Takeover Bid Defenses in the Province of Quehec

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INTRODUCTION

The takeover bid is a method of obtaining control of a corporation.[1] The corporation, partnership or individual making the bid solicits the shares of the corporation to be acquired, generally by means of advertisements in newspapers and through letters to share-

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[1] The Quebec *Securities Act*, R.S.Q. 1964, c.274 as am. by S.Q. 1967, c.82; S.Q. 1967, c.17; S.Q. 1971, c.77; S.Q. 1973, c.67; S.Q. 1974, c.70 defines a takeover bid as:

> ". . . an offer, other than an exempt offer, made to shareholders the last address of any of whom as shown on the books of the offeree company is in the province of Quebec, to purchase such number of voting shares of a company that, together with the offeror's presently owned shares, will in the aggregate exceed twenty per cent of the outstanding voting shares of the company." (s.113(g)).

I therefore use the term "control" not only to indicate absolute control by holding fifty percent plus one of the voting rights, but also *de facto* control resulting from the wide dispersion of the remaining shares among the other shareholders of the company. Although it is possible that a holder of 20% of the voting shares of a corporation will not have *de facto* control, in most publicly-owned corporations such a result is unlikely. The *Canada Corporations Act*, R.S.C. 1970, c.C-32 as am. by R.S.C. 1970, c.10 (1st Supp.); S.C. 1970-71-72; c.43 and c.63; S.C. 1972, c.17 defines a takeover bid as one where the offeror's ownership of the offeree company's shares is increased to over ten percent. Moreover, the offer need only be in respect of 'equity' shares and not necessarily 'voting' shares; (s.135.1). The *Canada Business Corporations Act*, S.C. 1974-75, c.33 substantially enlarges the definition in material respects but refers to voting shares and other securities giving the right to acquire such shares; (s.187).

For a treatment of the subject from the point of view of the law of the United States, the reader may wish to consult the following articles: J. E. Mullaney, *Guarding Against Takeovers — Defensive Charter Provisions* (1970) 25 The Business Lawyer 1441; M. M. Greenfield, *Regulation of Contested Cash Tender Offers* (1968) 46 Texas L.R. 915; E. C. Schmults and E. J. Kelly, *Cash Take-Over Bids — Defense Tactics* (1968) 23 The Business Lawyer 115; V. Brudney, *A Note on Chilling Tender Solicitations* (1967) 21 Rutgers L.R. 609; C. J. Barnhill, *The Corporate Raider: Contesting Proxy Solicitations and Take Over Offers* (1965) 20 The Business Lawyer 763.

holders, often enlisting the aid of stockbrokers to help publicize the offer and solicit tenders. The advertisements or letters state that the offeror wishes to purchase a specified number of shares at a stated price[2] and request shareholders who wish to accept the offer to tender their stock by sending their endorsed certificates to a named depository by a given date. Normally, the offer is conditional on a certain number of shares being tendered and the offeror will reserve the right to withdraw the offer if the required minimum tender is not achieved.[3] It is also common for the offeror to reserve the right to purchase more than the stated minimum number of shares if it so desires. The offer is usually priced substantially above the current market price of the offeree company's shares to induce shareholders to tender their stock. Most successful bids have offered shareholders premiums of a minimum of 30% to 40% above the pre-bid market price. If the specified minimum number are tendered, the offeror takes up the shares and sends the shareholders their payment.[4]

The advantages of a takeover bid over other acquisition techniques are its speed and relatively low cost. Mergers require lengthy negotiations between the parties; proxy solicitation campaigns usually endure many months and are rarely successful. On the other hand, voting control by means of a takeover bid can generally be achieved within a few weeks. Moreover, the takeover bid method provides a great tactical advantage in terms of the element of surprise, making it an effective weapon against a complacent incumbent management likely to oppose the bid. In comparison to the proxy contest, the costs of a takeover bid are relatively low. The offeror need not pay for any shares until those needed for control are actually tendered, whereas a proxy fight entails the slow accumulation of shares in the open market and a costly and lengthy solicitation campaign.

The causes which may precipitate a takeover bid are numerous. Companies with low earnings, low dividends and consequently a low market price for their shares are typical targets for a takeover

2 The offeror may offer either cash or other securities in exchange for the shares. This article, however, will focus on cash takeover bids.

3 The Quebec *Securities Act*, *supra*, note 1, s.114 prohibits any condition being attached to the offer other than a right of withdrawal should the minimum tender not be achieved or should the board of directors of the offeree company materially alter the undertakings, assets or capital of the offeree company subsequent to the date of the offer.

4 Under the Quebec *Securities Act*, *ibid.*, s.118(d), if more shares are deposited than the offeror is bound or willing to take up, they must be taken up on a pro rata basis.

attempt, as are companies which are excessively liquid or which have a substantial amount of undervalued assets. Causes which may be unrelated to the quality of the target company's management are the desire by the offeror to diversify vertically or horizontally by acquiring a going concern, or merely the desire by a well-financed group to acquire a business.

Most writers on the subject are in general agreement that the takeover bid fulfills important economic functions.[5] To the extent that business diversifications achieved by a tender offer are profitable, the takeover bid is a beneficial tool from an economic standpoint. As a means of transfering control of a corporation, it tends to promote efficiency in the employment of corporate assets, and to increase management's accountability to shareholders. Managements are induced to employ assets efficiently to reduce the chances of a takeover attempt and to retain the shareholder loyalty that is necessary to defeat a potential takeover. An unsuccessful bid will likewise promote managerial efficiency in order to avoid a second challenge.

In view of these benefits, the legislative approach adopted by most securities laws has been to require full disclosure of all relevant facts to enable shareholders to make rational decisions, without unduly inhibiting the use of the takeover bid as a corporate acquisition tool. It is for this reason that takeover bid circulars and directors' circulars need not be submitted to regulatory commissions for prior approval since this could alert the management of the offeree company to the bid and destroy the element of surprise necessary for a successful tender offer. Thus takeover bid legislation achieves a compromise between the need to protect shareholders and the need to retain the viability of the takeover bid technique. To achieve this goal the legislators have carefully circumscribed the conduct and regulated the disclosures of offerors. However, the conduct of the management and board of directors of the offeree company has not been statutorily regulated. It is only if the board of directors chooses to *recommend* acceptance or rejection of the offer that full disclosure is required on their part.[6] Moreover, the tactics used by incumbent management to defend against the bid are not regulated *per se*. Certain conduct may be prohibited by the common law; other tactics may be illegal under the relevant securities or company laws. Many defense tactics are, however, legal. To the extent that the latter are utilized by management in order to

[5] See *e.g.*, V. Brudney, *supra*, note 1.
[6] *Securities Act, supra*, note 1, s.129.

challenge a takeover bid to the detriment of the company or the shareholders' proprietary interest in their shares, the appropriate legislation should circumscribe their use. Such regulation of otherwise legal manoeuvres when used to the detriment of shareholders in a takeover bid situation would significantly improve the protection provided by our securities laws.

It is the object of this article to discuss some of the defense tactics available to management, to determine the legality of these manoeuvres under the common law and relevant statutes and, where appropriate, to outline the policy considerations which should govern their regulation. The article will focus on the *Securities Act*[7] and the *Companies Act*[8] of Quebec, and the federal *Canada Corporations Act*[9] and the *Canada Business Corporations Act.*[10]

DEFENSE TACTICS

The incumbent management's defense weapons may be conveniently categorized into anticipatory defense tactics and remedial defense tactics. Tactics of the anticipatory type are generally designed to make the offeree company less attractive to a potential offeror. Remedial tactics on the other hand are usually employed after the announcement of the bid, to impede the offeror's acquisition of control.

Managements which are alerted to a takeover attempt prior to its announcement gain a strong tactical advantage by neutralizing the element of surprise. It is therefore important for management to adopt anticipatory measures which should include the development of a defense plan in advance, regular scrutiny of the trading activity in the company's stock (unusually heavy volume may indicate that an offeror is beginning to take a position in the stock) as well as periodic reviews of the company's share register to determine if large holdings are being accumulated.

A. Anticipatory tactics: Making the offeree company less attractive

1. *Improving poor performance*

Management should attempt to correct any characteristic which may render the company vulnerable to a takeover attempt. Professors

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[7] *Supra,* note 1.
[8] R.S.Q. 1964, c.271 as am. by S.Q. 1965, c.72; S.Q. 1968, c.72; S.Q. 1969, c.26; S.Q. 1972, c.61; S.Q. 1973, c.65.
[9] *Supra,* note 1.
[10] *Supra,* note 1.

Hayes and Taussig have concluded that "the typical subject company has exhibited disappointing operating performance, paid decreasing dividends and is excessively liquid".[11] These characteristics will normally result in a depressed market valuation of the company's shares. On the other hand, a depressed share price may be the result of poor communications between management and investors and a public relations program may therefore be an effective tool.

2. *Changing accounting methods*

Management may alter accounting practices to affect operating performance and asset book values while nevertheless conforming to generally accepted accounting principles. For example, during inflationary periods the FIFO method of inventory valuation will result in greater accounting profits than the LIFO method.[12] Over-conservative accounting methods may make a corporation more vulnerable to a successful takeover by understating profits and asset values. A high ratio of tender-offer-price to book value per share will make the bidder's offer seem more attractive to shareholders than if shareholders were better informed of the real value of the company's assets. For example, a shareholder of a real estate company would be less likely to tender his shares at $100 even if book value per share were $70, if he were aware that the assets of the company were appraised at $250 per share.

Management should note however that frequently changing and overly liberal accounting practices may tend to erode investor confidence in the veracity and capabilities of the incumbent management, resulting in the very thing they are trying to avoid — a depressed market value for the company's stock. The tactic may at times therefore turn out to be counter-productive and the best course of action may be for management to adopt other means of informing shareholders of the intrinsic value of their investment.

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[11] S. Hayes and R. Taussig, *Tactics of Cash Take-Over Bids* (1967) 45 Harv. Bus.Rev. 135.

[12] The FIFO method of inventory valuation proceeds on the assumption that the first units received into inventory are the first to be sold, and that the last units received are still in inventory at the end of the accounting period. Thus, during a period of rising prices, it is the cost of earlier and therefore cheaper units which will be deducted from sales to determine income. The LIFO method assumes that units are sold in reverse order of receipt into inventory. Thus, during an inflationary period, it is the cost of later and therefore more expensive units which are deducted in the process of income determination. See M. Gordon and G. Shillinglaw, *Accounting: A Management Approach* (1969), 358 *et seq.*

3. *Restrictive contracts*

Another tactic designed to make the corporation unattractive to an offeror is to negotiate new or amend existing contracts to provide for penalties, acceleration or renegotiation in the event that control is acquired by outside interests. Such clauses could be inserted in loan agreements, supply contracts, collective bargaining agreements and leases. Alternatively, management could enlist the aid of suppliers, institutional lenders, labour leaders and landlords to inform the offeror that they do not favor the change in control and that their relationship with the target company or perhaps with the offeror (if such relationship exists with the latter) would be reappraised should the bid succeed. Where the continued success of the target company is dependent upon continuous, reliable and amicable relationships with suppliers, lenders, labour or lessors, such tactics could deter the offeror. However, if the offeror is able to renegotiate the target company's contracts, for example refinancing its loans on favourable terms, the tactic will be unsuccessful.

The ethics of such contractual restrictions are certainly dubious. Most would view such action as an attempt by incumbent management to preserve their offices and perquisites at the expense of the interests of the company and its shareholders. In addition, the legality of such action is questionable. At common law[13] as well as under section 117(1)(a) of the *Canada Business Corporations Act*,[14] it is the duty of directors to act honestly and in good faith with a view to the best interests of the corporation. However, if the parties to the contract honestly believe that a takeover would be harmful to the company, there can be legal justification for such amendments. Furthermore, where the restrictive covenant is included in the contract at the request of the other party, for example the lender — the loan being entered into in reliance on the integrity and expertise of the company's present management — there may be no legal grounds for complaint since the clause ostensibly has a legitimate business purpose and is apparently being imposed upon the company's management. However, if the restrictive provision is incorporated into the agreement at the request of the target's management, such an arrangement may be viewed as an attempt by incumbent management to perpetuate itself in control. Unless management can prove that they honestly and reasonably believed that

[13] *Regal (Hastings) Ltd* v. *Gulliver* [1942] 1 All E.R. 378 (H.L.); *Zwicker* v. *Stanbury* [1953] 2 S.C.R. 438; *Canadian Aero Service* v. *O'Malley* [1974] S.C.R. 592, 40 D.L.R. (3d) 371.

[14] *Supra*, note 1.

the takeover would be harmful to the offeree company, the officers and directors would be subject to liability for damages if, for example, the company's loan is called. The inclusion of such a restrictive provision would then be clearly inconsistent with the duty of directors and officers to avoid conflicts of duty and self-interest and to act in the best interests of their company.[15] The action in damages would belong to the company although a derivative action by a shareholder (even by the offeror if it owns shares at the time the loan is called) is available if the company refuses to sue.[16]

4. *Restrictive charter and by-law provisions*

Companies which are particularly prone to takeovers because of depressed stock market conditions or because they possess the characteristics mentioned above, may alter their charter or by-laws to obstruct an offeror's ability to gain control of their operations. The mere possibility of such delays may discourage a potential offeror.

A tactic which is used frequently in the United States is to amend the by-laws to increase the number of shares required to call a special meeting of shareholders, for example to 80%.[17] This tactic is clearly illegal in Quebec. Section 96(1) of the Quebec *Companies Act*[18] and section 103(1) of the *Canada Corporations Act*[19] contain provisions empowering the holders of 10% of the voting shares to requisition a special general meeting. The *Canada Business Corporations Act* reduces the required percentage to five.[20] However, in spite of these provisions, the same result may be obtained by increasing the quorum necessary for shareholders' meetings, for

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[15] See *e.g., Zwicker* v. *Stanburry, supra,* note 13 and *Canadian Aero Service* v. *O'Malley, supra,* note 13. Although these cases deal with directors reaping private profits, the principle elicited is that directors' self-interest in patrimonial matters must be subordinated to the interests of their company. See also the *Canada Business Corporations Act, supra,* note 1, s.117(1)(a).

[16] The *Canada Business Corporations Act, ibid.,* s.234 provides for a derivative action for federal companies incorporated or continued under it. For companies provincially incorporated under the law of Quebec, and those incorporated under the *Canada Corporations Act, supra,* note 1 and not continued under the *Canada Business Corporations Act,* the availability of a derivative action is doubtful. However, in the case of *Legacé* v. *Legacé* [1966] C.S. 489, the Superior Court, under their superintending powers (art.33 C.C.P.), allowed a derivative action as a remedy to the abuse of rights by those who were in control of the company.

[17] J. E. Mullaney, *supra,* note 1, 1460.

[18] *Supra,* note 8.

[19] *Supra,* note 1.

[20] *Supra,* note 1, s.137(1).

example requiring 90% of the voting rights to be present. The board of directors may adopt such a "super-quorum" by-law without the prior approval of shareholders.[21] It will be effective from the date of the resolution of the board of directors and will cease to have effect, unless confirmed in the interim, at the next annual meeting of shareholders.[22] Thus the offeror shareholder may requisition a special general meeting but the super-quorum requirement could indefinitely prevent its occurrence. The provision could also prevent the annual meeting from being one at which business can be transacted.

Even if the super-quorum by-law is rejected by the shareholders at a valid special or annual meeting, or otherwise ceases to have effect, there is nothing to prevent the directors under the Quebec *Companies Act* and the *Canada Corporations Act* from reenacting it immediately and repeating the process. Such a by-law will cause an offeror substantial delay and may postpone indefinitely his ability to gain control of the company's operations.

However, the power of directors to enact a super-quorum by-law is circumscribed by the *Canada Business Corporations Act.* Under section 98(4), if the by-law is not submitted to shareholders, or is rejected by them, it ceases to be effective, and any reenactment of the by-law, or one that is substantially similar, will be ineffective until confirmed by the shareholders. Section 98(5) provides that shareholders may initiate the enactment or repeal of by-laws. Moreover, section 234 provides that a shareholder may apply to the court for an order to amend the articles or by-laws of the corporation on the grounds that the powers of the directors are being exercised oppressively or in a manner that unfairly disregards his interests. Thus under the *Canada Business Corporations Act* it is more difficult to postpone indefinitely the offeror's acquisition of operating control. However, these limitations do not really reduce the effectiveness of the super-quorum by-law as a defense tactic, since the substantial delay possible, for example to obtain a court order, may nevertheless deter an offeror.

It has been suggested that the directors' power to adopt by-laws which are effective prior to shareholder approval should be limited to those concerning the operation of the company's business affairs, and to require shareholder approval as a condition precedent to the

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[21] See the *Canada Corporations Act, supra,* note 1, s.94(e), the *Canada Business Corporations Act, supra,* note 1, s.98(1) and the Quebec *Companies Act, supra,* note 8, s.88(2)(e).

[22] See the Quebec *Companies Act, supra,* note 8, s.88(3) and the *Canada Corporations Act, supra,* note 1, s.95.

effectiveness of those affecting the position of shareholders *vis-à-vis* the company.[23] It is submitted that the Quebec *Securities Act* and *Canada Business Corporations Act* should specifically prohibit the enactment of a super-quorum by-law *after* a takeover bid is announced and should render inoperative a preexisting one during the currency of the bid, and for a certain time after the expiry of the offer. This would enable the offeror who has acquired voting control to gain operating control as well. The effect of the by-law is to deprive shareholders (including the offeror) of a voice in the conduct of their company's affairs and its enactment in most cases is clearly an abuse of the directors' powers.

Another anticipatory defense tactic is the amendment by the board of directors of the company's charter to create an issue of preferred shares having disproportionately large voting rights. The company may then make an acquisition of another company using the preferred shares, or otherwise place the shares in friendly hands thereby making it more difficult for an offeror to gain control of the company's operations.

The directors of the offeree company may also propose an amendment to the company's charter to limit the number of votes which may be exercised by any one shareholder or his associates. This tactic will certainly deter a potential offeror, since having obtained a majority of the shares he will not be able to exercise the voting power commensurate with his holdings. However, the adoption of restrictive voting provisions runs the risk of alienating institutional investors, thereby depressing the market price of the company's shares. Whether the courts would strike down the amendment as an oppression of the minority or as an abuse of rights or bad faith on the part of the directors is uncertain. As mentioned above, under section 234 of the *Canada Business Corporations Act*, a shareholder may apply to the court for an order to amend the articles if the directors are exercising their powers in an oppressive manner. However, more specific regulation of the use of this defense tactic in a takeover bid situation is necessary.

One of the most effective deterrents to a potential offeror is to amend the company's charter to provide for the staggering of the directors' terms of office. This is a tactic used frequently both in Canada and the United States. Only a portion of the board will stand for election in any given year and this can delay for several years an offeror's ability to elect a majority of the board even though he owns a majority of the shares. This tactic will be ineffective if the

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[23] P. Anisman, *Take Over Bid Legislation in Canada* (1974), 278-279.

relevant statutes or the company's charter provide for the removal of directors during their terms of office. The Quebec *Companies Act* and the *Canada Corporations Act* contain no such provisions. However, section 104(1) of the *Canada Business Corporations Act* does allow shareholders to remove a director prior to the expiry of his term.

B. Remedial tactics: Making acquisition of control more difficult

The measures described below are normally taken after the bid has been announced. They may be conveniently divided into two categories: tactics intended to induce shareholders not to tender their shares and those aimed at foiling the bid regardless of the shareholders' wishes. From a policy viewpoint the latter measures should be rigidly circumscribed by law since they constitute an undue interference in a matter which, in general terms, concerns the shareholders and outsiders. The gap between management and ownership may result in management taking measures to preserve their offices which are opposed to the will of shareholders and which operate to the detriment of their rights and proprietary interest in their shares. There is not so much need for regulation of the former situation since there, in the final analysis, the decision is left in the hands of the shareholders.

I. TACTICS TO INDUCE SHAREHOLDERS NOT TO TENDER

1. *Shareholder communications*

Perhaps the most typical, and often the most effective, means of thwarting a takeover is for management to launch an aggressive publicity and communications campaign aimed at dissuading shareholders from tendering shares by arousing uncertainty as to the adequacy of the tender-offer-price, and sometimes by appealing to loyalty and patriotism. The assault will include advertisements in the press and direct contact through letters, telegrams, telephone calls and the directors' circular.

The target company's statements will normally emphasize the past progress and future potential of the company under its present management. The specific nature of the company's response will be influenced by whether the offer is for cash or securities. Where the consideration is securities, the target may attack the intrinsic value of the securities, their potential for appreciation and their marketability, as well as the potential of the offeror's business and the adverse effects which the change of control may have on the target's business. Regardless of the form of consideration, management may allege: (i) the inadequacy of the consideration being offered in relation to book value or recent market values or to the future potential of the company; (ii) that brokers who are encouraging the shareholder to tender are being paid fees for their efforts; and (iii) the tax consequences of the transaction. Shareholders will also be informed of the defensive measures that the company is adopting and that management has decided not to tender any of its shares.

The Quebec *Securities Act* imposes certain time limitations regarding a tender offer. The Act provides that every takeover bid must remain open for a minimum of twenty-one days and shares deposited may be withdrawn until the expiration of seven days from the date of the offer. If the offeror varies the terms of the offer, the seven day withdrawal period is renewed.[24] Where the offer is for less than all voting shares, the offeror may not take up deposited shares until the expiration of twenty-one days from the date of the offer.[25] If the offer is for all voting shares, the offeror cannot take up any shares prior to the expiration of the initial seven-day period of the offer.[26]

The imposition of time requirements recognizes that a takeover bid gives rise to a need on the part of shareholders for information concerning their company and for time to assess the merits of the bid in the light of the company's prospects and their own financial circumstances. The requirements therefore serve the dual purpose of giving the directors of the target company time to analyze a bid and communicate with shareholders, and giving shareholders time to assess information provided by the offeror and their company's management, and so reach a reasoned decision.

The Quebec *Securities Act* imposes disclosure requirements on the offeree company's directors only if they choose to make a recommendation to shareholders regarding acceptance or rejection of the bid. Disclosure is made through a directors' circular containing prescribed information. Thus a defense plan by incumbent management will usually include the drawing up of such a circular as a necessary incident to a communications campaign. The Act requires that it be sent to shareholders "together" with the board's recommendation.[27] This requirement may therefore impliedly prohibit

[24] *Supra*, note 1, ss.115 and 116.

[25] *Ibid.*, s.118(a).

[26] *Ibid.*, s.115.

[27] *Ibid.*, s.129, and s.39 of the *Regulations under the Securities Act*, Reg. 73-417, 30 July 1973, O.C. 2745-73, 25 July 1973, 105(24) Q. Off. Gaz., Part II, 4425 (Aug.8, 1973) as am. by Reg. 73-550, 5 November 1973, O.C. 3963-73, 31 October 1973, 105(31) Q. Off. Gaz., Part II, 5813 (Nov.14, 1973) and Reg. 74-172,

oral recommendations, although this interpretation is not free from doubt.[28]

The directors may be exposed to possible liability as a result of the nature and content of the statements made in the directors' circular. It is an offense under the Quebec *Securities Act* to knowingly send out a directors' circular if it contains or omits any material information that makes the circular false or misleading.[29] The directors will have the burden of proving that they did not know, and in the exercise of reasonable care could not have known, about the untruth of the information or the fact of the serious omissions.[30] If they fail to do so, they will be subject to the penalties prescribed by section 84 of the Act.

The incumbent management of the target company, by undertaking any facet of a communications campaign, incurs the risk of liability for false representation both under statute and under the Civil Law. The *Securities Act* defines as "a fraudulent act" any intentionally false misrepresentation of a material fact or its deliberate non-disclosure, as well as unreasonable assertions made in bad faith respecting the future of the company and deliberately false declarations in a directors' circular.[31] These fraudulent misrepresentations are punishable under the *Securities Act* unless they entail criminal liability,[32] in which case the provisions of the *Criminal Code* concerning fraud and false pretenses will apply.[33] Article 1053 of the Civil Code will impose liability in damages on directors for negligent misstatements causing damage to shareholders. In addition, section 94 of the Quebec *Securities Act* provides that directors may forfeit their offices if they are guilty of misconduct or seriously remiss in the performance of their obligations under the Act, or resort to practices tending to depreciate the value of the company's shares.

As can be seen from the foregoing, a communications campaign, although an effective tool, may impose liability on the directors. They should therefore take care not to exaggerate the company's prospects or make other statements which could expose them to legal action.

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3 April 1974, O.C. 1260-74, 3 April 1974, 106(9) Q. Off. Gaz., Part II, 1609 (Apr.24, 1974).

[28] P. Anisman, *supra*, note 23, 243.

[29] *Supra*, note 1, s.137(b).

[30] *Ibid.*, s.138.

[31] *Ibid.*, s.35(a), (b) and (h).

[32] *Ibid.*, s.84.

[33] R.S.C. 1970, c.C-34, ss.319, 320 and 338.

2. *Dividend increases*

A common defensive response to a takeover bid is to discourage shareholders from tendering their stock by increasing the dividend rate or declaring an extra dividend. The desired effect is two-fold: firstly, to give shareholders greater confidence in the intrinsic and potential value of their shares, thereby influencing them not to tender; and secondly, to drive up the price of the company's shares by increasing the dividend yield, and so reduce the tender-offer premium, making the offer less attractive. In addition, an extra dividend will decrease excess liquidity which may be important in discouraging an offeror, since the target company's liquidity may be one of its reasons for attempting a takeover. If the dividend rate is increased, it may provide some assurance that after the expiration of the offer the market price of the company's shares will remain near the level to which the announcement of the tender-offer-price has caused it to rise. However, if earnings do not keep pace with the dividend increase and an eventual reduction in the dividend is required, management's credibility will be damaged and investor confidence seriously eroded. The price of the company's shares may decline significantly, especially if financial institutions dispose of their holdings.

Furthermore, a dividend payment presupposes sufficient retained earnings to cover it. If directors declare and pay a dividend that impairs the capital of the company, they will be jointly and severally liable to the company for the amount of the dividend.[34] A change in dividend policy may also have unacceptable consequences for the company's financial resources; liquidity may be impaired (although not to the point of insolvency), thereby damaging its creditworthiness with suppliers and lenders; profitable investment projects may have to be foregone or delayed. The company's loan agreements will probably contain dividend payment restrictions in the form of working capital and/or earnings tests which must be met before specified payments can be made. The payment of a dividend in breach of these tests amounts to a default and will result in the loans being called. Thus directors may find themselves in breach of their duty of care and skill to the company and of their duty to act in the best interests of the company,[35] exposing themselves to an

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[34] *Canada Business Corporations Act, supra,* note 1, s.113(2)(c); *Canada Corporations Act, supra,* note 1, s.85(5); *Companies Act, supra,* note 8, s.91; this last Act renders the directors liable to shareholders as well.

[35] The directors' duty of care and skill under the common law is illustrated by the leading cases of *In re National Bank of Wales* [1899] 2 Ch. 629 and *In re City Equitable Fire Insurance Co.* [1925] Ch. 407. See also *Canada*

action in damages by the company or to a derivative action by shareholders.[36]

3. *Stock splits or stock dividends*

A mere pro rata increase in the number of shares owned by each shareholder might be expected to have little effect on the outcome of a takeover bid. However, this tactic capitalizes on the peculiarities of investor psychology; many investors view such declarations as extra dividends. The target company may benefit from the confusion created in the minds of shareholders as to the price they will receive should they decide to tender their stock. When the tender-offer-price is adjusted to account for the increase in shares outstanding, the premium offered may appear less attractive since it will naturally be fewer dollars per share. The ability of management to declare a stock dividend will, however, depend on the corporation having sufficient authorized but unissued common stock. The use of this tactic does, of course, raise some ethical questions.

4. *Proposed rights offering*

Evaluation of the merits of the bid will be disrupted if management announces to shareholders that it plans to issue new equity first to stockholders of record at a certain date. The value of the rights will depend on subsequent negotiations and determinations and hence an additional element of uncertainty as to the value of the tender-offer is introduced. However, management should not make such an announcement unless it intends to make the distribution. A subsequent failure to issue the rights, without proper financial justification, could entail liability in damages to the company (for breach of duty of care), and to shareholders (for negligent or fraudulent misstatements).

5. *Repurchase of shares*

Purchases by a corporation of its own shares, if permitted, tend to increase the price of the stock, making the tender-offer-price less attractive, and to remove stock from shareholders who might have tendered their shares. A disadvantage is that such purchases reduce the amount of outstanding shares and therefore reduce the number needed by the offeror to achieve control.

Business Corporations Act, supra, note 1, s.117(1)(b) and the cases citcd *supra,* note 15.

[36] *Supra,* note 16.

The case of *Trevor* v. *Whitworth*[37] established the principle that a corporation may not deal in its own shares. However, section 32(1) of the *Canada Business Corporations Act*[38] allows a federally incorporated company to acquire shares issued by it provided that such purchases do not render the company insolvent or reduce the realizable value of its assets to an amount less than the sum of its liabilities and stated capital.

The illegality of common share repurchases by companies incorporated under the Quebec *Companies Act*[39] and the *Canada Corporations Act*[40] can be circumvented by having employee pension funds, management or other friendly parties make open market purchases of the company's shares. This not only achieves the same result but eliminates the need for the target company to use its own funds and increases the number of shares the offeror needs to acquire control, in contrast to the situation when repurchases are made by the company itself.

Large-scale open market purchases by the target corporation or third parties do create some legal problems. Such purchases may be held to be a fraudulent manipulation of the public market price of stocks, contrary to section 338(2) of the *Criminal Code*.[41] Manipulative repurchases may also be an offense under section 35(i) of the Quebec *Securities Act*. If the repurchases are undertaken by a stock broker,[42] the broker and/or its salesman[43] run the risk of losing their registration under section 25a of the *Securities Act* should the Commission conclude that it is manipulative, abusive or unethical, thereby impeaching the "integrity" of the registrant.[44] If the directors of the company authorize a repurchase program which is clearly not in the best interests of the company due to its financial position at the time, they may be in breach of their duty of skill and care and their fiduciary duties, and hence liable in damages.[45]

Notwithstanding the risk of liability, open market purchases by the company, its management or friendly third parties may foil the

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[37] (1887) 12 A.C. 409.
[38] *Supra,* note 1.
[39] *Supra,* note 8.
[40] *Supra,* note 1.
[41] *Supra,* note 33.
[42] As defined by the *Securities Act, supra,* note 1, s.1(4).
[43] As defined by the *Securities Act, ibid.,* s.1(12).
[44] *Regulations under the Securities Act, supra,* note 27, s.2(a) and the Commission des Valeurs Mobilières du Québec, *Policy Statement* no. 17, decision no. 2936, Aug.6, 1972 as revised, s.III-c and *Policy Statement* no. 21, decision no. 3785, Oct.1, 1973 as revised, arts.7.10.1.1 and 7.17.
[45] *Supra,* notes 15 and 35.

takeover bid. The market for the company's securities may be thin, and these purchases may drive up the price of its shares substantially (even above the tender-offer-price). Thus shareholders, although possibly deprived of the takeover bid premium, nevertheless have an opportunity to sell their shares in the market at a significantly higher price. Although one may be tempted, from a policy viewpoint, to advocate the prohibition of repurchase programs during the currency of a takeover bid, the best interests of shareholders may be better served by merely tightening disclosure requirements.[46] The *Securities Act* requires persons or companies who own shares carrying more than 10% of the voting rights of a corporation to report their interest within 10 days of the end of the month in which they become insiders.[47] In the context of a takeover attempt, this disclosure requirement is insufficient. The offeree company's shareholders should be able to make the decision as to whether to tender their stock with full knowledge of all the facts. A repurchase program by management is a relevant fact, not only because the object of the program is to thwart the bid, but also because its effect will be to increase the market price of the stock. Shareholders will not know why the stock's market price has risen until a 10% shareholding has been accumulated and the disclosure requirement is triggered. Moreover, it may be possible to increase significantly the price of the stock by purchases which fail to amount to a 10% shareholding. Thus disclosure requirements should be tightened to oblige management to report its intention of undertaking a repurchase program and the purpose of the program.[48] The disclosure should be made in the directors' circular or through any other means of direct written communication. This will give shareholders an opportunity to evaluate the alternative courses of action open to them: they may dispose of all their shares in the market at the repurchase-program induced higher price or they may tender their shares and receive (perhaps) an even higher price. The latter course of action runs the risk that the bid will fail or that if more shares are tendered than the offeror is obliged to acquire, the shareholder will have only a *pro rata* portion of his holdings taken up.

An alternative policy approach is to require that all repurchase programs undertaken during a takeover bid be authorized by a by-law which has no effect until it has received shareholder approval.

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[46] See P. Anisman, *supra*, note 23, 296.

[47] *Supra*, note 1, s.142.

[48] For an extensive discussion of this point see P. Anisman, *supra*, note 23, 296-299.

II. TACTICS TO PREVENT TAKEOVER REGARDLESS OF THE WILL OF SHAREHOLDERS

1. *Large-scale selling of offeror's shares by third parties*

Where a takeover attempt is made by means of an exchange offer, a decline in the market price of the offeror's securities will result in a corresponding reduction in the value of the exchange package offered to the target company's shareholders. If the extent of the decline is substantial and the offeror is unwilling to increase the consideration paid to offeree shareholders, the bid must inevitably fail. One possible but little used tactic therefore, is for the target company's management to bring about this situation by inducing friendly financial institutions to sell the offeror's shares, or by launching a detrimental rumor campaign regarding its business affairs. Needless to say, such manipulative trading practices are not only unethical in the extreme, but run the risk of criminal liability as well as liability in damages or for offenses under the relevant securities legislation.

2. *Taking legal action*

Legal proceedings, although rarely resorted to in Canada, may be an effective means of aborting a takeover attempt.[49] The result may be achieved by causing the offeror significant delays, by impressing upon it that a successful bid will require prohibitive legal expenses and protracted litigation or representations to regulatory bodies. Support for the offeror's bid in the eyes of its shareholders may be eroded as a result of the threat of such proceedings.

There are various ways in which this tactic may be employed. The target company may lodge a complaint with the Securities Commission under section 36 of the Quebec *Securities Act* alleging that an offense or fraudulent act has been committed, for example a failure to disclose a material fact in the offeror's takeover circular. The Commission may then launch an investigation. Management may persuade the Attorney General to intervene on its behalf in relator proceedings, to seek an injunction under the *Combines Investigation Act* on the grounds that a successful takeover bid will have anti-

[49] P. Anisman states that there is no recorded instance in Canada of defending directors resorting to the courts or to regulatory bodies to thwart a bid; *supra*, note 23, 286. However the tactic is used regularly in the United States. A recent example of an unsuccessful application by directors to the courts to stop a bid is the takeover of Texasgulf by the Canada Development Corp.

competitive consequences.[50] The target company may even go so far as to take over another company in order to create a situation whereby if the offeror's takeover attempt is successful, serious anticompetitive consequences will result. The use of this last tactic is rare since the time required to effect another takeover would normally be too long.

If the offeror is a foreign-controlled corporation, the takeover bid may fall under the provisions of the *Foreign Investment Review Act*[51] which require that the offeror give prior notice of the bid to the Foreign Investment Review Agency[52] and demonstrate that the acquisition of control will be of significant benefit to Canada.[53] The operation of the *Foreign Investment Review Act* in the province of Quebec gives the target company's management a number of opportunities to defend against a takeover bid. Management may, under certain circumstances, make representations to the Federal Minister of Trade and Commerce under sections 9(b) and 11(3) of the Act to the effect that the takeover will not be of significant benefit to Canada.[54] The Governor in Council may refuse to allow the takeover, and the Act does not provide for an appeal from his decision.

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[50] R.S.C. 1970, c.C-23 as am. by S.C. 1974-75, c.76. A relator action is an action brought by the Attorney General at the instance of some other person. It is really a form of procedure which will lead to a certain remedy, in this case an injunction. Where the Attorney General intervenes at the instance of a private citizen, questions of legal standing to seek the desired remedy cannot be entertained by the court since the Crown has the power (and perhaps the duty) to see that the law is obeyed. The Attorney General has the absolute discretion as to whether he will intervene; see H.W.R. Wade, *Administrative Law* 3d ed. (1971), 124. The target company itself has no standing to seek an injunction under the *Combines Investigation Act;* ss.29.1 and 30(2) provide only that the Attornies General may seek an interim injunction or an injunction to prevent a "merger" (as defined by s.2 of the Act). However, if the takeover will obviously have serious anticompetitive consequences, it is likely that the Attorney General will intervene in injunctive proceedings at the relation of the target company. S.31.1 of the Act further provides that any person who has suffered damage as a result of a merger may sue and recover from the offeror the amount of the loss suffered.

[51] S.C. 1973-74, c.46.

[52] *Ibid.*, s.8(1).

[53] *Ibid.*, s.9.

[54] Representations by the offeree company are possible only if the offeror has announced its intention to make the bid. Otherwise, the fact of the offeror's application will be kept secret unless the Minister finds it necessary to consult with the target company under the circumstances set out in s.11(3)(b) of the Act. In many cases, the Minister will seek representations from the parties. Thus the operation of the Act makes a surprise takeover bid unlikely and promotes agreement between the target and the foreign-controlled offeror.

Section 114 of the Quebec *Securities Act* prohibits conditional takeover bids, save for the two exceptions mentioned therein.[55] Hence an offeror cannot make a bid conditional upon approval being obtained from the Governor in Council under the terms of the *Foreign Investment Review Act*. Thus the offeror has two alternative courses of action. First, it may proceed with the takeover without obtaining prior approval. However, should the takeover subsequently be disallowed, the offeror will have to divest its holdings of the target's shares.[56] The divestiture may be at a lower price than the tender-offer-price and the expense and time invested in the bid will have been in vain. The offeror's management will be severely criticized by its shareholders. The second and most usual course of conduct is for the offeror to announce its intention to make a bid should it obtain the necessary approval. It then seeks the approval of the Governor in Council and subsequently launches its bid. This course of action clearly eliminates the element of surprise since the target's management will have many months to prepare a defense to the bid. In fact, the Act tends to discourage the making of a bid when the target's management is in opposition. Without the consent of management, it is unlikely that the offeror will be able to gather sufficient information concerning the offeree to convince the Minister that its acquisition of control will be of significant benefit to Canada. Thus the operation of the *Foreign Investment Review Act* in the province of Quebec gives the target company's management a significant tactical advantage and reduces the offeror's prospects of success in a contested takeover bid. It is submitted that section 114 of the Quebec *Securities Act* should be amended to permit takeover bids which are conditional upon obtaining approval from various regulatory bodies and government agencies.

It is also possible, although improbable, that where the target company initiates legal action, an irate stockholder of the offeror might bring a derivative action against the directors of the offeror challenging the takeover bid. The plaintiff could allege the defensive measures taken by the target's management and argue that these can only end in a long and expensive legal battle resulting in a waste of the company's assets, and other harmful consequences. This may succeed in alarming the offeror's board of directors sufficiently to prompt it to abandon the offer.

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[55] *Supra*, note 3.

[56] *Foreign Investment Review Act*, *supra*, note 51, s.20(2).

3. *Increasing outstanding stock*

The tactic of increasing outstanding shares has a threefold purpose: (i) to make it more difficult and expensive for the offeror to obtain tenders of sufficient shares to exercise control, particularly where the shares are placed with friendly third parties; (ii) to increase the offeror's risk by rendering the minimum number of shares which it is obligated to take up under the terms of its offer insufficient for the desired control; and (iii) to dilute any share interest the offeror may have acquired prior to the announcement of the offer. On the other hand, the tactic will tend to increase the company's liquidity and thus enhance its attraction as a takeover target. It should be noted moreover that the risk of achieving the desired effects will be greater if the company's charter provides for pre-emptive rights whereby shares to be issued must first be offered to shareholders already holding shares in the company.

Where the offeror makes its offer conditional upon the deposit of a minimum number of shares, section 118(c) of the Quebec *Securities Act* obliges it to purchase the designated minimum when an amount equal to it or greater has been tendered. However, an increase in the shares outstanding may mean that to the extent the minimum specified includes an insufficient safety factor, the offeror will not achieve control although it receives the specified number of shares. Thus a relatively slight increase in the number of shares outstanding could be disastrous. If the offeror decides to retain the shares purchased, it may be burdened with interest payment obligations incurred to finance the purchase without having obtained control. It is unlikely that the target company's dividend would be sufficient to cover these payments. If the offeror decides to sell the shares taken up to eliminate interest payments, it may have to sell at a substantial loss since the market price of the stock will usually decline after the termination of the tender offer. If the offeror is selling what amounts to control of a particular class of shares, it may have to file a prospectus under section 50 of the *Securities Act*, thereby incurring the legal, printing and perhaps underwriting expenses attendant on a public offer.

The objective of the target company's management is to increase the number of shares required for control as soon as possible. Thus management will employ transactions which do not require prior stockholder approval or prior registration under the Quebec *Securities Act*. Two techniques are usually employed — private placements of the target company's shares for cash and acquisitions of securities or assets of third party corporations in exchange for the target's shares.

Private placements of securities with financial institutions are exempted from registration under sections 20(g) and 52(a) of the Quebec *Securities Act.* Acquisitions in return for securities are exempt from the takeover provisions of the Act if the company acquired is a private company or if the acquisition is by way of private agreement with fewer than fifteen shareholders. Thus management may approach a control group of a large public company and effect an acquisition by issuing shares without having to comply with the takeover provisions of the Act (providing the control group consists of fewer than fifteen shareholders). Under the *Canada Corporations Act*[57] and the *Canada Business Corporations Act*[58] the directors may allot shares by resolution, without the need for shareholder approval. The Quebec *Companies Act*[59] allows directors to allot shares by a by-law which, though effective immediately, must be subsequently confirmed by shareholders.

Management must take care that the consideration received for the issuance and sale of additional shares is adequate. Par value shares may not be issued at a discount from par,[60] and when they are issued for a non-cash consideration, this must be at least equal to the par value of the shares.[61] No par value shares may be issued for such consideration in cash or in kind as may be fixed by the board of directors.[62] The directors will be jointly and severally liable for the shortfall of value between the non-cash consideration received for par value shares and the par value equivalent.[63] No similar liability is expressly imposed by the Quebec *Companies Act* and the *Canada Corporations Act* in respect of a non-cash consideration for no par value shares. However, section 113(1) of the *Canada Business Corporations Act* imposes liability on directors for the shortfall of value between the non-cash consideration and the cash equivalent

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[57] *Supra,* note 1, s.35.

[58] *Supra,* note 1, s.25(1).

[59] *Supra,* note 8, s.44.

[60] *Canada Corporations Act, supra,* note 1, s.101(1); *Companies Act, supra,* note 8, s.42.

[61] *Canada Corporations Act, ibid.; Companies Act, ibid.*

[62] The *Canada Corporations Act, ibid.,* ss.13(12) and 13(13), imposes on directors the duty to act in good faith and in the best interests of the company in fixing the consideration for no par value shares. Moreover, where the consideration is not cash, directors must in good faith determine that such consideration is the fair equivalent of the appropriate cash consideration. The *Companies Act, ibid.,* does not expressly impose such duties. Presumably, the directors' fiduciary duties are sufficient for the purpose.

[63] *Canada Corporations Act, ibid.,* s.101(2); the section applies to public companies only.

had the shares been issued for money on the date of the resolution of the board. In addition, if the directors issue shares (with or without par value), at a significant discount from their market value in order to defend against a takeover, the company will suffer damage and the directors may be in breach of their fiduciary duties and of their duty of care. Moreover, if they issue shares at a deep discount for the purpose of protecting their control position, the directors may not be acting in the best interests of the company nor in good faith. Thus they may be subject to a stockholder derivative action. The directors may be able successfully to defend against the suit in either situation by proving that they had a reasonable belief that harm would result to the company should the takeover bid succeed and that therefore they were acting in good faith and in the best interests of the company.[64]

The tactic of issuing shares to foil a bid should be severely circumscribed by law. The manoeuvre results in a dilution of capital and of the shareholders' voting power at the discretion of the directors (since no prior shareholder approval is required), usually for an improper purpose — to perpetuate the incumbent management in office. Moreover, the tactic may prevent a successful bid and hence deprive shareholders of the opportunity to consider the merits of the offer. The following amendments to the provincial and federal statute law could be considered: (i) prohibiting absolutely the issuance of shares during a takeover bid; or (ii) limiting the issuance of shares during a takeover bid to rights offerings (to present shareholders) or to distributions to the general public (*i.e.* no sales *en bloc*); or (iii) requiring that all share allotments during a takeover bid must be effected by a by-law which has no effect until approved by shareholders.

CONCLUSION

Takeover bid legislation should achieve a balance of interests. Present legislation attempts to balance the interest of the shareholder (providing him with information with which to evaluate the merits of a bid) with society's economic interest in retaining the takeover bid technique as a viable means of acquiring corporate control.

[64] See *Teck Corp.* v. *Millar* (1973) 33 D.L.R. (3d) 288. The British Columbia Supreme Court held that the directors of a company may use their power to issue new shares to prevent a majority shareholder from retaining control if they act in good faith in what they reasonably believe to be the best interests of the company. If their primary purpose is to act in the best interests of the company, the directors will be held to be acting in good faith even though they may personally benefit from the result.

Little legislative attention has been devoted to the balancing of competing interests when incumbent management attempts to prevent a successful bid by the variety of manoeuvres outlined above. Management's opposition may be motivated either by self-interest or the best interests of the company and its shareholders. At times, of course, the two interests may coincide. Research has revealed that the final offer-price in defended takeover bids reflects a considerably greater premium over the pre-bid market price of the target's shares than is the case for unopposed bids.[65] Hence defending against a takeover may not only be in the company's interest in certain instances, but may also directly serve the best interests of shareholders by increasing the ultimate takeover value of their property. The law must therefore delicately regulate the use of defense tactics in order to eliminate the abuses but retain the advantages which may accrue to the company and to shareholders from a defended bid.

In theory, the case law should serve as sufficient regulation since the relevant jurisprudence imposes on directors and senior officers the duty to act in the best interests of the company and to avoid conflicts of duty and self-interest.[66] However, in practice, jurisprudential regulation is insufficient. The party which alleges a breach of fiduciary duty has the burden of proving it. Moreover, incumbent management can normally hide its true motives by making a variety of allegations tending to show that its opposition is in the best interests of the company and its shareholders — for example, that the offer price is inadequate given the company's prospects or the goodwill built up by management. Management may even justify its opposition by alleging that it constitutes an attempt to induce the offeror to increase its offering price in order to ensure a successful bid. Thus some statutory intervention seems essential.

The tactics discussed are appropriate for all companies regardless of size, with the exception of negotiating restrictive covenants. It seems unlikely that a smaller company would have sufficient bargaining power with landlords, lenders or unions to effect this purpose. The time required to implement other tactics may limit management's ability to employ them. For example, the company cannot issue additional shares quickly by way of stock dividend or otherwise, if it has insufficient authorized but unissued capital stock. Thus the importance of devising and implementing a defense plan

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[65] M. A. Weinberg, *Weinberg on Take-overs and Mergers* (1971), para.2465.

[66] See *Canadian Aero Service* v. *O'Malley*, *supra*, note 13; see also *Canada Business Corporations Act*, *supra*, note 1, s.117(1)(a).

in advance becomes evident. The company, in order to succeed in preventing a successful bid, must be prepared with, for example, restrictive charter provisions and ample authorized capital well in advance of a takeover attempt.

The tactics most likely to succeed and at the same time the least likely to expose the directors to liability are those intended to make the target company less attractive to a potential offeror,[67] and a communications campaign by management. Both are susceptible to effective advance planning, and if a takeover is not attempted because the target has become unattractive, any potential legal issues are less likely to arise than if a takeover *is* attempted and the offeror is forced to abandon it because of tactics employed subsequent to its initiation.

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[67] With the possible exception of negotiating or amending contracts to provide for restrictive provisions.