HOSTILE TAKEOVER BIDS: DEFENSIVE STRATEGIES

RICHARD A. SHAW, Q.C.*

This article, after noting that many oil and gas companies are vulnerable to takeovers and that merger transactions are reaching record-breaking dollar volumes, examines and recommends steps that a corporation may take when facing a hostile takeover bid. These steps are defensive strategies that a chief executive officer, a board of directors, and other players should consider implementing when handling a merger. Recommended strategies for a corporation facing a takeover situation include creating a special committee, choosing appropriate financial and legal advisors, establishing a data room, and seeking other potential buyers. The author concludes that a successful defensive strategy can maximize value for a corporation's shareholders.

Après avoir noté la vulnérabilité de nombreuses sociétés pétrolières et gazières aux prises de contrôle et le fait que les opérations de regroupement atteignent des valeurs en dollars sans précédent, l'auteur examine et recommande les stratégies défensives qu'un directeur général, un conseil d'administration et d'autres acteurs peuvent envisager pour résister à une tentative d'achat hostile — création d'un comité spécial, recours à des conseillers financiers et juridiques compétents, mise en place d'une salle d'informations et recherche d'autres acheteurs possibles. L'auteur conclut qu'une stratégie défensive réussie peut s'avérer avantageuse pour les actionnaires d'une société menacée.

TABLE OF CONTENTS

* Partner, McCarthy Tétrault, Calgary, Alberta.

(1) In responding to a hostile takeover bid, it is the duty and the obligation of the board of directors of the target corporation to obtain the maximum possible value for its shareholders in the circumstances, and the board is entitled to implement appropriate strategies within reasonable bounds directed to that end.

(2) Ultimately, the shareholders have the right to choose between alternative transactions or courses of action which may be available to them to maximize the value. In the Canadian context, the board of a target corporation and its management may not resist and prevent a takeover bid at all costs. Said another way, the "just say no" defence, which is popular in the American takeover context, is not easily applied under Canadian corporate and securities law.

I. THE BATTLE BEGINS

The hostile bid will often begin with a phone call from the chief executive officer (CEO) of the bidder to the CEO of the target — late at night or perhaps first thing in the morning, shortly before the bidder issues a press release announcing the takeover. Another scenario is the unscheduled visit by representatives of the bidder and its financial advisors late on a Friday afternoon, perhaps before a long summer weekend or shortly before a Christmas break. They cheerfully announce to the CEO of the target that they have arrived to complete a friendly merger, and that they are prepared to negotiate the terms of that merger throughout the weekend and announce it on Monday morning before the stock markets open. This scenario is commonly known as a "bear hug." The battle has begun — and the term "battle" with all the images that warfare brings to mind is appropriate — for now the life of the target's CEO and board members will be filled with building defensive strategies, responding or reacting to offensive manoeuvres, launching counterattacks, and seeking alliances with white knights. Sometimes the "bear hug" works, but predictably most CEOs will reject such an approach as negotiating a takeover or merger on short notice will not allow the target adequate board time to assure that its shareholders receive fair and full value for their shares.

Target corporations may not be surprised by a hostile bid or by the identity of the hostile bidder. Where the target's financial results in the public marketplace are lagging behind its peers or its management is failing to increase the corporation's share price as compared to its peers, it may quickly be rumoured as a takeover target. Significant institutional shareholders may become restless with poor financial results and a low share price and may be receptive to the initiation of a hostile bid.[4] Potential suitors will often contact the target before launching a hostile bid with a view to coming to terms on a friendly transaction. Such approaches may result in efforts to negotiate a friendly transaction or may simply be rebuffed.

---

[4] Rigel Energy Corp. has reportedly put itself up for sale after pressure from institutional shareholders. See S. Chase, "Rigel CEO Recognizes Investor Impatience" *The Globe & Mail* (3 June 1999) B4.

III. INITIAL DEFENSIVE RESPONSE

The target's CEO will immediately take steps to advise his or her board of directors of the hostile bid and schedule a meeting of the directors, which will likely occur later that same day. Members of the takeover response team will be contacted. This team will consist of senior officers, financial advisors, legal counsel, and a public relations officer or firm. Contact will also be initiated with the target's bankers and its transfer agent. Prior to the directors' meeting, time permitting, a meeting of the response team will be convened, and tasks will be assigned as follows:

- Financial advisors will be specifically asked to review the adequacy and fairness of the bid from a financial point of view and to obtain details on the bidder and its track record, if any, in other bidding situations.

- Lawyers will be instructed to update the board of directors on the duties and responsibilities of the board in responding to the bid, the types of responses that may be considered, and the various legal issues to be faced by the board in fashioning a response to the bid.

- The public relations officer or firm will prepare and issue an initial press release to the market by the close of business on the day that the bid is received. It should contain a simple and clear message to the effect that the corporation has been notified of the bid, that it will be convening a meeting of its directors to consider the bid, and that shareholders should not tender to the bid until they have received more information from the target's board.

At the initial meeting of the target's board, one of the principal issues for determination is whether it is appropriate to establish a special committee of the board of directors, made up of directors who are independent of management, to oversee the board's response to the takeover bid. Because of the inherent self-interest of management directors and the need to be assured that decisions are made in the best interests of the corporation and its shareholders as a group, the independent committee of directors will provide strong evidence that decisions are not taken in self-interest. This is not required where the board has a large number of outside directors who are independent of management.[9] Senior officers, such as the CEO, should not be members of the special committee;[10] however, a senior representative of management, the CEO in nearly all instances, should always be available to the special committee for consultation. It is the author's practice to have senior management representatives present at most meetings of the special committee with such representatives absenting themselves from the deliberations of the committee on matters such as retention bonuses and severance arrangements that may create an inherent conflict for management representatives.

---

[9] *Re Olympia & York Enterprises* (1986), 59 O.R. (2d) 254 at 272 (H.C.J.), aff'd (1986), 59 O.R. (2d) 280 (Div. Ct.).

[10] *CW Shareholdings* v. *WIC Western International Communications* (1998), 39 O.R. (3d) 755 at 779 (Gen. Div.) [hereinafter *WIC I*].

(2) Have reasonable grounds for their actions - directors must have reasonable grounds on which to base their actions in responding to the bid (*i.e.*, they must meet their duty of care). Such grounds are established by satisfying the following tests (the "Unocal Test"):[11]

(a) in good faith, the board perceived a threat to the Corporation;
(b) the board acted after proper investigation; and
(c) the defence to the takeover is proportional to the threat posed;

(3) Obtain maximum value for shareholders - the directors should obtain the maximum value for shareholders under the circumstances; and

(4) Allow shareholders to make the final decision - the directors must allow shareholders to make the final decision as to whether or not to accept a particular bid or to make a choice between two or more competing bids or alternative transactions.[12]

American jurisprudence pertaining to mergers indicates that where a corporation is to be sold or merged with another corporation, the directors' responsibility is to obtain the maximum value reasonably obtainable for the shareholders of the Corporation and to do so by means of an auction (the "Revlon duty"[13]). In Canada, Farley J. of the Ontario Court of Justice has characterized the response of the target board as one of "objective prospective reasonability":

> It is reasonable that a target board not roll over and play dead. If it were completely passive, it would be soundly criticized for not doing anything to maximize the situation for the target organization. Whatever it does must be reasonable — although I would think the principle is objective prospective reasonability....[14]

What is "objective prospective reasonability"?

> If the board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.[15]

In Canada, the board is not required to conduct an auction in order to maximize shareholder value. It is merely one way to prevent conflicts of interest that may arise when there is change of control by requiring that directors act in a neutral manner

---

11 See *Unocal* v. *Mesa Petroleum*, 493 A.2d 946 (Del. Sup. Ct. 1985).
12 *National Policy 62-202, Take-Over Bids — Defensive Tactics* (1997) 20 O.S.C.B. 3525.
13 *Revlon* v. *McAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).
14 *Rogers Communications* v. *Maclean Hunter* (1994), 2 C.C.L.S. 233 at 245 (Ont. Gen. Div.) [hereinafter *Maclean Hunter*].
15 *Ibid.*

experience of the candidates, the extent of their prior involvement with the target corporation and their continuing interest in the target corporation, the need for a particular type of expertise, such as expertise in valuing heavy oil reserves, the likely location of potential white knights, and the fees to be paid. Where the target has a significant number of American investors, both a Canadian and an American financial advisor may be engaged. Following these interviews, the successful candidate or candidates will be chosen and an agreement detailing the services to be provided by the financial advisors and the fees to be paid will be settled and executed with the financial advisors. Typical services to be provided by the financial advisors are:

(1) undertaking, in consultation with management, a comprehensive analysis of the business, operations, financial condition, and prospects of the target and the bidder, and of any other potential purchaser or acquiror;

(2) reviewing with management the target's strategic plans and business alternatives;

(3) evaluating the hostile bid;

(4) advising the special committee and board of directors on the foregoing matters and reviewing any recommendations to shareholders concerning the hostile bid and other alternatives;

(5) furnishing an opinion with respect to the adequacy, from a financial point of view, of the consideration to be received by the target's shareholders under the hostile bid or otherwise;

(6) to the extent requested by the target, assisting it in developing and implementing strategic alternatives to the hostile bid, including the preparation and implementation of a marketing plan, the screening of prospective interested parties, and the coordination of data room access and potential purchaser's due diligence reviews;

(7) as required by the target, assisting in negotiating with the hostile bidder or other interested parties; and

(8) rendering an opinion as to the fairness from a financial point of view to the target and its shareholders of any consideration to be paid in connection with the hostile bid or an alternative transaction.

The financial advisors will advise the board as soon as is reasonably practicable on the fairness, from a financial point of view, of the hostile bid. This will entail the preparation by the financial advisors of value information concerning the target and, if shares are being offered in the bid, concerning the bidder. It will take the financial advisors a week to ten days to prepare this information for presentation in an organized manner to the special committee.

corporation following completion of the hostile bid.[19] The executive employment contracts are designed to adequately protect the senior executives in a constructive dismissal or firing after a change of control.

F. DETERMINING INITIAL COURSE OF ACTION

A critical decision must be made by the special committee early in its deliberations. Will it seek to sell the target corporation to the highest bidder, or will it determine to "just say no"? There are few takeover bids in Canada where, once a target is in play, it survives.[20] The directors may determine that continuing the long-term growth strategy of the target corporation is the way to maximize value for shareholders. Once the corporation is in play, the directors may lose the ability to convince the shareholders of this long-term value as shareholders may look for short-term, immediate gain. The shares will quickly fall into the hands of arbitrageurs whose principal interest is in making a quick profit and exiting the target corporation's stock. In the author's practice, he consistently advises special committees to initiate the process to seek a third party or so-called "white knight" to make a superior offer to that of the hostile bidder. Applicable securities laws allow a hostile bidder to complete its bid within a minimum of twenty-one days following the mailing of the bid.[21] Establishing a data room, initiating contact with potential white knights, arranging for the execution and delivery of confidentiality agreements before the white knights may enter the data room, following up on additional questions or concerns of these third parties, and obtaining a formal bid by potential white knights for the target corporation is an intensive and time-consuming process. If not begun very soon after the hostile bid is launched, the target's board may find itself without alternatives when the hostile bid reaches its expiry date. Beginning the process of seeking a transaction with a third party does not obligate the board to accept the highest, or any bid, that might be made by interested white knights. The target's board may still determine that the hostile bid, as well as any proposal by a white knight, is not in the best interests of the corporation, and it is entitled to "just say no" and refuse to accept the hostile bid or any other bid

---

19 This occurred following the completion by Luscar Coal Income Fund of its successful hostile bid for Manalta Coal Income Trust where Luscar launched a lawsuit against former directors and officers of Manalta Coal Limited to prevent them accessing severance payments under executive employment contracts. These had been put in place when the Manalta Coal Income fund was established more than eleven months earlier and retention bonuses were authorized by the Manalta Special Committee dealing with the response to the Luscar bid. See I. McKinnon, "Luscar sues Manalta executives of $18m in golden parachutes" *The Financial Post Daily* (25 September 1998) 1. A similar action was taken by Sunoma Energy Corp. against officers and directors of Barrington Petroleum Ltd. following Sunoma's successful hostile bid for Barrington. See S. Chase, "Sunoma launches suit over Barrington payouts. Seeking $3.75 million in damages" *The Globe & Mail* (25 January 1999) B3.

20 Some examples of survivors are: Loewen Group Inc.'s defence of the takeover bid made by Service Corp. International in the fall of 1996; Silcorp Limited's defence of the takeover bid made by Alimentation Couche-Tard Inc. in late 1996; Mark's Work Wearhouse Limited's defence of the takeover bid of Dylex Ltd. in 1997; and Argentina Gold Corp.'s defence of the takeover bid by Barrick Gold Corp. in late 1998 and early 1999.

21 *Securities Act*, S.A. 1981, c. S-6.1, s. 135(c) [hereinafter *Alberta Securities Act*]; *Securities Act*, R.S.O. 1990, c. S-5, s. 95(2) [hereinafter *Ontario Securities Act*].

disclosed, is a standstill provision preventing the interested party from taking steps to acquire shares or assets of the target without the consent of the board of directors of the target for a period of eighteen months to two years. The standstill will be the subject of much negotiation, and an issue for the target's board will be when the standstill should terminate. If a number of interested parties access the data room and the target signs a deal with one of them, should the remaining interested parties be released from the standstill to allow them to make their own bids with the intent of keeping the auction alive and increasing shareholder value? Or will a successful white knight prevent the target corporation from waiving the standstill provision in those circumstances?[23]

J. SPECIAL COMMITTEE FEES

Members of the special committee of directors formed to deal with a hostile bid cannot possibly anticipate, unless they have been involved in the process before, the amount of time and effort that must be committed to the process of defending a hostile bid. For the uninitiated, it is more time and effort than can possibly be imagined; it means meetings at all times of the day, every day of the week through holidays, birthdays, and anniversaries. It means long hours, expanded duties and responsibilities, and very likely a loss of a directorship when it is all over, regardless of whether the hostile bidder or the white knight is successful. In many cases, it means the loss of friendships and business connections that have been established and nurtured over many years. For this effort, special fees, over and above customary committee meeting fees, are appropriate for the members of the special committee. Depending upon the size of the target corporation and the complexities likely to be involved in the defence of the bid, special directors' fees in the range of $25,000 to $50,000 for each member of the special committee are warranted and justifiable, with the chairman being entitled to an amount greater than the other members of the special committee. It is the author's practice to initiate discussion of these fees at the very first meeting of the special committee and to have them in place at an early date. These fees are in addition to regular meeting fees that the directors will receive for attending minuted meetings of the special committee.

K. DIRECTORS' AND OFFICERS' INSURANCE

The special committee will initiate a review of the corporation's directors' and officers' ("D&O") insurance coverage to determine whether it is adequate and whether there are any provisions which may place the directors and officers at risk, either during the course of the bid or following its completion. One area of significant risk is a lawsuit by the target corporation against its former directors and officers at the instance of the successful hostile bidder following completion of the bid. D&O policy forms prevalent in Canada contain exclusions from coverage for lawsuits, other than derivative

---

[23] See R.R. Sorell & P. Kurtz, "Advising the Target in Canada" in *Mergers and Acquisitions Strategies for Creating Value and Growth* (Toronto: Insight, 1999) at 7-8 for a discussion of the enforceability of the standstill clause.

and in anticipation of, a bid by another income trust.[28] In that case, the court upheld the plan and ruled that where a plan is established *bona fide* and for proper business purposes, the dilution or voiding of rights feature of a rights plan did not offend any principle of trust law or any common law principle requiring equal and non-discriminatory treatment between and among unitholders.[29]

If the target does not have a shareholder rights plan, it is still useful to put one into place. This author strongly recommends to special committees that the target implement a rights plan even after the hostile bid has been made. While it may be more difficult to successfully defend the rights plan before a securities commission, it still remains the most potent defensive tool available to a target's board to gain time to respond to the hostile bid. Coincident with the adoption of the plan, counsel for the special committee will commence preparations of the defence to the inevitable securities commission or court hearing that will be brought by the hostile bidder to cease-trade the rights plan or have it declared invalid.

N. CONTACTING SHAREHOLDERS

The financial advisors and financial officers of the target will develop a list of its major shareholders and initiate contact with them to seek their views on the hostile bid and to determine whether they are likely to accept the hostile bid. This will assist the target in assessing the need to find a higher bid or in developing alternative defensive strategies. In making these contacts, the target and its advisors must take care not to selectively disclose to these shareholders material information that has not otherwise been disclosed to all shareholders.

O. TIMETABLE

Counsel should review with the special committee a typical response timetable to a hostile takeover bid. A sample of such a response timetable is found in Appendix "B." It assumes that the target has a shareholder rights plan in place that requires a permitted bid to be outstanding for sixty days and the hostile bid is to expire twenty-five days after it is made.

The action items listed above will be dealt with by the special committee over a period of days shortly after it has been established. Decisions on these matters should be taken in the first week following the announcement of the hostile bid. Further meetings of the special committee will then be called as required to deal with additional matters as they arise. Care must be taken to carefully document the matters considered and the decisions taken at the special committee and directors' meetings. This role is normally performed by a lawyer in the firm engaged by the special committee. Complete and lengthy minutes will help to establish that the directors have properly discharged their fiduciary duty and duty of care in responding to and dealing with the

---

[28] *PrimeWest Energy Trust* v. *Montreal Trust Company of Canada* (8 January 1999), Calgary 9801-17656 and 9801-17657 (Alta. Q.B.).

[29] *Ibid.* at 9.

bid and respond to questions and answers. Anyone with access to the toll-free number may participate and ask questions, including the hostile bidder and its advisors.

B. REVIEWING THE HOSTILE BID

While preparing the directors' circular in response to the hostile bid, financial advisors and counsel to the special committee will examine in detail the bid documents received from the hostile bidder to determine whether they are deficient in any respect or whether they reveal a breach by the bidder of any of the takeover bid rules. Results gleaned from this analysis may then form the basis for an application to securities commissions to cease trade or to otherwise delay the hostile bid, again with the objective of gaining additional time for the target to respond to the bid and to develop other value-maximizing transactions.

C. DEFENDING THE TARGET'S ACTIONS

Counsel for the target will prepare material to respond to potential attacks by the hostile bidder on actions taken by the special committee and the target's board of directors in responding to the hostile bid. Primarily, this preparation is directed at defending the shareholder rights plan but sometimes may extend to the payment of break-up fees or the granting of asset lock-ups to white knights. Preparations must be made for a hearing either before one or more securities commissions or before a court of law. The choice of forum will be in the hands of the hostile bidder. In the normal course, in order for a bidder to take up and pay for any shares tendered to its bid, it must ensure that an existing shareholder rights plan does not continue in effect. The bidder cannot risk acquiring ownership of the target's shares in excess of the threshold level for triggering the rights plan (typically 20 percent or more of the target's common shares) while the rights plan remains in place due to the "poison" that may be visited on the bidder. The poison is a massive dilution of the bidder's shareholdings due to the issue of the target's stock to shareholders other than the bidder at a 50 percent discount to the market price.

If the hostile bidder has not succeeded before a commission or a court to have the shareholder rights plan cease-traded or declared invalid and, upon the expiry of the hostile bid, the shareholder rights plan does continue in effect, the hostile bidder has no choice but to extend its bid for a minimum additional period of ten days. The target will await with great anticipation the choice made by the hostile bidder in seeking to dispense with the shareholder rights plan. That choice will ultimately determine the timing for the bid. In the recent bid by Alberta Energy Company Limited ("AEC") for Pacalta Resources Ltd. ("Pacalta"), Pacalta responded by implementing a tactical poison pill of thirty-five days' duration without shareholder approval. Relying on *Ivanhoe*, counsel for the bidder submitted that the tactical poison pill should be cease-traded. Staff of the OSC and the Alberta Securities Commission were of the view that AEC's application was premature and so advised AEC for the following reasons, among others:

advisors with a view to reaching an amicable merger. The bidder's objective is to avoid having to absorb a break-up fee to be paid to a white knight if the hostile bidder tops the bid of the white knight. The hostile bidder will want to have access to confidential data in the data room and to participate in any formal auction process that may be initiated by the target. Historically, in Canada, hostile bidders are kept at arm's length until the target has found a white knight and has entered into a pre-acquisition agreement or a business combination agreement with a white knight. Following that, the target may be willing to allow a hostile bidder access to its data room, subject to the signing of an appropriate confidentiality agreement. The bidder will balk at, and should refuse to sign, any standstill provision in the confidentiality agreement, while the target and its advisors will generally insist on the signing of such a clause. Advisors typically counsel a target's board against allowing the hostile bidder access to the data room until the transaction with the white knight has been inked, on the theory that, should word leak to potential white knights that the hostile bidder is being given access to the data room, there is a serious risk that they will withdraw from the process.

An example of a hostile bidder gaining access to the target's data room is the bid by Amoco Canada Petroleum Limited ("AMOCO") for Home Oil Company Limited ("Home Oil") in 1995. There, Amoco was denied access to Home Oil's data room until after potential white knights had had the opportunity to review the confidential documentation and Home Oil had entered into a business combination agreement with Anderson Exploration Ltd. Following such access, Amoco did not increase its bid. A more recent example is the bid by AEC for Pacalta where AEC was granted access to Pacalta's data room during the auction process and was allowed to submit a bid as part of that process. AEC and Pacalta subsequently entered into a pre-acquisition agreement on 20 April 1999, and AEC was successful in acquiring Pacalta.

In the author's view, the target's board and its advisors should maintain open communications with the bidder and its advisors. This is a difficult objective for advisors to the special committee to accomplish in the emotion of the battle. Ultimately, the board's duty is to maximize value for the shareholders. It is to be expected that most hostile bidders do not start with their "best price"; however, their best price may not be forthcoming following the signing by the target of a transaction with a white knight which incorporates a break-up fee and perhaps an asset lock-up in order to dissuade other parties from topping the bid of the white knight. By allowing the hostile bidder to be part of the auction process, the target can be assured that all interested players participate in the auction and that the maximum possible price will be obtained for shareholders.

VI. A CRITICAL CHOICE

After the initial volleys, the special committee may find itself with some breathing room. Control of the timetable is now the bidder's prerogative. It could launch a securities commission hearing or court action to remove the shareholder rights plan. Or it could extend the twenty-one day time period of the bid to approximately thirty-five

(2) What is the position of the target's major shareholders, particularly its institutional shareholders? Are they continuing to back the board of directors and management in resisting the bid, or is there an indication that they are seeking either to dispose of their shares or to tender a significant number of their shares to the hostile bid?

(3) What has been the market activity in the target's stock? Has a substantial amount of stock traded hands since the bid? If so, that may indicate that large blocks of stock are now held by arbitrageurs whose sole interest, after taking into account the time value of money, will be to recover their investment and who consequently will be more likely to tender to the hostile bid.

(4) Are the board and management able to make a credible case that continuing with the corporation's business plan and objectives is more likely to maximize value for shareholders, albeit over a longer period of time, than a short-term value-maximizing hostile takeover bid? Is the time horizon for creating that value so long that shareholders will not be prepared to wait? Even if the time horizon is not so long, will shareholders wait?

(5) Do the financial advisors and the target know what the shareholders are likely to do if no alternative transaction is presented to them? In many instances, major shareholders will be willing not to tender their shares at the time of the initial expiry of a hostile bid. As time passes, there will be significant pressure brought to bear on the target's board and its management to find an alternative higher value transaction or to reach an amicable agreement with the hostile bidder so that the shareholders do not suffer the inevitable drop in share price following a failed bid. Or, said another way, once the target is in play, it is very difficult not to complete a business combination transaction with some party.

Because of the limited time frame available to the target to mount an effective defence and to seek alternative transactions, it is the author's practice to recommend to special committees that they seek alternative value-maximizing transactions to the hostile bid. The most common of these alternatives is to conduct an auction of the corporation.[35] The financial advisors will have received an indication from interested parties that have visited the data room as to their continued interest in proceeding to an auction. Assuming there are several parties interested in bidding for the target, the special committee and the financial advisors will implement a formal bid process inviting bids from the remaining interested parties. An invitation for bids will be issued to the interested parties setting out a timetable for the submission of the bids, as well as the terms and conditions governing the bids. The initiation of the formal request for bids will normally be sanctioned by the full board of directors. Consideration will also need to be given to allowing the hostile bidder to participate in the bid process. If that is to occur, the hostile bidder will most likely wish to have access to the data room

---

[35] For discussion of other possible defences to a takeover bid see R.A. Shaw, Q.C., "Board Diligence During a Takeover (From the Target's Perspective)," *supra* note 3 at 51ff.

(3) where the break-up fee represents a reasonable commercial balance between its potential negative effect as an auction inhibitor and its potential positive effect as an auction stimulator.[38]

In that case, the court found a break-up fee of $30 million, representing approximately 2.6 percent of the market capitalization of the outstanding shares of the target, reasonable and, if anything, low in comparison to break-up fees common in the market place. Typical break-up fees are in the range of 2 percent to 4 percent of market capitalization.[39]

B. ASSET LOCK-UPS

An asset lock-up is an agreement made by the target corporation with the white knight or successful bidder in an auction process to sell or dispose of a valuable portion of the target's business at a typically favourable price aimed at inducing the white knight to complete a transaction with the target corporation or enticing the bidder to make or improve its bid. An asset lock-up is acceptable under Canadian law.[40]

Blair J., in the *WIC I* case, ruled that the granting of an asset lock-up may be a proper and acceptable measure for the target to adopt to stimulate bidding in the context of the entire transaction, including break-up fees, where "it strikes a reasonable commercial balance between its potential negative effect as an auction inhibitor depressing shareholder value and its potential positive effect as an auction stimulator enhancing shareholder value."[41] The factors to be taken into account in making this choice are:

(a) whether the process by which the directors of the target company exercised their obligation to maximize shareholder value complied with their duties as target-corporation directors;

(b) whether the overall commercial balance and proportion between the auction inhibiting and auction stimulating effect of such an agreement in the circumstances has been struck, *i.e.*, whether the agreement is likely to preclude further bidding, in the sense of harming or significantly dampening the auction process, and thus deprive the shareholders of potential additional value;

(c) whether the price for the optioned asset is within the range of reasonable value attributed to that asset, or whether it represents such a discount that it would result in a disproportionate erosion in the value of the corporation making it uneconomical for others to bid; and

---

38 *Supra* note 10 at 771.

39 For a critical view of break-up fees, see *Corporate Governance Review*, vol. 9, issue 2 (Toronto: Fairvest Securities Corp., Feb/March 1997) at 19.

40 *WIC I, supra* note 10 at 772.

41 *Ibid.*

(1) No-shop clause — This is an agreement by the board of directors and management to cease all efforts in respect of the sale of the target, to close any data rooms, and not to provide any further information to any third parties concerning the business and affairs of the target.

(2) Fiduciary-out clause — This is an exception to the no-shop clause which will allow the target's board of directors to respond to *bona fide* offers if, in the opinion of counsel, it is necessary for the directors to satisfy their fiduciary duties under applicable corporate legislation as expressed in the form of a written opinion from counsel or recorded in minutes of a meeting of the special committee or of the board of directors.

(3) Recommending the transaction — The target's board of directors will agree to unanimously recommend the transaction with the white knight to its shareholders, subject to the right of the target's board to withdraw its recommendation in order to satisfy its fiduciary obligations.

(4) Lock-up of directors and management — The successful bidder will require that directors and management of the target agree to tender their shares to the successful bidder, including shares to be received by them upon the exercise of in-the-money options, and to deliver a lock-up agreement recording their obligation to do so. An issue to be resolved in such agreements is whether it is a hard lock-up (where the shares may not be withdrawn to be submitted to a higher-value transaction) or a soft lock-up (the shares may be withdrawn to be submitted to a higher-value transaction with none or some of the increased consideration being received by the white knight).

(5) Expense reimbursement — The successful bidder may request reimbursement of certain of its expenses incurred in connection with the making of the bid. Certainly, if the directors withdraw their recommendation as a consequence of a higher offer being made by another party or if another party announces a bid at a higher price and the successful bidder's transaction does not proceed, the target will be required to reimburse the white knight for its expenses.

(6) Break-up fee — The business combination agreement will provide for a break-up fee to be payable in the event that the successful bidder's transaction is not completed due to the withdrawal of the directors' recommendation, another transaction being announced providing a higher value to the shareholders of the target, or the target commits a material breach of its obligations under the business combination agreement.

(7) Confidentiality agreements with third parties — The successful bidder will seek a covenant from the target to not release other parties who have signed confidentiality agreements with the bidder from the standstill clause contained in those agreements.

XI. THE END GAME

A target's directors and management are relieved where a friendly transaction can be completed with a white knight. A business combination agreement with the white knight will provide for the continuance of directors' and officers' insurance for the benefit of the former directors and officers of the target corporation and for a cooperative transfer of control of the target corporation's business and affairs to the white knight upon completion of the transaction.

Hostile bid situations do not all end in a fending-off of the hostile bidder by a transaction with a white knight or otherwise. The hostile bidder often wins — after a protracted battle and an increase in the price offered. Where the special committee and its advisors have been unable to obtain competing bids or the competing bids are not better than the hostile bid, another critical point will be reached in the bid process. The target and its advisors must give serious consideration to opening negotiations with the hostile bidder to have it increase its bid in return for the ongoing protection of the target's board and management and a cooperative transfer of control. The target will have less and less leverage to conduct a successful negotiation on these issues with the hostile bidder as time passes and the target is unable to announce an alternative transaction with a white knight or some other form of transaction that provides increased value to its shareholders. This is also part of the value in maintaining open communication with the bidder and its advisors. Maintaining these lines of communication will give the target's board and its advisors a better opportunity, in the author's view, to negotiate a truce with the successful hostile bidder that will protect management and directors of the target corporation from the risk of lawsuits following completion of the hostile bid.

XII. CONCLUSION

Takeover bids create headlines in the financial press and create a bonanza of fees for financial and legal advisors. A successful defence that maximizes value for the target's shareholders demands dedication and hard work under intense scrutiny and pressure by the target's board and management. This article will hopefully be a guide to those impressed with the obligation to mount that successful defence.

APPENDIX "B"

RESPONSE TIMETABLE

Day	Event	Response by Target	Action
T-10	Offeror will likely request list of shareholders from transfer agent of target	Convene takeover defence team meeting to discuss possibility of takeover Financial advisor begins to analyze value maximization alternatives	
T (day 0)	Offeror mails bid	Obtain copy of offer, circulate to all board members, legal counsel, and financial advisor Notify directors of special board meeting	Formulate public relations plan (first step is press release) Reserve space in national press Press release and material change report Press release to announce receipt of offer Financial advisor begins to analyze alternatives
T+1 (day 1)	Meeting of advisors and management	Consider preliminary response to offer, including applicability of pill, prepare for board presentation, establish schedule of board meetings	

Day	Event	Response by Target	Action
T+10	Mail directors' circular Issue press release	Press release to announce mailing of directors' circular and whether recommendation included	Press release regarding directors' circular
T+8 to T+17		Continue analysis by legal and financial advisors and board of offer, alternatives, and submissions to regulatory authorities Draft supplemental to directors' circular (to include recommendation of directors if not included in initial circular)	
T+17	Directors' meeting	Directors to consider recommendation and approve supplemental directors' circular	
T+18	Mail amendment to directors' circular	Press release to announce mailing of supplemental directors' circular and whether recommendation included	
T+18 to T+60	Continued pursuit of submissions to regulatory authorities	Directors to consider progress of value maximization alternatives Continued analysis of value maximization alternatives	Newspaper advertisements responding to offer
T+20	Offeror applies to OSC to cease-trade rights plan	Target commences preparation of defence for hearing	Target issues press release indicating it will defend rights plan
T+25	Offeror extends bid number of days needed to accommodate OSC hearing	Continued work by target on alternative transactions and preparation for OSC hearing.	
T+27 to T+39	OSC hearing convened		