most instances, be perceived by the regulators as additional defensive measures subject to careful scrutiny by the regulators. In deciding whether to prohibit continued use of the poison pill, securities commissions consider the likelihood that the target company will be able to find a better bid, and they usually limit the search for alternative bids to at most 60 days after the initial bid was commenced. To conclude, considering that the bid made by DynamicGiant does not appear to be structurally coercive, the board of directors of Easytarget can adopt a poison pill in order to obtain 10 to 30 days in addition to the minimum 35-day period required by law to conduct an auction or other value maximization process for the shareholders.

Delaware Yankee: Delaware's corporate law affords boards much more discretion and avoids the regulatory approach you describe. From *Household* on, the Delaware courts have emphasized that directors' responses to takeover bids are part of their statutory managerial responsibilities. Thus, poison pills may be used for any legitimate corporate purpose, and not just to protect a process for developing alternative transactions in the face of a hostile bid. In our view, the latter approach — limiting the use of the pill to protecting efforts to sell the company — effectively takes away from the board the decision about whether and when to put the company up for sale.

The hard question is what limits the board's discretion in maintaining a poison pill. Practitioners have always speculated that Delaware courts would endorse the so-called "just say no" approach, in which the board can maintain a poison pill simply to continue its existing strategy and block a hostile bid indefinitely. That issue was what was addressed in the well-known decision by Chancellor Chandler in the *Airgas* case last year, in which the Court of Chancery declined to compel the elimination of the poison pill in the face of an all-shares, all-cash tender offer accompanied by an undertaking to complete a second-step merger promptly and on the same terms. The board's concern that the court legitimated has been described as "substantive coercion": The risk that despite board advice to the contrary, stockholders might choose to tender into an inadequate bid due to ignorance or mistaken belief about the value of the stock.

This is not a position that the Delaware court found easy to reach: At a minimum, it required substantial proof of the basis for the expressed concern, and in the *Airgas* case itself, the court took considerable comfort from the fact that three of the directors who voted to maintain the pill had been nominated by and elected with the aid of the hostile bidder. So no one should think that directors can "just say no," without more; even under Delaware's relatively director-centric approach, courts can and do demand specific evidentiary support for the proposition that the board's maintenance of the pill is justified.

Canadian's response: Most of the early Canadian cases dealing with poison pills involved situations where the target board had initiated a search for competing offers in response to a hostile bid. Therefore, and as in Delaware, where multiple bids had emerged from that process, the case law naturally held that "there comes a time when the pill must go" to enable the shareholders to decide for themselves, and that poison pills should not permit the management of the target to interfere between competing bids.

In the last decade, however, boards have increasingly decided not to initiate a sale process when facing a hostile bid. Instead, they have continued to focus on continuing the company's existing business plan. Unfortunately, Canadian securities commissions have made no useful distinction between these two scenarios. When the Canadian regulators have set aside poison pills over the years, they have acted under the assumption that target company shareholders are able and have a "right" to decide in ALL circumstances, with the benefit of the board's advice, whether or not to sell their shares into a bid. We question, however, whether invoking this assumption is consistent with good policy, in light of substantial new circumstances that emerged over the last decade in the capital markets, such as: More rigorous corporate governance practices that arguably reduce the risk of management entrenchment; the recent challenging environment for potential white knights to obtain acquisition financing; powerful consolidation of certain industries; and a withdrawal from the M&A market by private equity firms leading to a less efficient M&A market in certain industries. A wise poison pill policy should also take account of the specifics facts of each case, including whether the shareholder base is widely disaggregated, the identity of the target's shareholders and their possible conflicting interests, the identity of the bidders, and current economic conditions and industry-specific challenges or conditions.

These contextual considerations are not well suited to a doctrinaire regulatory

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approach; they are much more readily addressed by informed, independent directors familiar with the target company and its plans and position in the industry. It is therefore troubling, in my view, that securities regulators have generally declined to defer to any extent to the business judgment of a board of directors of a target company before terminating a poison pill, despite the fact that the issuance of securities, pursuant to a pill or otherwise, is specifically within the board's corporate power to manage and direct the business and affairs of a corporation pursuant to corporate law. The difficult question is instead how much deference to accord to target board decisions to maintain the poison pill.

In light of the policy premise adopted by Canadian securities regulations — i.e., that shareholders are entitled to decide for themselves whether to sell their shares — the Canadian answer to that question of how much to defer to board decision making is essentially not at all. That position, however, fails to address why there should be any difference between the ability to sell shares and the ability to sell a company as a whole, where both actions involve a change of corporate control and payment of a premium for that change. As a matter of corporate law, the board of directors usually has the power to decide whether to approve a fundamental transaction such as a merger or sale of all assets, and shareholders only vote if the board first approves the transaction. For these types of transaction, the board of directors is established by law as the appropriate party to negotiate with a third party on behalf of the corporation or its stakeholders — and justifiably so, considering their knowledge of the business, their independence, and their fiduciary duties. Why should a transaction structured as a takeover bid be dramatically different than any other sale of control of a corporation? In terms of the ability to negotiate with a hostile bidder, the board of directors is certainly better equipped than a diverse and unorganized group of shareholders. To the extent that the shareholders are not satisfied with the board's consideration of a change of control transaction, they have numerous options including selling their shares in the market, replacing the board at the shareholders meeting, and making claims against the directors for breach of fiduciary or other legal obligations.

And yet Canadian regulators have continued to reject the more flexible, case-specific approach employed by the Delaware courts. Canadian regulators have not yet considered, let alone embraced, the concept of substantive coercion. Thus, even if the board of Easytarget reasonably expects that the current business plan will deliver greater returns than the hostile bid from DynamicGiant yet believes that shareholders will reject its advice, it cannot prevent the bid from proceeding in Canada.

Delaware Yankee: That might be an unfortunate result, although Canadians looking at the Delaware system shouldn't conclude that directors have the power to "just say no" forever. Whether in Delaware or Canada, it's important to recognize that the stockholders' power to elect directors is a major check on use of the poison pill. Specifically, bidders can seek to replace incumbent boards with directors who are presumably friendlier to their bids, and less likely to deploy or maintain a poison pill to foreclose those bids. Thus, for example, unless Easytarget's board is staggered, the stockholders can replace the incumbent directors just four months from now at the annual meeting. Then, if directors nominated by DynamicGiant conclude, in the exercise of their fiduciary duties, that the DynamicGiant bid is in the best interests of Easytarget's stockholders and the corporation, they will eliminate the poison pill and the bid will go forward. This accountability mechanism needs to be taken into account in evaluating the need for and scope of any form of judicial or regulatory accountability in regard to maintenance of the poison pill.

Of course, if the board were staggered (in which case it wouldn't be called Easytarget, would it?) the electoral check on use of the poison pill takes much longer: Two successive annual elections are needed to change control of the board. That's why the most interesting Delaware poison pill cases, like *Airgas*, involve companies with classified boards. But even in these cases, I claim that boards can't *just* say no: A decision to maintain a poison pill to deter a structurally uncoercive takeover bid for all shares, with a promise to complete a second-step merger promptly and on the same terms as the offer, requires the directors to demonstrate not only their independence from management but also a very specific and significant basis for believing that the hostile bid is inadequate in light of the value offered by continuing the company's existing business plan.

That sort of proof is not impossible, as *Airgas* demonstrated. To me, the most significant fact in *Airgas* was that the directors who were elected with the help of the hostile bidder decided, once in office, to support the incumbents' opposition to the hostile bid. And history may well prove them right: Airgas' stock price as of September 12, 2012, was $84.79 per share, 21 percent higher than even the $70 per share hostile bid, which presumably should have included a premium for control. In contrast, the increase in the Dow Jones average over the period since that bid was withdrawn was just 8.4 percent. In my view, this story counsels against reflexive philosophical limitation on the role of directors in responding to hostile takeover bids.

Canadian's response: Under most common Canadian corporate statutes, shareholders are entitled to remove any directors at a meeting of shareholders, making the staggered board useless as a takeover defense. Therefore, all decisions by a board, including a decision to maintain a poison pill, come under scrutiny by the shareholders every year . . . if not earlier, if a meeting is duly requested by shareholders.

Following the *Airgas* decision in Delaware, numerous practitioners in Canada have started to question the need for the Canadian securities commissions to intervene in determining whether a poison pill should be maintained. Some have even suggested that securities commissions

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should withdraw from the field and repeal their policy guidelines on poison pills. The securities commissions have advised that they are reviewing the rules on poison pills and that they intend to publish a paper soon addressing the matter. I suggest that they should let the balance of powers between board and shareholders under corporate statutes proceed without regulatory interference. Ironically, back in 1986 when adopting the policy on defensive measures, Canadian securities commissions were concerned that boards of directors would unduly interfere with takeover bids. Now, we suggest that the real concern is whether securities commissions should be empowered to interfere with the board's and shareholders' separation of powers and deny the ability of the board of directors to manage the affairs of a corporation.

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