

TAKEOVER BIDS IN CANADA AND TENDER OFFERS IN THE UNITED STATES

Torys provides insight on steering takeover transactions through the regulatory regimes on both sides of the border.

*A Business
Law Guide*

Torys LLP

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**Takeover Bids in Canada and
Tender Offers in the United States**
A Guide for Acquirors and Targets
A Business Law Guide

TORYS
LLP

This guide is a general discussion of certain legal matters and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the matters in this guide with you, in the context of your particular circumstances.

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Takeover Bids in Canada and Tender Offers in the United States

A Guide for Acquirors and Targets

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Introduction

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The border between Canada and the United States is virtually invisible in the world of mergers and acquisitions, with M&A activity between the two countries fuelled by economic, political and geographical drivers. Canada is a relatively appealing source of target companies for U.S. companies because of its physical proximity, cultural and regulatory similarity, minimal geopolitical risk and wealth of natural resources. At the same time, Canadian companies wishing to be global players – or otherwise grow significantly – naturally look for acquisition opportunities in the much larger U.S. market.

This guide focuses on cross-border transactions structured as takeover bids in Canada or tender offers in the United States. Takeover bids and tender offers involve an acquiror making an offer to target shareholders to acquire some or all of their shares. In a hostile situation, a takeover bid or tender offer is the only way to acquire a Canadian or U.S. target company. In a friendly situation, many variables will influence whether this is the best way to acquire a target, compared with a merger (in the United States) or an amalgamation or plan of arrangement (in Canada). The best form of transaction will often become apparent during planning or negotiations and will depend on how quickly the acquiror wants to gain control of the target, the tax implications of the transaction, the available methods of financing the transaction, regulatory hurdles such as antitrust review, and various other factors.

This guide provides a side-by-side review of the Canadian and U.S. legal regimes governing takeover bids and tender offers to help acquirors and targets prepare for a cross-border bid. Generally speaking, takeover bids for Canadian targets must comply with Canadian law, and tender offers for U.S. targets must comply with U.S. law. The regulatory situation may be more complicated, however, if a target has a significant number of shareholders in both jurisdictions. For example, the hostile bids by Petro-Canada for Canada Southern Petroleum and by Barrick Gold for NovaGold had to comply simultaneously with the Canadian and U.S. legal regimes because the targets in both deals were incorporated in Canada but had many U.S. shareholders by virtue of being listed on U.S. stock exchanges.

The general principles underlying the Canadian and U.S. takeover laws are the same, as are the practical effects of many specific rules of each jurisdiction. Both legal regimes are designed to ensure fair and even-handed treatment of target shareholders by ensuring that they are all offered the same consideration and given full disclosure of all material information pertaining to a bid. A secondary objective of both legal regimes is to provide a predictable set of rules and a level playing field for potential bidders, targets and other capital market participants.

Regulatory Differences at a Glance

Despite the many similarities between the Canadian and U.S. legal regimes, the details and terminology of some of the legal requirements differ. These are some of the main differences:

- The Canadian takeover rules are triggered when an acquiror crosses a bright-line 20% threshold ownership in a target company. The U.S. tender offer rules are triggered by widespread solicitation of public shareholders combined with other qualitative factors; open market purchases are not generally considered to be tender offers.
- Prospectus-level disclosure is required in both jurisdictions if a bidder offers shares as consideration; under the U.S. rules, this disclosure may be subject to intensive review by the Securities and Exchange Commission, which could significantly affect the timing of the transaction.
- Canada's early warning rules require a toehold position to be disclosed when the acquiror's ownership exceeds 10%, and following this disclosure, further purchases must be halted until the necessary regulatory filings are made. The U.S. early warning rules require a toehold position to be disclosed when the acquiror's ownership exceeds 5%.
- The minimum tender condition for a bid, which will reflect the applicable corporate law requirements for a second-step squeeze-out merger in the target's jurisdiction of incorporation, is typically 66 2/3% in Canada and 90% in the United States.
- Stronger and more effective takeover defences have historically been permitted under the U.S. regime, meaning that Canadian companies have been somewhat easier targets for unsolicited bids, although this difference is becoming less pronounced as a result of various developments on both sides of the border.
- The pre-merger notification requirements under Canada's *Competition Act* are triggered if, among other things, a bid is for more than 20% of the target's voting shares; the pre-merger notification requirements under the U.S. *Hart-Scott-Rodino Antitrust Improvements Act of 1976* may be triggered by the acquisition of a certain dollar value of securities, regardless of the percentage of target securities acquired.

- In Canada, foreign investments by non-Canadians may be subject to review either on national security grounds or if more than 33 1/3% of the voting shares of a Canadian corporation are acquired. In the United States, foreign investments by non-Americans are subject to review only on national security grounds.

In cross-border transactions, the parties must determine whether both Canadian and U.S. rules will apply or whether an exemption is available from some or all of one country's requirements. If no exemption is available, the parties will have to quickly become familiar with both sets of laws and comply with the stricter requirements. Thorough preparation and effective planning will enable the parties to navigate through the applicable requirements so that companies can structure and execute their cross-border takeovers as smoothly and efficiently as possible.



The Lay of the Land

2

Triggering the Canadian and U.S. Legal Regimes

Target Shareholders in Canada

Takeover bids in Canada are governed by the corporate and securities laws of each province and territory.¹ For example, Ontario laws will apply if a takeover bid is made to Ontario shareholders of a target company. If a bid is also made to shareholders in other provinces or territories, as would typically be the case, it will be subject to the laws of those jurisdictions. In describing Canadian legal requirements, this guide focuses on the requirements under Ontario law, which are very similar to those of the other provinces and territories.

The Ontario takeover bid rules are triggered when an acquiror (with any joint actors) crosses a threshold of 20% ownership of a target's outstanding equity or voting securities. If a purchase of the target's shares triggers the takeover bid rules, the acquiror must make the same offer to all of the target's shareholders by way of a formal takeover bid circular unless an exemption is available.

In measuring its ownership of the target's securities, an acquiror must include securities that it beneficially owns or exercises control or direction over. Any securities that an acquiror has the right to acquire within 60 days, such as options, warrants or convertible securities, are deemed to be beneficially owned by the acquiror. The holdings of any other party that is acting jointly or in concert with the acquiror must also be included. Under Ontario law, whether a person or entity is "acting jointly or in concert" with the bidder will generally depend on the facts and circumstances, subject to the following:

- A parent or subsidiary is deemed to be acting jointly or in concert with a bidder, as is any party that acquires or offers to acquire securities with the bidder; and
- Certain other parties, including major shareholders and anyone exercising voting rights with the bidder, are presumed to be acting jointly or in concert with the bidder, although the presumption can be rebutted on the basis of the facts and circumstances.

¹ In the case of non-corporate entities such as income trusts, the constating documents (e.g., the declaration of trust), as well as principles of trust law, will be applicable rather than corporate law. This guide focuses on the laws governing corporate entities; the principles governing other entities are substantially similar.

There are several exemptions from Ontario's takeover bid rules. Private agreements to purchase securities from not more than five persons are exempt. If there is a published market for the target's securities, the price under this exemption may not exceed 115% of the market price. Normal-course purchases of up to 5% of a class of a target's securities during any 12-month period are also exempt. The price paid for securities under this exemption may not be greater than the market price of the securities on the date of acquisition. These two exemptions are important ones under Ontario law, particularly for institutional purchasers such as private equity and hedge funds.

Target Shareholders in the United States

Tender offers for U.S. companies are governed by federal securities laws and related rules of the Securities and Exchange Commission (SEC) as well as by the corporate laws of the target's jurisdiction of incorporation. In describing the U.S. legal requirements other than federal law, this guide focuses on the corporate laws of Delaware because a significant number of U.S. companies are incorporated there and the laws of many other states are very similar to Delaware's.

Instead of a bright-line quantitative test equivalent to Canada's 20% threshold, an eight-factor qualitative test is applied to determine whether a transaction triggers the U.S. tender offer rules. However, most of the U.S. tender offer rules do not apply unless the target's equity securities are listed or widely held, meaning that they are registered with the SEC under the *Securities Exchange Act of 1934* (Exchange Act).

The eight tender offer factors, each of which is relevant but not individually determinative, are as follows:

1. The bidder makes an active and widespread solicitation of public shareholders.
2. The solicitation is for a substantial percentage of the target's stock.
3. The offer is at a premium above the prevailing market price.
4. The terms are firm rather than negotiable.
5. The offer is contingent on the tender of a fixed minimum number of shares.
6. The offer is open for a limited period of time.
7. Shareholders are subject to pressure from the bidder to sell their stock.
8. The bidder publicly announces an intention to gain control of the target, and then rapidly accumulates stock.

The consequence of triggering the U.S. tender offer rules with respect to a registered security is essentially the same as the consequence of triggering the Canadian rules: the acquiror must make the same offer to all target shareholders by way of formal documentation that is mailed to shareholders and filed with securities regulators.

Cross-Border Exemptions

Some transactions may simultaneously trigger the Canadian takeover bid rules and the U.S. tender offer rules. A bid for the shares of a Canadian company that has a significant number of U.S. shareholders could trigger both countries' rules unless an exemption is available to grant relief from the U.S. rules. Conversely, a tender offer for the shares of a U.S. company that has a significant number of Canadian shareholders could trigger both countries' rules unless an exemption is available to grant relief from the Canadian rules. Where the two legal regimes impose different requirements, a transaction that is subject to both regimes will have to comply with the more stringent rules.

Canadian and U.S. securities regulators have adopted cross-border exemptions so that a bid may proceed primarily under the laws where the target is organized, even if the target has shareholders residing in both jurisdictions. If a cross-border exemption is available, the parties to a transaction will save time and avoid duplicative regulation. A tender offer for the shares of a U.S. target company with less than 40% of its shareholders residing in Canada will usually be exempt from most of the Canadian rules, and a takeover bid for the shares of a Canadian target company with less than 40% of its shareholders residing in the United States will usually be exempt from most of the U.S. rules. These cross-border exemptions from regulation are discussed in greater detail in part 9, "Avoiding Dual Regulation: Cross-Border Exemptions," below.

Disclosure Liability

Under Canadian and U.S. law, acquirors' and targets' public communications, whether oral or written, about a bid are heavily regulated and subject to liability to private plaintiffs and securities regulators. Substantial due diligence is usually required to help ensure that the parties' disclosure to the market and in filings with securities regulators is accurate and not misleading.

Alternatives to a Bid

There are advantages and disadvantages to takeover bids and tender offers when compared with alternative ways of acquiring a target. The best form of transaction will often become apparent in the planning or negotiating phase, depending on a myriad of factors including the tax implications of different structures, the available methods of financing the transaction, potential regulatory hurdles such as antitrust review, and the target's receptiveness to an acquisition.

A takeover bid or tender offer is usually the fastest way to obtain control of a target in Canada or the United States and is the only way to acquire a hostile target because the offer is made directly to the target's shareholders, bypassing its management and directors. On the other hand, if an acquiror is unable to obtain a minimum threshold of the target's shares in a takeover bid or tender offer, a second-step shareholders' meeting to vote on squeezing out the non-tendering shareholders will be required. This could eliminate the timing advantage of takeover bids and tender offers in obtaining full ownership of the target.

In Canada, amalgamations and plans of arrangement are the main alternatives to takeover bids. Both of these options require a target shareholders' meeting and supermajority (66 2/3%) approval of the transaction. A single-step merger in the United States is equivalent to an amalgamation in Canada and is the main alternative to a tender offer. These transactions generally also require approval by a majority of the target's shareholders.

A plan of arrangement is a very flexible way to acquire a Canadian company. This method requires court approval following a hearing and, although this may provide a forum for disgruntled stakeholders to air their grievances, a plan of arrangement allows the parties to deal with complex tax issues, to amend the terms of securities (such as convertibles, exchangeables, warrants or debentures) and to assign different rights to different holders of securities.

Plans of arrangement also provide acquirors with greater flexibility than takeover bids to deal with the target's outstanding stock options – for example, if the option plans do not include appropriate change-of-control provisions for accelerated vesting or termination. Plans of arrangement have the added benefit of being eligible for an exemption from the SEC's registration and disclosure requirements for securities that the acquiror offers as consideration.

Takeover bids and tender offers may be more difficult to finance than other kinds of transactions. In the case of a merger or amalgamation, assuming the requisite shareholder vote is obtained, the acquiror can immediately secure the financing with a lien on the target's assets, since the acquiror will own 100% of the target at the time it needs to pay the target's shareholders. In the case of a bid or tender offer, if the bidder does not obtain sufficient tenders (generally

90%) to complete a compulsory or short-form second-step merger to acquire any untendered shares, the acquiror may find it more difficult to secure financing.

In Canada, amalgamations and plans of arrangement are permitted to be subject to a financing condition, whereas bids are not; however, the target's board will generally insist on financing being in place for an arrangement. U.S. tender offers and mergers are both permitted to be subject to a financing condition (see "Conditions" in part 4, "The Rules of the Road," below).

Friendly Versus Unsolicited Transactions

A key variable in structuring any takeover bid or tender offer is whether the transaction is friendly or unsolicited. Although unsolicited transactions often result in a change of control, the initial unsolicited bidder is often not the successful party. In addition to the risk of failure associated with unsolicited deals, friendly transactions have historically been more desirable for the following reasons:

- A friendly acquiror can obtain access to confidential information for due diligence purposes, whereas in an unsolicited situation, access will not be granted unless necessary for the target's board to fulfill its fiduciary duties to target shareholders.
- A friendly acquiror can obtain a "no-shop" covenant, which prevents a target from soliciting competing offers (subject to a "fiduciary out") so that only serious third-party bidders are likely to interfere with the transaction.²
- A friendly acquiror may have the benefit of a break fee, expense reimbursement and the right to match competing bids (as the quid pro quo for the fiduciary out).
- To be successful, an unsolicited bidder may have to indirectly pay the break fee as well as the purchase price if the target has already agreed to a friendly transaction with a third party.
- Friendly transactions allow greater flexibility to structure a transaction to meet tax and other regulatory objectives.

² See "Deal Protections," in part 6, below.

- In unsolicited transactions, the target will actively solicit competing transactions and take other actions to thwart the bid, such as attempting to negatively influence the granting of regulatory approvals, initiating litigation and taking other defensive measures that make unsolicited transactions more complicated and potentially more expensive.
- Friendly transactions avoid acrimony and preserve relationships.

Despite the advantages of friendly deals, it is sometimes necessary for a bidder to bypass an unwilling target board. There are good reasons for proceeding with an unsolicited offer in some circumstances, and several factors have caused unsolicited transactions to gain popularity in recent years. The advantages of unsolicited offers for acquirors include the following:

- In an unsolicited transaction, the acquiror determines the initial bid price and the time of launching the transaction without having to negotiate with the target, whereas in a friendly deal, the target's board will likely seek a higher price as a condition of making a favourable recommendation to target shareholders.
- In an unsolicited transaction, the target is forced to consider and respond to a bid within a relatively short statutory time frame, and the highest price usually wins.
- An unsolicited transaction may avoid certain difficult management issues associated with mergers of equals, such as who will be CEO and how the board will be constituted.
- In an unsolicited transaction, there is less risk of rumours circulating in the market during negotiations, causing a run-up in the target's stock price and potentially making the deal more expensive.

Going-Private Transactions

The term “going-private transaction” is generally used to refer to an acquisition of a public company's outstanding securities by a related party, such as an existing significant shareholder, members of management or an acquiror in which an existing shareholder or management will have an interest. Because the acquiror is a related party of the issuer and public shareholders are being “squeezed out” of their equity interest, going-private transactions involve inherent conflicts of interest and inequalities of information. To protect public shareholders in these circumstances, both Canadian and U.S. laws prescribe heightened

legal requirements when a takeover bid or tender offer is also a going-private transaction. These rules are set forth primarily in Multilateral Instrument 61-101, *Protection of Minority Securityholders in Special Transactions*, in Ontario and Quebec, and Rule 13e-3 under the U.S. Exchange Act.

For a takeover bid, MI 61-101 generally requires

- a formal, independent valuation of the target's shares, which must be supervised by an independent committee of the target's board; and
- heightened disclosure, including disclosure of the background to the bid and any other valuations prepared or offers received for the target's securities in the past two years.

A bidder will also be required to obtain minority shareholder approval of a second-step transaction if it wants to acquire full ownership of the target, as will usually be the case; the bidder may, however, count shares tendered to its bid toward that approval if certain conditions are satisfied (see part 5, "Second-Step Transactions," below).³

Like MI 61-101, Rule 13e-3 under the Exchange Act also imposes heightened disclosure requirements for going-private transactions.⁴ Detailed information is required about the target board's decision-making process, the rationale and purpose of the transaction, the alternatives considered by the board and other offers received for the target's securities during the past two years. The board must also explain the reason why the transaction is considered fair to target shareholders, and must provide supporting information such as prior appraisals or opinions, and even informal materials like presentations to the board by investment bankers.

In contrast to MI 61-101, no formal valuation is required under Rule 13e-3. However, the target's board will typically form a special committee to review the transaction and will also request a financial adviser to provide a fairness opinion to support the board's exercise of its fiduciary duties (see part 6, "The Target's Board of Directors," below).

³ For a going-private transaction structured as an amalgamation or plan of arrangement, MI 61-101 similarly requires approval by a majority of the minority shareholders.

⁴ Rule 13e-3, like the U.S. tender offer rules, applies only when the target's securities are listed on a U.S. stock exchange or registered with the SEC. Furthermore, an exemption is available if the number of securities held by U.S. holders is relatively small.

In the context of private equity buyouts of public companies, the heightened legal requirements applicable to going-private transactions give rise to timing and process considerations. If a going-private transaction provides management with a significant equity interest following the closing of the transaction (as is often the case if the acquiror is a private equity firm), minority approval and a formal valuation may be required under MI 61-101. Furthermore, under U.S. rules, the acquiror and not just the target could become subject to the heightened disclosure obligations of Rule 13e-3 and be required to provide, among other things, information about the fairness of the transaction and plans for the target.

The factual circumstances that could trigger the going-private rules are very similar in Canada and the United States, but subtle differences in the legal tests could result in one jurisdiction's rules being triggered but not the other's. Companies should seek advice at an early stage about a transaction's potential to trigger the going-private rules and strategies that can be used to avoid triggering them inadvertently.



Pre-transaction Issues

3

Insider Trading

At the very outset of a potential transaction in either Canada or the United States, a company's directors and any officers involved in the deal should be aware of their responsibilities under securities laws as insiders who possess material, non-public information. It is extremely important for both bidders and targets to have comprehensive internal policies and procedures aimed at preventing insider trading, tipping or selective disclosure of material non-public information.

Any purchases or sales of target securities by an acquiror or its executive officers or directors during the six months leading up to a Canadian takeover bid⁵ or during the 60 days leading up to the announcement of a U.S. tender offer must be disclosed in the documentation filed with securities regulators and mailed to shareholders.

Public Disclosure About a Bid

Public companies must keep the market informed of important corporate developments. In the context of M&A transactions, companies must reconcile the business advantages of keeping potential transactions confidential with the legal obligation to provide disclosure under securities laws. Parties to a deal will want to conduct themselves and manage any negotiations in a way that will minimize the risk of a disclosure obligation crystallizing when such an announcement would be premature or would jeopardize the transaction. The question of when to publicly announce a transaction is a complex matter of judgment that should be discussed with advisers.

Canadian public companies must promptly announce any material change in their business or affairs in a news release, and they must file a material change report with securities regulators within 10 days of the change. Determining when a material change has occurred in the context of a friendly deal is difficult. The Ontario Securities Commission noted, in *Re AiT Advanced Information Technologies Corp.*, that an important factor in determining whether a material change has occurred is whether both parties are committed to proceeding with the transaction and whether there is a substantial likelihood that the transaction will be completed.

⁵ Twelve months in the case of a takeover bid made by an insider.

Canadian issuers that are “foreign private issuers” under SEC rules (which includes almost all Canadian companies) must furnish a report to the SEC on Form 6-K to disclose material events at the time when the information is publicly disclosed in Canada.⁶

U.S. domestic companies are not always obliged to disclose material changes as promptly as required by Canadian law. Instead, U.S. companies are entitled to keep material corporate developments confidential until a specific event triggers a disclosure obligation. In the M&A context, entering into a “material definitive agreement” triggers an obligation for U.S. domestic companies to file a report on Form 8-K disclosing the transaction.

Many companies announce M&A transactions as soon as the parties reach an agreement on price and structure, even if a legal disclosure obligation has not yet crystallized, partly because they are concerned about material information being leaked to the market. Until a material transaction is announced, a company may not trade in its own securities (such as under a share repurchase program) because that would amount to insider trading. This is known in the United States as the “abstain or disclose” rule. If trading activity in a company’s securities is unusually high or if rumours begin circulating about the company, a stock exchange may ask for an explanation and may compel public disclosure of any material information. In addition, companies may not actively mislead the market – for example, by falsely denying the existence of material news.

A company’s public statements about a potential M&A transaction are subject to civil liability for material misstatements or omissions in both Canada and the United States.

Acquiring a Toehold

The potential advantages of acquiring target stock before making a bid are the same in Canada and the United States. Market purchases may be made at prices below the formal offer price, thereby reducing the ultimate cost of the acquisition or providing a form of breakup fee by allowing the bidder to tender to a higher bid by a third party. However, toehold acquisitions are more popular in Canada than in the United States because of the greater risk in the United States of a

⁶ In Canada, a material change report may be filed confidentially if the company reasonably believes that publicly disclosing the information would be unduly detrimental. Whether it is advisable to file confidentially will depend heavily on the facts and circumstances. In the United States, the SEC does not permit confidential material change filings; instead, foreign private issuers that make confidential filings in Canada

do not make any SEC filing until the information is released publicly in Canada. We believe that filing confidentially in Canada without the availability of a comparable procedure in the United States entails risks for cross-border companies under the U.S. civil liability regime. Consult counsel as early as possible to help determine the best course of action.

target's takeover defences effectively preventing a change of control and leaving the acquiror with an unwanted block of stock (see part 6, "The Target's Board of Directors," below, for a comparison of Canadian and U.S. takeover defences).

When acquiring a toehold other than through ordinary market transactions, bidders may want to avoid the Canadian "pre-bid integration" rules. These rules require that (i) the consideration paid in a formal offer be at least equal to and in the same form (e.g., cash or shares) as the highest price paid in any private transaction during the 90 days before the bid, and (ii) the proportion of shares sought in a formal offer be at least equal to the highest proportion of shares purchased in any such transaction. (As a partial exception to this rule, a formal bid may include shares as part of the consideration even if cash was paid in the pre-bid purchase, but in that case, shareholders must be given the option of electing all-cash consideration.)

Pre-bid purchases of shares of a Canadian company may be counterproductive because securities acquired before a bid do not count toward the 90% minimum that the acquiror needs to entitle it to acquire the remaining target shares in a second-step transaction without a shareholder vote. Furthermore, if a shareholder vote is required to approve a second-step business combination, securities acquired before the bid must be excluded in determining whether majority approval has been obtained (see part 5, "Second-Step Transactions," below).

In the United States, shares acquired in a toehold will count toward the 90% minimum and there are no U.S. rules equivalent to Canada's pre-bid integration rules. However, in both jurisdictions, any pre-bid transactions in a target's securities will have to be fully disclosed in the bid documentation.

Early Warning Disclosure

Although the rules governing pre-bid purchases in Canada differ from those in the United States, in both jurisdictions any purchase of securities before a formal offer is commenced could trigger an early warning disclosure requirement. Like the takeover rules generally, the Canadian early warning requirements apply to voting or equity securities of a target, whereas the equivalent U.S. beneficial ownership reporting rules apply only to voting equity securities that are registered under section 12 of the Exchange Act – that is, listed or widely held securities.

The disclosure requirement is triggered when the acquiror (including others acting together with the acquiror) crosses the 10% level in Canada or the 5% level in the United States. (If a formal bid is already outstanding, the Canadian threshold becomes 5%.) If a Canadian target is listed on both a Canadian and a U.S. stock exchange, the lower U.S. reporting threshold of 5% will apply.

In Canada, the acquiror must promptly issue a news release disclosing its future investment intentions, and must file a report with securities regulators within two business days. The acquiror must halt purchases of the target's stock until the report is filed unless it already owns 20% or more of the stock. The obligation to halt purchases means that the acquiror will want to purchase the largest single block of shares possible in crossing the 10% threshold. Material changes in the information on file with securities regulators or further acquisitions of 2% or more of the target's stock will trigger further disclosure.

In the United States, a bidder must file a beneficial ownership report with the SEC within 10 days of acquiring more than 5% of a target's voting securities and disclose any plans or proposals with respect to the target. Any material change in the facts disclosed in the report will trigger a requirement for amended filings. A purchase of an additional 1% of the target's stock is deemed to be a material change for this purpose. The amendment must be filed promptly unless the owner was previously a passive investor, in which case an amendment must be filed within 10 days of the bidder's changing its investment intent regarding the target's securities. There will be a 10-day cooling-off period after the amended filing is made, during which the bidder may not vote or acquire additional target securities.

Lockup Agreements

Entering into lockup agreements with major target shareholders to secure their participation in a deal is common in both Canada and the United States. Entering into a lockup agreement is an alternative to acquiring a toehold or, in Canada, relying on the private agreement exemption to acquire target shares in advance of a formal offer. Under a lockup agreement, an acquiror may agree to pay more than the 15% premium permitted under Canada's private agreement exemption as long as it offers identical consideration to all target shareholders. In both jurisdictions, locked-up shares may be counted for purposes of determining whether an acquiror has reached the 90% minimum needed to complete a second-step transaction without a vote by target shareholders. If a shareholder vote is required, locked-up shares may be counted toward the majority approval requirement (see part 5, "Second-Step Transactions," below).

An issue under Canadian law is whether a shareholder that enters into a lockup agreement would be treated as acting jointly or in concert with the offeror. If so, the bid may be treated as an insider bid requiring a formal valuation, and the shares may not be counted toward the majority approval of a back-end going-private transaction. However, the fact that the shareholder has entered into a lockup agreement with the offeror, even if the agreement is irrevocable and

broadly worded, will not alone be sufficient to establish that the shareholder and offeror are acting jointly or in concert. Generally, for a “joint actor” relationship to exist, there must be other circumstances beyond the agreement, such as a prior or existing relationship between the shareholder and the offeror, some other involvement by the shareholder in the planning or negotiation of the transaction, or some collateral benefit accruing to the shareholder as a result of signing the lockup agreement.

Under U.S. rules, an acquiror is required to disclose its entry into a lockup agreement if the purchase would result in the acquiror’s owning more than 5% of the target’s stock. Although Canadian law does not require detailed disclosure about a lockup agreement until the bidder’s circular is filed, the Canadian practice is similar to the U.S. rule, whereby disclosure is provided at the time the lockup agreement is signed. As in the case of pre-bid purchases, acquirors in both jurisdictions must disclose the details of lockup agreements in the formal offering documentation that is filed with securities regulators and delivered to target shareholders, and those filings must include a copy of the agreement itself.



The Rules of the Road

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Timeline

Please see the appendix for a cross-border bid timeline.

Announcing a Transaction

A friendly transaction will be announced when a merger or support agreement is signed, if it has not already been announced during the negotiating period. In the United States, any informal written materials (such as news releases, investor presentation materials or website postings) that the acquiror or target uses between the time the transaction is announced and its closing must be filed with the SEC on the same day.

Commencing a Transaction

In Canada, a bidder may commence a bid by publishing a summary advertisement; but the more common practice is to commence by mailing the bid to target shareholders. In the United States, a transaction must be formally commenced soon after being announced. Commencement of a U.S. bid occurs with the publication of a summary advertisement. In both jurisdictions, the acquiror must notify the applicable stock exchange(s) and deliver the bid to the target. In Canada, the acquiror must file a takeover bid circular with securities regulators. The U.S. equivalent of a takeover bid circular is Schedule TO, which the acquiror files with the SEC and which contains an offer to purchase that is mailed to target shareholders.

Takeover bid circulars and Schedule TOs contain extensive disclosure about the transaction for the benefit of target shareholders. These disclosure requirements are summarized in part 7, “Documentation and Regulatory Review,” below.

The Target's Response

In a friendly transaction, the target's response to a bid is typically mailed to its shareholders along with the acquiror's materials. Under Canadian rules, the target's position regarding a takeover bid must be disclosed in a directors' circular, which must be filed no later than 15 days after commencement of the bid.

In the circular, the directors must (i) recommend that shareholders either accept or reject the bid, and the circular must provide the reasons for the recommendation; or (ii) explain why no recommendation is being made. The directors may also state that the bid is being considered and request that shareholders refrain from tendering their shares until the board is ready to make a recommendation, in which case the final deadline for the board's recommendation is seven days before expiry of the bid. The circular must

disclose any information that would reasonably be expected to affect the target shareholders' decision to accept or reject the bid.

The U.S. equivalent of a directors' circular is Schedule 14D-9, which must be filed with the SEC within 10 business days of commencement of the tender offer. Like the Canadian directors' circular, Schedule 14D-9 must disclose the target board's position regarding the transaction. Until the Schedule 14D-9 is filed with the SEC, the target is prohibited from communicating with its shareholders about the transaction, except to advise them to "stop, look and listen" – that is, to refrain from tendering their shares until the board finishes its review of the offer and discloses its position in the Schedule 14D-9. In the Schedule 14D-9, the board may recommend acceptance or rejection of the offer, or it may state that it has no opinion or is unable to take a position.

Because the Canadian and U.S. deadlines for the directors' circular and Schedule 14D-9 are different, in a cross-border transaction that is subject to both sets of rules, the operative deadline for the target's initial filing is 15 calendar days or 10 business days after commencement, whichever is shorter.

Expiration of an Offer

In Canada, a bid must be open for a minimum of 35 calendar days after commencement. The bid may be extended, but if all conditions are satisfied except those waived by the bidder, the acquiror must first take up the tendered shares.

In the United States, the minimum offering period must last for at least 20 business days. A U.S. bid may be extended, but no shares may be taken up and withdrawal rights must be available throughout the extension period. Alternatively, an acquiror may take up shares and grant a subsequent offering period lasting at least three business days if all conditions to the offer are satisfied or waived and shares are taken up on a daily basis. The most likely reason for having a subsequent offering period would be that during the minimum offering period, the acquiror failed to acquire the 90% minimum needed to effect a second-step transaction without a shareholder vote. Because the Canadian and U.S. offering periods are different, a cross-border bid will have to be open for the longer Canadian minimum of 35 calendar days.

Changes to Bids

Under Canadian rules, a notice of variation or change must be filed with securities regulators if the terms of a bid are varied or a change has occurred that would reasonably be expected to affect a target shareholder's decision to accept or reject the bid. A bid must be open for at least 10 days following any such change

or variation except in the case of all-cash bids if the variation is the waiver of a condition. The notice of variation or change must be sent to all holders except those whose securities have already been taken up.

Certain variations (such as lowering or changing the form of bid consideration, lowering the proportion of shares sought in a bid or adding new conditions) may be viewed by Canadian securities regulators as prejudicial to target shareholders. In such circumstances, the regulators may intervene to cease trade the bid, require that the extension be open for longer than 10 days or require that a bidder commence a new bid.

In the United States, an acquiror must promptly amend the Schedule TO filed with the SEC and notify target shareholders of any material change in the offer. Material changes originating with the target company must similarly be disclosed in an amended Schedule 14D-9.

The last day for increasing or decreasing the percentage of target securities sought in a U.S. tender offer or changing the consideration without extending the offering period is the 10th business day following commencement (the same day that the target's Schedule 14D-9 is due). The last day for other material changes (e.g., waiving a condition or eliminating a subsequent offering period) without having to extend the offering period is 15 business days following commencement.

Withdrawal Rights

The Canadian rules permit shareholders to withdraw their tendered shares at any time before the shares are taken up or if they have not been paid for within three business days of being taken up. If the bid has changed, tendered shares may be withdrawn at any time during the 10 days following notice of the change. These withdrawal rights are not applicable for increases in consideration or waivers of conditions in all-cash bids.

The U.S. rules permit shareholders to withdraw their tendered shares at any time before the minimum offering period expires or during an extension of the bid (other than a subsequent offering period). Shareholders may also withdraw after the 60th day from commencement if the acquiror has not yet paid for the shares. Withdrawal rights need not be granted during subsequent offering periods.

Price

The general rule is that all target shareholders must be offered identical consideration in a takeover bid in Canada or tender offer in the United States. This makes it impossible – absent exemptive relief – for bidders to extend offers to shareholders on just one side of the border to avoid regulation on the other side of the border. In U.S. terminology, these equal treatment rules are referred to as

the “all-holders” and “best-price” rules. Furthermore, any price increases during the course of a Canadian bid or U.S. tender offer must be retroactive.

Purchases Outside a Bid

From the time that a takeover bid or tender offer is announced until it expires, the acquiror may not purchase or arrange to purchase target securities, publicly or privately, except under the terms of the formal offer – that is, in compliance with the best-price/all-holders rules and other requirements. The Canadian rules (but not the U.S. rules) provide an exception for limited market purchases during a bid, but this is rarely relied on because doing so could negatively affect the acquiror’s ability to effect a second-step business combination (see part 5, “Second-Step Transactions,” below). Private agreement purchases are also prohibited for 20 business days after a bid expires.

Collateral Benefits

Some ancillary agreements or arrangements in connection with takeover bids and tender offers may raise the question whether unequal consideration is being offered to different shareholders. Examples include commercial arrangements with a target’s customers or suppliers who are shareholders, or employment arrangements with a target’s employees who are also shareholders.

In Canada, bidders sometimes seek exemptive relief to permit such collateral arrangements. Canadian regulators have, however, relaxed the prohibition in respect of employment compensation, severance or other employment benefit arrangements. These are not prohibited if (i) the arrangement merely enhances group plan benefits for employees generally; or (ii) the arrangement is fully disclosed and relates to a shareholder who beneficially owns less than 1% of the target’s securities, is not conferred for the purpose of increasing the consideration paid under the bid or providing an incentive to tender and is not conditional on the shareholder’s supporting the bid in any way.

Alternatively, if the shareholder beneficially owns 1% or more of the target’s equity securities, employment-related benefits are not prohibited if an independent committee of the target’s board of directors determines that (i) the shareholder is providing at least the equivalent value in exchange for the benefits; or (ii) the value of the benefits is less than 5% of the value that the shareholder would receive for tendering to the bid. The independent committee’s opinion, if any, would have to be disclosed in the takeover bid circular or directors’ circular.

In the United States, aggrieved shareholders of target companies have sometimes sued under the best-price rule, arguing that side payments by bidders

under commercial or employment arrangements are really part of the tender offer consideration and should be paid to all shareholders.

U.S. courts have taken inconsistent approaches to deciding whether such collateral arrangements fall within the ambit of the best-price rule. The inconsistent jurisprudence combined with the severity of the remedy (increasing the consideration paid to all shareholders) created a litigation risk associated with tender offers in the United States. To avoid this risk, companies sometimes avoided tender offers in favour of mergers as their means of acquiring target companies.

The SEC amended the best-price rule in an attempt to remedy the disincentive to conduct tender offers. The changes clarified that the best-price rule does not apply to payments or offers to make payments that are made in connection with a tender offer but that are not part of the consideration for the securities tendered. Like Canada's latest rule changes on collateral benefits, the SEC's rules now include a specific exemption for employment compensation, severance and other employee benefit arrangements. To qualify for the exemption, a payment or an offer of payment must be made only for past or future services and must not be calculated on the basis of the number of securities tendered. Arrangements will be presumed to satisfy those two criteria if they are approved by an independent compensation committee (or another independent committee) of the target's or bidder's board of directors, depending on the circumstances.

Conditions

Takeover bids and tender offers are permitted to be conditional except that in Canada, financing conditions are not permitted. Acquirors bidding for Canadian targets must make adequate financing arrangements before making a bid. This does not mean that the financing must be unconditional. Rather, the bidder must "reasonably believe the possibility to be remote" that it will not be able to pay for the securities. What types of conditions are acceptable is a matter of judgment that should be discussed with advisers.

In contrast to Canadian requirements, financing conditions are permitted in U.S. tender offers so the acquirer may terminate the offer if it cannot obtain the necessary financing. The prevalence of financing conditions is to some extent a function of the state of the M&A markets. Financing conditions are less common in competitive, target-friendly M&A markets than in buyer-friendly markets in which credit conditions are tight. When an acquirer negotiates a financing condition, it may agree to compensate the target with a reverse breakup fee if the acquirer terminates on the basis of lack of financing.

Shareholder Approval

Takeover bids and tender offers involving all-cash consideration do not require approval by a bidder's shareholders. U.S. stock exchange rules may require approval by the bidder's shareholders if the consideration includes the bidder's securities and the number of securities that the bidder is issuing exceeds 20% of its outstanding securities.

Similarly, TSX rules now require approval by a bidder's shareholders for an acquisition involving a public company target if the number of securities to be issued exceeds 25% of the bidder's outstanding securities. If a bidder is listed on both Canadian and U.S. stock exchanges, one exchange may defer to the shareholder approval requirements of the other, depending on which is the issuer's home jurisdiction and, in the case of the TSX, where the majority of trading takes place.

Following a bid, approval by the target's shareholders may or may not be required to enable the acquiror to purchase the untendered shares and acquire full ownership of the target (see part 5, "Second-Step Transactions," below).



Second-Step Transactions

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An acquiror is highly unlikely to acquire all of a target's shares in a takeover bid or tender offer and, therefore, some form of second-step transaction will be necessary to obtain 100% ownership. The form of second-step transaction and its speed will depend primarily on the percentage of target shares that the acquiror owns after the bid. The mechanics of second-step transactions are governed by the provincial or state corporate laws under which the acquiror and target are incorporated or organized. To simplify the mechanics of the deal, acquirors commonly incorporate a new subsidiary as an acquisition vehicle in the same jurisdiction where the target is incorporated or organized.

Second Steps in Canada

When a bidder obtains at least 90% of the outstanding shares of a target company under a bid, provincial corporate law statutes generally confer a compulsory acquisition right in favour of the bidder to acquire the balance of the securities. In calculating the 90% threshold, securities held by the bidder at the time of making the bid or acquired in the open market during the bid must be excluded. No shareholder approval is required for a compulsory acquisition and, as a result, it can be completed quickly and efficiently.

If the statutory compulsory acquisition procedure referred to above is not available because the bidder achieved less than a 90% tender to the bid, the bidder will instead be able to effect a transaction that squeezes out the remaining minority shareholders (at the same price as was offered under the bid) as long as the bidder (i) owns at least 66 2/3% of the outstanding shares after the bid; (ii) acquired through the formal bid a majority of the shares that it did not own beforehand; and (iii) satisfies the additional requirements of the business combination rules under Multilateral Instrument 61-101.

MI 61-101 requires, among other things, that the bidder make clear in its takeover bid circular that it intends to undertake this type of transaction after the bid, and it must do so within 120 days of the expiry of the bid. The bidder can then effect a squeeze-out transaction and the minority shareholders will be "cashed out." The minimum tender condition for a takeover bid will reflect the 66 2/3% voting requirement under the *Canada Business Corporations Act* and Ontario's *Business Corporations Act*. The bidder will be able to complete the transaction because it will control the votes necessary to have the amalgamation approved and because it will be entitled to vote the shares tendered to the formal bid toward the majority approval required under the business combination rules.

The business combination rules are viewed as containing a complete code for these types of transactions and, accordingly, squeeze-out transactions completed under these rules are not typically susceptible to challenge by minority shareholders.

Second Steps in the United States

In most U.S. states (including Delaware, the most popular state of incorporation for U.S. public companies), an acquiror must own at least 90% of a target's shares following a tender offer to effect a short-form merger. The minimum tender condition for a U.S. bid will reflect this 90% voting requirement. Like a compulsory acquisition in Canada, a short-form merger does not require a shareholder vote and can be consummated very quickly after the tender offer is completed. In contrast to a compulsory acquisition, for purposes of calculating the 90% minimum, the acquiror may count all of its target shares, including those purchased before the tender offer was commenced.

If an acquiror owns less than 90% of the target's shares following a tender offer, target shareholders will be entitled to vote on a long-form merger at a shareholders' meeting. Majority approval will be required to approve the merger (as opposed to Canada's 66 $\frac{2}{3}$ % requirement), and the acquiror is permitted to vote its shares so that it will have sufficient voting power to approve the merger.

Appraisal Rights

Target shareholders who object to a second-step transaction are, under the corporate laws of most jurisdictions, entitled to appraisal rights – that is, they are entitled to apply to a court for an appraisal of the value of their shares (which could be higher or lower than the tender offer price, but is likely to be equal to the tender offer price if the transaction was arm's length). The appraised value will be paid by the surviving company to objecting shareholders who satisfy all the requirements of the relevant corporate law. Appraisal rights are available for all second-step transactions by Canadian companies. In the United States, most states provide appraisal rights unless the surviving company is listed on a stock exchange and the tender offer consideration consists solely of stock (other than cash in lieu of fractional shares).



The Target's Board of Directors **6**

Overview of Fiduciary Duties

Directors of a target company facing a potential takeover must make important decisions quickly. In Canada, the provincial or federal corporate laws under which the target is incorporated or organized will govern the board's conduct. In addition, securities regulators have adopted a national policy on defensive tactics that encourages unrestricted auctions for the benefit of shareholders. The fiduciary duties of a U.S. target's directors are governed by the state corporate laws where the target is incorporated or organized. In discussing the U.S. requirements, this part focuses on the laws of Delaware because it is the most common state of incorporation for publicly traded U.S. companies, and the laws of many other U.S. states are similar to Delaware's laws.

Regardless of where a target is organized, the general rule is that directors facing a change of control must exercise due care and act honestly and in good faith with a view to the best interests of the corporation. The board's decision-making process must be reasonable under the circumstances and must enable, and be seen to enable, informed decision making by the directors. By exercising their fiduciary duties diligently, a target's directors will help protect the company and themselves against litigation.

In discharging their duties, directors of a target company must be sensitive to conflicts of interest they may have. Conflicts arise because of the role played by a takeover as a mechanism to displace management and directors. Outside directors are in a conflict position that is perhaps different in degree – but not in kind – from the position of inside directors. Both share responsibility for the conduct of the business and affairs of the company.

The courts, while accepting that even outside directors may not be totally free from the inherent conflict of inside directors, have recognized the crucial function that outside directors perform during the negotiation and approval of extraordinary corporate transactions that involve real conflict of interest for management and inside directors. In these situations, outside directors can play an important role by providing a more independent review.

To enhance the decision-making process, a target board should consider whether it would be appropriate to establish a special committee made up of independent directors to consider takeover bid responses. A special committee is desirable, for example, when the target company has a controlling shareholder whose objectives may differ from those of other securityholders or when members of management are hostile to a bid. There are, however, no hard and fast rules as to when a special committee should be constituted; that decision should be made by the board, taking all the circumstances into account.

Provided that directors act without conflict of interest and with due care in what they honestly believe to be the best interests of the corporation, courts will defer to their business judgment. This is referred to as the “business judgment rule.” Courts will generally defer to many of the decisions that directors face in corporate control situations, such as whether to solicit alternative proposals or put a company up for auction. The use of a special committee of independent directors can be an important element in obtaining the benefit of the business judgment rule.

A target’s board in Canada or the United States should keep the following principles in mind when deciding whether to conduct a broad public auction:

- A public auction may often be advisable but is not required by law.
- Although price is persuasive, the highest bid is not automatically the best bid – the surrounding facts and circumstances must be taken into account.
- Market checks on the value of a target are extremely valuable, but a market check may sometimes be achieved in ways other than via a public auction.

The Duty to Maximize Shareholder Value

Canada’s securities regulators have taken the position in National Policy 62-202 that the primary objective of takeover bid laws is to protect the bona fide interests of the target’s shareholders. Consistent with this, the board’s duty under corporate law to act in the best interests of *the corporation* has generally been interpreted to mean acting in a manner that maximizes *shareholder value*. In other words, the interests of the corporation have been equated with the interests of shareholders.

But under the Supreme Court of Canada’s decision in *BCE Inc. v. 1976 Debentureholders (BCE)*, the fiduciary duty analysis will be more complicated than simply maximizing shareholder value when the best interests of shareholders (to get the highest price possible for their shares) conflict with those of other stakeholders, such as bondholders. According to the SCC, acting with a view to the best interests of the corporation requires directors to consider the interests of all stakeholders; there is no overriding duty to maximize shareholder value.

Directors can take comfort from the *BCE* decision insofar as the SCC reaffirmed the principle that board decisions are generally entitled to a high degree of deference under the business judgment rule. As long as directors

- get their process right,
- respect the legal rights and the reasonable expectations of all securityholders and creditors, and
- have regard to the interests of all stakeholders affected by their decision,

their balancing of the conflicting stakeholder interests in determining the best interests of the corporation will be treated as a matter of business judgment that is not to be overturned by the courts unless it falls outside the range of reasonableness. Nonetheless, boards of directors should act with particular caution, and with the advice of counsel, in situations in which the best interests of shareholders appear to conflict with those of other stakeholders.⁷

In the United States, if the actions of a target's board suggest that the directors failed to exercise reasonable business judgment, the courts will impose a heightened standard of review on the board by looking at the "entire fairness" of the transaction to target shareholders.

Once a U.S. target is "up for sale," the target's board is obliged to seek the best price reasonably available for shareholders. This is known as the "Revlon" duty, and it applies to corporate control situations unless the target's stock is widely held before the transaction and will remain widely held after the transaction. Under the Revlon test, a sale of a target is considered inevitable, and the duty to seek the best price is triggered, if the target

- initiates a bidding process;
- seeks an alternative to an unsolicited transaction that also involves a breakup or change of control; or
- otherwise abandons its long-term strategy through a change of control.

Canadian companies are sometimes referred to as being "always for sale." This means that the fiduciary duties of a Canadian board do not depend on whether a change of control is inevitable. But despite the different nuances of Canadian and U.S. laws, the factors that boards in both countries should consider and the processes that they should use in evaluating the merits of competing transactions or responding to an unsolicited offer are very similar.

⁷ For a comprehensive discussion of the fiduciary duties of directors in Canada, including the Supreme Court of Canada's decision in the *BCE* case, please refer to *Torys' Business Law Guide Responsibilities of Directors in Canada*.

Target Board Practices

In light of directors' fiduciary duties, certain target board practices are advisable in both Canada and the United States. Courts will consider these practices in deciding whether the business judgment rule will protect the board's decisions. The target's board should

- conduct a complete and careful investigation and analysis of any proposed transaction;
- maintain a majority of independent directors or consider forming a special committee;
- seek a fairness opinion from a financial expert stating that the consideration is fair to the target's shareholders;⁸ and
- keep records of the process to demonstrate that the board's fiduciary duties were exercised through full and careful deliberation about the merits of a transaction.

Defensive Measures

Boards of directors often take defensive measures against bids that they believe are not in their company's best interests or do not reflect the true value of the company's shares. Courts and securities regulators in Canada and the United States will accept defensive tactics that are consistent with the board's exercise of its fiduciary duties.

Canadian securities regulators have adopted certain fundamental principles to guide the evaluation of defensive measures. The decision whether to tender shares to a takeover bid is for shareholders to make. Target company management and directors must not pre-empt or frustrate that right. Defensive measures have historically been more aggressive in the United States than in Canada, although

⁸ With respect to fairness opinions, a panel of the Ontario Securities Commission recently stated its view that a fairness opinion prepared by a financial adviser who is being paid a success fee does not assist an independent committee in demonstrating the due care they have taken in complying with their fiduciary duties. Boards may want to consider, depending on the circumstances, obtaining a fairness opinion from a second firm of financial advisers that is not entitled to a success fee on the transaction.

one general principle is theoretically the same in both jurisdictions: target shareholders are not supposed to be coerced.

The influence of institutional shareholders over corporate control transactions is increasing in both Canada and the United States. Although a Canadian target's available legal defences are thought to be somewhat weaker than a U.S. target's, the board may mount a defence against a hostile bid by lobbying the company's institutional shareholders to persuade them that the bid should be rejected. In the United States, institutional shareholders have pressured some companies to abandon their poison pills, thus eroding the board's power to "just say no" even when it might be legal to do so.

Under U.S. law, defensive measures taken by a target's board of directors will face enhanced scrutiny to ensure that the directors exercised their business judgment properly. The enhanced scrutiny standard was established in *Unocal Corp. v. Mesa Petroleum Co.* in 1985. Under the *Unocal* test, for a defensive measure to be valid, the board must have reasonable grounds for believing that the bid amounts to a threat to corporate policy and effectiveness, and the defensive measures must be proportionate to the threat and not preclusive or coercive.

Poison Pills

Shareholder rights plans, or "poison pills," consist of certain rights granted to existing shareholders (either before or in the face of an unsolicited bid or as part of a target's takeover-preparedness program). These rights allow existing shareholders to either purchase target shares at a substantial discount or require the company to buy them back at a substantial premium, in each case rendering an unsolicited bid uneconomic because of massive dilution of the bidder's position.

Rights plans have historically been cease traded by Canadian securities regulators after approximately 45 to 60 days. The theory behind this approach is that the only legitimate purpose of a pill is to provide the target board with sufficient time to attempt to obtain a better bid; moreover, while it is permissible, for that purpose, to delay allowing shareholders to respond to a bid, it is impermissible to deprive them of that opportunity. However, recent decisions of securities regulators, echoing court decisions on the duties of target directors, suggest that regulators may give more latitude to target boards in their use of rights plans and may reject an application to cease trade a rights plan if an unsolicited bid is partial or coercive in nature, or if shareholders have approved the rights plan subsequent to the bid being made (in effect expressing the shareholders' view that the bid is inadequate or otherwise not the best available alternative to the target).

In the United States, a target's board may be able to "just say no" and keep its pill in place for a longer period of time than has traditionally been allowed in Canada. But even in the United States, a poison pill is not necessarily a "show-stopper" because a court may not permit it to indefinitely block a fully financed, fair offer, and shareholders may also exert pressure on a company to remove the pill. Like all defensive measures, poison pills are subject to enhanced scrutiny under the U.S. *Unocal* test.

State Anti-takeover Statutes

Some U.S. states have anti-takeover laws that prohibit second-step mergers for three to five years unless they have board or shareholder approval, restrict control block acquisitions or impose substantive fair price standards on acquisitions that the target's board has not approved in advance. These statutory defences are not found in corporate statutes in Canada.

Legal Challenges

A Canadian or U.S. target may attempt to delay or avoid a takeover by bringing a lawsuit against the acquiror on various grounds. A target may seek a preliminary injunction on the basis that a transaction would violate antitrust laws. Other common defensive actions that targets take include challenging the acquiror's disclosure in its regulatory filings or challenging the legality of the acquiror's pre-bid purchases.

Alternative Transactions

A target's board may consider entering into a transaction to help defend itself against a hostile takeover. Some transactions that are more common in the United States are regarded as questionable tactics under Canada's national policy if they are used solely to frustrate a takeover bid or impede an auction. These include selling or optioning assets, issuing employee stock options, granting "golden parachutes" to executive officers, selling stock or options to a friendly third party or entering into other material transactions outside the ordinary course of business.

Defensive transactions that are permissible in both Canada and the United States (as long as they are consistent with the target board's fiduciary duties) include making an issuer bid, granting a special dividend to shareholders or otherwise recapitalizing the company.

Defensive Charter or By-law Provisions

Defensive measures that are built into a target company's charter or by-laws are usually invalid under Canadian law but are common in the United States. One exception is the use of dual class share capitalization structures. Stock exchanges

in the United States usually refuse to list the shares of U.S. companies that attach differential voting rights to different classes of shares; however, doing so is not uncommon in Canada, particularly among family-controlled companies.

Defensive provisions that may be part of a U.S. target's organizational documents include

- implementing staggered boards that prevent shareholders from replacing directors “without cause” or replacing the whole board at once;
- imposing supermajority voting or fair price requirements for business combinations;
- prohibiting or restricting the power of shareholders to call a meeting;
- issuing blank cheque preferred stock that can be used for a poison pill or issued to a “white knight” (a friendly acquiror) or a “white squire” (a friendly purchaser of the target's assets);
- adopting “anti-greenmail” provisions that prohibit the company from buying back an acquiror's toehold position (to deter bidders from holding a company for ransom);⁹
- limiting shareholders' ability to remove directors without cause or to act by written consent instead of by voting at a shareholders' meeting;
- granting power to the board to set its own size and fill any vacancies; and
- prohibiting cumulative voting for the election of directors.

Deal Protections

The parties to a friendly transaction usually want to protect their deal from third-party interference and may also plan to compensate one side if the other side backs out. These protections are negotiated extensively as part of the merger or support agreement (see part 7, “Documentation and Regulatory Review,” below). Deal-protection measures are subject to the target board's fiduciary duties discussed above – that is, those duties cannot be emasculated by contractual deal protections.

⁹ “Greenmail” is not possible in Canada because of the rule that companies' offers to purchase their own securities must be made to all shareholders.

No-Shop and Go-Shop Clauses

A “no-shop” clause prevents a target from soliciting competing offers. This clause is combined with a fiduciary-out clause, which entitles the target’s board to consider unsolicited alternative transactions (sometimes referred to as “window shopping”) to the extent necessary to fulfill its fiduciary duties. Before a target exercises its fiduciary out, it may give the incumbent bidder a chance to match the competing offer.

Some deals, particularly those involving financial buyers, also include a “go-shop” feature, which gives a target a specified period of time – usually 30 to 60 days after signing a transaction agreement – to actively seek out a higher-value transaction. A target may negotiate a go-shop if an auction has not been conducted and the board believes, in exercising its fiduciary duties, that it needs to check the market to ensure that the price agreed to with the incumbent acquiror represents the maximum value obtainable in the circumstances. A no-shop period will begin once the go-shop period ends.

Breakup Fees

If a target decides to abandon a transaction in favour of a higher-value transaction, it will usually have to pay a breakup fee to the incumbent bidder. The breakup fee, also known as a “termination fee,” is typically in the range of 2%–3% of the transaction’s value. Breakup fees may justifiably be somewhat higher for smaller deals, where the absolute value of the breakup fee is still reasonable, or when an auction has been conducted and the target’s value has therefore been tested by the market. In that case, the board may be more confident that vigorously protecting the deal is in the best interests of shareholders.

Setting breakup fees too high could violate the target board’s fiduciary duties by discouraging other potential acquirors from making a higher offer. Many institutional shareholders’ voting guidelines require them to reject transactions involving excessive breakup fees. Targets sometimes negotiate reverse breakup fees when they are not initially for sale or when they are seeking to be compensated for additional regulatory or legal risks (as compared with entering into an alternative transaction) or for the risk of the bidder being unable to obtain financing to complete the transaction.

Asset Lockups

Another form of deal protection involves the target’s granting a bidder certain rights over some of the target’s assets (via a joint venture, licensing or option arrangement) that can be exercised if the target rejects the deal in favour of a superior proposal. This sort of deal protection is uncommon in the United States except when a target can demonstrate that the transaction could not go forward without it. An asset lockup has been upheld in Canada in a case in which the lockup was granted to a new bidder to encourage rather than inhibit an auction.



Documentation and Regulatory Review

7

Canadian and U.S. securities laws require the parties to provide very similar disclosure in their regulatory filings for the benefit of target shareholders. Generally speaking, takeover bid circulars in Canada and the U.S. equivalent, the Schedule TO, must include comprehensive information about the transaction and the negotiations leading up to it, the bidder's plans regarding the target and any material non-public information that the bidder has learned in the course of investigating the target.¹⁰ In addition, prospectus-level disclosure about the acquiror will be required if the consideration includes securities.¹¹

Canadian regulators are unlikely to review the filings. In the United States, unless a tender offer exemption is available, the SEC may review the parties' filings, including the financial information; ask questions and seek clarification about the disclosure; and require additional filings or mailings to target shareholders. This regulatory review could delay the planned expiration date of a tender offer or otherwise lengthen the timetable for completing a transaction.

In both jurisdictions, the bidder and target are potentially liable to private plaintiffs for any material misstatements or omissions in the disclosure.

Acquiror's Offer to Purchase

An acquiror's takeover bid circular or Schedule TO must cover the following topics:

- background of the offer, which includes material contracts, arrangements, understandings, relationships, negotiations or transactions between the bidder and the target during the past two years (this disclosure is required in Canada only if the information is currently material);
- any material non-public information that the bidder has learned about the target, such as projections or other information acquired during due diligence;
- the bidder's plans for material changes to the target, such as extraordinary transactions or delisting from a stock exchange;
- any agreements or arrangements between the acquiror and any of the target's officers or directors;

¹⁰ Additional disclosure requirements apply to going-private transactions (see "Going-Private Transactions" in part 2, "The Lay of the Land," above).

¹¹ If the acquiror is not already a reporting issuer, offering securities as consideration could also give rise to new, ongoing reporting obligations.

- any transactions in the target's securities by the acquiror and its officers and directors (during the past six months¹² under Canadian rules and during the past 60 days under U.S. rules); and
- details regarding the financing arrangements – that is, the terms of any agreements, including conditions of financing and alternative arrangements if financing falls through.

Canadian regulators have enhanced the filing requirements associated with takeover bids. Agreements between the offeror and the target, between the offeror and a target securityholder, or between the offeror and an officer or a director of the target must be filed, as well as any other material documents that could affect control of the target, such as a voting trust agreement. Any agreements or contracts referenced in a U.S. offer to purchase, such as financing commitments, must be filed with the SEC as exhibits.

Financial Statements

Under Canadian and U.S. requirements, the acquiror's historical financial statements must be filed and sent to target shareholders if the consideration includes securities. In the United States, historical financial statements may be required even in an all-cash transaction if there is a financing condition or if the bidder is not a reporting company and the offer is for less than all of the target's securities.

Pro forma financial statements will have to be prepared to show the effect of an exchange of securities if the transaction is significant to the acquiror and is not an all-cash deal. As an exception in the United States, pro forma financial statements are not required in unsolicited transactions.

The Target Directors' Response

A target company's directors must disclose their position on an offer in a directors' circular in Canada or a Schedule 14D-9 in the United States. Like the bidder's disclosure, this disclosure must be truthful and not misleading and must include, in addition to the directors' recommendation to accept or reject the deal, all pertinent information that could affect a target shareholder's decision to tender, including the following:

¹² Twelve months in the case of a takeover bid made by an insider.

- information about directors' and officers' trading in the target's securities during the six months preceding the bid (in Canada) or during the 60 days preceding the bid (in the United States);
- a description of any arrangements, board resolutions, negotiations, agreements or other material actions taken in response to the bid – that is, dividends, asset sales or other extraordinary transactions that could be characterized as defensive in nature (these may be kept confidential under U.S. rules if the negotiations are preliminary and disclosure would jeopardize them); and
- full disclosure about any fairness opinion delivered to the target's board.

The Merger Agreement

Key provisions of the merger agreement entered into by the parties to a friendly deal typically include the following:

- deal-protection measures such as
 - a breakup fee and expense reimbursement provisions specifying the circumstances under which the fees will be payable – for example, upon the target board's support of a competing transaction or upon a competing transaction being completed;¹³ and
 - a no-shop clause (subject to a fiduciary out) enabling the board to consider unsolicited, potentially superior offers;
- detailed representations and warranties regarding the nature and quality of the target's business;
- certain representations regarding the acquiror's business (if shares are offered as consideration or if there is a financing condition);
- permission for continued access by the acquiror to confidential information about the target;

¹³ The acquiror may pay a reverse breakup fee as a penalty if it fails to complete the transaction (often only for specified reasons, such as regulatory approval being denied or financing falling through, but also sometimes on a "no-fault" basis so the provision acts as a liquidated damages clause if the buyer fails to close for any reason).

- a minimum tender condition that cannot be waived without the target's agreement, to ensure that the minority shareholders can be "squeezed out" in a second-step transaction;
- a "material adverse effect" clause, which permits the acquiror to abandon the transaction upon certain negative changes in the target's business pending closing; and
- the target's agreement
 - to carry on its business in the ordinary course until the transaction closes; and
 - not to take extraordinary actions or incur certain expenditures without consulting with or obtaining the consent of the acquiror.



Other Regulatory Considerations

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Antitrust/Competition Laws

Canada's *Competition Act* establishes procedural and substantive regimes for the review of transactions involving the acquisition of businesses operating in Canada. The policy statements of the Canadian Competition Bureau, the federal agency responsible for enforcing Canadian competition laws, elaborate and expand upon the procedural and substantive requirements of the *Competition Act*.

Pre-merger Notification

Procedurally, the *Competition Act* requires that pre-merger notification (PMN) be given to the Commissioner of Competition (Commissioner) of the proposed acquisition of voting shares of a corporation that carries on (or controls a corporation that carries on) an operating business in Canada, if the parties and the transaction exceed all these specified thresholds:¹⁴

- **Size of the parties.** The parties to the transaction, together with their affiliates, have assets in Canada – or annual gross revenues from sales in, from or into Canada – that exceed C\$400 million.
- **Size of the transaction.** The target corporation (or corporations controlled by it) has assets in Canada that exceed C\$70 million, or annual gross revenues from sales in or from Canada that exceed C\$70 million.¹⁵
- **Voting threshold.** As a result of the transaction, the purchaser will hold more than 20% (or more than 50%, if it already holds 20%) of the votes attached to all outstanding voting shares of the target corporation.

In addition to notifying the Commissioner of a proposed transaction, parties to notifiable transactions are required to supply the Commissioner with specified information and to await the expiration of a statutory (no close) waiting period before the transaction may be completed. The waiting period is 30 days unless prior to its expiry, the Commissioner issues a supplementary information request,

¹⁴ In addition, whether or not a merger is notifiable, it can be reviewed by the Commissioner under the substantive merger provisions of the *Competition Act* both prior to closing (assuming the transaction comes to the Commissioner's attention) and for a period of up to one year following its substantial completion.

¹⁵ Subject to an annual increase tied to the increase in Canadian GDP.

which extends the waiting period until 30 days after the parties have provided the Commissioner with the required information.¹⁶

Service Standards

In accordance with its published *Service Standards*, the Competition Bureau classifies merger transactions as *non-complex*, *complex* or *very complex*. Once the complexity of a proposed merger has been determined, the Commissioner and staff undertake (on a best-efforts basis) to complete their review of the merger within specified time periods: within 14 days, in the case of a *non-complex* transaction; within 10 weeks, in the case of *complex* mergers; and within five months, in the case of *very complex* mergers.

Upon the completion of the review, the Commissioner typically issues a “no-action” letter to advise the parties that no applications will be made to the Competition Tribunal for an order under the merger provisions of the *Competition Act*. If a no-action letter is issued, the Commissioner retains the right to challenge a merger transaction for up to one year after its completion.

Advance Ruling Certificates

As an alternative to a PMN filing, the parties to a notifiable transaction may apply to the Commissioner for an advance ruling certificate (ARC) that, if issued, both eliminates the PMN filing requirement and prevents the Commissioner from subsequently challenging the transaction. However, the issuance of an ARC is discretionary, and typically one will be issued only if the transaction does not raise any significant merger law issues.

¹⁶ In addition, the Commissioner can apply to the Competition Tribunal for an order to delay the completion of a merger transaction by an additional 30 days (which can be extended to 60 days) beyond the statutory waiting period upon certifying to the Competition Tribunal that an inquiry in respect of the merger is underway and that, in the absence of an order, a party to the merger would be likely to take action that would substantially impair the Competition Tribunal’s ability to remedy the effect of the merger on competition.

Hart-Scott-Rodino

The Canadian pre-merger notification regime is similar to the U.S. regime established by the *Hart-Scott-Rodino Antitrust Improvements Act of 1976* (HSR).

For acquisitions exceeding specified thresholds of party and transaction size, HSR requires that pre-transaction notice must be given to regulatory authorities, and that a waiting period of 30 days (10 days in the case of a cash tender offer) be observed before securities can be acquired or the transaction completed. As in Canada, this period can be extended if a request for additional information (referred to as a “second request”) is issued.

The current U.S. transaction-size threshold is US\$65.2 million, measured as the value of the voting securities that will be held as a result of a tender offer. A transaction exceeding that threshold may require notification if one party’s net sales or total assets exceed US\$13 million and the other party’s net sales or total assets exceed US\$130.3 million. If the size of the transaction exceeds US\$260.7 million, notification is required regardless of the size of the parties’ assets or sales.

Foreign Investment Review

The Canadian government encourages foreign investment if the investment will contribute to economic growth and employment opportunities in Canada. An investment by a non-Canadian that will result in the acquisition of control of a Canadian business is subject either to review and approval or to notification under the *Investment Canada Act*. Government approval is required for direct foreign investments if the gross assets of the Canadian business exceed specified monetary thresholds. The current threshold is C\$312 million¹⁷ unless the business involves culture, in which case the threshold is C\$5 million. Amendments to the Act have been passed that, once implemented, will change the general review threshold to C\$600 million in enterprise value, with additional increases to C\$1 billion until 2013, followed by annual GDP-indexed increases thereafter.

Investments will be approved if they meet a “net benefit to Canada” test; however, investments in certain culturally sensitive areas, such as book publishing and film/video distribution, are subject to a greater level of scrutiny and are generally prohibited if the business is Canadian-controlled.

The review period usually lasts for 45 days after a complete application is submitted, although the government can extend the period for a further 30 days if the review has not been completed.

¹⁷ This threshold is for acquisitions made in 2009. The amount is adjusted annually.

Investments by foreign state-owned enterprises (SOEs) are subject to separate federal government guidelines designed to require the SOE to satisfy criteria relating to governance, transparency and commercial orientation.

Additionally, the government may review any transaction if there are reasonable grounds to believe the transaction “could be injurious to national security.” The *Investment Canada Act* does not define “national security” but the expectation is that it will be invoked sparingly. Factors likely to be considered in assessing whether there is a potential national security issue are the investor’s country of origin and the nature of the business activities undertaken or planned to be undertaken in Canada. It is likely that the concept of national security will be considered to be broader than traditional military or strategic considerations. A national security review may be commenced for virtually any investment, regardless of whether it would involve acquiring control of a Canadian business or exceed the asset/enterprise value thresholds referred to above. For example, the acquisition of a non-controlling minority interest in a Canadian business could be subject to a national security review (but not a traditional “net benefit” review). As a result it will be important to identify potential national security issues early in transaction planning.

Certain industries in Canada are also subject to quantitative limits on foreign ownership, and Canadian residency or citizenship is sometimes a prerequisite for serving as a director. The affected industries include broadcasting, insurance, airlines, banking and telecommunications. For example, the *Broadcasting Act* requires that Canada’s broadcasting system be effectively owned and controlled by Canadians.

In the United States, the mechanism for reviewing and potentially blocking foreign acquisitions that affect national security is the *Foreign Investment and National Security Act of 2007* (FISIA), which amended section 721 of the U.S. *Defense Production Act of 1950*, a section commonly known as “Exon-Florio” that charges the President, acting through the Committee on Foreign Investment in the United States (CFIUS), with reviewing acquisitions of U.S. businesses by foreign persons when national security is implicated. The President is authorized to prohibit transactions (or to require divestiture if a transaction has already been completed) that threaten to impair the national security of the United States if that threat has not been mitigated through an agreement negotiated with CFIUS.

CFIUS’s review of a transaction can be commenced by parties to a transaction making a voluntary filing, or by CFIUS itself either before or after the transaction is completed. After accepting a filing, CFIUS conducts a 30-day review to determine whether a second stage, 45-day investigation is warranted. FISIA is recent reform legislation that expands the scope of national security beyond national defence to include the potentially broad concepts of homeland security,

critical infrastructure, critical technologies and critical resource requirements. CFIUS may also take into account the relationship of the relevant country with the United States. However, the presence of a foreign government-controlled acquiror creates a rebuttable presumption that a second-stage, 45-day investigation will take place.

CFIUS has declined to clarify the scope of its newly expanded national security mandate, but rather has said that it would assess national security implications on a case-by-case basis. As a consequence, many more foreign acquirors than in the past are making filings with CFIUS out of an abundance of caution. Particular care is warranted in the case of foreign acquirors from countries about which there are political sensitivities. The challenges and uncertainties, including the potential politicization of the CFIUS review process, are highlighted by the difficulties encountered in certain transactions (for example, the proposed buyout of 3Com, a U.S. computer networking company, because of the minority participation by China's Huawei Technologies).

Tax Planning

Although a detailed discussion of potential tax issues is beyond the scope of this guide, tax implications will be a key consideration in many takeover bids and tender offers and should be incorporated into the transaction planning at an early stage.



Avoiding Dual Regulation: Cross-Border Exemptions

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Canadian and U.S. regulators have established cross-border exemptions from regulation so that a bid may proceed primarily under the rules of the target company's jurisdiction. If a cross-border exemption is available, the parties will generally not have to comply with two sets of procedural rules, the filed documents will not have to meet two sets of disclosure criteria and the regulators in the jurisdiction where the deal is exempt will probably not review the documentation or impose timing requirements.¹⁸ This means that the parties can save time and avoid duplicative regulation.

Even if a cross-border exemption is available, certain rules pertaining to the fairness of the transaction will continue to apply. For example, bids must be open to all shareholders in both jurisdictions, the deal documents must be sent to all shareholders, and all shareholders must be treated substantially equally (although not necessarily offered exactly the same form of consideration). In addition, the parties are liable in both jurisdictions for misleading disclosure, insider trading or other fraudulent activities in connection with the transaction.

The Multijurisdictional Disclosure System

Canadian securities regulators and the SEC established the Multijurisdictional Disclosure System (MJDS) in 1991 to provide relief from dual regulation for certain Canada-U.S. transactions. The MJDS is based on the premise that the underlying principles and scope of regulation in Canada and the United States are very similar. Under the MJDS, the parties to a transaction need to comply with the laws of only one jurisdiction. The criteria for securing MJDS exemptions are extremely favourable to cross-border Canadian and U.S. companies.

Canadian Targets Under the MJDS

If a Canadian or U.S. company seeks to acquire a Canadian target, the Canadian takeover bid rules (as well as the prospectus rules, if the consideration includes securities) will apply, but the transaction will be exempt from most of the U.S. tender offer rules as long as

¹⁸ Although the SEC does not generally review the filed documents relating to Canadian bids that are exempt from the U.S. tender offer rules, it will do so if the offer is hostile.

- the target is a Canadian foreign private issuer (which will usually be the case if the majority of its securities are owned by Canadians); and
- less than 40% of the target's securities are beneficially owned by U.S. residents.

If the consideration in an MJDS transaction includes securities of the acquiror, the U.S. registration and disclosure requirements can be met by filing the Canadian prospectus with the SEC as long as the acquiror is a Canadian company that (i) has been a reporting issuer in Canada for at least three years; (ii) has been listed on a Canadian stock exchange for at least one year; and (iii) has a public float of at least C\$75 million.

If any of those three criteria is not met but the Canadian acquiror has been reporting for at least one year, relief from the U.S. prospectus rules will still be available for offerings of

- investment-grade debt or preferred securities; or
- any other kinds of securities if the acquiror's public float is at least US\$75 million (in which case the acquiror's financial statements – unless they are prepared in accordance with U.S. GAAP or International Financial Reporting Standards – will have to be reconciled to U.S. GAAP).

U.S. Targets Under the MJDS

The situation under the MJDS is reversed when a Canadian or U.S. bidder seeks to acquire the shares of a U.S. target company. In that case, the U.S. tender offer rules will apply (as well as the U.S. registration and disclosure requirements, if the consideration includes securities), but there will be an exemption from the Canadian takeover bid rules if less than 40% of the target company's shares are owned by Canadian residents. (The transaction may still be subject to Canadian regulation at the second step if insufficient securities were acquired in the bid to complete a compulsory acquisition [see part 5, "Second-Step Transactions," above]). For U.S. acquirors, there will also be an exemption from the Canadian prospectus rules if securities are offered as consideration, as long as the acquiror

- has a 12-month SEC reporting history; and
- has a public float of at least US\$75 million or is offering non-convertible, investment-grade debt or preferred securities.

Non-MJDS Exemptions

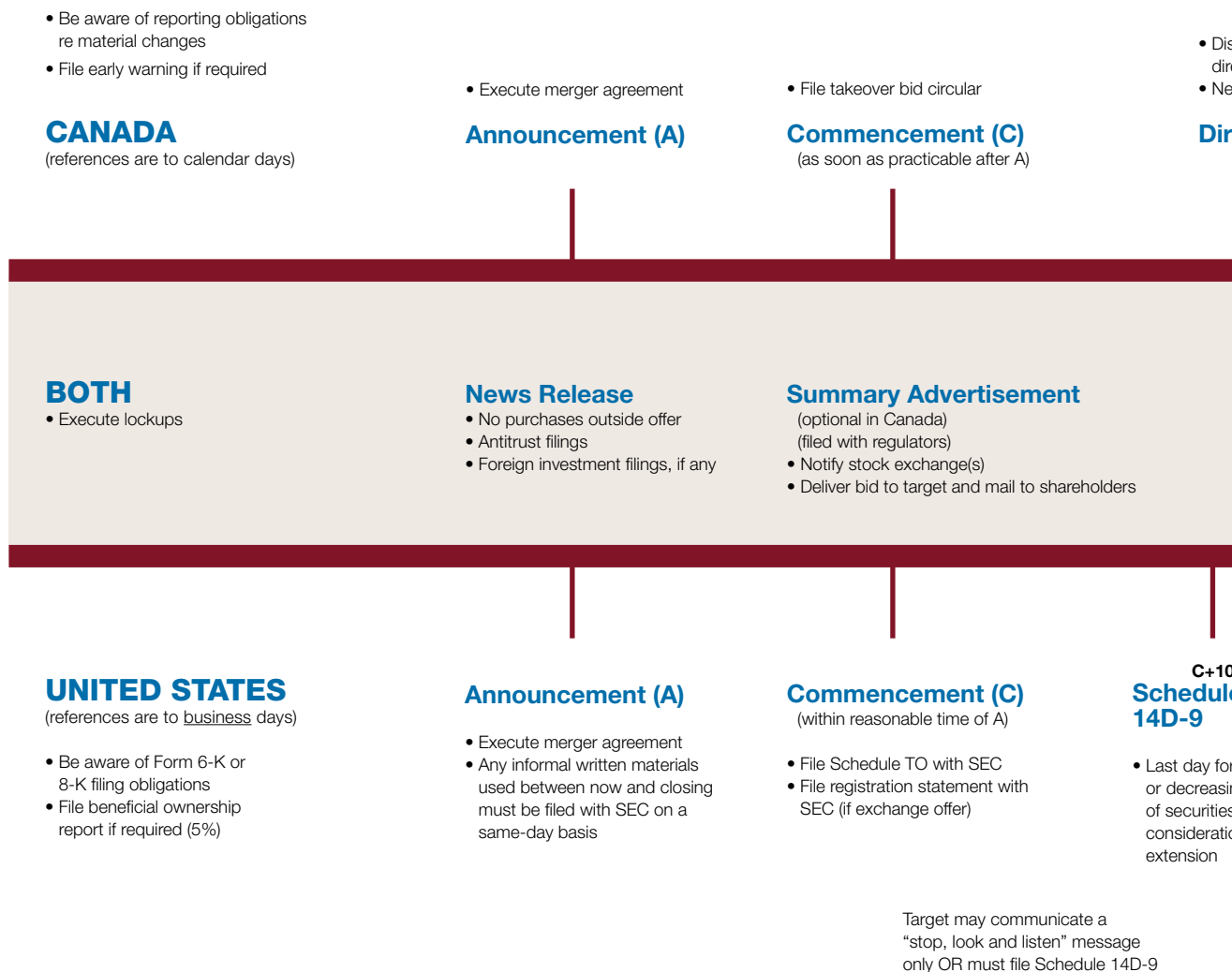
A non-MJDS exemption from regulation may be available if the target's percentage of shareholdings in a jurisdiction is extremely small. In Ontario, there is a *de minimis* exemption if fewer than 50 shareholders holding less than 2% of the shares reside in Ontario. There is also an exemption from the takeover bid rules for transactions involving non-Canadian targets with Canadian shareholdings of less than 10% of the outstanding securities if certain other conditions are met (including that Canadian shareholders are entitled to participate in the bid on terms as favourable as those for other shareholders).

Similarly, an exemption is available from the U.S. tender offer rules if the target is a foreign issuer with U.S. shareholdings of 10% or less. This is referred to as the "Tier I" exemption. The advantages of Tier I over MJDS are that (i) there is less risk of regulatory liability under Tier I because the offer documents are not formally filed with the SEC (although they must be delivered to target shareholders); and (ii) purchases by the bidder and others during the offer period are not restricted under the Tier I exemption, as they are under MJDS.

A very limited Tier II exemption is also available for targets with U.S. shareholdings between 10% and 40%, but this exemption is much less favourable than the MJDS exemption and, therefore, Canadian companies are less likely to rely on it.

Appendix

Cross-Border Timeline from Announcement to Expiry of a Bid



disclose target
directors' position
news release

Directors' Circular

C+15

- Last day for variation without extension (except waiver of condition in all-cash bid)

C+25

- Last day for target board's recommendation if bid not extended

C+28

- No extension before shares taken up if conditions satisfied
- No private agreement purchases by acquiror for 20 business days after expiry
- News release

Expiry of Bid

C+35

Bids will expire near the same time since Canadian expiry is 35 calendar days and U.S. expiry is 20 business days

o
e

C+15

- Last day for other material changes without extension

or increasing
ng number
s sought or
on without

C+20

Expiry of Minimum Offering Period (MOP)

(subject to SEC review)

MOP 3+

End of Subsequent Offering Period

(unless delayed by SEC review)

← Subsequent offering period (at least three business days) →

