Mediating Rights and Responsibilities in Control Transactions

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There is a growing debate as to the relative merits and consequences of a shift to a more shareholder-centric corporate governance framework. How much "direct democracy" makes sense in corporate decision making? If power is to be transferred to shareholders, should responsibilities be imposed (and, if so, how)? These issues have long been addressed by courts and regulators in the context of unsolicited control transactions. In its recent *Air Products & Chemicals v. Airgas* decision, the Delaware Chancery Court canvassed the evolution of its law on this point and concluded that implicit in the power (and responsibility) of the board of directors to manage the business and affairs of the corporation is the power to determine the long-term strategy of the corporation, including when and if a sale of control of the corporation should be pursued. By contrast, Canadian securities regulation has consistently adopted a shareholder-centric approach to unsolicited change of control transactions. This is an approach that is increasingly difficult to reconcile with Canadian corporate law as it has evolved since these issues were first considered by securities regulators. The answer to this growing inconsistency, we suggest, is for Canadian securities regulators to repeal their "defensive tactics" policy in the recognition that our courts have become better equipped to adjudicate such matters.

Nous assistons à une intensification du débat concernant les mérites relatifs et les conséquences d'un passage à un cadre de gouvernance corporative plus centré sur les actionnaires. Dans quelle mesure la « démocratie directe » prend-elle son sens sur le plan des prises de décisions corporatives ? Si le pouvoir doit être transféré aux actionnaires, les responsabilités devraient-elles être imposées (et dans ce cas, comment ?). Depuis longtemps, ces questions sont réglées par les tribunaux et les régulateurs dans le contexte des transactions de contrôle non sollicitées. Dans son dernier arrêt dans l'affaire *Air Products & Chemicals c. Airgas*, le tribunal américain *Delaware Chancery Court* a analysé l'évolution de son droit sur ce point, et a conclu que le pouvoir de déterminer la stratégie à long terme de la Société, y compris quand et si une vente de contrôle de la Société doit être effectuée, est inhérent au pouvoir (et à la responsabilité) du conseil d'administration qui gère les affaires commerciales et autres de la Société. En revanche, la réglementation canadienne en matière de valeurs mobilières a

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constamment adopté une démarche centrée sur les actionnaires en matière de transactions de changement de contrôle non sollicitées. C'est cette démarche qu'il est de plus en plus difficile de réconcilier avec le droit canadien des sociétés, car elle a évolué depuis que les régulateurs des valeurs mobilières ont commencé à se pencher sur ces questions. D'après nous, la réponse à cette incohérence croissante est le rejet, par les régulateurs canadiens des valeurs mobilières, de leur politique de « tactique défensive » en reconnaissance du fait que nos tribunaux sont désormais mieux équipés pour juger de telles affaires.

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> *On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy.*[1]

IN ITS RECENT *AIR PRODUCTS & CHEMICALS V. AIRGAS*[2] *DECISION*, the Delaware Chancery Court addressed the ongoing tension between board and shareholder control of the corporation. The issue as framed by Chancellor William B. Chandler III was "when, if ever, will a board's duty to 'the corporation and its shareholders' require [the board] to abandon concerns for 'long term' values (and other constituencies) and enter a current share value maximizing mode?"[3] In turn, the Chancellor's thorough analysis of how Delaware law has evolved over the last quarter-century calls into question, once again, the role allocated under Canadian law to a board of directors that is faced with a hostile or unsolicited take-over bid.

1. Francesco Guerrera, "Welch condemns share price focus" Financial Times (12 March 2009), online: <http://www.ft.com/cms/s/0/294ff1f2-0f27-11de-ba10-0000779fd2ac.html#axzz1JohpWhG1> (quoting Jack Welch, former CEO of General Electric).

2. Civil Action No. 5249–CC (Del. Ch. 2011) (QL) [Airgas].

3. *Ibid*. at 4, citing *TW Services v. SWT Acquisition*, 1989 WL 20290 at 8 (Del. Ch. 1989) [TW Services].

The basic question raised by the Airgas take-over battle related to who, as between the shareholders and the directors, could decide when and if the corporation was for sale. The Delaware Chancery Court determined that under Delaware corporate law it is the board that is entitled to make this decision. This does not imply that the board of a Delaware corporation can always and forever block a hostile tender offer. However, it does mean that a board of directors, acting in good faith, in accordance with its duties under corporate law, and in such a way that its actions are able to withstand enhanced judicial scrutiny of its conduct, can "just say no" to an unsolicited transaction.

This approach stands in clear contrast with Canadian securities regulation, which, as we will show, elevates the primacy of shareholder choice and generally denies a Canadian board the ability to block a take-over transaction that shareholders are otherwise willing to accept. We question whether this approach is ultimately consistent with the powers (and responsibilities) allocated to a board of directors under Canadian corporate law.[4] Moreover, we suggest that a number of consequences follow from an emphasis on the primacy of shareholder choice. Under Canadian corporate law, the board of directors is ultimately responsible for managing the business and affairs of the corporation and in doing so it has a statutory duty to act in the best interests of the corporation. By contrast, individual shareholders can generally be assumed to act in their own interests, and, as shareholders, generally owe no duties to the corporation or to other shareholders. As a result, we suggest that the allocation of rights and responsibilities between shareholders and directors as set out in Canadian securities regulation leads to the creation of a responsibility vacuum. The board, which owes a statutory duty to and is charged with managing the business and affairs of the corporation, is unable to prevent a change of control that the shareholders, as a body but without necessarily acting collectively, are able to effect, all while owing no duties (to the corporation or to each other) in connection with that result.

To begin with, we review the *Airgas* decision in detail and map out the evolution of Delaware law in this area. We then contrast this area of Delaware law with Canadian securities regulation and discuss the apparent conflict between Canadian securities regulation and Canadian corporate law insofar as it relates

4. See further Edward Waitzer & Sean Vanderpol, "Let courts rule on poison pills" *Financial Post* (25 January 2011), online: <http://opinion.financialpost.com/2011/01/24/let-courts-rule-on-poison-pills/>.

to the respective roles of shareholders and directors in the context of an unsolicited change of control transaction. Finally, we discuss some of the practical consequences of the model of shareholder primacy that has been adopted by Canadian securities regulation. To this end, we explore in particular the prejudice to target shareholders and the systemic prejudice that result from this approach.

We conclude that Canadian securities regulators should vacate the field. This approach was advocated in the June 2008 report of the Competition Policy Review Panel (the Panel), which recommended, based on broad consultations and input from the legal and investment banking community on both sides of the border, that Canadian securities regulators repeal their policy on defensive tactics and cease to regulate conduct by boards in relation to poison pills.[5] The Panel recommended instead that the regulation of substantive decision making by directors in respect of change of control proposals should be left to the courts. The Panel noted that, except in rare cases, the duties imposed by corporate law do not give rise to material differences in the responsibilities or actions of Canadian versus Delaware directors in deciding whether to engage in a sale process in response to an unsolicited acquisition proposal. Recent decisions by Canadian securities regulators reaffirm the merits of the Panel's proposal.

I. THE *AIRGAS* DECISION

To briefly review the facts, in February 2010, Air Products announced that it had made an unsolicited bid to acquire Airgas for US $60 per share. The offer was all cash and for all of the shares. It was structurally non-coercive and non-discriminatory and was backed by secured financing. The Airgas board unanimously rejected the tender offer, labelling the bid "extremely opportunistic" and a gross undervaluation of Airgas.[6] Air Products subsequently increased its bid, which continued to be rejected by the board of Airgas. Notably, Airgas did not solicit alternative purchasers or otherwise undertake an auction of the corporation. Airgas instead relied on the defensive measures that it had in place to reject the bid and "just say no," including a staggered board and a shareholder rights plan, or poison pill.

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5. Competition Policy Review Panel, *Compete to Win* (Ottawa: Public Works and Government Services Canada, 2008) at 76-78, online: <http://www.ic.gc.ca/eic/site/cprp-gepmc.nsf/eng/home>.

6. *Airgas*, *supra* note 2 at 51.

The defences employed by Airgas effectively prevented shareholders of Airgas from accepting the bid. Air Products therefore sought to circumvent those defences by seeking to replace a majority of the Airgas board of directors in the hope that such replacement nominees would then decide to redeem the poison pill and allow the Air Products bid to proceed. Given the staggered board of Airgas, this strategy required Air Products to win two successive annual meeting elections.[7] Absent judicial relief, Air Products would not have been able to take its bid directly to Airgas shareholders.[8] At Airgas's annual meeting on 15 September 2010, Air Products successfully had three independent nominees that had been selected by it elected to the nine member Airgas board of directors. It also attempted to implement changes to the by-laws of Airgas that would have resulted in the date of the next Airgas annual meeting being moved up. These by-law changes received the necessary shareholder support but were eventually invalidated by the Delaware Supreme Court.[9]

Following the election of the three Air Products nominees to the Airgas board, Airgas signalled to Air Products a willingness to negotiate, but emphasized that the then current offer price (US $65.50 per share) was viewed as grossly

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7. The Airgas corporate charter allowed 33 per cent of the outstanding shares to call a special meeting of the shareholders and remove the entire board without cause by a vote of 67 per cent of the outstanding shares (as opposed to a simple majority of the voting shareholders for the election of directors). The Delaware Chancery Court considered whether this approach, while theoretically possible, was realistically attainable by Air Products and ultimately found that it was impossible to predict, given the number of variables. However, it did make note of the sheer lack of historical examples where an insurgent had ever achieved such a percentage (*i.e.*, 67 per cent of all outstanding shares) in a contested control election.

8. Given the traditional reluctance of the Delaware courts to redeem a poison pill, it has generally been the view in Delaware that the only way to circumvent a poison pill (in the face of a staggered board) is to successfully contest two director elections, allowing the hostile bidder to take de facto control of the target board and cause the target to redeem its pill. Not surprisingly, there does not appear to be any instance where a hostile bidder has replaced a majority of the directors on a staggered board by winning two successive elections.

9. *Airgas et al. v. Air Products & Chemicals*, 8 A.3d 1182 (Del. Sup. Ct. 2010) [*Airgas* (Del. Sup. Ct.)]. In order to facilitate its strategy of winning successive proxy contests and thereby ultimately replacing a majority of the pre-existing board, Air Products sought to amend Airgas's bylaws to require Airgas to hold its 2011 annual meeting in January. The shareholders approved this amendment, but Airgas challenged the amendment in court. Although Air Products was successful at first instance, this decision was subsequently overturned by the Delaware Supreme Court, which ruled that the Airgas annual meetings must be spaced "approximately" one year apart (at 1186). As a result, Air Products was unable to bring forward the timing of the next annual meeting for election of directors.

inadequate and that the board viewed US $78 as the minimum starting price for negotiations. While brief discussions between the parties took place, they did not progress and were soon discontinued. Meanwhile, and at the request of the new board members nominated by Air Products, Airgas retained a third independent financial advisor (and independent legal counsel for the new nominees).

On 9 December 2010, Air Products made its "best and final offer" for Airgas for US $70 per share.[10] Air Products also indicated that it would not pursue the bid indefinitely and that it would not contest another board election.[11] On 22 December 2010, the board of directors of Airgas unanimously rejected the offer by Air Products for US $70 per share as "clearly inadequate" and confirmed its previous view that Airgas was worth at least US $78 per share.[12] Importantly, after joining the board and after having consulted with management, the other board members, and their financial advisors (including the new independent financial advisor retained at their request), the independent board members selected by Air Products joined with the existing Airgas board members in this determination. In effect, the Air Products nominees "changed teams" once they joined the board. Having gained access to the board, management, and the Airgas advisors—and being subject to the same legal duties as the other Airgas directors—these new board members agreed with the board's original decision to reject the offer by Air Products as inadequate.[13] The entire Airgas board therefore continued to maintain the Airgas poison pill, effectively blocking the

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10. *Airgas*, *supra* note 2 at 95.
11. As a consequence of the Delaware Supreme Court decision (*Airgas* (Del. Sup. Ct.), *supra* note 9), the strategy of winning two successive proxy contests would have required Air Products to keep its tender offer for Airgas open from February 2010 through at least (approximately) September 2011.
12. *Airgas*, *supra* note 2 at 106.
13. *Ibid.* The unanimity of the board, even after the successful proxy contest run by Air Products, arguably contributed to the judge's conclusion regarding the integrity of the decision-making process followed by the Airgas board. As Chancellor Chandler noted, *ibid.* at 14:

> Here, even using heightened scrutiny, the Airgas board has demonstrated that it has a reasonable basis for sustaining its long term corporate strategy—the Airgas board is independent, and has relied on the advice of three different outside independent financial advisors in concluding that Air Products's offer is inadequate. Air Products's *own three nominees* who were elected to the Airgas board in September 2010 have joined wholeheartedly in the Airgas board's determination, and when the Airgas board met to consider the $70 "best and final" offer in December 2010, it was one of those Air Products Nominees who said, "We have to protect the pill" [emphasis in original].

Air Products bid and preventing Airgas shareholders from having the opportunity to tender into the offer. This was done despite the general consensus that a majority of the Airgas shares would be tendered into the offer by Air Products for US $70 per share absent the poison pill.

Chancellor Chandler, in a long and carefully reasoned decision that surveyed the evolution of the law in Delaware relating to poison pills from 1985 to the present, ruled in favour of Airgas and sustained the poison pill. While expressing his personal reservations, he concluded that under current Delaware law "the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."[14] In accordance with its statutory duties, the board had viewed the tender offer as a threat to the corporation (*i.e.*, an allegedly inadequate price that was nevertheless likely to have been accepted by a majority of the shareholders) and had taken a proportionately reasonable response to that threat by implementing and sustaining the poison pill.[15] As a consequence of this decision, Air Products withdrew its bid.[16]

II. THE EVOLUTION OF DELAWARE LAW

As noted, the Delaware Chancery Court in *Airgas* concluded that under Delaware corporate law the board of a corporation cannot be forced to abandon its long-term strategy by a hostile tender offer. Therefore, provided it acts in accordance with its duties, it can "just say no" (but not "never") to an unsolicited bid. As a result, Delaware corporate law allocates to the board, as part of its responsibility to manage the business and affairs of the corporation, the power to decide, as a threshold matter, whether there should be a change in control of

14. *Ibid.* at 5. In his decision, Chancellor Chandler noted that, in his personal opinion, the pill had "served its legitimate purpose" (at 11). Airgas had enjoyed ample opportunity to inform its stockholders about its view of the intrinsic value of Airgas and to make its case against an allegedly inadequate offer by Air Products. He also acknowledged, however, that binding Delaware precedent prevented him from substituting his own business judgment for that of the (unanimous) Airgas board.
15. *Ibid.* The Chancellor noted that a large percentage of Airgas's shareholders were merger arbitrageurs, who had purchased Airgas stock below the offer price of US $70 and so would be willing to tender into an inadequate offer in order to make a return on their investment, regardless of whether the offer fairly valued Airgas in a sale. This was sufficient to establish a threat of substantive coercion.
16. On Friday, 18 February 2011, three days after the ruling of the Delaware Chancery Court, Airgas stock closed at US $64.08 on the New York Stock Exchange.

the corporation. In this respect, the balance of power as between boards and shareholders is tilted towards the board.

It is useful to briefly review the development of Delaware law in this area. The use of the poison pill as a take-over defence was first sanctioned by the Delaware Supreme Court in 1985 in its decision in *Moran v. Household International, Inc*.[17] In this decision, the court concluded that under the *Delaware General Corporation Law*[18] the board had the authority to adopt a rights plan.[19] It also noted that a decision by the board to redeem or to not redeem the rights was subject to review with a view to the board's duties, an analysis that would require scrutiny of the board's actions in light of the "threat" posed by the hostile tender offer.[20] Thus, while a board had the prima facie power and authority to implement a poison pill, the decision to do so—as well as the decision to maintain the pill in the face of a tender offer—was subject to evaluation within the context of the board's duties of care and of loyalty (*i.e.*, its duty to act in the best interests of the corporation and its shareholders).[21] *Moran* set the stage for the Delaware courts to explore the balance of power between shareholders and boards in the context of change of control transactions. Through subsequent decisions, the Delaware courts developed and refined their analysis of the different types of threats that could sanction the use (and maintenance) of defensive tactics.

In *City Capital Associates Ltd. Partnership v. Interco*,[22] the Delaware Chancery Court considered the use of defensive tactics in the face of a structurally

17. 500 A.2d 1346 (Del. Sup. Ct. 1985) [*Moran*].

18. Del. Code Ann. tit. 8, ch. 1 (2011).

19. *Moran*, *supra* note 17 at 1357. The Delaware Supreme Court cited, among other sources of authority, the general power of the board under the *Delaware General Corporation Law*, *ibid.*, to manage the business and affairs of the corporation.

20. *Moran*, *ibid.* at 1356. The Delaware Supreme Court noted the potential for structural coercion—*i.e.*, a two-tiered tender offer that could, independent of the price offered, influence a shareholder's decision to tender or not tender to the offer.

21. Under well-settled Delaware law, it is the *Unocal* standard of enhanced judicial scrutiny that applies to a review of defensive measures implemented by a board. Under the *Unocal* framework, the target board must show that it had reasonable grounds for believing a danger to corporate policy and effectiveness existed (*i.e.*, the board must be able to articulate a legally cognizable threat) and that any board action taken in response to that threat was reasonable in relation to the threat posed. *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. Sup. Ct. 1985).

22. 551 A.2d 787 (Del. Ch. 1988) [*Interco*].

non-coercive offer. While the hostile bidder had argued that a non-coercive bid could not constitute a threat that justified the use of a defensive tactic, the court disagreed, stating:

> Our law, however, has not adopted that view and experience has demonstrated the wisdom of that choice. …
>
> Even where an offer is noncoercive, it may represent a "threat" to shareholder interests in the special sense that an active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal, or may be able to arrange an alternative transaction or a modified business plan that will present a more valuable option to shareholders.[23]

Despite concluding that a non-coercive offer could pose a threat, the Delaware Chancery Court determined that in the circumstances at hand it did not and ordered the rights to be redeemed. The board of Interco had, in response to the hostile bid, developed a recapitalization plan for shareholders and was not otherwise engaged in an auction of the company or in negotiations with the hostile bidder.[24] The court therefore concluded that the only function of the pill would be to preclude the shareholders from exercising a judgment about their own interests that differed from the judgment of the (interested) directors and that this was not, in the circumstances, a sufficient threat to justify maintenance of the poison pill.

The Delaware Chancery Court in *Interco*, while empowering a board to deploy defensive tactics and recognizing the usefulness of those tactics in the face of an "inadequate" offer, ultimately reserved for shareholders the right to decide between competing alternatives. It therefore suggested that the authority of the board of directors to maintain a poison pill was time-limited. At the conclusion of this time period, the shareholders had the right to make their own decision. The court stated:

> Our corporation law exists, not as an isolated body of rules and principles, but rather in a historical setting and as a part of a larger body of law premised upon shared values. To acknowledge that directors may employ the recent innovation of "poison pills" to deprive shareholders of the ability effectively to choose to accept a noncoercive offer, after the board has had a reasonable opportunity to explore or create alternatives,

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23. *Ibid.* at 797-98.
24. The hostile bid for the shares of Interco was for a price of US $74 per share, payable in cash. The recapitalization plan developed by Interco in response to the bid was valued by its financial advisor at US $76 per share, although the court noted that this was "inherently a debatable proposition" (*ibid.* at 795).

> or attempt to negotiate on the shareholders' behalf, would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporation law.[25]

While the Chancery Court in *Interco* attempted to strike a balance between boards and shareholders, the Delaware Supreme Court, in *Paramount Communications v. Time*[26] signalled a shift from this approach. In *Paramount*, the Delaware Supreme Court found itself confronted with the question of whether the Time board, having developed a long-term strategic plan (in this case, a merger with Warner), could be required to jettison that plan and allow the shareholders of the corporation to, in effect, determine its strategy by tendering to the hostile offer put forward by Paramount. The answer was unequivocally no. The board, having developed a long-term strategy for the corporation, was not obligated to abandon those plans in the face of a hostile tender offer and could take measures in response to that offer that would prevent shareholders from effectively overriding the long-term strategy. The Delaware Supreme Court concluded that its role was neither to question the board's determination as to which strategy was to be pursued, nor to determine which alternative offered shareholders the "better" deal. These were ultimately decisions for the board.

The decision in *Paramount* resulted in an explicit recognition of the risk of substantive coercion (in that particular case, that shareholders might tender to a hostile offer in ignorance or in a mistaken belief of the strategic benefit that a business combination with Warner might produce) as a legitimate threat that would justify a "proportionate" response from the board (*i.e.*, a response that precluded shareholders from accepting the tender offer).[27] *Paramount* therefore struck a new balance between boards and shareholders, empowering boards to select and pursue the corporation's long-term strategy, even in the face of alternatives offered to the shareholders. The Delaware Supreme Court stated:

> Paramount argues that, assuming its tender offer posed a threat, Time's response was unreasonable in precluding Time's shareholders from accepting the tender offer or receiving a control premium in the immediately foreseeable future. Once again, the contention stems, we believe, from a fundamental misunderstanding of where the power of corporate governance lies. Delaware law confers the management

25. *Ibid.* at 799-800.
26. 571 A.2d 1140 (Del. Sup. Ct. 1990) [*Paramount*].
27. *Ibid.* at 1155.

> of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.[28]

The end result of this line of cases, as noted by Chancellor Chandler in *Airgas*, is a recognition that the power to "just say no" lies with boards of directors. Chancellor Chandler was concerned with some of the implications of his decision, notably the potentially broad scope given to boards to cite the threat of substantive coercion as justification for, in effect, preferring their own views to those of shareholders.[29] He noted that the Delaware Chancery Court had attempted to more narrowly define the concept of substantive coercion, suggesting that it only operate to allow the board time to tell "its side of the story," after which the potential for shareholder confusion would be substantially lessened and shareholders should be competent to make their own decision.[30] In *Airgas*, there had clearly been ample time for the board to make its case to shareholders. However, Chancellor Chandler accepted that Delaware law did not accept a more narrow view of substantive coercion and that, as a result, he was obligated to apply binding precedent to find in favour of Airgas.[31]

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28. *Ibid.* at 1154 [citations omitted]. The conclusion from *Paramount* was reaffirmed by the Delaware Supreme Court in its decision in *Unitrin v. American General Corp.*, 651 A.2d 1361 (Del. Sup. Ct. 1995). This decision again justified the use of defensive tactics in response to the threat of substantive coercion—*i.e.*, the fear that shareholders might accept an inadequate offer because of ignorance or mistaken belief regarding the board's assessment of the longer-term value of Unitrin's stock.
29. The concept of substantive coercion was coined by Ronald J. Gilson and Reinier Kraakman in "Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?" (1989) 44 Bus. Law. 247. The Delaware court has struggled with this issue for some time. See *e.g.* Vice Chancellor Leo Strine, "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?" (2010) 66 Bus. Law. 1.
30. *Airgas*, *supra* note 2 at 135, citing *Chesapeake Corp. v. Shore*, 771 A.2d 293 at 324-25 (Del. Ch. 2000).
31. See *Airgas*, *ibid.* at 31. Chancellor Chandler concluded his review of Delaware case law with a discussion of the decision of former Delaware Chancellor Allen in *TW Services*, *supra* note 3. He remarked on the distinction made in that decision between a board that had elected to continue to manage the enterprise in a long-term mode (and not pursue a sale or other immediate value-enhancing transaction) and a board that, in response to a hostile bid, had

Under Delaware corporate law, therefore, poison pills do not have a set expiration date. A board that acts in good faith and in accordance with its duties—rigorously examined under enhanced judicial scrutiny—can, in the exercise of its managerial powers, act to preserve its long-term strategic goals for the corporation, even in the face of a majority of shareholders that would otherwise wish to adopt an alternative approach. The decision as to whether a change of control can proceed is therefore, at first instance, a decision that must be made by the board of directors. This does not mean that shareholders are powerless in the face of a hostile tender offer. As demonstrated in the *Airgas* saga, the shareholders, who elect the board of directors, can disagree with the board's determination with respect to a particular change of control transaction and can seek to elect a different board. Indeed, in response to the *Airgas* decision, corporate governance debates are likely to focus on the legitimacy of staggered boards. However, it will be the board—which is charged with both the power to manage the business and affairs of the corporation and the responsibility to do so in accordance with its duties—that makes the threshold decision.[32]

III. CANADIAN SECURITIES REGULATION

The events in the attempted Airgas take-over and the development of Delaware corporate law stand in contrast to the law and policy in Canada governing the conduct of boards in response to an unsolicited take-over bid, in particular as embodied by *National Policy 62-202—Take-over Bids—Defensive Tactics*.[33] *National Policy 62-202* emphasizes shareholder primacy in change of control transactions, stating that

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elected to pursue a management-endorsed breakup transaction that operated as a functional alternative to the bid itself (such as in *Interco*, *supra* note 22). He suggested that this decision supported the view that a board could "just say no" to a hostile tender offer. However, he further suggested that the issue presented by a board that responds to a tender offer with an alternative restructuring or recapitalization transaction is fundamentally different than that posed by a board that "just says no" and maintains the status quo.

32. Clearly, as shown in *Airgas*, *ibid.*, replacement board members, conscious of their duties as directors, could determine to, in effect, "overrule" the shareholders that elected them.

33. O.S.C. NP 62-202, (1997) 20 O.S.C.B. 3525 [*National Policy 62-202*]. In contrast to the United States, where the regulation of substantive decision making by directors in the context of a change of control transaction is left to the courts, Canadian securities regulators, through their public interest jurisdiction, play a large role with respect to take-over defences.

> [t]he primary objective of the take-over bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. The take-over bid provisions should favour neither the offeror nor the management of the target company, *and should leave the shareholders of the target company free to make a fully informed decision.*"[34]

The substantive thrust of *National Policy 62-202* was adopted in 1986 and has not changed since.[35] Canadian securities regulators have generally applied *National Policy 62-202* to cease trade poison pills within a fixed period of time following the commencement of a hostile bid, so as to ensure that shareholders are not "deprived of the ability to respond to a take-over bid or to a competing bid."[36]

Two recent examples of the application of *National Policy 62-202* are the decision of the British Columbia Securities Commission (BCSC) in *Icahn Partners LP v. Lions Gate Entertainment Corp.*[37] and the decision of the Ontario Securities Commission (OSC) in *Re Baffinland Iron Mines Corp.*[38] In *Lions Gate*, the board was faced with an unsolicited bid from funds associated with Carl Icahn. Initially, Icahn made a partial take-over bid of US $6 per share in cash, seeking an approximately 30 per cent ownership interest in Lions Gate (including the 19 per cent he already held). In response, the board adopted a poison pill. Unlike a typical Delaware poison pill, the Lions Gate pill allowed for a "permitted bid"—if a hostile bidder were to structure its bid according to specified conditions, including a majority of the minority minimum (and non-waivable) tender condition, then the Lions Gate pill would not be triggered.[39] As a consequence, by its own terms, the Lions Gate pill allowed a hostile bidder to circumvent the board if it complied with the conditions set out in the poison pill. The Icahn bid was not a permitted bid. While Icahn subsequently amended the terms of his bid by increasing the price and extending the bid for all of the shares of Lions Gate, it continued not to qualify as a permitted bid. Icahn therefore applied to the BCSC for an order cease trading the Lions Gate pill.

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34. *Ibid.*, s. 1.1(2) [emphasis added].
35. *National Policy 62-202*, *ibid.*, came into effect in 1997, replacing *National Policy 38*, which had been formulated in the 1980s.
36. *National Policy 62-202*, *ibid.*, s. 1.1(5).
37. 2010 BCSECCOM 233 [*Lions Gate*].
38. (2010), 33 O.S.C. Bull. 11385 [*Baffinland*].
39. *Lions Gate*, *supra* note 37 at paras. 10-11.

Although the Lions Gate board put defensive measures in place in response to the Icahn bid, it did not otherwise undertake an auction for Lions Gate or seek other purchasers. As noted by the BCSC in its decision, "The Lions Gate board concluded that it was not the time to put the company in play, and took no steps (and does not intend to take any steps) to seek a competing bid or an alternative transaction."[40] Indeed, Lions Gate appears to have attempted to undertake a strategy similar to that employed by the Airgas board and "just say no" (subject to the caveat that, unlike in *Airgas*, the board had not indicated a price it considered to be fair value, and Icahn could nevertheless circumvent the Lions Gate board by making a permitted bid).

The BCSC determined to cease trade the Lions Gate pill, concluding that it was in the public interest that each shareholder of Lions Gate be allowed to decide whether or not to accept or reject a bid and that the imminent expiration of the Icahn bid would, unless the pill was cease traded, jeopardize this right. Given that Lions Gate was not actively seeking alternative transactions, the BCSC concluded that there was no further utility to the pill.[41]

In *Baffinland*, the board was faced with an unsolicited take-over bid made by Nunavut Iron Ore Acquisition Inc. (Nunavut) for CDN $0.80 per share. Baffinland had, in advance of the Nunavut offer, adopted a shareholder rights plan (which, as in *Lions Gate*, also provided for a permitted bid mechanism that allowed a hostile bidder to structure its bid so as to avoid triggering the pill). The shareholder rights plan had been approved by the shareholders of Baffinland. The Nunavut offer was not a permitted bid. Following the Nunavut offer, Baffinland ultimately entered into a support agreement with ArcelorMittal S.A. (Arcelor) that contemplated a competing offer by Arcelor for all the shares of Baffinland at a price of CDN $1.10 per share. Nunavut, which had not increased its offer in response to the Arcelor transaction, applied to the OSC for an order cease trading the Baffinland rights plan.[42]

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40. *Ibid.* at para. 16.

41. *Ibid.* Shortly after the Lions Gate poison pill was cease traded, Icahn nevertheless extended his bid and made numerous additional extensions thereafter. On 16 June 2010, Icahn took up approximately 13.2 per cent of the outstanding Lions Gate shares under his original bid. A further 2 per cent were tendered during his subsequent offering period, which expired on 30 June 2010.

42. *Baffinland*, *supra* note 38.

The OSC granted the application. It emphasized that its focus was to protect the interests of Baffinland shareholders and that, accordingly, "one of the issues we must consider is whether the Rights Plan will likely result in Baffinland shareholders being deprived of the ability to respond to the Nunavut Offer."[43] While it recognized that the Nunavut offer, which at that time was substantially below the Arcelor offer, had little chance of succeeding unless amended, the OSC concluded that the events with respect to the two offers should unfold without hindrance by the pill. It stated that "[i]t is the Baffinland shareholders who should determine the outcome of the two competing bids for their shares."[44]

These two decisions illustrate the extent to which the approach to unsolicited take-over bids generally taken by Canadian securities regulators under *National Policy 62-202* is heavily tilted towards shareholder choice.[45] In the context of a hostile tender offer, *National Policy 62-202*, as generally interpreted by Canadian securities regulators, provides that it is the shareholders, and not the board, who are able to decide whether the corporation is for sale. As a consequence, even if the board of directors determines, in accordance with its statutory duties, to implement a poison pill or other defensive tactic, Canadian securities regulators will ultimately override this business judgment in order to allow shareholders to make up their own minds concerning the proposed change of control transaction.

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43. *Ibid.* at para. 25.
44. *Ibid.* at para. 55. After protracted bidding between Nunavut and Arcelor, the two ultimately joined forces and acquired Baffinland for CDN $1.50 per share.
45. The decisions in *Lions Gate* and *Baffinland* can be contrasted with the OSC decision in *Re Neo Material Technologies Inc.* (2009), 32 O.S.C. Bull. 6941 [*Neo*], and the Alberta Securities Commission decision in *Re Pulse Data Inc.*, [2008] A.W.L.D. 695. Both of these decisions resulted in the securities regulator refusing to cease trade the applicable shareholder rights plan. A key factor in each decision, however, was that shareholders of the target had, prior to the decision, supported the implementation by the board of a rights plan adopted specifically in response to the hostile bid in question. Thus, while the result in each case was different, it can be argued that the approach was still ultimately based on a principle of shareholder choice. As the OSC stated in *Baffinland*, *supra* note 38 at para. 51 (while commenting on its decision in *Neo*):

> [I]n our view, *Neo* does not stand for the proposition that the Commission will defer to the business judgment of a board of directors in considering whether to cease trade a rights plan, or that a board of directors in the exercise of its fiduciary duties may "just say no" to a take-over bid. Such a conclusion would have been inconsistent with the provisions of NP 62-202 and the relatively long line of regulatory decisions that began with *Canadian Jorex*. *To the contrary, the Commission in* Neo *deferred to the wishes of shareholders as contemplated by NP 62-202* [emphasis added].

This approach is arguably inconsistent with the power (and responsibilities) allocated to a board of directors under Canadian corporate law, particularly as it has evolved since Canadian securities regulators first started exercising their public interest jurisdiction to intervene in contested change of control transactions.

IV. CANADIAN CORPORATE LAW

As is the case under Delaware law, under the *Canada Business Corporations Act*,[46] and under similar corporate law statutes enacted by each of the Canadian provinces and territories, directors have a duty to manage the business and affairs of the corporation.[47] In discharging this duty, directors must act honestly and in good faith with a view to the best interests of the corporation and must exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances.[48] The role of shareholders is very limited. They elect the directors, but it is the directors who manage the business and affairs of the corporation—not the shareholders themselves. Often the interests of shareholders (and other stakeholders in the corporation) are co-extensive with the interests of the corporation, but if they conflict, the directors' duty is clear—it is to the corporation and it requires a consideration of the long-term interests of the corporation. As stated by the Supreme Court of Canada in its decision in *BCE v. 1976 Debentureholders*, "The fiduciary duty of the directors to the corporation is a broad, contextual concept. It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation."[49]

Under the *CBCA*, when faced with a change of control transaction, the board must therefore assess whether that transaction is in the best interests of the corporation. This does not automatically require the board to prefer (or defer only to) the interests of shareholders.[50] While shareholder considerations are obviously central in such an assessment, the Court in *BCE* stated that,

46. R.S.C. 1985, c. C-44 [*CBCA*].
47. *Ibid.*, s. 102(1).
48. *Ibid.*, s. 122(1).
49. [2008] 3 S.C.R. 560 at para. 38 [*BCE*].
50. Also of import, the interests of the shareholders are those of the shareholders as a group and not only those shareholders who might be interested in accepting a change of control transaction.

> [i]n considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule. …
>
> There is no principle that one set of interests—for example the interests of shareholders—should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way.[51]

V. DIRECTORS VERSUS SHAREHOLDERS

The statutory duties of directors under the *CBCA*, as interpreted by the Court in *BCE*, can be difficult to reconcile with the shareholder-centric approach to take-over bids reflected in *National Policy 62-202*. Individual shareholders presumably act in their own interests and generally owe no duties to other shareholders or to the corporation in connection with their actions. The board, on the other hand, is charged with a duty to the corporation itself, which can involve a consideration of the interests of many stakeholders and a long-term view of the corporation.

Of course, shares are the property of the shareholders, and shareholders should be free to dispose of their property as they see fit. However, it is important to recognize the distinction between a sale of shares and a sale of control of the corporation, which is the collective result of individual decisions by a sufficient number of shareholders (who have no direct claim over the assets or operations of the corporation) to tender their shares to the same offer. It is far from evident that the power of shareholders to freely dispose of their shares ought to trump the board's statutory duty to manage the business and affairs of the corporation, at least in the context of a sale of control of the corporation. Institutionally, the board has access to the greatest amount of information concerning the corporation and its business. It is responsible for using that information to develop long-term strategy and oversee day-to-day management. Why should it therefore be subordinate to a decision of the shareholders to abandon that strategy in favour of the pursuit of a short-term personal goal? If the shareholders are free to force a change in the long-term strategy of the corporation, what implications are there for the power of the board to manage

51. *BCE*, *supra* note 49 at paras. 40, 84.

the business and affairs of the corporation and otherwise act in the best interests of the corporation?[52]

In contrast to take-over bids, under Canadian corporate law a fundamental corporate transaction, such as an amalgamation, plan of arrangement, or sale of substantially all of the corporation's assets, requires prior approval of the board. These types of corporate transaction are, for a number of reasons, some of the common methods by which a change of control is effected. Thus, at least some change of control transactions require the approval of the board in order to be implemented, and this is a decision that the board must make in the context of the statutory duties it owes. This policy approach, which allows for take-over bids to proceed in the face of opposition of the board of directors, therefore arguably results in two functionally similar forms of change in control transactions receiving different legal treatment.

More critically, the allocation of rights and responsibilities between shareholders and directors embodied by *National Policy 62-202* would seem to lead to the creation of a responsibility vacuum. The shareholders themselves, as a body but without necessarily acting collectively, are able to effect a change in control of the corporation, but owe no duties (to either the corporation or to each other) in connection with that result. The board is subject to statutory duties under corporate law and is charged with the management of the business and affairs of the corporation, but is unable to prevent a change of control. This mismatch has played a role in making Canadian corporations attractive targets for acquirers. Indeed, we suggest that regardless of the theoretical inconsistency of this approach, a number of practical consequences follow from this model of shareholder primacy.

A. PREJUDICE TO TARGET SHAREHOLDERS

First, there is the problem of structurally coercive bids. Canadian securities laws impose a number of procedural requirements with respect to the conduct of

52. Arguably, defensive tactics taken by a well-meaning board of directors that wishes to act in the best interests of the corporation could be largely identical to those being undertaken by a board of directors acting with an improper purpose (such as entrenchment). While this may be an explanation for the adoption by Canadian securities regulators of a general rule against defensive tactics, it is arguably not a justification. Rather, it suggests that a more detailed and nuanced framework of (judicial) analysis is required for situations involving a potential conflict of interest. One can disagree with the result in *Airgas*, *supra* note 2, as Chancellor Chandler did, but there seems little basis to question the rigorous and thorough decision-making process followed by the Airgas board.

take-over bids, such as minimum timing requirements, disclosure requirements, pre- and post-bid integration rules, and the requirements to make the bid to all shareholders and to offer identical consideration. Securities laws impose few substantive requirements, however, for take-over bids other than in the context of transactions involving interested or related parties. As a result, an offeror can, in full compliance with the procedures set out in Canadian securities laws, make a take-over bid that is structurally coercive—*i.e.*, one that could result in shareholders making a rational decision to tender to the bid irrespective of their views on the fundamental value of their shares.

For example, if an offeror bids at a premium to market for only 50.1 per cent of the shares of a target (or makes a full cash bid, but reserves the ability to waive its minimum tender condition), then shareholders of the target are faced with a classic "prisoner's dilemma." If they view the bid as being undervalued, they must nevertheless factor into their calculations the possibility that other shareholders will tender to the offer. If other shareholders tender, but they do not, then they have lost the offered control premium, with potentially no certainty of receiving a subsequent offer for their shares. If they tender, but other shareholders do not, then they are no worse off—the bid will fail, and they still have the future opportunity to obtain a control premium for their shares. Consequently, the rational response for shareholders, assuming they are otherwise unable to coordinate their actions, is to tender to such a bid—the possibility of remaining as shareholders of a controlled company without necessarily receiving a subsequent offer for their shares will lead them to the conclusion to tender their shares rather than risk such an outcome.[53]

The problem of uncoordinated shareholder response to a take-over bid illustrates a second consequence of the approach to take-over bids adopted by *National Policy 62-202*. In the absence of a poison pill, an offeror negotiates with a diffuse shareholder body and, in effect, seeks only to clear the minimum price of the median shareholder of the corporation (*e.g.*, the minimum price

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53. Canadian securities regulators seem to give little weight to the potential for a coerced shareholder response to a take-over bid. As the OSC stated in *Baffinland*, *supra* note 38 at para. 39:

> Baffinland made a number of submissions with respect to the coercive nature of the Nunavut Offer, focused primarily on the reservation by Nunavut of the right to waive at any time the minimum tender condition in its offer and take up whatever Baffinland common shares are tendered at the time. The vast majority of take-over bids in this jurisdiction are made with a minimum tender condition that may be unilaterally waived by the offeror. A take-over bid is not inherently coercive for that reason.

that it will take for the offeror to acquire 50.1 per cent of the shares). A diffuse shareholder body is generally limited in its ability to coordinate a response to the bidder. This hampers the ability of the shareholders, acting on their own, to extract from the bidder any extra value over and above the minimum clearing price that the bidder might otherwise be prepared to pay. For example, if a bidder is willing to pay $10 a share, but the median shareholder is willing to accept $6 a share, then the bid will be successful at $6 a share, leaving the excess value to be captured by the bidder instead of the shareholders. A board that can "just say no" can serve as a collective bargaining agent for the shareholders, concentrating their bargaining power within a single entity and potentially enabling shareholders to capture at least some portion of this extra value.

In allowing a board to deploy a poison pill or other defensive tactic in a "genuine attempt to obtain a better bid,"[54] *National Policy 62-202* seems to recognize, to some extent, the threat posed by an inadequate offer and the value that a board, armed with negotiating authority, can create. However, the fact that a pill must always, at some point, be cease traded, vitiates the utility to a board of employing a defensive tactic. The time period in which to develop an alternative transaction (if that is the judgment of the board) is not of its own choosing, as Canadian securities regulators will ultimately form—and act upon—their own view as to when enough time has been allotted. Moreover, hostile bidders, being well aware of *National Policy 62-202* and the manner in which it is generally applied by Canadian securities regulators, are cognizant of the time-limited nature of the board's defensive abilities and can plan and act accordingly.[55]

54. *National Policy 62-202*, *supra* note 33, s. 1.1(6).

55. For example, in *Lions Gate*, Icahn timed his bid to expire prior to the shareholder meeting called by Lions Gate to consider approval of the pill adopted by the board in response to his hostile tender offer. This effectively forced the BCSC to cease trade a pill that could well be supported by the Lions Gate shareholders or risk losing the opportunity for shareholders to tender to the bid. Lions Gate nevertheless proceeded to put the poison pill to shareholders, who ratified the pill by a substantial margin, even though the vote was only symbolic (*supra* note 37). Similarly, in *Baffinland*, Nunavut waited until after the OSC had cease traded the Baffinland pill to amend and vary its bid (which at the time of the OSC hearing was substantially less than the competing Arcelor bid), increasing the consideration offered but changing its bid into a partial bid for less than all of the shares (*supra* note 38).

B. SYSTEMIC PREJUDICE

Leaving aside the questions of structural or substantive coercion, a model of shareholder primacy with respect to take-over bids also has consequences for Canadian corporate governance and the overall conduct of Canadian change of control transactions. Most critically, a board is not free to determine when the corporation will be "put in play"—it must always confront the possibility that it will be faced with a potential sale of control at an inopportune (or opportunistic) time. As a result, even though a board of directors is required by corporate law to look to the long-term interests of the corporation, *National Policy 62-202* arguably creates an environment that emphasizes the achievement of short-term goals and favours the choices made by shareholders—such as merger arbitrageurs—that typically operate on a short-term time horizon.

Another result of *National Policy 62-202* is that a board of directors can in effect be forced, against its own judgment, to abandon its long-term strategy for the corporation. The absence of an ability to "just say no" conditions board responses to a hostile bidder. If a board cannot block an unsolicited transaction, the choice of the board is to either attempt to fend off the take-over bid on its merits (and risk the acquisition by the hostile bidder of a controlling stake in the corporation at an inadequate price) or to try to procure an alternative and more favourable transaction for shareholders, even if the timing of a transaction would otherwise be inopportune. Moreover, a board's ability to exert control over a value-maximizing sales process can be limited, as bidders can "opt out" of the board process and take their offer directly to shareholders, thereby reducing the board's negotiating leverage vis-à-vis third parties. Thus, a board that elects to conduct a sale process in response to a hostile tender offer can nevertheless be limited in its ability to achieve the best outcome for the corporation (and its shareholders).

VI. CONCLUSION

In its assessment of the threats that can be posed to a corporation by an unsolicited tender offer, the jurisprudence in Delaware has evolved to recognize the threat of structural coercion, the threat posed by an inadequate offer, and the threat of substantive coercion. In the end, the latter concept essentially embodies the idea that it is the board of directors that is responsible for the business and affairs of the corporation and that implicit in that responsibility is the power, at first instance, to determine, acting in accordance with its duties,

whether and when control of the corporation should be sold. Arguably, consistency demands this conclusion. If the shareholders, and not the board, are entitled to determine whether to sell control of the corporation, then the board ultimately has a diminished managerial role with respect to the corporation itself, as it is not free to pursue its elected long-term strategy for the corporation and can be driven to pursue shorter-term goals at the election of the shareholders. As a further practical matter, stripping a board of the ability to "just say no" can diminish the board's ability to counter the threat posed to the corporation and its shareholders by an inadequate or structurally coercive offer. A bidder can elect to simply "wait out" the board and take its offer directly to shareholders, reducing both its incentive to negotiate with the board and the board's leverage in those negotiations.

Canadian securities regulators, in their approach to defensive tactics, have adopted an alternative view of the appropriate balance of power between shareholders and boards. With an emphasis on ensuring that shareholders are not deprived of the ability to respond to a take-over bid, the question becomes when—not whether—a pill should be cease traded. This approach, as embodied in *National Policy 62-202* and generally applied in Canadian take-over bid contests, hearkens back to the 1992 OSC decision in *Re Canadian Jorex Ltd*.[56] This decision has been approvingly cited as standing for the principle that there comes a time when a shareholder rights plan "has got to go." However, it is worth remembering that in *Canadian Jorex* the board had acted to allow one bid to proceed, while maintaining a pill to block an alternative bid. The maxim that "bad facts make bad law" may be apposite.

While the approach of Canadian securities regulators to defensive tactics has remained relatively static since the decision in *Canadian Jorex*, Canadian capital markets, ownership demographics, and corporate governance standards have all evolved dynamically. Corporate law has continued to evolve, and courts have become better equipped to address the nuanced duties of directors in control transactions. In *BCE*, the Court expressly stated that a board's duties are owed to the corporation, which can involve a consideration of the interests of more than just shareholders and requires a long-term view of the corporation.[57]

56. (1992), 15 O.S.C. Bull. 257 [*Canadian Jorex*].

57. *BCE*, *supra* note 49 at para. 102.

Former Delaware Chancellor William T. Allen noted long ago that the long-term/short-term distinction in corporate law preserves the norm of shareholder-oriented property theory, while affording directors considerable latitude to deal with other corporate stakeholders. He concluded that

> our law of corporate entities is bound itself to be contentious and controversial. It will be worked out, not deduced. In this process, efficiency concerns, ideology, and interest group politics will commingle with history (including our semi-autonomous corporation law) to produce an answer that will hold for here and now, only to be torn by some future stress and to be reformulated once more. And so on, and so on, evermore.[58]

Increasingly, corporate governance scholarship views director-centric governance of public companies as being desirable from shareholders' own perspectives. At minimum, there is consensus as to the need for more nuanced theories of corporate structure and purpose than a simple shareholder primacy rule provides.[59] The more dynamic approach to poison pills that has evolved in Delaware law recognizes a relationship between the board's duty to manage the corporation and its role in change of control transactions. It further recognizes the value that can be added by a board that is acting in accordance with its duties (and whose actions are able to bear enhanced scrutiny) under corporate law.

Following the recent decision in *Airgas*, it may be time for Canadian securities regulators to reconsider their basic approach to and role in adjudicating defensive tactics, recognizing and respecting not only the statutory obligations of boards of directors under corporate law in the context of change of control transactions, but also the ability of Canadian courts to appropriately scrutinize and oversee board conduct in such context. To paraphrase the OSC in *Canadian Jorex*, there comes a time when *National Policy 62-202* has got to go.

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58. William T. Allen, "Our Schizophrenic Conception of the Business Corporation" (1992) 14 Cardozo L. Rev. 261 at 281.

59. Lynn A. Stout, "New Thinking on 'Shareholder Primacy'" (UCLA School of Law, Law-Econ Research Paper No. 11-04, 2011), online: <http://ssrn.com/abstract=1763944>.