

# B·U·S·I·N·E·S·S & T·H·E L·A·W

*This monthly newsletter is intended to provide timely insights into and analyses of developments in the law and other matters which affect the conduct of business in Canada.*

Volume 6, Number 3

March, 1989

Pages 17-24

## "Poison Pills"—Shareholder Rights Plans

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### Introduction

The recent implementation by Inco of a shareholder rights plan or "poison pill" as a defence against a possible future hostile takeover bid represents the first time that this strategy, now adopted by more than 700 U.S. companies, has been employed in Canada.

### What Is a "Poison Pill?"

Shareholder rights plans or "poison pills" constitute the most significant recent development in takeover defence strategies. Under a shareholder rights plan, a corporation's board of directors issues certain rights to existing holders of common shares. These rights have the following key provisions: (i) a "flip-in" provision, (ii) a "flip-over" provision and (iii) a termination provision.

#### (i) *The "Flip-In" Provision*

The "flip-in" provision provides that, once an acquiror buys more than a specified percentage of the voting shares of the target corporation (e.g., 20% or more in the case of the Inco rights plan), holders of the rights (except the acquiror whose rights become void) become entitled to "flip-in" and purchase common shares of the target company having a market value of twice the exercise price of the rights. For example, if the exercise

price of the rights is \$100 and the voting shares of the target are trading at a market price of \$25 at the time of the acquisition, the holder of a right is entitled to purchase eight common shares for \$100, i.e., at a 50% discount. In more complicated plans, the "flip-in" is triggered by specified self-dealing transactions between the acquiror and the target. These could include a merger, transfer of assets in return for shares of the target, or purchase of assets from the target.

#### (ii) *The "Flip-Over" Provision*

The "flip-over" provision typically entitles the holder of the right to purchase the acquiror's common voting shares (or those of a merged entity) having a value equal to twice the exercise price of the rights. This is allowed in the event that the target corporation consolidates, or amalgamates with, or enters into an arrangement with the acquiror in which the target's shares are converted into or exchanged for other securities, cash, or other property.

The Inco "poison pill" also added as another triggering event any transaction in which Inco sells

#### In this Issue

"Poison Pills"—Shareholder Rights Plans <i>Albert J. Hudec</i> .....	17
Trade Secrets and Hazardous Materials <i>Doug Deeth</i> .....	19
Observations on the Merger Review Process under the <i>Competition Act</i> <i>Peter H.G. Franklyn</i> .....	21
Investment in Canada <i>Joel S. Schachter and Susan Zimmerman</i> .....	22
Termination of a Franchise—Trade Implications <i>T.B. Ashton</i> .....	24

# BUSINESS & LAW

ISSN 0825-4982

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Subscription Rate: \$165 per year

Published monthly



De Boo

**Richard De Boo Publishers**  
A Division of International Thomson Limited  
81 Curlew Drive, Don Mills, Ontario M3A 3P7  
Telephone (416) 445-4940 from Toronto  
1-800-387-0142 from Ontario and Quebec  
1-800-268-7625 from other provinces  
FAX (416) 445-5352

Letters to the editor are welcome. Correspondence should be sent to Business & The Law, c/o Editorial Department, at the above address.

assets aggregating more than 50% of either book value or fair market value, or generating more than 50% of the operating income or cash flow of the corporation.

### (iii) Termination Provisions

The third key element to a shareholder rights plan is a provision permitting the board of directors, prior to the occurrence of a "flip-in" event, to terminate the rights. The intent of this provision is to encourage a potential hostile acquiror to condition its bid on the redemption of the "poison pill" and to negotiate an acceptable bid with the board of directors of the target in return for its agreement to terminate the rights.

Some recent U.S. rights plans have also provided for termination of the rights by a simple majority vote of shareholders where the board of directors refuses to do so, and the potential acquiror is able to provide an acceptable fairness opinion respecting the adequacy of its offer. A plan recently proposed in Canada by Pegasus Gold Inc. permits termination of the rights by a 50% vote of share-

holders where an offer is made to all shareholders equally.

### The Purpose and Effect of Shareholder Rights Plans

"Poison pills" are not intended as an absolute bar to takeovers. They are meant to encourage an otherwise hostile acquiror to negotiate with the directors of the target company and to dissuade the acquiror from employing abusive takeover tactics. As one U.S. court has commented, shareholder rights plans provide "a shield to fend off coercive offers and a gavel to run an auction."

A shareholder rights plan will not deter acquirors from making an offer with the condition that the target board of directors redeem the rights. Nor will it prevent acquirors from soliciting proxies to remove the board and redeem the rights.

A recent study by Wachtell, Lipton, Rosen & Katz, a prominent firm of U.S. takeover attorneys, indicates that as of January, 1988, 60 companies with rights plans had been acquired or were parties to agreements to be acquired. This included 53 companies which were acquired after receiving an unsolicited bid, or after having a substantial percentage of its stock acquired by a party seeking control.

### Implementing a Shareholder Rights Plan

A corporation implementing a rights plan issues rights as a dividend to common shareholders. Each right permits the holder to purchase one share of common stock at any time during a set exercise period, usually 10 years. The exercise price is fixed at what the board, with the advice of its financial advisors, considers the approximate value of the stock will be at the end of the exercise period.

The rights trade with the issuer's common stock but are not exercisable until a purchaser acquires beneficial ownership of the specified threshold percentage of the corporation's stock or announces its intention to commence a takeover bid. When such an event occurs, the rights detach or are "unstapled" and become exercisable. Separate certificates for the rights are mailed to shareholders.

Shareholder approval of a rights plan is not required under corporate law but the Toronto Stock Exchange requires listed issuers to obtain shareholder approval of a plan prior to implementation. Recently, in the case of Pegasus Gold Inc., the

Exchange responded to a concern of the issuer that "well-financed investors with special interests, arbitrageurs and speculators" would buy shares before the vote to block the plan, and it agreed to disenfranchise shareholders buying 5% or more of the shares after announcement of the vote.

### **The Legality of Shareholder Rights Plans**

In the U.S., the legality of shareholder rights plans was upheld in 1985 by the Delaware Supreme Court. Subsequent judicial decisions have illustrated that the courts will generally defer to the business judgment of directors in implementing a well-drafted shareholder rights plan where the features of the plan are reasonable in relation to the threat posed by potential hostile bidders (i.e., where the plan is designed and used to protect shareholders against inadequate bids or abusive takeover tactics, and does not overreach by endeavouring to entrench existing management).

In some U.S. states, shareholder rights plans have been held invalid for the reason that acquiring shareholders who exceed a threshold shareholding face exclusion from the "flip-in" and "flip-over" provisions. This offends the corporate law requirement that all shares of a class must be treated as equal. In other jurisdictions, however, rights plans have been upheld under corporate law on the theory that the plan discriminates among shareholders as distinct from shares.

### **Guidelines for Directors**

Based on the extensive U.S. experience with shareholder rights plans, the following points should be kept in mind by Canadian directors considering implementation of a shareholder rights plan:

1. In determining whether or not to proceed with a shareholder rights plan, the board of directors should consult with the corporation's senior management, its financial advisors and its legal counsel. It should consider all relevant factors including the shareholder protection and share value enhancement likely to be derived from the plan, and its potential anti-takeover effects.
2. The proposed plan should be assessed by an independent committee of outside directors having access to their own financial and legal advisors.
3. Where a plan is being implemented in response to an actual hostile bid, and partic-

ularly where a recapitalization plan or a leveraged buyout proposal from management are the alternatives, the courts will be more diligent in scrutinizing the board's behaviour for possible conflicts of interest. In such circumstances, the implementation of the plan must be based on a reasonable belief that danger to corporate policy or potential injury to shareholders exists due to the hostile bid, and that the implementation of the "poison pill" is reasonable in relation to the threat posed by the hostile bid.

4. Where a hostile bid puts a target corporation in play, the board of directors has a duty to evaluate competing bids. It must encourage a fair and complete competitive auction process which will provide shareholders with superior economic value for their interests in the target corporation.
5. In deciding whether or not to terminate a rights plan so as to advantage a favoured bidder, the conduct of the directors will be subject to normal fiduciary standards. The decision to continue or abandon the takeover defence must be made in what the board believes to be the best interests of all shareholders.