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Introduction¹

The current climate for mergers and acquisitions has been relatively quiet in recent months. Nevertheless, despite a leveling off of market activity, there have been interesting developments that may influence the legal environment for M&A lawyers, and which are worth mentioning in light of the impact they may have on future M&A transactions. This article will review recent judicial consideration of shareholder support agreements and the business judgment rule, proposed changes to the Toronto Stock Exchange bid rules and the increasing debate over the use of “break fees,” to address current issues that will likely face many lawyers and their clients.

Shareholder Support Agreements

In July 2001, the British Columbia Supreme Court issued a significant decision in connection with the Norske Skog Canada Ltd. (“Norske”) acquisition of Pacifica Papers Inc. (“Pacifica”) dealing with, among other things, the legality of shareholder support arrangement plans under the *Canada Business Corporations Act* (“the CBCA”). Although the validity of the shareholder support agreement in this case was ultimately upheld, the court’s discussion of whether such support arrangements constitute “illegal proxy solicitations”, and therefore contravene section 150(1) of the CBCA, merits consideration.

Norske and Pacifica entered into an arrangement agreement whereby Norske was to acquire all of the issued and outstanding common shares of Pacifica. The \$900 million deal, whereby Pacifica would become a wholly owned subsidiary of Norske, had the support of all of Norske’s shareholders and 73.6% of Pacifica’s shareholders.

Two Pacifica shareholders challenged the validity of the support agreements. The trial judge characterized the support agreements as commitments by Pacifica shareholders to give proxies to vote in favor of the transaction, stating that “in seeking the support agreements, Pacifica

was soliciting proxies.” The plaintiffs argued that this contravened s. 150(1) of the CBCA, which at the time prohibited the solicitation of proxies unless a management proxy circular in the prescribed form accompanied the notice of the shareholders’ meeting, thereby rendering the shareholders’ approval of the plan of arrangement invalid.

While Pacifica argued that s. 150(1) did not prohibit Pacifica from soliciting support agreements prior to the mailing of the proxy circular, the Court held that the provision requires that a proxy circular be delivered to shareholders *before their proxies are solicited*. Hence, the judge found the agreements “clearly unenforceable” and “illegal,” as they resulted from an “unlawful solicitation prohibited by the CBCA.” It was therefore “open to all of the shareholders to give or withhold their proxies, regardless of whether they signed a support agreement.”

Despite the contravention of s. 150(1), the trial judge nonetheless upheld the transaction due to the absence of any evidence that any of the shareholders who had entered into support agreements were misled. While the British Columbia Court of Appeal affirmed the trial judge’s decision that the arrangement was fair and reasonable, as required by the CBCA, it expressed reservations on two fronts. First, the court of appeal, in *obiter*, expressed reservations as to whether a plain reading of s.150(1) supported the restriction that a proxy circular had to be delivered prior to any solicitation. And second, the court of appeal held that the reason why the shareholders who signed support agreement could not be required to vote for the arrangement was because “proxies are always revocable, rather than any alleged illegality.” The court of appeal’s reasons, however, are difficult to understand, for while proxies are usually not given for consideration and thus ought to be revocable, commitments to vote shares in a particular way ought to be binding on the shareholder because such commitments are given for valuable consideration.

From these decisions, it seems that to avoid a challenge to the validity of a support agreement, it would be best to provide in the support agreement that the

shareholder agrees to support and vote in favor of the transaction but does not agree to provide a proxy for that purpose. It should be noted that this case was decided prior to the passing of an exception to the s.150(1) prohibition; namely that a person, other than management of the issuer, may solicit proxies without delivering a dissident proxy circular if the number of persons whose proxies are solicited is 15 or fewer. This exception is not currently available under the Ontario *Business Corporations Act* or many other corporations statutes. As a result, an exemption order may be sought by Ontario companies from the Ontario Securities Commission in order for an acquiror to avoid a claim that the support agreement is not valid.

The Business Judgment Rule

When boards and directors make business decisions, it is generally the case that courts will not interfere so long as the decisions are informed and are reasonably justifiable. This is the “business judgment rule.” As the court in one case put it, “Where business decisions have been made honestly, prudently, in good faith and on reasonable and rational grounds, the court will be reluctant to interfere and usurp the board of directors’ functions in managing the corporation.”²

Recently, the Ontario Superior Court of Justice considered rule in *UPM-Kymmene Corp. v. UPM-Kymmene Maramichi Ltd.*³ The case, which is currently under appeal, raises the issue of when a court will substitute its judgment for that of a board of directors when reviewing business decisions. It is particularly noteworthy in the current climate of greater focus on corporate governance and accountability.

Repap concerned the employment agreement between Repap and its executive chairman, which was approved by Repap’s board of directors. The court set aside the employment agreement on the grounds that the board did not make an informed decision on a reasonable basis.

In the case, Mr. Berg, the chairman of Repap, a Canadian public company, submitted an employment agreement for approval by Repap’s board of directors. At a board meeting, the company’s com-

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pensation committee recommended that the agreement be approved, though according to the court, the compensation committee did not make a "serious attempt" to "review, analyze and discuss with any diligence" the proposed employment contract. As well, the court found that there was consistent evidence that at that board meeting, relatively little time was allocated to consideration of the agreement. Without much comment or discussion, the court found that the board voted unanimously in favor of "rubber-stamping" the agreement. In reviewing the evidence, the court concluded that in this case, the board could have determined without much effort that Repap could not afford the services of Mr. Berg and as a result set aside the agreement, essentially finding that the board failed to make an informed decision on a reasonable basis.

In considering the board's actions, the court applied the business judgment rule to determine whether the board's decision to accept the employment contract was shielded from judicial scrutiny. According to the court, the "business judgment rule protects boards and directors from those that might second-guess their decisions. The court looks to see that the directors made a reasonable decision, not a perfect decision. This approach recognizes the autonomy and integrity of a corporation and the expertise of its directors."

In considering the business judgment rule, the court stated that "directors are only protected to the extent that their actions actually evidence their business judgment." In the court's view, the "principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions." As a result, "the business judgment rule cannot apply where the board of directors acts on the advice of a directors' committee that makes an uninformed recommendation." The court therefore concluded that while it was not unreasonable for the board to assume that its compensation committee had acted responsibly, "this did not relieve the directors of their independent obligation to make an informed decision on a reasonable basis." The procedural steps followed by the board leading up to the relevant board

meeting fell short, in the court's view, of the "exercise of prudent judgment in the interests of the shareholders that is expected of directors."

The trial court's decision in *Repap* suggests that a board of directors cannot shield its decisions under the business judgment rule merely by relying on the advice of board committees. While the court states that board decisions are not subject to microscopic examination, the court's examination of the evidence seems to indicate that the directors need to show a court that they have conducted an independent and diligent investigation of the facts to arrive at a decision that is informed and at least reasonably justified.

TSX Exchange Bid Rules

On July 2, 2002, the board of directors of the Toronto Stock Exchange approved amendments to the Toronto Stock Exchange company manual in respect of various matters. The amendments will come into effect upon approval by the Ontario Securities Commission.

The proposed amendments, particularly those relating to the TSX takeover bid legislation, may cause lawyers to consider having their clients utilize the TSX exchange bid rules rather than the takeover bid rules under the Ontario *Securities Act*. The most significant change is that the current restriction on attaching conditions to a stock exchange takeover bid, other than establishing a maximum number of shares sought, and in the case of a transaction in which notice must be given under the provisions of the *Competition Act*, making the bid conditional on no action being taken by the Director of Investigation and Research within the specified time period, contained in the current TSX rules will be removed. As a result, the proposed rules will permit an offeror to attach additional conditions to an exchange bid. The rules for TSX exchange bids will thus more closely resemble securities legislation on circular takeover and issues bids, which allow offerors to attach conditions, other than financing ones, to takeover bids. This change is connected with a further proposed amendment, which will allow a bid to be withdrawn in the event that a particular condition attached to the

bid is not satisfied, and which will remove restrictions on the types of amendments that can be made to exchange bids. Where amendments are made close to the expiry of a bid, however, the TSX may delay timing of the book for tenders to ensure that amendments are communicated to security holders. The TSX will continue the practice of lighter disclosure requirements for TSX bids compared to OSC bids, though the bid disclosure must be settled with the TSX in advance of mailing.

Break fees

Recently there has been continuing discussion over the use of break fees in takeover bids. Generally, break fees refer to payments made by a target company to the offeror in the event that the offeror's bid is not ultimately consummated. They are used to attract a bidder to make an offer, to protect the bidder after the offer is made and to compensate the bidder for the time, money and effort spent preparing the bid.

The issue received attention in March 2002 in light of Sun Life Financial Services of Canada Inc.'s \$6.9 billion takeover offer for Clarica Life Insurance Co. In order to protect Sun Life's offer from competing bids, the proposed takeover of Clarica included a \$310 million break fee for Sun Life in the event that Clarica shareholders tendered their shares to a competing offeror (Sun Life also had the right to match any competitor bids). The 4.5% break fee in this case was said to be above the usual transactional break fee average.

The primary concerns with high break fees is that they are seen by some to either coerce shareholders to accept an offeror's bid, or that they may effectively preclude competitor bids. Investors are placed in the position of either accepting or rejecting the offer, without the opportunity to solicit further bids. As a result, in the end, it is in effect the directors, rather than the shareholders, who end up deciding whether to accept an acquirer's offer. This may, in some cases, be cause for concern, since it is the board's duty to ensure that shareholders get the best possible value for their shares and that shareholders can reap the financial gains of competition;

prohibitive break fees that circumvent shareholder choice and that impede competition may conflict with this duty.

This lack of effective shareholder control of potential takeover bids, particularly when they are used to coerce share-

holder acceptance and to discourage competition, has led some securities commissions to debate whether break fees should be regulated. It may be that in an appropriate case — where, for example, the integrity of markets and the protection of

shareholders are at issue — regulators will consider regulating the size of break fees. However, the OSC took the more sensible course in this case and declined to intervene, leaving any intervention to the courts. ■

¹ I acknowledge the valuable contribution to this article of Hanif Nori, an articling student at Torys LLP.

² *CW Shareholdings v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755 (Gen. Div.).

³ [2002] CarswellOnt 2096 (S.C.) [hereinafter *Repap*]



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