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Jody W. Forsyth
Bennett Jones Verchere

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Jody W. Forsyth*

Poison Pills: Developing a Canadian Regulatory and Judicial Response

I. *Introduction*

It is trite to say that the United States has witnessed an explosion of hostile take-over activity in recent years.[1] Potential acquirers have employed both non-coercive techniques such as conditional bids[2] and proxy solicitations,[3] and coercive techniques such as "street sweeps"[4] and two-tier, front-end loaded bids.[5] In response, target corporations have fought back with a wide variety of defences designed to defeat any undesired take-over attempt. One of the most widely contested of these defences is the shareholder rights plan, or "poison pill" as it is better known.

As with most corporate matters, the American experience with hostile take-overs has spread to Canada.[6] The controversy surrounding the use of the poison pill likewise found its way to Canada when, on October 3, 1988, Inco Limited became the first corporation in this country to adopt a shareholder rights plan.

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*LL.B., M.B.A. (Dalhousie); Associate, Bennett Jones Verchere, Calgary, Alberta. (The original text of this article was submitted in August, 1989; however, quiet securities markets since that time have resulted in few changes to the law that is the subject matter of this paper).

1. M. Baxter, "The Fiduciary Obligations of Directors of a Target Company in Resisting an Unsolicited Takeover Bid" (1988), 20 Ottawa L. Rev. 63, at 63 & n. 2; L. Grafstein, "Whose Company Is it Anyway?: Recent Developments in Canadian Takeover Law" (1988), 46 U. T. Fac. L. Rev. 522, at 522 & n. 1; R. Micheletto, "The Poison Pill: A Pancea for the Hostile Corporate Takeover" (1987), 21 J. Marshall L. Rev. 107, at 107 & n. 2.
2. A conditional bid is a take-over bid that the acquirer makes conditional upon its acquisition of, *inter alia*, financing and regulatory approvals along with the removal of any defensive mechanisms erected by the target.
3. A potential acquirer will attempt to solicit a number of proxies sufficient for it to control a shareholder vote of the target corporation on either the acquirer's take-over bid or the removal of the target's defensive mechanisms.
4. A "street sweep" occurs where the potential acquirer purchases a large number of the target's shares in open market acquisitions. Street sweeps often occur immediately following a failed take-over bid while a large number of shares are still in the hands of arbitrageurs.
5. A two-tier, front-end loaded bid is one in which the potential acquirer first makes a take-over bid for a bare majority of the shares of the target and, when successful, squeezes out the remaining shareholders in a second-step merger for a consideration significantly less than that given to those shareholders who tendered into the original bid.
6. Baxter, *supra*, note 1, at 63 & n.l.

This paper will discuss the legal issues that arise from the use of poison pills by corporations in Canada. Part II will provide a brief overview of the structure of the most common forms of shareholder rights plans. Part III will review the principles that have evolved in the United States regarding the legality of both the adoption and maintenance of poison pills. Finally, based on both the foregoing and a review of basic Canadian securities and corporate law principles, Part IV will attempt to define principles that Canadian judicial and regulatory bodies may and/or should develop to govern both the adoption and maintenance of shareholder rights plans.

II. *The Various Forms*

Although poison pills come in many different shapes and sizes, every pill has the same fundamental characteristics.[7] Rights are first distributed to all common shareholders of the corporation. The exercise price is set "out of money" and the rights are subject to redemption at any time by the target's directors for a nominal price. The rights are non-exercisable and trade with and only with the common shares until triggered by an entity (an "Acquiring Entity") through either its acquisition of, or its announcement of a take-over bid for, a pre-set percentage of the target's common shares. At this point, the rights trade separately and may be exercised. The rights held by the Acquiring Entity are declared null and void.

A "flip-over" rights plan provides that where the target amalgamates, merges, or in any way combines with the Acquiring Entity, the rights "flip-over" and entitle their holders to acquire a number of common shares of the Acquiring Entity equal to twice the value of the exercise price. Although this form of pill is effective against the two-tier, front-end loaded take-over bid, it does little to prevent or deter an entity from either "sweeping the street" or proceeding with a take-over bid for all of the target's common shares.

To overcome this deficiency, the "flip-in" rights plan was developed.[8] A "flip-in" rights plan provides that where an Acquiring Entity simply exists, the rights "flip-in" and entitle their holders to acquire a number of common shares of the target equal to twice the value of the exercise price.

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7. See generally, D. Resenzweig, "Poison Pill Rights: Toward a Two-Step Analysis of Directors' Fidelity to Their Fiduciary Duties" (1988), 56 Geo. Wash. L. Rev. 373, at 374-75; M. Cohen, 'Poison Pills' as a Negotiating Tool: Seeking a Cease-Fire in the Corporate Takeover Wars", [1987]Colum. Bus. L. Rev. 459, at 462-68; R. Micheletto, *supra*, note 1, at 112-19.

8. L. Herzel and R. Shepro, "The Changing Fortunes of Takeover Defences" (1987), 15 Sec. Reg. L. J. 116, at 121-23.

Finally, a "back-end" rights plan provides that, where an Acquiring Entity merely exists, the rights entitle their holders to a package of debt obligations of the target in an amount equal in value to the long-term value of the corporation's common shares as determined by the directors.

Both the flip-over and flip-in rights plans render any take-over economically prohibitive by diluting the Acquiring Entity's equity and voting interest in the target. On the other hand, the back-end rights plan is designed not to prevent a take-over, but rather to ensure that any such offer is tendered at a price at least equal to the long-term value of the target's common shares.

The heart of the poison pill lies in its redemption provisions. Although the target's directors have no legal means of blocking a take-over bid, the mere existence of the pill renders any take-over without the redemption of the pill's rights economically prohibitive. Thus, a potential acquirer is encouraged to negotiate a take-over that is acceptable to the target's directors. Directors will/should reject any take-over bid which does not constitute an offer of full and fair value to all of the target's shareholders. It is at least arguable that the target's directors may also reject any take-over bid which, although constituting an offer of full and fair value, is not in the best interests of stakeholders of the target other than its common shareholders.[9]

III. *The American Experience*

The validity of poison pills has been litigated in the United States for the past several years. Opponents of shareholder rights plans have argued that they are not consistent with federal securities regulations, that they are invalid as a matter of corporate law on the grounds that they are discriminatory and that, in both adopting and maintaining poison pills, targets' directors have breached the fiduciary duties they owe to their corporations.

1. *Securities Law*

The regulation of securities transactions in the United States is within federal jurisdiction pursuant to its power to regulate interstate commerce.[10] Although the federal government has taken steps to regulate corporate take-overs, many states believe that more restrictive regulation is required and have hence proceeded to enact their own take-over

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9. See *infra.*, pp. 190-192.
10. *U.S. Const.,* Art. I, s. 8, cl. 3 (the "Commerce Clause").

legislation. Although many such statutes have been declared unconstitutional, some of the more recent ones have survived.

(i) *Federal*

Federal regulation of the take-over process was provided for in the *Williams Act*,[11] which added paragraphs 13(d) and (e) and paragraphs 14(d) through (f) to the *Securities Exchange Act of 1934*.[12] The intent of the *Williams Act* is to protect shareholders by producing a take-over environment in which they will receive full disclosure of terms of any take-over bid,[13] by allowing any tendering shareholder to withdraw his/her shares within seven days of a bid being sent to them,[14] by providing that where a bid is for less than all of the common shares, and more shares are tendered than were requested shares will be taken up on a *pro rata* basis,[15] and by providing that where increased consideration is offered for shares during the course of a bid, the increased consideration must be paid to all tendering shareholders, regardless of whether the shares were tendered before or after the increased consideration was offered.[16,17]

Perhaps the most interesting of all the provisions of the *Williams Act* is paragraph 78n(e) which states that it is unlawful for any person "to engage in any fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer or request or invitation for tenders . . . .[18] Although it was argued that this provision gave the Securities and Exchange Commission (the "SEC") the authority to regulate the substantive fairness of both take-over bids and defences to take-over bids, the United States Supreme Court held in *Schreiber* v. *Burlington Northern, Inc.*[19] that:

> Nowhere in the legislative history is there the slightest suggestion that [paragraph 78n(e)] serves any purpose other than disclosure, or that the term "manipulative" should be read as an invitation to the courts to

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11. 15 U.S.C., Paras. 78m(d)-(e), 78n(d)-(f) (1986) (the "*Williams Act*").
12. 15 U.S.C., ss. 78a-78kk (1986) (the "SEA").
13. SEA, cl. 14(d) (1).
14. SEA, cl. 14(d) (5).
15. SEA, cl. 14(d) (6).
16. SEA, cl. 14(d) (7).
17. *See generally* M. Berman, "SEC Takeover Regulation Under the Williams Act" (1987), 62 N.Y.U. L. Rev. 580; M. Steinberg, "Tender Offer Regulation: The Need for Reform" (1988), 23 Wake Forest L. Rev. 1.
18. The term "tender offer" is the American equivalent of the Canadian term "take-over bid."
19. 472 U.S. 1 (1985).

> oversee the substantive fairness of tender offers; the quality of any offer is a matter for the marketplace.[20]

Thus, this provision comes into play only where there has been a misrepresentation or non-disclosure. The scope of protection provided for in the *Williams Act* is further limited by the narrow interpretation that has been placed on the term "tender offer" by the United States Court of Appeal.

First, in *S.E.C.* v. *Carter Hawley Hale Stores, Inc.*,[21] the SEC applied for injunctive relief to prevent Carter Hawley Hale Stores, Inc. from repurchasing its own shares in the open market in an attempt to defeat a take-over bid without complying with the disclosure requirements of the *Williams Act.* The Ninth Circuit Court held that the proper test to determine whether the repurchase was a "tender offer" within the meaning of the *Williams Act* was the "Wellman eight factor test." Pursuant to this test, only those offers that have the "overall effect of pressuring shareholders into selling their stock" fall within the ambit of the Act.[22] While the Court recognized that

> there certainly was shareholder pressure in this case, it was largely the pressure of the marketplace and not the type of untoward pressure the tender offer regulations were designed to prohibit.[23]

As a result, the application was dismissed. The result clearly implied that "street sweeps" are not within the definition of a "tender offer" for the purposes of the *Williams Act.*

Second, in *Hanson Trust PLC* v. *SCM Corp.*,[24] Hanson Trust PLC ("Hanson") had made a cash take-over bid for any and all shares of SCM Corporation ("SCM"). In the face of defensive actions by SCM, Hanson terminated its bid and entered into five privately negotiated cash purchases and one open market acquisition, acquiring a total of twenty-five percent of SCM's shares. SCM sought to prevent these purchases on the grounds that Hanson had not complied with the disclosure requirements of the *Williams Act.* The Second Circuit Court rejected the "Wellman eight factor test," stating that "the elevation of such a list to a mandatory 'litmus test' appears to be both unwise and unnecessary."[25] However, it did adopt a test similar in tone to the approach used by the Ninth Circuit Court in *Carter Hawley Hale* in stating that stock purchases

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20. *Ibid.,* at 11-12.
21. 760 F.2d 945 (9th Cir. 1985).
22. *Ibid.,* at 950.
23. *Ibid.,* at 952.
24. 774 F.2d 47 (2nd Cir. 1985).
25. *Ibid.,* at 57.

fall within the meaning of a "tender offer" for the purposes of the *Williams Act* only where "there will be substantial risk that solicitees will lack information needed to make a careful considered appraisal of the proposal put before them."[26] Since the solicitees in this case were "highly sophisticated professionals," the Act's protection was not necessary and the purchases were thus held to not constitute a "tender offer."[27]

It is therefore apparent that federal securities regulation does little to prevent or deter either coercive take-over techniques or defensive mechanisms. For this reason, some states have stepped in to fill a perceived void.

(ii) *State*

Three different types of "second generation" state anti-take-over statutes[28] have evolved.[29] First, "business combination" statutes provide that where an entity acquires twenty percent or more of the target's shares, it may not engage in any kind of corporate combination with the target unless approval of such a combination is given by the target's directors prior to the entity's share acquisition.[30] Second, "fair price" statutes provide that certain corporate combinations between an acquiring entity and the target are prohibited unless they are approved by eighty percent of all shareholders and a majority of disinterested shareholders. This "supermajority" vote is not required where either two-thirds of the directors approve of the combination or the shareholders receive a "fair price" for their shares.[31] Finally, "control share acquisition statutes" provide that where "control shares," normally defined to be twenty percent or more of the target's common shares, are acquired in a "control share acquisition," those shares retain their voting rights only where the acquisition is approved by both a majority of both disinterested shareholders and all shareholders.[32]

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26. *Ibid.*
27. *Ibid.*
28. "First generation" state anti-take-over statutes provided both enhanced disclosure requirements and the ability of a state official not to allow a take-over bid to proceed where he/she considered it to be inadequate. The statutes applied where ten percent of the target's shares were held by state residents. Such statutes were held to be unconstitutional as a violation of the Commerce Clause: *Edgar* v. *MITE Corp.*, 457 U.S. 624 (1982). "Second generation" state anti-take-over statutes attempt to circumvent the decision in *MITE Corp.* by requiring the take-over bid to have a closer nexus to the state before the legislation will be applicable.
29. See generally, P. Hablutzel and D. Selmer, "Hostile Corporate Takeovers: History and Overview" (1988), 8 N. Ill. U.L. Rev. 203, at 213-29.
30. See, e.g., *N.Y. Bus Corp. Law*, s. 912 (1986).
31. See, e.g., *Illinois Business Corporation Act*, Ill. Rev. Stat. c. 32, para. 7.85 (1985).
32. See, e.g., *Control Share Acquisition Chapter*, Ind. Code Ann., s. 23-1-42 (1987) (the "Indiana Anti-Take-over Statute").

It is arguable that all three of the above types of state anti-take-over statutes are unconstitutional for either imposing a burden on interstate commerce in violation of the Commerce Clause, or for being pre-empted by the *Williams Act* in violation of the Supremacy Clause.[33] The constitutionality of only the control share acquisition statutes has been definitely determined.

In *CTS Corp.* v. *Dynamics Corp. of America*,[34] the United States Supreme Court considered the constitutionality of the Indiana Anti-Take-over Statute.[35] The Court first stated that where compliance with both federal and state law is possible, the state law will be pre-empted only if it "frustrates the purposes of the federal law."[36] It was then held that as the Indiana Anti-Take-over Statute "protects the independent shareholder against both of the contending parties,"[37] it "furthers a basic purpose of the *Williams Act*"[38] and thus does not violate the Supremacy Clause.[39] The Court next considered the Commerce Clause issue, concluding that the statute does not discriminate against interstate commerce because "[i]t has the same effects on tender offers whether or not the offeror is a domiciliary or resident of Indiana."[40] The Court also rejected an argument that the statute violates the Commerce Clause by subjecting a corporation to more than one set of regulations:

> The Indiana [Anti-Take-over Statute] poses no such problem. So long as each State relegates voting rights only in the corporation it has created, each corporation will be subject to the law of only one State. No principle of corporation law and practice is more firmly established than a State's authority to regulate domestic corporations, including the authority to define the voting rights of shareholders.[41]

Thus, the Indiana Anti-Take-over Statute was found to be constitutional. While some argue that the plurality of approaches to the substantive regulation of take-over legislation requires federal pre-emption with one consistent regime,[42] it is apparent that until Congress

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33. *U.S. Const.*, Art. IV, cl. 2 (the "Supremacy Clause"). The Supremacy Clause provides that federal law is the "Supreme Law of the Land," notwithstanding any state law to the contrary.
34. 107 S.Ct. 1637 (1987).
35. For a critical analysis of this decision, *see* M. Kapusta, "Tipping the Tender Balance: *CTS* Gives New Life to State Takeover Law" (1988), 18 *Stetson L. Rev.* 147.
36. *CTS Corp.* v. *Dynamics Corp. of America, supra*, note 34, at 1644.
37. *Ibid.*, at 1645.
38. *Ibid.*
39. *Ibid.*, at 1648.
40. *Ibid.*, at 1648-49.
41. *Ibid.*, at 1649.
42. *E.g.*, T. Fiflis, "Of Lollipops and Law — A Proposal for a National Policy Concerning Tender Offer Defenses" (1986), 19 U.C. Davis L. Rev. 303; But see Berman, *supra*, note 17.

so acts, the state legislation shall remain. It is also apparent that the state anti-take-over statutes do not attempt to limit the use of defensive mechanisms; to the contrary, the statutes act as legislated forms of these defensive mechanisms.

2. *Corporate Law*

Shareholder rights plans must not only meet the strictures of both federal and state securities laws, but must also be in compliance with the corporate laws of the state of incorporation. Under this heading, most state courts have focused their attention on an investigation of whether or not directors have breached their fiduciary duties in either adopting or maintaining poison pill defences. However, a proper analysis must first consider the structural validity of such plans.[43]

(i) *Discrimination*

Acquiring entities will often argue that a shareholder rights plan is *ultra vires* the adopting corporation in that it unfairly discriminates between holders of the same class of shares of the corporation. However, it is this very discrimination that gives the pill its "poison."

To determine the validity of any particular distribution of voting rights among holders of different classes or series of shares in a corporation, one must first turn to the corporate legislation of the appropriate jurisdiction. The problem here, however, is that one will rarely find a corporation statute that explicitly allows or disallows discrimination between shares or shareholders of the same class. As a result, two opposite lines of authorities have developed on this point.

One line of authorities traces its origins to the Supreme Court of Delaware's decision in *Providence and Worcester Co.* v. *Baker.*[44] In that case, the Court was asked to determine the validity of an article in a corporation's certificate which provided, *inter alia,* that each shareholder was entitled to one vote for every common share owned by him/her not exceeding fifty shares, and one vote for every twenty shares owned by him/her more than fifty. The Delaware corporate law statute did not provide an explicit answer as to the permissibility of this discrimination.[45]

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43. M. Van Meter, "Share and Share Unalike: Judicial Response to Poison Pill Discrimination Among Shareholders of the Same Class" (1987), 33 Wayne L. Rev. 1067, at 1072-73.
44. 378 A.2d 121 (1977).
45. *Del. Code Ann.* tit. 8, s. 151(a) provides that "Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof . . . and which classes or series may have such voting powers, full or limited, or no voting powers . . . as shall be stated and expressed in the certificate of incorporation . . . ."

The Court drew a distinction between discrimination among shareholders and discrimination among shares, concluding that the former was permissible:

> In the final analysis, these restrictions are limitations upon the voting rights of the stockholder, not variation in the voting powers of the stock *per se.* The voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding. In the hands of the smaller stockholders, unrestrained in the exercise of their voting rights, the same stock would have voting power equal to all others in the class.[46]

As a result, both flip-over/flip-in[47] and back-end[48] plans have been upheld by courts in a number of subsequent cases. It should be noted, however, that no Delaware case has addressed the discrimination issue specifically in relation to poison pills.[49]

The opposite line of authorities is well illustrated by the decision of the United States District Court in *Amalgamated Sugar Co.* v. *NL Industries, Inc.*[50] In that case, NL Industries had adopted a flip-over/flip-in rights plan. The New Jersey corporate law statute did not explicitly allow or disallow discrimination among either shares or shareholders.[51] Although factually similar to *Providence and Worcester Co.,* the Court reached a different result:

> I find that the rights plan, and in particular the flip-in provision of that plan . . . is *ultra vires* as a matter of New Jersey Business Corporation law. The flip-in effects a discrimination among shareholders of the same class or series.[52]

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46. *Supra,* note 44, at 123.
47. *E.g., CRTF Corp.* v. *Federated Department Stores, Inc.,* 683 F. Supp. 422 (S.D.N.Y. 1988).
48. *E.g., Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. S.C. 1986).
49. N. Nixon and P. Shoback, "The Reasonable Pill: A Primer for Directors and Their Counsel on the Adoption and Use of a Shareholder Rights Plan" (1989), 1 De Paul B.L.J. 1, at 18.
50. 644 F. Supp. 1229 (S.D.N.Y. 1986).
51. *N. J. Stat. Ann.,* s. 14A:7-1(1) provides that "Each class and series [of shares] may have such designation and such relative voting, dividend, liquidation and other rights, preferences, and limitations as shall be stated in the certificate of incorporation . . . ."
52. *Supra,* note 50, at 1234. It is important to note, however, that the Court was also very disturbed by the fact that the rights could no longer be redeemed to clear the way for a possible take-over bid.

Both flip-in[53] and back-end[54] plans have been invalidated in subsequent cases on the basis of discrimination.

This review of the cases demonstrates that it may be difficult to predict if a U.S. court will invalidate either a flip-over/flip-in or back-end rights plan on the basis of discrimination. One author notes that only Delaware and those jurisdictions that rely on Delaware corporate law have upheld discriminatory plans.[55] However, even if all other states invalidate such plans, the large number of Delaware corporations will ensure the survival of the poison pill.

Assuming that a shareholder rights plan is not invalidated on the grounds of discrimination, it must still be shown that the directors of a target corporation have not breached their fiduciary duties in either adopting or maintaining the rights plan.

(ii) *Fiduciary Duties*

Directors owe their corporations both a duty of care and a duty of loyalty in the performance of their tasks. The burden of demonstrating a breach of a fiduciary duty is placed on the party alleging the breach due to the operation of the business judgement rule, which is a

> presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[56]

(a) *Duty of Care*

A director's duty of care arises out of his/her obligation to act on an informed basis. This has been interpreted to mean that in making a business decision, a director must consider "all material information reasonably available" to him/her.[57] Thus, a breach of the duty of care will result where directors act both swiftly and without adequate information.[58]

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53. *E.g., R.D. Smith & Co.* v. *Preway Inc.,* 644 F. Supp. 868 (W.D.Wisc. 1986) (although in that case the rights plan was not enjoined because the plaintiff failed to demonstrate irreparable harm); *Bank of New York Co. Inc.* v. *Irving Bank Corp.,* 536 N.Y.S.2d 923 (N.Y.S.C. 1988).
54. *E.g., Minstar Acquiring Corp.* v. *AMF, Inc.,* 621 F. Supp. 1252 (S.D.N.Y. 1985).
55. Van Meter, *supra,* note 43, at 1093.
56. *Aronson* v. *Lewis,* 473 A.2d 805 (Del. S.C. 1984).
57. *Smith* v. *Van Gorkom,* 488 A.2d 858, at 872 (Del. S.C. 1985).
58. *Ibid.,* at 874; See also *Hanson Trust PLC* v. *ML SCM Acquisition Inc.,* 781 F.2d 264, at 275 (2d Cir. 1986).

The duty of care is concerned not so much with what actions directors take, but with the way in which they are taken. To this end, the duty of care imposes on directors desiring to either adopt or maintain a shareholder rights plan a hurdle that is merely procedural in nature. So long as all actions by the directors are properly "papered," no breach of the duty of care should occur.

In the context of directors' fiduciary duties, a discussion of any and all substantive hurdles that may exist to either the adoption or maintenance of a shareholder rights plan has been discussed by the American courts within the ambit of the duty of loyalty.

(b) *Duty of Loyalty*

An investigation into the standard of conduct required of a director in order to meet his/her fiduciary duty of loyalty to his/her company in the context of a hostile take-over must begin with the decision of the Supreme Court of Delaware in *Unocal Corp.* v. *Mesa Petroleum Co.*[59] In that case, Mesa Petroleum Co. ("Mesa") initiated a two-tier, front-end loaded cash take-over bid for sixty-four million shares of Unocal Corp.'s ("Unocal's") outstanding stock at a price of U.S. $54 per share. This number, together with the number of shares already held by Mesa, would have been sufficient to give it control of Unocal. The back-end of the transaction would have resulted in the exchange of the remaining publicly held shares of Unocal for subordinated securities worth U.S. $54 per share. After meeting with both its financial and legal advisors, Unocal's board of directors adopted a unanimous resolution rejecting Mesa's tender offer as inadequate. At a subsequent meeting, after once again receiving advice from its advisors, Unocal's board of directors unanimously resolved to exchange forty-nine percent of its outstanding shares for debt obligations worth U.S. $72 per share. The Unocal offer excluded Mesa. Mesa promptly challenged the propriety of this discriminatory defensive self-tender.

The Court first stated that a Delaware corporation may deal selectively with its shareholders, provided that in so doing its directors do not breach their fiduciary duties.[60] While it then went on to hold that the business judgement rule applies in the context of a take-over,[61] the Court also stated that:

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59. 493 A.2d 946 (1985).
60. *Ibid.*, at 953-54.
61. *Ibid.*, at 954.

> Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.
>
> In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden "by showing good faith and reasonable investigation . . . ."
>
> A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgement rule, it must be reasonable in relation to the threat posed. (Footnotes omitted)[62]

The Court then concluded that the actions of Unocal's directors, confronted with a coercive take-over bid from a "corporate raider with a national reputation as a 'greenmailer',"[63] satisfied the above tests and that they were therefore protected by the business judgement rule.[64] As a result, a preliminary injunction that was granted against Unocal was vacated.

That the principles enunciated in *Unocal* are also applicable to evaluate the standard of directoral conduct in relation to both the adoption and maintenance of shareholder rights plans was confirmed by the Delaware Supreme Court in *Moran* v. *Household International, Inc.*[65] In that case, the board of directors of Household International, Inc. ("Household") adopted a flip-over rights plan prior to any announcement of a take-over bid for the company's shares. Moran was both a director of Household and chairman of Dyson-Kissner-Moran Corporation ("DKM"), Household's largest shareholder. DKM was interested in conducting a leveraged buyout of Household and therefore challenged the propriety of that company's poison pill.

The Court first noted that, unlike previous cases, the defensive measures employed by Household's directors were not adopted in response to any specific threat. However, it concluded that:

> This distinguishing factor does not result in the Directors losing the protection of the business judgment rule. To the contrary, pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule.[66]

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62. *Ibid.*, at 954-55.
63. *Ibid.*, at 956.
64. *Ibid.*, at 958.
65. 500 A.2d 1346 (1985).
66. *Ibid.*, at 1350.

After finding that the directors were authorized to adopt the shareholder rights plan, the Court then applied the three-prong test outlined in *Unocal* to determine whether or not the directors would be afforded the protection of the business judgment rule. First, the Court found that the directors had acted in good faith in reacting to what they "perceived to be the threat in the market place of coercive two-tier tender offers."[67] Next, the Court held that the directors were reasonably informed of the effects of the poison pill given that they received advice from both their legal and financial advisors and that the plan was critiqued before the board by Moran himself.[68] Finally, the Court concluded that the rights plan was reasonable in relation to the threat posed from the ever increasing frequency of coercive take-overs in the financial services industry.[69]

It is important to note that while the Court upheld the adoption of the flip-over plan in *Moran,* it also cautioned that

> that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders ... Their use of the Plan will be evaluated when and if the issue arises.[70]

A liberal reading of *Moran* would suggest that so long as coercive take-over tactics continue to be employed, and so long as directors properly "paper" their transactions, the *adoption* of a shareholder rights plan will not be invalidated as a breach of the directors' fiduciary duties. This theory is supported by a long line of cases in which the adoption of flip-over,[71] flip-in[72] and back-end[73] rights plans have all been upheld. The only noteworthy cases going against this trend are two decisions of the United States Court of Appeal involving attempts by Dynamics

67. *Ibid.,* at 1356.
68. *Ibid.*
69. *Ibid.,* at 1356-57.
70. *Ibid.,* at 1357.
71. *E.g., Horwitz* v. *Southwest Forest Industries, Inc.,* 604 F. Supp. 1130 (D.Nev. 1985).
72. *E.g., Gelco Corp.* v. *Coniston Partners,* 652 F. Supp. 829 (D.Minn. 1986); aff'g in part, vacated in part, 811 F.2d 414 (8th Cir. 1987); *CRTF Corp.* v. *Federated Dep't Stores, Inc., supra,* note 47; *City Capital Associates Limited Partnership* v. *Interco Inc.,* 551 A.2d 787 (Del. Ch. 1988) appeal dismissed, 556 A.2d 1070 (Del. S.C. 1988); *Mills Acquisition Co.* v. *MacMillan, Inc.,* C.A. No. 10168 (Del. Ch. Oct. 17, 1988); rev'd in part, 559 A.2d 1261 (Del. S.C. 1989); *Grand Metropolitan Public Ltd.* v. *Pillsbury Co.,* C.A. 10323 (Del. Ch. Dec. 16, 1988).
73. *Supra,* note 48.

Corporation of America ("Dynamics") to take over CTS Corporation ("CTS").[74]

On March 10, 1986, Dynamics made a take-over bid for one million common shares of CTS, which, if successful, would have increased Dynamics' ownership of CTS to twenty-seven and one-half percent. On that same day and without consideration of the terms of the offer, CTS announced that it was opposed to Dynamics' bid. The directors of CTS proceeded to adopt a flip-in rights plan whose "poison" was released by the acquisition of fifteen percent of the company's stock. At no time did the directors discuss the fairness of the price contained in Dynamics' take-over bid. Dynamics moved to enjoin the rights plan and was successful at the District Court level.[75]

On appeal to the Seventh Circuit Court, Posner C. J. affirmed the District Court's decision.[76] He first noted the inherent conflicts of interest experienced by directors in adopting measures designed to deter or prevent take-overs and noted that

> These problems have seemed serious enough to warrant a more searching judicial review of corporate decisions concerning defensive measures to takeovers than of decisions concerning ordinary business decisions.[77]

Posner was also deeply concerned that

> The tender offer was not evaluated in a cool, dispassionate, and thorough fashion .... [I]t is apparent that the insiders on the board, in particular the chairman, decided from the start to block the tender offer, before its ramifications for shareholder welfare were considered.[78]

The Court proceeded to affirm the District Court's decision on the basis that CTS's directors had failed to consider the fairness of the take-over price[79] and that the plan triggered at less than a majority shareholding.[80] It concluded that the plan "effectively precludes a hostile takeover, and thus allows management to take the shareholders hostage. To buy CTS, you must buy out its management."[81]

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74. For a summary of these two decisions, see K. Crowder, "Recent Developments in the Use of the Poison Pill Antitakeover Defense: Limiting the Business Judgement Rule" (1987), 31 St. Louis U. L. J. 1083, at 1093-101.

75. *Dynamics Corp. of America* v. *CTS Corp.,* 637 F. Supp 406 (N.D. Ill. 1986).

76. *Dynamics Corp. of America* v. *CTS Corp.,* 794 F.2d 250 (7th Cir. 1986) ("CTS I").

77. *Ibid.,* at 256.

78. *Ibid.,* at 257.

79. *Ibid.*

80. *Ibid.,* at 259. The Court noted that poison pills are often upheld as a mechanism designed to protect minority shareholders from an inadequate second-step merger. Where the plan triggers at less than a majority shareholding, such a justification is no longer valid.

81. *Ibid.*

As a result of the Court's decision, Dynamics' take-over bid was successful. A committee of outside directors of CTS then recommended that the board adopt a back-end plan that would trigger at a twenty-eight percent holding of the company's common stock, an amount only one-half of one percent above that then held by Dynamics. The plan would cancel automatically where a cash take-over bid for all outstanding shares was made at a price of U.S. $50 or more. The board adopted the plan and once again Dynamics challenged the directors' actions in court. This time, however, the District Court denied its motion.[82] Dynamics appealed.

Once again, the matter came before Posner C.J.[83] He first reiterated that

> courts are not simply to rubber stamp the board's judgment but must review it carefully to make sure that in adopting the poison pill the board really was acting in the best interests of the corporation.[84]

Judge Posner then stated that in conducting that review

> the court must consider the procedures leading up to the adoption of the poison pill and the terms of the poison pill.[85]

In applying the above test, the Court first expressed concern regarding the compensation of CTS's financial advisors, there being some thought that they would receive an "incentive fee" if the company were sold to a "white knight."[86] Second, the Court noted that there was in the evidence no justification for setting the triggered ownership percentage below fifty percent.[87] Finally, sufficient evidence was not found to warrant the U.S. $50 per share cancellation provision, the Court noting that "the pill cannot be upheld if the trigger price is an unreasonably high sale price."[88] On this basis, the case was remanded to the District Court for further consideration.

The willingness of Judge Posner in both CTS I and CTS II to consider the "procedures leading up to the adoption of the poison pill and the terms of the poison pill itself" indicate that the United States Court of Appeal adopted a significantly higher standard in relation to the adoption of poison pills than the Delaware courts in assessing the directoral

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82. *Dynamics Corp. of America* v. *CTS Corp.*, 638 F. Supp. 802 (N.D. Ill. 1986).
83. *Dynamics Corp. of America* v. *CTS Corp.*, 805 F. 2d 705 (7th Cir. 1986) ("CTS II").
84. *Ibid.*, at 708.
85. *Ibid.*
86. *Ibid.*, at 710-11.
87. *Ibid.*, at 712.
88. *Ibid.*, at 714.

requirements of "good faith and reasonable investigation" as enunciated in the *Unocal* case. However, the two cases may also be seen simply as a reiteration of the duty of care test clothed in duty of loyalty language, the result once again being that in adopting poison pills, directors must properly "paper" their transactions.

Assuming that, in general, directors act upon reasonable grounds in *adopting* shareholder rights plans, it is important to remember that their actions in relation to the *maintenance* of those plans must also meet the three-prong test enunciated in *Unocal*.[89] This principle comes into play where the directors refuse to redeem poison pill rights in the face of a take-over bid.

This was exactly the situation before the court in *Grand Metropolitan Public Ltd.* v. *Pillsbury Co.*[90] In that case, Grand Metropolitan Public Ltd. ("Grand Met") sought an order directing Pillsbury Co. ("Pillsbury") to redeem rights associated with its flip-in poison pill so that Grand Met could proceed with a fully financed take-over bid for all common shares of Pillsbury at a cash price of U.S. $63 per share. The sole basis on which the directors refused to redeem the rights was the alleged inadequacy of the offered price.

After stating that the case was governed by the principles enunciated in *Unocal*, the Court concluded that

> Surely, Board action which bars Pillsbury shareholders from electing to sell their stock ... when, (a) only shareholder interest is at stake ... is harsh treatment of shareholders to whom fiduciary duties are owed. And the means to accomplish that treatment, considered in context and result, are Draconian.
>
> In the principal, if not in all, Delaware cases validating use of the Pill, it is apparent that the purpose thereof was to create a "defense" against hostile, coercive acquisition techniques.[91]

Given that the take-over bid was a cash offer for all of the common shares of Pillsbury, there was no coercion involved and the directors were therefore ordered to redeem the poison pill rights so that the take-over bid might proceed.

It was noted in *Pillsbury* that the only interests at stake were those of the shareholders. However, that may not always be the case, and where other interests are affected by a take-over bid, it appears that such interests may be taken into account by the directors. As stated by the Delaware Supreme Court in *Unocal*

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89. See discussion of *Moran, supra*, at pp. 169-171.
90. *Supra*, note 72.
91. *Ibid.*, at 25-26.

> If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, *the impact on "constituencies" other than shareholders (i.e.,* creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in the exchange. (Emphasis added)[92]

It is important to note that the above principle was modified by the Delaware Supreme Court in *Revlon, Inc.* v. *MacAndrews & Forbes Holding, Inc.*[93] In that case, Pantry Pride, Inc. ("Pantry Pride") had made a conditional take-over bid for Revlon, Inc.'s ("Revlon's") common shares at a cash price of U.S. $56.25 per share. Revlon's directors instead agreed to a leveraged buyout by Forstmann Little & Co. ("Forstmann") because the latter was willing to support the face value of recently issued Revlon notes. As part of that agreement, Revlon agreed to both a "lock-up" option on two of its divisions and a "no-shop" provision. Pantry Pride then challenged the Revlon-Forstmann agreement.

On appeal, the Court first found that the directors' decisions to both adopt the back-end rights plan and issue certain note obligations were protected by the business judgement rule pursuant to the principles enunciated in *Unocal.*[94] It then went on to state that when it became apparent that the company was to be sold

> [t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[95]

The Court concluded that the directors had put the interests of the noteholders before the interests of the shareholders and that, on the facts of the case, this constituted a breach of their duty of loyalty.[96] The directors had argued that, under the *Unocal* principles, they were permitted to consider the effect of a take-over on constituencies other than the shareholders. The Court rejected this argument, holding that:

> A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. *Unocal,* 493 A.2d at 955. However, such concern for non-stockholder interests is inappropriate when an auction among active

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92. *Supra,* note 59, at 955.
93. *Supra,* note 48.
94. *Ibid.,* at 180-81.
95. *Ibid.,* at 182.
96. *Ibid.*

> bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.[97]

The reasoning of the Court in *Revlon* has been applied in several subsequent cases.

In *CRTF Corp.* v. *Federated Dept. Stores, Inc.*,[98] Federated Department Stores, Inc. ("Federated") refused to redeem rights issued pursuant to a flip-over/flip-in rights plan at a time when it was receiving competing bids from both CRTF Corp. ("CRTF") and R. H. Macy & Co. ("Macy's"). Federated subsequently agreed to redeem the rights with respect of the Macy's bid, but did not afford the CRTF bid the same treatment. However, Federated's directors did state that they were still open to receive better bids from either CRTF or any other third party and would consider redeeming the rights in relation to such a bid should it materialize. CRTF claimed that Federated's directors had breached their fiduciary duties under "auction" conditions, as defined in *Revlon*. In refusing to grant injunctive relief, the Court concluded that in this fact situation

> We see nothing at this point that suggests that the Federated Board is acting with any other motive than to enhance the bidding and to raise the price for the benefit of the shareholders. Thus, we do not find that [CRTF] has, at this stage of the record, demonstrated a likelihood of success on the issue of the invalidity of the pill as applied in this situation, that is, on the continued invocation of the Rights Plan vis-a-vis CRTF's present two-tiered bid.[99]

Different results were reached, however, in both *Mills Acquisition Co.* v. *MacMillan, Inc.*[100] and *City Capital Associates Limited Partnership* v. *Interco Inc.*[101] In both cases there was an "auction" for the target corporation that had in place a flip-in rights plan. In both cases a bidder sought an order requiring the redemption of the target's rights so that the target's shareholders could choose between, in the former case, one of two take-over bids, and in the latter case, a take-over bid and a proposed corporate restructuring. In both cases the order was granted.

In merging the principles applied in both *Revlon* and *CRTF*, the Court in *Interco* held that

> If [a determination that an offer is inadequate] is made in good faith ..., it alone will justify leaving a poison pill in place, even in the setting of a

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97. *Ibid.*
98. *Supra*, note 47.
99. *Ibid.*, at 441.
100. *Supra*, note 72.
101. *Ibid.*

> noncoercive offer, for a period while the board exercises its good faith business judgment to take such steps as it deems appropriate to protect and advance shareholder interests in light of the significant development that such an offer doubtless is. That action may entail negotiation on behalf of shareholders with the offeror, the institution of a *Revlon*-style auction for the Company, a recapitalization or restructuring designed as an alternative to the offer, or other action.
>
> Once that period had closed, and it is apparent that the board does not intend to institute a *Revlon*-style auction, or to negotiate for an increase in the unwanted offer, and that it has taken such time as it required in good faith to arrange an alternative value-maximizing transaction, then, in most instances, the legitimate role of the poison pill in the context of a noncoercive offer will have been fully satisfied. The only function then left for the pill at this end-stage is to preclude the shareholders from exercising a judgment about their own interests that differs from the judgment of the directors, who will have some interest in the question.[102]

To summarize, the American position appears to be that, in most instances, the directors' decision to adopt a poison pill will not be questioned, so long as the transaction is properly "papered." However, the directors' decision to not redeem rights issued pursuant to the adoption of a poison pill in the face of a non-coercive take-over bid will come under closer scrutiny. Where the directors have made a decision to sell the corporation, they appear to be permitted to consider only the interests of the shareholders. Furthermore, where such an "auction" has come to an end, the directors must permit the shareholders to decide which of two or more non-coercive alternatives is in their best interests.

IV. *Developing a Canadian Position*

While many lessons may be learned from the American experience in the regulation of the use of poison pills over the last several years, it is by no means clear that the standards that have developed in that country should be applied in Canada. Not only is the regulatory regime more restrictive in Canada, but it is also suggested that philosophical differences in the approach to the regulation of business in general dictate that a position on the use of poison pills must be generated which is uniquely Canadian.

1. *Securities Law*

The regulation of take-over bids in Canada provides not only the same protections as those afforded under the *Williams Act* in the United

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102. *Ibid.*, at 798.

States,[103] but provides enhanced protection in two significant ways. First, the definition of a "take-over bid"[104] is more inclusive, thus protecting shareholders against the discriminatory effects of "street sweeps." Second, second-step mergers such as going private transactions are regulated, thus providing enhanced shareholder protection against coercive two-tier, front-end loaded bids. Of even more significance is the fact that securities regulators in Canada have recently taken steps to regulate defences to take-over bids.

Take-over bids are regulated under both corporate law statutes[105] and securities law statutes.[106] A take-over bid is defined under the CBCA to mean any offer to acquire shares that, if combined with shares already owned by the offeror, would exceed ten percent of any class of issued shares of an offeree corporation.[107] The OSA provision kicks in at an ownership level of twenty percent and applies only where the offer is made to a person or company in Ontario.[108] Both Acts exempt purchases made through a recognized stock exchange.[109] In this regard, it should be noted that the TSE regulates take-over bids in much the same manner as do both the CBCA and the OSA.[110] While the CBCA exempts offers made to fewer than fifteen shareholders,[111] "street sweeps" are effectively prohibited because any purchase of more than five percent of the outstanding shares of a class of shares within any twelve month period falls within the take-over bid provisions of both the OSA[112] and TSE.[113]

The regulatory regimes provide a period of at least twenty-one days within which shareholders may deposit shares pursuant to a take-over

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103. *See* Subsection III.1.i, *supra*, at p. 161.
104. A "tender offer" in terms of the language used in the context of the *Williams Act*.
105. *E.g.*, *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, as am. (the "CBCA"), Part XVII (Take-over Bids), ss. 194-206. The CBCA is the model corporation law statute in Canada and all future references to Canadian corporation statute law shall refer to the CBCA.
106. *E.g.*, *Securities Act*, R.S.O. 1980, c. 466, as am. (the "OSA"), Part XIX (Take-over Bids and Issuer Bids), ss. 88-100e. Due to the existence of The Toronto Stock Exchange (the "TSE") within Ontario, the OSA is the prominent securities law statute in Canada and all future references to Canadian securities statute law shall refer to the OSA.
107. CBCA, 194.
108. OSA, subs. 88(1).
109. CBCA, 194; *Canada Business Corporations Regulations*, SOR/79-316, as am., para. 58 (c); OSA, para. 92(1)(a).
110. The General By-law of The Toronto Stock Exchange ("TSE B/L"), Part XXIII (Stock Exchange Take-Over Bids and Issuer Bids).
111. CBCA, s. 194.
112. OSA, para. 92(1)(b). However, note that the OSA will exempt private purchases made from five or fewer persons where the consideration paid does not exceed 115 percent of the market price of the shares purchased, pursuant to para. 92(1)(c).
113. TSE B/L, subs. 23.14.

bid.[114] These shares may be withdrawn at any time within twenty-one days of the date of the bid.[115] Where the offeror increases the consideration offered for the shares, such increased consideration must be paid to all tendering shareholders.[116] Where the bid is for less than all the shares of any class and more shares are deposited than the offeror is willing or bound to take up, shares must be taken by the offeror on a *pro rata* basis.[117] Finally, both the offeror[118] and the directors of the offeree corporation[119] must send to all shareholders of the offeree corporation to whom the take-over bid applies a circular that contains sufficient information and recommendations so that the shareholders may make an informed decision with respect to the tendering of their shares.

To this extent, the Canadian regulatory regime mirrors that put in place in the United States pursuant to the *Williams Act.* However, the Canadian regime goes further and regulates offeror conduct subsequent to a successful take-over bid to ensure that any subsequent appropriation of minority shareholdings is achieved only for fair value. The Ontario Securities Commission (the "OSC") has stated as its policy that:

> Unless [the controllers already hold ninety percent or more of the participating securities of the issuer], an issuer shall not carry out a going private transaction unless . . . the transaction obtains minority approval of each class of affected securities in accordance with the following provisions:
>
> (a) If the consideration to be received by a holder of an affected security of the particular class is, (i) payable wholly or partly other than in cash or a right to receive cash within thirty-five days after the approval of the going private transaction, or (ii) payable entirely in cash and is less in amount than the per security value or the mid-point of the range of per security values, arrived at by the valuation prepared in connection with the going private transaction, then the approval shall be given by two-thirds of the votes cast by the minority.
>
> (b) In cases other than those referred to in clause (a) above, the approval shall be given by a majority of the votes cast by the minority.[120]

A "going private transaction" is defined to mean:

> [A]n amalgamation, arrangement, consolidation or other transaction proposed to be carried out by an insider of an issuer as a consequence of which the interest of the holder of a participating security of the issuer in

114. CBCA, para. 197(c); OSA, s. 94.
115. CBCA, para. 197(a) (shares may be withdrawn at any time within 10 days of the date of the bid); OSA, 94.
116. CBCA, para. 197(d); OSA, subs. 96(3).
117. CBCA, para. 196(1)(c); OSA, 94.
118. CBCA, subs. 198(1); OSA, subs. 97(1).
119. CBCA, subs. 201(1); OSA, subs. 98(1).
120. O.S.C. Policies, Section 9.1, II.B.1.

> that security may be terminated without the consent of that holder and without the substitution therefor of an interest of equivalent value in a participating security of the issuer or of a successor to the business of that issuer or of another issuer that controls the issuer but does not include the acquisition of participatory securities pursuant to a statutory right of acquisition.[121]

The exemption from the definition of a "going private transaction" of "an acquisition of participatory securities pursuant to a statutory right of acquisition" ties in with the minority shareholder approval exemption where "controllers already hold ninety percent or more of the participating securities of the issuer" in that the offeror of a take-over bid in which ninety percent of the shares held by entities other than the offeror were acquired has a statutory right to acquire the remaining shares held by such entities.[122] Such entities may elect as consideration for their shares either the same consideration as was paid for shares acquired during the course of the take-over bid or the fair value of the shares to be fixed by a court.[123]

In addition to the protection afforded under section 9.1, II.B.1 of the OSC Policies, a minority shareholder subject to a second-step merger may also take advantage of both the appraisal[124] and oppression[125] remedies contained in the CBCA.

The appraisal remedy provides that where a corporation resolves to amalgamate with another corporation (*e.g.* a squeeze-out transaction),[126] a shareholder is entitled "to be paid by the corporation the fair value of the shares held by him . . . ."[127] Where the corporation and shareholder cannot agree as to what constitutes fair value, such a determination will be made by a court.[128] The oppression remedy provides that where the corporation's actions are either "oppressive or unfairly prejudicial" or "unfairly disregard" the interest of any shareholder, then the court "may make any interim or final order it thinks fit."[129]

It is clear that the Canadian regulatory regime effectively nullifies most, if not all, of the coercive take-over techniques employed in the United States. It is perhaps for this reason that securities regulators in this

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121. R.R.O. 1980, Reg. 910, as am. para. 164(1)(a).
122. CBCA, subs. 206(2).
123. CBCA, subs. 206(3)(c).
124. CBCA, s. 190.
125. CBCA, s. 241.
126. CBCA, para. 190(1)(c).
127. CBCA, subs. 190(3).
128. CBCA, subs. 190(15), (16).
129. CBCA, subs. 242(2), (3).

country have recently pronounced National Policy No. 38 relating to take-over bids and defensive tactics. Mr. Stanley Beck, in his role as chairman of the OSC, summed up the thrust of the Policy in this way:

> The Policy essentially takes the position that target directors have no role other than advising the shareholders as to their opinion with respect to the bid and seeking out alternative offers or higher bids. But it does not seek to prohibit defensive tactics completely, other than placing restrictions on those devices that deny to shareholders the opportunity to tender to the bid: Rather, it allows the use of tactics to encourage an auction market.[130]

Thus, the securities regulators of this country have made their position clear: It is shareholders who are to make the take-over decision. In this regard, it should be noted that the OSC will permit the adoption of poison pills only where such adoption has obtained or will obtain shareholder approval.[131,132] A similar view is also held by the TSE.[133]

It is equally clear that the OSC has available to it a wide range of discretionary remedies through which it may enforce its views. First, the Commission has the ability to prohibit the issuance of either the poison pill rights or the securities exchanged for those rights upon the triggering of the pill.[134] Second, even should the Commission not prohibit the issuance of the rights, it could nullify the effect of the issuance by requiring the filing of both a preliminary prospectus and a prospectus.[135,136] Finally, even should the rights plan go forward, the

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130. S. Beck and R. Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics", [1987] *Meredith Memorial Lectures* 119, at 131.
131. D. Westell, "OSC makes it clear it wants shareholders to approve poison pills", *The Globe and Mail*, February 9, 1989, at B14.
132. This is in line with National Policy No. 38, para. 3 which provides that while the administrators are concerned with company tactics that may abuse shareholder rights, "Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns."
133. J. McNish, "Shareholders to get say on Pegasus plan", *The Globe and Mail*, December 13, 1988, at B1.
134. Pursuant to TSE B/L, Part XIX (Listed Companies), s. 19.06, the TSE has the authority to reject notice of a proposed issuance of securities. The OSC's power to oversee such a decision is derived from OSA, para. 22(2)(c) which provides that "The Commission may, where it appears to it to be in the public interest, make any decision, with respect to any by-law, ruling, instructions, or regulation of any such stock exchange."
135. This, of course, first assumes that the issuance of the rights would constitute a "distribution" under the OSA. The prospectus exemption available for a rights issuance under OSA, subpara. 71(1)(h)(i) is available only where "the Commission has not informed the issuer in writing within ten days of the giving of the notice [of the conditions of the issuance] that it objects to the proposed trade."
136. If the poison pill was adopted in the face of an actual or imminent bid, time would be of the essence, and the delay caused by the requirement to file and receive receipts for both a preliminary prospectus and a prospectus would in all likelihood allow the take-over bid to reach the point of fruition before the rights plan could take effect.

Commission could at any time, in its discretion, order that all trading in the rights is to cease.[137]

The decision in *Re Canadian Tire Corp.*[138] serves as evidence of the judiciary's reluctance to interfere with the OSC's exercise of its discretionary remedies. In that case, the Commission issued a cease trading order to restrain take-over bid for forty-nine percent of the common shares of Canadian Tire Corporation ("CTC"). Although there had been no breach of the OSA, the regulations thereunder or of the policies of the Commission, the OSC found that the bid circumvented the operation of certain take-over bid protections that were applicable to the Class A non-voting shares of CTC and for that reason was in contravention of the public interest.[139]

The Ontario Divisional Court refused to interfere with the OSC's order, stating that:

> Out of respect for the expertise of the Commission, for the weight of the responsibility it bears, and for the stature it has achieved in the industry it is called upon to regulate, the Courts have repeatedly expressed the view that its actions should not lightly be interfered with.[140]

It is therefore clear that the securities regulators in this country have the ability to enforce their view that only shareholders are entitled to make the take-over decision. While securities regulation is to be preferred to judicial action in a take-over dispute given both the regulators' expertise and ability to respond quickly, it is suggested that, in maintaining their position, securities regulators are acting contrary to an interpretation of judicial precedent that it is, in fact, the directors who have the right to make the take-over decision in this country.[141] If subsequent case law should prove this interpretation to be correct, it is further suggested that any action on the part of the OSC to prevent the adoption or maintenance of a shareholder rights plan on the basis that it prevents shareholders from making the take-over decision is an improper exercise of its discretion.

2. *Corporate Law*

It is expected that shareholder rights plans will raise the same corporate law issues in Canada as they have raised in the United States. To this end,

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137. OSA, subs. 123(1) provides that "The Commission may, where in its opinion such action is in the public interest, order, subject to such terms and conditions as it may impose, that trading shall cease in respect of any securities for such a period as is specified in the order."
138. (1987), 35 B.L.R. 56 (O.S.C.); aff'd (1987) 35 B.L.R. 117 (Ont. Div. Ct.).
139. *Ibid.*, at 126.
140. *Ibid.*, at 131.
141. This is a point which is elaborated upon in *infra*, at pp. 190-192.

poison pills must prove first to be structurally valid, and second, to not result in the breach of fiduciary duties of those directors that choose to either adopt or maintain such plans. In addition, the adoption or maintenance of a poison pill must not effect a result that is oppressive to the adopting corporation's shareholders.

(i) *Discrimination*

A review of American authorities[142] revealed that courts in the United States are divided on the issue of whether shareholder rights plans are invalid due to the discrimination that is created among shareholders. The courts that have upheld poison pills have reasoned that state corporate legislation prohibits only discrimination among shares. Rights plans, they maintain, discriminate among shareholders and not among shares *per se.*

The starting point of an investigation into the probable Canadian position on this issue must begin with a consideration of the corporate legislation. Section 24 of the CBCA provides, in part, that:

> 24(3) — Where a corporation has only one class of shares, the rights of the holders thereof are equal in all respects . . .;
>
> 24(4) — The articles may provide for more than one class of shares and, if they so provide, (a) the rights, privileges, restrictions and conditions attaching to the shares of each class shall be set out therein . . .

Subsection 24(4) is very similar to provisions of both the Delaware[143] and New Jersey[144] corporate law statutes discussed in subsection III.2.i above in that it does not explicitly state whether discrimination among either shares or shareholders is permitted where there is more than one class of shares. Where there is but one class of shares, however, subsection 24(3) of the CBCA makes it perfectly clear that such discrimination is not permissible in stating that the "rights of the *holders*" of such shares are equal in all respects.

The effect of subsection 24(3) was considered in *Jacobsen* v. *United Canso Oil & Gas Ltd.*[145] In that case, the plaintiff shareholder challenged one of the defendant's corporate by-laws which stated that no person was entitled to vote more than one thousand shares of the defendant company notwithstanding the number of shares actually held. As the defendant corporation had but one class of shares, subsection 24(3) was applicable and the Court concluded that the by-law was invalid.

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142. See *supra,* at pp. 165-167.
143. *Supra,* note 45.
144. *Supra,* note 51.
145. (1980), 113 D.L.R. (3d) 427 (Alta. Q.B.).

The reasoning of the Court in *United Canso* led the drafters of Alberta's *Business Corporations Act* (the "ABCA"),[146] which is based on the CBCA, to incorporate an additional subsection into its section 24. Subsection 24(5) of the ABCA therefore provides that:

> 24(5) — Subject to section 27, if a corporation has more than one class of shares, the rights of the holders of the shares of any class are equal in all respects.

Section 27 of the ABCA permits different rights to attach to different series of shares within the same class.

The drafters of the ABCA gave the following reasons for the addition of subsection 24(5):

> Mr. Justice Forsyth's decision [in *United Canso*] however, insofar as it relates to the CBCA, is founded entirely upon CBCA s. 24(3) which applies only "if a corporation has only one class of shares". The judge did not expressly say so, but it appears that if the corporation before him had had more than one class of shares, his decision might have been different. In the present state of CBCA s. 24, it is easy to see why the judge might hold that view, as CBCA s. 24(4) which allows the articles to provide for more than one class, does not say that the shares of a class are equal. However, while the CBCA draws a distinction between a corporation having one class of shares and a corporation having more than one class, we do not think that that distinction is based upon any policy considerations. It appears to us that the relationship of United Canso's common shareholders among themselves should be the same whether or not the corporation had issued another class of shares. S. 25(5) of the draft Act would therefore apply to corporations having more than one class of shares the rule that the rights of the holders of the shares of a class are equal.[147]

If the drafters of the ABCA are correct, it would therefore appear that while discrimination among shares or shareholders in a corporation that has more than one class of shares would not be permissible for policy reasons, the actual wording of the CBCA may allow for this eventuality. Fortunately, the Ontario Court of Appeal has spoken directly to this issue.

In *Bowater Canadian Ltd.* v. *R. L. Crain Inc.*,[148] the plaintiff shareholder challenged the validity of a "step-down" provision which entitled the original holder of a share to ten votes per share but entitled any transferee to only one vote per share. As the defendant corporation

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146. S.A. 1981, c. B-15.

147. Institute of Law Research and Reform, *Proposals For a New Alberta Business Corporations Act*, Vol. 1: Report (August, 1980), at 75.

148. (1987), 62 O.R. (2d) 752 (C.A.).

had more than one class of shares, the interpretation of subsection 24(4) of the CBCA was called into question. The Ontario Court of Appeal agreed with the trial judge that

> although there was not express prohibition in the CBCA against a step-down provision, s. 24(4) of the Act should be interpreted in accordance with the general principles of corporation law with the result that the rights which are attached to a class of shares must be provided equally to all shares of that class, this interpretation being founded on the principle that rights, including votes, attach to the share and not to the shareholder.[149]

On this basis, the Court then explicitly adopted subsection 24(5) of the ABCA as expressing the "applicable principle of corporate law."[150]

On the basis of both the wording of subsection 24(5) of the ABCA and the above case law, it may be concluded that discrimination among either shares or shareholders of corporations having more than one class of shares is probably not permissible in Canada. However, this does not end the matter.

In seeking to uphold the validity of poison pills, it may first be argued that any possible discrimination among shareholders does not occur until an Acquiring Entity actually exists. That is, until the pill is triggered, no discrimination exists. Thus, *adoption* of poison pills would not be discriminatory; only the subsequent *maintenance* of pills would give rise to any such problem. The weakness in this argument may be seen by analogy to an argument that discrimination in dividend rights does not occur until a dividend is actually declared. Such an argument would obviously not succeed as such discrimination would be declared invalid at any time.

A more persuasive argument in favour of the validity of shareholder rights plans is that they do not discriminate among shareholders but among rightholders, and that the latter form of discrimination is permissible under the CBCA. Although it may be countered that the shareholder/rightholder distinction is not a valid one in the case of a poison pill given that the rights are initially issued to all shareholders and trade with and only with the shares until the pill is triggered, the fact still remains that any discrimination that may exist between shareholders exists in their rights *qua* rightholder, and not their rights *qua* shareholder.

The provision of the CBCA that governs the issuance of rights is section 29, which states, in part, that:

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149. *Ibid.*, at 754.
150. *Ibid.*, at 755.

> 29(1) — A corporation may issue certificates, warrants or other evidences of conversion privileges, options or rights to acquire securities of the corporation, and shall set out the conditions thereof (a) in the certificates, warrants or other evidences; or (b) in certificates evidencing the securities to which the conversion privileges, options or rights are attached.

Given that the CBCA does not prohibit discrimination among rightholders, it may be argued that such discrimination is permissible given that rightholder rights then become determinable solely under the contract between the issuer of the rights, the trustee for the rights plan and the holder of the rights.

A court may have an aversion to such an argument given that this simply allows a corporation to do indirectly what it cannot do directly.[151] A court may also accede to an argument that the fundamental principle of shareholder equality should be extended to encompass all security holders of a corporation (*i.e.,* as a matter of common law, there should exist right/rightholder equality). However, such reasoning could be further countered with an argument that there is a fundamental difference between the nature of a right and that of a share. A rightholder has not risked capital in the corporation and should, therefore, not be afforded a high degree of statutory protection. This protection should not be granted until the holder exercises his/her rights, makes a contribution of capital to the corporation and receives shares in return.

Regardless of the merits of any of the above arguments, it is suggested that the validity of shareholder rights plans should not be determined on such a technical basis. The underlying purpose of equality is to protect shareholder interests. It would be ironic indeed if, in the name of such protection, a defensive mechanism, one of whose primary purposes is to protect shareholder interests, was invalidated. It is suggested that the propriety of shareholder rights plans is better analysed under corporate law principles relating to the fiduciary duties of corporate directors.

(ii) *Oppression*

Subsection 241(2) of the CBCA provides that:

> If, . . . the court is satisfied that in respect of a corporation or any of its affiliates
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> (a) any act or omission of the corporation or any of its affiliates effects a result,
> (b) the business or affairs of the corporation or any of its affiliates are or have been carried on or conducted in a manner, or

151. G. Coleman, "Poison Pills in Canada" (1989), 15 C.B.L.J. 1, at 10.

> (c) the powers of the directors of the corporation or any of its affiliates are or have been exercised in a manner
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> that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director or officer, the court may make an order to rectify the matters complained of.

The oppression remedy could operate in two ways with respect to a shareholder rights plan.[152] First, it may be argued that a pill oppresses existing shareholders of the target corporation in that it discourages potential bids for their shares. Second, it may be argued that a pill oppresses an Acquiring Entity in that it discourages it from making a potential bid for the target corporation's shares and that, upon triggering of the pill, the Acquiring Entity's rights are voided with resulting punitive dilution to its interest in the target corporation.

With respect to the availability of an oppression remedy on behalf of existing shareholders of the target corporation, an argument may be made that no such remedy is available where there exists no Acquiring Entity in that there is no interest that is being presently oppressed.[153] The availability of an oppression remedy where an Acquiring Entity does exist will depend in large measure upon the court's view of the evidence relating to the propriety of poison pills. This is, of course, an issue of great debate and is well beyond the scope of this paper.

With respect to the availability of an oppression remedy on behalf of an Acquiring Entity, it may be argued that only its interests as a shareholder are protected and that therefore no remedy is available on the basis that it is discouraged from making a bid for the target corporation's shares. This reasoning was adopted by the court in *Stone* v. *Stonehurst Enterprises Ltd.*[154] In that case, shareholders of Stonehurst Enterprises Ltd. received two offers to purchase the assets of the corporation, one offer for $325,000 and a second offer from the minority shareholder for $330,000. The majority shareholder voted to accept the lesser offer. The minority shareholder applied to have the contract of sale set aside, claiming that the acceptance of the lesser offer was oppressive. In dismissing the application, Landry J. noted that:

> It must be remembered, and it is very important in this case, that it is only the interest of a shareholder *as such,* or of a director or officer *as such* that is protected by [the oppression remedy] section.

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152. *Ibid.,* at 9.
153. See, e.g., Michalak v. *Biotech Electronics Ltd.* (1986), 35 B.L.R. 1 (Que. Sup. Ct.); *Bank of Montreal* v. *Dome Petroleum Ltd.* (1987), 54 Alta. L.R. (2d) 289 (Q.B.).
154. (1987), 80 N.B.R. (2d) 290 (Q.B.).
155. *Ibid.,* at 305.

> The applicant must establish that his interest *as a shareholder* has been affected. He may of course have other interests, such as being a prospective purchaser of the assets of the company. But it is only the applicant's interest as a shareholder which we must be concerned with in applying [the oppression remedy section].[155]

This same reasoning supports an argument that no oppression remedy on behalf of an Acquiring Entity is available on the basis that, upon triggering of the pill, its rights are voided with resulting punitive dilution to its interest in the target corporation in that it is only the Acquiring Entity's interest as a rightholder that is thereby affected and a rightholder is not protected under section 241 of the CBCA.[156]

Regardless of an Acquiring Entity's entitlement to an oppression remedy on its own behalf, it may always attempt to bring an application for an oppression remedy on behalf of the existing shareholders of the target corporation.[157]

(iii) *Fiduciary Duties*

The common law has always provided that directors owe their corporations both a duty of care and a duty of loyalty. These duties have now been statutorily mandated under subsection 122(1) of the CBCA, which provides that

> 122(1) — Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would in comparable circumstances.

Although the degree to which these duties may dictate the ability of directors to either adopt or maintain a shareholder rights plan has never been tested in Canada, there is sufficient jurisprudence to provide a foundation for such an analysis.

(a) *Duty of Care*

Liability for a breach of duty of care has rarely been imposed upon directors at common law, primarily due to the lack of directoral

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156. CBCA, subs. 241 (2) protects "security holders." CBCA, subs. 2(1) defines a "security" to mean "a share of any class or series of shares or a debt obligation of a corporation and includes a certificate evidencing such a share or debt obligation." Therefore, a rightholder is not a "security holder."

157. The Acquiring Entity could argue that it is a "proper person" to bring an application for an oppression remedy on behalf of existing shareholders pursuant to the definition of "complainant" contained in CBCA, s. 238.

qualifying standards and the fact that, by the very nature of their office, directors are called upon to exercise judgement which is very difficult to objectively assess.[158]

While the statutory phrasing of the duty arguably raises the standard of care required of directors at common law,[159] it is suggested that, as in the United States, the duty of care imposes merely procedural checks on directoral conduct leading to either the adoption or maintenance of a shareholder rights plan and that all substantive hurdles in this context arise within the ambit of the directors' duty of loyalty.

(b) *Duty of Loyalty*

Most of the English and Canadian cases that consider the nature of directors' duty of loyalty have involved situations in which the directors of a target corporation have been issued shares in an attempt to deter or prevent a particular entity from gaining control of the corporation. From the early cases, two distinct tests evolved.

The first test focused on the subjective intent of the directors. As stated in *Re Smith & Fawcett Ltd.*,[160] directors "... must exercise their discretion *bona fide* in what they consider — not what a court may consider — to be in the best interests of the company, and not for any collateral purpose."[161] The second test focused on whether or not the actions of the directors were within the "proper purpose" for which their power to act was granted. Therefore, even where the directors acted in good faith with a view to the best interests of the corporation, a share issuance would be set aside where its primary purpose was to ensure control by the directors and not to raise additional capital for the corporation.[162]

Both of the above tests were considered in the seminal case of *Teck Corp.* v. *Millar.*[163] In that case, Afton Mines Ltd. ("Afton") owned a resource property which it desired to have developed by an outside entity. Teck Corporation Ltd. ("Teck") was interested in developing the property and acquired shares in Afton, sufficient in number to give it control. The directors of Afton determined that it was in the best interests of the corporation to have the property developed by Canex Exploration

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158. B. Welling, *Corporate Law in Canada: The Governing Principles* (Toronto: Butterworths, 1984), at 328-31.
159. Directoral conduct will now be measured against the actions that a "reasonably prudent person would exercise in comparable circumstances". *See supra*, at pp. 187.
160. [1942] Ch. 304.
161. *Ibid.*, at 306.
162. *Hogg* v. *Cramphorn Ltd.*, [1967] 1 Ch. 254.
163. [1973] 2 W.W.R. 385 (B.C.S.C.).

Inc. ("Canex") and thus proceeded to enter into a development contract with Canex, a term of which gave Canex an option to acquire thirty percent of Afton's voting shares. Such an acquisition would have destroyed Teck's majority and therefore have prevented it from acquiring the contract for itself. Action was brought against the directors of Afton, claiming, *inter alia*, that they had exercised their share issuance power for an improper purpose.

Writing for the Supreme Court of British Columbia, Berger J. first noted the inconsistency between the two tests outlined above:

> [I]f *Hogg* v. *Cramphorn* is right, directors may not allot shares to frustrate an attempt to obtain control of the company, even if they believe that it is in the best interests of the company to do so. This is inconsistent with the law as laid down in *Re Smith & Fawcett*.[164]

He then went on to reject the approach followed in the *Hogg* case and stated:

> I think the courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. . . . If there are not, that will justify a finding that the directors were actuated by an improper purpose.[165]

The Court concluded that the directors had reasonable grounds for believing that it was in the best interests of the corporation to have its property developed by Canex and that, therefore, the directors had not breached their fiduciary duty of loyalty to Afton.

The approach in *Teck* has been followed by both the Ontario High Court[166] and the Manitoba Court of Appeal.[167] However, the approach in *Hogg* continues to be followed in England,[168] and was also recently adopted by the Nova Scotia Supreme Court.[169] It is clear, therefore, that the issue has not been definitively resolved in this country.

It is suggested that the approach of Mr. Justice Berger in *Teck* is to be preferred to that followed in applying the "proper purpose" test.[170] First, it must be noted that the share issuance power under the CBCA is not a limited one.[171] Therefore, any judicial statement that directors issued

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164. *Ibid.*, at 410.
165. *Ibid.*, at 414.
166. *First City Financial Corp. Ltd.* v. *Genstar Corp.* (1981), 33 O.R. (2d) 631, at 646; *Re Olympia & York Enterprises Ltd. and Hiram Walker* (1986), 59 O.R. (2d) 254, at 270-73.
167. *Olson* v. *Phoenix Industrial Supply Ltd.* (1984), 26 B.L.R. 183.
168. *E.g., Howard Smith Ltd.* v. *Ampol Petroleum Ltd.*, [1974] 2 W.L.R. 689 (P.C.).
169. *Exco Corp.* v. *Nova Scotia Savings & Loan Co.* (1987), 35 B.L.R. 149.
170. *See* Baxter, *supra*, note 1, at 86-88; B. Welling, *supra*, note 158, at 341-51.
171. CBCA, subs. 25(1) states that "shares may be issued at such times and to such persons and for such consideration as the directors may determine."

shares for an "improper purpose" cannot be justified. It follows that the only restraint on the directors' power to issue shares is that they must act "honestly and in good faith with a view to the best interests of the corporation" in accordance with their fiduciary duty under paragraph 122(1)(a) of the CBCA. However, it is very difficult for a court to determine the subjective motive or intent behind directors' actions. The refinement added by *Teck* that the directors must have reasonable grounds for their belief removes this problem and places a tactical burden on the directors to show objective justification for their actions.

Note that the approach in *Teck,* when applied in a takeover context, is in basic accordance with the approach applied in the United States under the *Unocal* three-prong test.[172] Before *Teck,* it need only have been argued that the directors had acted in good faith, thus fulfilling but the first requirement of the *Unocal* test. It is suggested that the requirement in *Teck* that the directors must have reasonable grounds for their belief is essentially equivalent to the second and third requirements of the *Unocal* test that the directors show reasonable investigation and that any defensive measure they adopt must be reasonable in relation to the threat posed.

Another important aspect of the *Teck* case is the position adopted by Berger J. that in determining what is in the best interests of the corporation, directors are entitled to consider interests other than those of the shareholders. As he stated

> The classical theory is that the directors' duty is to the company. The company's shareholders are the company (Boyd C. in *Martin* v. *Gibson* (1907), 15 O.L.R. 623) and therefore no interests outside those of the shareholders can legitimately be considered by the directors. . . .
>
> A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders.[173]

To hold that directors are entitled to base their decisions upon consideration of interests in addition to those of shareholders is in accordance with the very wording of the directors' statutory duty itself. The CBCA makes it clear that the directors owe their duty to the

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172. See *supra,* at pp. 168-170.
173. *Supra,* note 163, at 412-13.

corporation.[174] It is a fundamental principle of corporate law that a corporation is an entity unto itself, distinct from its shareholders.[175] Therefore, when a corporation receives a take-over bid, the directors are under a duty to react to that bid in the best interests of the corporation itself, and not in the best interests of solely the shareholders.

This approach is consistent with that applied in the United States.[176] However, it must be noted that under the principles developed in that country, once it is determined that a company is to be sold, only shareholder concerns are to be considered.[177] To this extent, the American position is in accordance with that held by Canadian securities regulators as pronounced in National Policy No. 38.[178] However, it is suggested that such an approach should not be followed in Canada. No logical alteration of the directors' duties results simply because an "auction" for the company is underway. Interests of constituencies other than shareholders become no less worthy of protection.

If interests of constituencies other than shareholders are to be considered with respect to a take-over bid, it is only logical that it be the directors, and not the shareholders,[179] that should be responsible for making the take-over decision.[180] Such an approach also recognizes the duty imposed on directors by subsection 102(1) of the CBCA to "manage the business and affairs" of the corporation for which they act. As Berger J. stated in *Teck*

> When a company elects its board of directors and entrusts them with the power to manage the company, the directors are entitled to manage it.... [T]he shareholders have no right to alter the terms of the directors' mandate except by amendment of the articles or by replacing the directors themselves.[181]

Similar sentiments have also been recently expressed by the Delaware Court of Chancery in *Paramount Communications, Inc.* v. *Time, Inc.*[182]

> The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the

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174. CBCA, para. 122(1)(a) states that: "Every director . . . shall act honestly and in good faith with a view to the best interests of the *corporation*" (emphasis added).
175. *Salomon* v. *Salomon & Co., Ltd.,* [1897] A.C. 22 (H.L.).
176. See *supra* at pp. 173.
177. *Ibid.*
178. See *supra,* at pp. 180.
179. Shareholders do have the right to decide on issues involving a "fundamental change" to the corporation. *See,* CBCA, Part XV, "Fundamental Changes".
180. CBCA, subs. 102(1) provides that "Subject to any unanimous shareholder agreement, the directors shall manage the business and affairs of a corporation."
181. *Supra,* note 163, at 430.
182. *Fed. Sec. L. Rep.,* para. 94,514, at 93,264.

wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.[183, 184]

Not only should directors be entitled to make the take-over decision, but *obiter* in *First City Financial Corp.* v. *Genstar Corp.*[185] would appear to indicate they are obligated to so decide:

> The right and indeed the obligation of directors to take steps that they honestly believe are in the interests of the company and its shareholders in a take-over contest or in respect of a take-over bid, is perfectly clear and unchallenged.[186, 187]

Although directors may be permitted to make the take-over decision, it is important to note that shareholder interests do not thereby go unprotected. First, in discharging their statutory duty of loyalty under paragraph 122(1)(a) of the CBCA, the directors must often regard the shareholders as the most important of the corporation's constituencies that are to be considered. Where the interests of the shareholders are not properly considered, the directors may be held liable. Second, shareholders also have the right to apply for a remedy under subsection 241(1) of the CBCA where they consider that their interests have been oppressed, unfairly prejudiced or unfairly disregarded by the directors.[188] Finally, just as the citizens of a democracy have a right to replace their government where they feel that it has not adequately represented them, so may the shareholders of a corporation replace its directors.[189]

It is left now only to determine the propriety of either the adoption or maintenance of a shareholder rights plan by a corporation's directors in light of the above approach to analyzing their duty of loyalty. It was noted above[190] that in the United States judicial focus has shifted from an

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183. *Ibid.*, at 93,284.

184. Although the *Paramount Communications* case held that it was acceptable for the directors of a corporation to enter into a merger transaction, even though that merger was opposed by a majority of the corporation's shareholders, on the basis that the merger would, in the directors' opinion, result in a higher long term value of the corporation, comment was not passed upon the question of whether or not directors of a corporation may refuse to redeem poison pill rights where they, for whatever reason, conclude that a potential take-over bid is not in the best interests of the corporation.

185. (1981), 33 O.R. (2d) 631 (Ont. H.C.).

186. *Ibid.*, at 646.

187. *See also Smith* v. *Van Gorkam*, 488 A.2d 858, at 873 (Del. S.C. 1985) where Horsey J. stated that "In the merger context, a director may not abdicate that duty by leaving to the shareholder alone the decision to approve or disapprove the agreement."

188. *See* Subsection IV.2, *supra*, at pp.

189. CBCA, subs. 106(3) provides for the election of directors by the shareholders. CBCA, subs. 109(1) provides that "the shareholders of a corporation may by ordinary resolution at a special meeting remove any director or directors from office."

190. See *supra*, at pp. 185-187.

analysis of the adoption of poison pills to an analysis of the operation of poison pills. Such a shift should also occur in Canada, albeit for different reasons. The shift in the United States was premised on the grounds that coercive take-over techniques still abound and that it is therefore always reasonable for a board of directors to adopt a shareholder rights plan.[191] However, it was shown that Canadian laws nullify the deleterious effects of most, if not all, coercive take-over techniques.[192] The point remains, however, that in the context of a take-over there are constituencies other than the shareholders to consider and thus, it is always reasonable for a board of directors to put in place a mechanism that allows them to screen any potential take-over bid to determine if such a take-over would or would not be in the best interests of their corporation.

Where it is determined that no breach of duty arose upon the adoption of a shareholder rights plan, directors of Canadian corporations clearly remain under a duty to ensure that all decisions regarding the maintenance of a poison pill are made in good faith and on reasonable grounds, with a view to the best interests of the corporation. The only distinction to be made between the American approach and the suggested Canadian approach at this point is that the directors of Canadian corporations should continue to consider the interests of all constituencies of the corporation, and not just those of the shareholders.

V. *Conclusion*

The shareholder rights plan has evolved as one of the most effective mechanisms for preventing or deterring a take-over bid which directors view as not being in the best interests of their corporation. American precedent provides a solid foundation upon which a Canadian judicial and regulatory response to the adoption and maintenance of poison pills may be formed. However, due to differences in both the take-over environment and philosophical beliefs regarding market regulation, it is suggested that a truly Canadian position must be developed.

Canadian securities regulators have taken the same position as have both the American federal government and courts in stating that the take-over decision is to be made by the shareholders of the target corporation. Furthermore, it is clear that these regulators have the machinery at their disposal to enforce their view.

It is suggested that Canadian corporate law principles dictate that the take-over decision is to be made by the target's directors, acting in good

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191. *Ibid.*
192. See *supra*, at pp. 176-180.

faith and on reasonable grounds with a view to the best interests of the corporation. It is further suggested that in making such a decision, directors have an obligation to consider the interests of all constituencies of the corporation and not just those of the shareholders.

To the extent that the views of the Canadian securities regulators conflict with those of the judiciary in interpreting the above corporate law principles, it is suggested that the former must give way.