



Shareholder Rights Plans

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On May 12, 2009, the Ontario Securities Commission rendered its decision regarding the shareholder rights plan of Neo Material Technologies Inc. The OSC's decision is an important addition to the law in Canada relating to the use of shareholder rights plans, or "poison pills."

Pala's Bid for Neo

On February 9, 2009, Pala Investments Holdings Limited announced its intention to purchase up to a maximum of 23 million Neo shares at a price of \$1.40 per share. The cash offer, which was not supported by Neo, was for approximately 21% of Neo's shares and, if successful, would have resulted in Pala owning approximately 41% of Neo's shares. The offer was a "permitted bid" under Neo's existing shareholder rights plan (the "Original Rights Plan") and as such did not trigger the issuance of rights to frustrate Pala's offer. Pala's offer was commenced on February 25.

On February 12, and in response to Pala's offer, Neo's board adopted a second shareholder rights plan (the "New Rights Plan"). The New Rights Plan was put in place to prevent a "creeping" take-over of Neo, a "permitted bid" under the New Rights Plan being only an offer to all of Neo's shareholders for all of their shares (in contrast to a "permitted bid" under the Original Rights Plan, which allowed a bid for less than all of Neo's shares). The New Rights Plan was intended to operate in addition to the Original Rights Plan.

On March 10, Neo's board announced its unanimous recommendation that Neo's shareholders reject Pala's offer, citing a number of reasons, including: (i) that the offer was financially inadequate (Neo's financial advisor giving an opinion to that effect); (ii) that the offer provided Pala with effective control of Neo

without paying an appropriate control premium; (iii) that the offer was coercive; (iv) the adverse effect on the liquidity of Neo's shares after the offer, if successful; (v) the risk of losing Neo's management if the offer was successful; (vi) its opportunistic timing; and (vii) that the offer was not a permitted bid under the New Rights Plan.

On April 21, Pala announced that it would amend its offer to (i) decrease the maximum number of Neo shares that could be taken up under the offer, from approximately 20% to approximately 9.25%, (ii) increase the offer price, and (iii) extend the expiry time of the offer to May 15. Pala made these amendments to its offer on April 27. If Pala's offer, as amended, was successful, Pala would own 29.9% of Neo's shares.

At Neo's annual and special meeting held on April 24, the New Rights Plan was approved by over 80% of the votes cast, excluding the votes cast by Pala. Shareholders representing more than 80% of the outstanding shares of Neo voted on the resolution to approve the New Rights Plan.

Pala applied to the OSC on April 15 to have the Original Rights Plan and the New Rights Plan cease traded, contending that it was in the public interest for Neo's shareholders to be able to have the opportunity to tender to Pala's offer.

The Arguments Presented to the OSC

In support of its application, Pala made the following arguments to the OSC:

- Canadian securities law, which permits partial bids, dictates that the ultimate decision to accept or reject an offer to acquire shares, such as Pala's offer, should be made by each individual shareholder and not by the directors or management of the target company. The continuation of the Original Rights Plan and the New Rights Plan would have the effect of denying Neo's shareholders one of their inherent rights of

ownership, to decide for themselves whether or not to tender to Pala's offer.

- In the circumstances, the Original Rights Plan and the New Rights Plan did not serve either of the central purposes of shareholder rights plans under Canadian securities law: to give a board more time to find an alternative value-enhancing transaction and to ensure the equal treatment of shareholders.
- The Pala offer was not coercive nor part of a strategy to effect a creeping take-over of Neo. Pala had offered to enter into a standstill agreement to the effect that it would not increase its ownership of Neo beyond 40% of Neo's shares for 12 months following the completion of its offer, subject to certain qualifications.
- The Original Rights Plan and New Rights Plan served no purpose other than to create an impediment to bids. As such, they were contrary to the best interests of Neo's shareholders and against the public interest.

In opposing Pala's application, Neo made the following arguments to the OSC:

- The issue of whether a tactical pill should stay is a decision of the shareholders of a company. Companies are governed by shareholder democracy and through the exercise of that democracy, shareholders have the ability to implement a rights plan designed to prevent a creeping or coercive bid.
- In exercising their fiduciary duties, the business judgment of Neo's board and management was that the time was not right to run an auction or allow control of Neo to be acquired by any one shareholder.
- Neo's shareholders "just said no" to Pala; they ratified the business judgment of Neo's board and management and, with full knowledge of Pala's bid, sanctioned the New Rights Plan.
- There was no public interest basis for the OSC to override the informed decision of Neo's shareholders, and to do so would

offend well established principles of corporate governance and securities regulation.

OSC staff made these submissions regarding Pala's application:

- The OSC recognizes that defensive tactics such as shareholder rights plans can, in appropriate circumstances, be adopted for legitimate purposes, such as obtaining a better bid.
- The evidence suggested that the Neo board had exercised its fiduciary duty in adopting the New Rights Plan. The majority of Neo's shareholders accepted that the purpose of the New Rights Plan was legitimate, and accepted the New Rights Plan.
- Canadian securities law does not support the conclusion that directors cannot restrict the ability of shareholders to exercise their fundamental right to dispose of shares as they see fit. Rights plans do this and they are not prohibited by Canadian securities law.
- Cases involving rights plans support the conclusion that there comes a time when a rights plan must go. The benchmark for determining when that time comes has generally been when the rights plan no longer serves its purpose. The New Rights Plan continued to serve its purpose in accordance with the will of the substantial majority of Neo's shareholders.
- The approval of Neo's shareholders of the New Rights Plan was significant; it was the ratification of a defensive tactic aimed specifically at Pala's offer.
- The informed decision by the overwhelming majority of Neo's shareholders to approve a defensive tactic directed specifically at Pala's offer should allay any concerns the OSC might have about the New Rights Plan being abusive of the rights of Neo's shareholders.

The OSC's Decision

The OSC issued its decision on May 11, refusing the relief sought by Pala and stating that it was not satisfied that granting Pala's request to cease trade the New Rights Plan was in the public interest. In coming to its decision, the OSC said it was influenced by these considerations:

- The New Rights Plan was adopted by Neo's board in the context of, and in response to Pala's offer.
- There was no evidence that the process undertaken by Neo's board to evaluate and respond to Pala's offer, including the decision to implement the New Rights Plan, was not carried out in what the Neo board determined to be the best interests of Neo and its shareholders, as a whole.
- An overwhelming majority of Neo's shareholders (excluding Pala) approved the New Rights Plan while Pala's offer remained outstanding.
- The evidence supported a finding that Neo's shareholders were sufficiently informed about the New Rights Plan prior to casting their votes.
- There was no evidence to suggest that management or Neo's board coerced or unduly pressured Neo's shareholders to approve the New Rights Plan.

More detailed reasons for the OSC's decision will be released at a later date.

Implications of the OSC's Decision

Shareholder rights plans have been justified on the basis that they provide targets with time to pursue alternatives to an unsolicited offer. Canadian securities regulators have held that at the time the plan no longer serves a legitimate interest, the "pill must go". This time has generally been held to be when the target has exhausted the realistic possibility of obtaining alternatives to the unsolicited offer.

In the face of Pala's offer, Neo did not attempt to seek alternatives for the company. Rather, it told

its shareholders that it believed that the best course of action was to carry on with its business plan. It then proceeded to receive the endorsement of its shareholders for this strategy through ratification of the New Rights Plan. To remain in effect, the New Rights Plan must be ratified again by Neo's shareholders next year.

Canadian securities regulators have consistently said that each contested rights plan situation must be dealt with on its particular facts. Nonetheless, a new trend may be emerging. In *Re Pulse Data* (2007), the Alberta Securities Commission did not cease trade a shareholder rights plan which was adopted in the face of an unsolicited offer and approved by its shareholders during the course of the offer. The offer was for all of the shares of the target. The Neo decision seems to apply that precedent to partial offers as well. It was thought that boards in Canada, unlike those in the United States, did not have the "just say no" defense available to them. It may be that with the assistance of approving shareholders, Canadian boards may now have a new potential course of action when faced with an unsolicited take-over bid.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.

If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.

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