Torys on Mergers and Acquisitions

M&A 2011-6
November 23, 2011

Canadian Securities Regulators Considering Changes to Corporate Governance in M&A Transactions

By Karrin Powys-Lybbe, Michael Siltala and Cornell Wright

The Ontario Securities Commission staff is considering proposals that would have a significant impact on corporate governance surrounding M&A transactions. Following several recent decisions on the use of shareholder rights plans, the OSC is considering allowing shareholders to authorize a company's board of directors to "just say no" to a hostile bid. The OSC is also considering amendments to its related party transaction rules to address some of the corporate governance deficiencies it identified in its decision regarding the plan of arrangement implemented by Magna International Inc. in August 2010.

Shareholder Rights Plans

The OSC is considering a rule that would allow companies to keep a shareholder rights plan in place in the face of a hostile bid provided that shareholders have approved the plan. The intent of the rule would be to provide a more predictable and transparent regime for hostile bids and to avoid the need for the securities regulators to decide on a case-by-case basis whether and, if so when, bidders should have the opportunity to put their bids to shareholders.

In recent decisions, securities regulators in Canada have demonstrated a willingness to reconsider their traditional position that the only legitimate purpose for a rights plan is to buy time for the target board to seek value-maximizing alternatives to a hostile bid. Those decisions have left open the question whether continued deployment of a rights plan in the face of a hostile bid could be justified on the basis of a shareholder vote when the board is not seeking an alternative transaction. A rule allowing companies to maintain a rights plan in the face of a hostile bid would be significant in that it would expressly allow boards to "just say no" to a hostile bid if the board has been authorized to do so by a shareholder vote, which could be held annually or in the face of the bid.

In the United States, Delaware courts have long allowed a board of directors to use a rights plan to block a hostile bid that it considers inadequate, even when it appears that shareholders would have accepted the bid, as long as the board is acting in good faith and conducts a reasonable investigation relying on outside advisers.

Related Party Transactions

The OSC is also looking at changes that would subject related party transactions to greater scrutiny by boards of directors and shareholders. The changes recall many of the criticisms that the OSC levelled against Magna International's board of directors. They also reflect demands from investors, who are showing less deference to the judgments of boards of directors in corporate decision making.

To discuss these issues, please contact the authors.

One of the changes being considered would require all transactions involving related parties to be completed under the supervision of a special committee of disinterested directors. The committee would have to be authorized to negotiate (or oversee the negotiation of) the specific transaction terms and to consider alternatives. The special committee would also be required to (i) recommend that the board propose or support the transaction and that shareholders vote in favour of it, or (ii) determine that the transaction is fair to minority shareholders and allow shareholders to vote without a recommendation. The effect of the changes would be to avoid a scenario where shareholders are asked to approve a transaction without the special committee having recommended it or determined it is fair, as occurred in the Magna International case.

The OSC is also considering requiring minority shareholder approval for all related party transactions that have a value in excess of 10% of a company's market capitalization. This is significantly lower than the current threshold of 25%. Formal valuations would be required only for transactions that have a value in excess of 25% of a company's market capitalization (although the special committee would, in practice, require formal financial advice, which would be disclosed to shareholders when their approval is required).

The direction of the changes being considered is consistent with the Canadian approach to regulating related party transactions, which relies heavily on compliance with technical formal valuation and minority shareholder approval requirements. That approach can be contrasted with the approach taken in the United States, where related party transactions are commonly attacked in court on the grounds that directors have breached their fiduciary duty of loyalty. The Delaware court applies an "entire fairness" standard of review to related party transactions, which requires that they be entirely fair in process and price to the minority shareholders. In determining entire fairness, the court focuses on how the special committee actually negotiated the transaction – whether it in fact simulated the role that a third party with negotiating power would have played. For example, in one recent case involving a NYSE-listed company's acquisition of another company from its controlling shareholder (*In Re Southern Peru Copper Corporation*), the Delaware court found fundamental flaws in the special committee process and ordered the controlling shareholder to pay the company $1.2 billion in damages to remedy what the court concluded was an unfair transaction, even though the holders of more than 90% of the company's shares had voted to approve the transaction.

If the OSC decides to proceed with these proposals after consultation with the other Canadian securities regulators, draft rules will be published for public comment.