CORRELATION BETWEEN BREAK FEE AND ASSET PURCHASE OPTION REGULATION IN CANADA AND ITS EMPIRICAL EFFECTS

by

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Abstract

This thesis focuses on break fee and asset purchase option regulation in Canada and the empirical effects of that regulatory regime. The structure of this thesis is divided into three broad sections. The first section of the thesis (Chapter 2) assesses the Canadian general corporate and securities law related to directors' duties imposed on target directors when implementing any defensive tactic. These general directors' duties affect the implementation of all defensive tactics and thus form a significant part of the regulatory scheme governing break fees and asset purchase options. The second section of this thesis (Chapter 3) considers the specific directors' duties applicable exclusively to break fees and asset purchase options. This second section then analyses the doctrine underlying the complete Canadian regulatory framework, governing break fees and asset purchase options. The third and final section of the thesis (Chapter 4) analyses the empirical economic effects created by the Canadian regulatory regime of directors' duties governing the use of break fees and asset purchase options. This analysis draws its empirical evidence on the effects of Canadian break fees, from a crucial study by P. Andr´e, S. Khalil and M. Magnan, (2007) *"Termination Fees in Mergers and Acquisitions"*.

Past research has focussed exclusively on describing the regulatory regime, or on providing substantive data on the effect of break fees and asset purchase options. The key novel element provided in this thesis is that it establishes a logical correlation between the regulatory framework of directors' duties imposed on the use of break fees and asset purchase options and the empirical effects of the regulatory framework. In this regard, I argue that the empirical effects of break fees and asset purchase options are strongly tied to the regime regulating its

implementation. Secondly, I argue that much of the "positive" empirical findings on the effects of break fees and asset purchase options correlate with the "broad director welfare function" approach to regulatory design (developed in Chapter 3). Finally, this thesis proposes limited changes to this regulatory regime governing break fees and asset purchase options while maintaining the "broad director welfare function" as the underlying doctrine.

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Chapter 1: Introduction

1.1 Topic of analysis

The transfer of ownership of a corporation is an event with broad and far-reaching implications not only for the shareholders but also for the corporate stakeholders. In this regard, defensive tactics such as break fees and asset purchase options stand at a unique intersection in corporate and securities law where the interests of target shareholders, bidder shareholders, and target management directly intersect. This intersection would have little economic behavioural relevance if all the parties involved had completely converging interests in the transaction; however, this is not the case.[1]

This thesis focusses specifically on two defensive tactics called break fees and asset purchase options. I selected these two contractual devices as the focus of this thesis as they are practically employed as the norm in current Canadian takeovers.[2] In this regard, the thesis will attempt to analyse the doctrine underlying the regulatory framework, governing the implementation of break fees and asset purchase options. Secondly, this thesis aims aim to establish a logical correlation between the before-mentioned regulatory framework and the empirical effects of break fees and asset purchase options. This analysis will be divided into three broad sections discussed below.

[1] L.A. Bebchuk and A. Cohen, "The cost of entrenched boards" (2005) 78 Journal of Financial Economics 409 at 409; M.R. Gillen, "Economic Efficiency and Takeover Bid Regulation" (1986) 24:4 Osgoode Hall Law Journal 921 at 921.
[2] P. Andr´e, S Khalil and M Magnan, "Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers" (2007) 34:3-4 Journal of Business Finance & Accounting 541 at 541-566.

1.2 Introduction to the regulatory regime governing break fees and asset purchase options

For structural purposes, this thesis divides the total regulatory framework governing the implementation of break fees and asset purchase options, into two broad segments. The first of these two segments consists of general directors' duties and rules applicable to the implementation of all defensive tactics. Although these general directors' duties and rules, apply universally to all defensive tactics, they also apply unaltered to the use of break fees and asset purchase options. As such, this general-segment forms a significant part of the total regulatory framework governing break fees and asset purchase options.[3] This general-segment is examined in Chapter 2 of this thesis. The second segment of the regulatory framework consists of specific directors' duties and rules applicable exclusively to the implementation break fees and asset purchase options. These specific directors' duties and rules are not generally applicable to all defensive tactics, only break fees and asset purchase options. This specific-segment of the regulatory regime is examined in Chapter 3 of this thesis. Chapter 3 also examines the application of the general directors' duties (discussed in Chapter 2) to break fees and asset purchase options specifically.

This examination of the regulatory framework governing break fees and asset purchase options has two functions within the broader scheme of the thesis. Firstly, this analysis aids in the development of a doctrine underlying the regulatory regime governing break fees and asset purchase options. Secondly, this analysis enables me to examine whether a logical correlation exists between the regulatory regime and the empirical effects created by break fees and asset purchase options.

[3] *Torstar Corp. (Re)* 1986 LNONOSC 187, 9 O.S.C.B. 3087 (Ont. Securities Comm.) at 9-11.

1.3 Introduction to the correlation between the regulatory regime and the empirical effects of break fees and asset purchase options

In the third and final section of the thesis (Chapter 4), I examine empirical evidence on the effects of Canadian break fees. I base this examination on one particular authoritative study carried out by *P. Andr´e, S. Khalil, and M. Magnan*.[4] After briefly describing these findings, I proceed to analyse the empirical economic effects created by the Canadian regulatory regime of break fees and asset purchase options. In conducting this analysis, I attempt to show a logical correlation between the Canadian directors' duties as examined in Chapter 2 and 3 of this thesis and the empirical outcomes created by Canadian break fees and asset purchase options, as demonstrated by *P. Andr´e, S. Khalil, and M. Magnan*.[5]

Correlation within the scope of this thesis is defined as; a logical "mutual relationship or connection"[6] between the regulatory framework[7] and the empirical effects of break fees and asset purchase options. If this correlation is successfully established, it will form an entirely novel element presented in this thesis, expanding on the existing literature. Past research has focussed exclusively on describing the regulatory regime, or on providing substantive data on the effect of break fees and asset purchase options. If successful, this thesis will thus add another layer to the examination of break fee and asset purchase regulation, by linking the substantive data on the causational effects of break fees and asset purchase options, to the regime regulating it. This new layer of examination is tremendously important as it directly dictates the consequences of the general and specific provisions of the regulatory regime.

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[4] P. Andr´e, *supra* note 2.
[5] P. Andr´e, *supra* note 2.
[6] *Oxford Dictionary*, 11d ed, *sub verbo* "correlation".
[7] Specifically the regulatory framework of general and specific directors' duties (and rules) regulating the implementation of break fees and asset purchase options.

In considering the before-mentioned correlation, I will rely heavily on the proposed doctrine underlying the regulatory regime of directors' duties. I will thus critically evaluate the role that this underlying doctrine plays in creating the empirical outcomes (behavioural effects) produced by break fees and asset purchase options, in practice. A secondary central idea presented in this thesis is that this doctrine[8] is responsible for much of the "positive" findings arising from the Canadian and U.S. studies on the effects of break fees and asset purchase options. Finally, this thesis proposes limited changes to the regulatory regime governing break fees and asset purchase options, which preserve the essential elements of the proposed doctrine underlying the regulatory regime, while improving areas where the empirical results indicate weakness.

[8] In this context, "Doctrine" refers to as an approach to regulatory design.

Chapter 2: The regulatory regime part 1: General directors' duties and rules applicable to the implementation of any defensive tactic

2.1 Introduction to the fabric of law regulating defensive tactics

As mentioned above, I have chosen to divide the regulatory regime governing the implementation of break fees and asset purchase options into two segments. The first section of the regulatory regime sets general duties for target directors to comply with when implementing break fees, asset purchase options or any other defensive tactic. The second section of the regulatory regime applies only when target directors (specifically) implement break fees or asset purchase options. This chapter will describe, analyse, and evaluate the first of these two broad sections of the regulatory regime. I will thus analyse the general directors' duties and rules stemming from securities and corporate law[9] focussing on substance, functioning, goals, interaction, and enforcement.

This chapter along with the following chapter assesses the regulatory framework governing break fees in its entirety. This assessment is then used within the broader scope of the thesis, to examine the doctrine underlying the regulatory regime and finally, to establish a logical correlation between the regime and the effect of break fees and asset purchase options.

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[9] *Torstar*, *supra* note 3 at 9-11.

2.2 Securities law related regulation of defensive tactics

2.2.1 Introduction to securities law related regulation of defensive tactics

Securities law forms the first and most substantial branch of law regulating takeover situations and the resulting defensive tactics. Securities law based regulation of defensive tactics is found in various sources described below:

Table 1: Securities law sources and contents

	Source:	**Contents:**
1.	Provincial securities legislation.	Contains the delegation of powers and most of the basic principles, obligations, and requirements of legal actors in the securities market as well as their civil liability.
2.	Regulations (made by cabinet).	Contains the rule-making process and most of the applicable fees.
3.	Rules set by the securities regulators.	Contains the substantive elements of securities law regulation.
4.	Self-Regulatory Organisations Rules. (“SRO Rules”)	SRO’s that regulate the securities markets (includes stock exchanges) can discipline its members for breach of its internal rules or external laws.
5.	National and Multi-Lateral Instruments.	Contains most of the detailed elements of securities law regulation
6.	National and Multi-Lateral Policies.	Contains the guiding principles of securities law regulation.
7.	Staff Notices (of the commissions or CSA).[10]	Used as a fast method for notifying market participants of recent developments or problems and indicating how staff will use their discretion.

[10] The CSA has representatives from each commission collaborating nationally on securities issues and developing new initiatives.

Table 1: Securities law sources and contents (continued)

8.	Orders, Decisions and Rulings of the Securities Commissions.	Securities-commission-staff apply and enforce securities laws on a day-to-day basis. The commission has the right to take appeals from its staff. The commission also has primary jurisdiction over certain issues such as disclosure questions during a takeover bid.
9.	Court precedent.	Authoritative source of various securities law issues.

[11]

Securities law primarily regulates securities markets through the rules, instruments, policy statements, and rulings of the securities regulators as well as through provincial statute, executive regulation, and judicial decisions. In this first section of the chapter, I examine the substantive content, functioning, and goals of these principle sources of securities law.

2.2.2 Where does the securities law related regulation of defensive tactics start: The equality principle

Defensive tactics may be instituted pre-emptively[12] or may be instituted in reaction to a takeover bid.[13] It is important to note that the (current or future) takeover bid always forms the central motivation for the implementation of the takeover defence. Because of the central role that the takeover bid plays in the functioning and regulation of defensive tactics, it is important to establish what exactly constitutes a takeover bid. *Multilateral Instrument 62-104* and the *Ontario Securities Act* ("OSA") provide us with the following definition of a takeover bid.

> "take-over bid" means an offer to acquire outstanding voting securities or equity securities of a class made to one or more persons, any of whom is in the local

[11] *Torstar*, *supra* note 3 at 9-11; M. Condon, A. Anand, et al. *Securities Law in Canada Cases and Commentary*, 2d ed. (Toronto: Edmond Montgomery Publications, 2010) at 525.
[12] One example of a pre-emptive defensive tactic would be a dormant shareholder rights plan.
[13] Break fees and asset purchase options serve as two examples of *ex post facto* defensive tactics.

> jurisdiction or whose last address as shown on the books of the offeree issuer is in the local jurisdiction, where the securities subject to the offer to acquire, together with the offeror's securities, constitute in the aggregate 20% or more of the outstanding securities of that class of securities at the date of the offer to acquire but does not include an offer to acquire if the offer to acquire is a step in an amalgamation, merger, reorganization or arrangement that requires approval in a vote of security holders.[14]

From the abovementioned definition, one can deduce six requirements for the existence of a takeover bid, namely:

1. There must be an offer to acquire securities of a target corporation;
2. The offer must be made to holders of outstanding securities in the secondary market;
3. The offer must be made for voting or equity securities, not preference shares;
4. The offer must be made to persons in Canada;
5. The securities subject to the offer, together with the securities already held by the offeror, must represent 20% or more of the outstanding voting (or equity) securities; (and)
6. The takeover must not be in the form of an arrangement requiring approval in a vote of security holders.

If all of the abovementioned elements are present in a bid, and the offer is not covered by an exception,[15] then the offer will be deemed a takeover bid, unless the offeror can show that the purchase will not result in a change of controlling interest. If the offer is deemed to be a takeover bid, takeover bid regulation will apply to the offer and any defensive tactic taken in opposition to the bid. The "active" securities law regulation of defensive tactics thus starts here, when all the elements of a potential change-of-control-transaction are present.

[14] *Multilateral Instrument 62-104* s.1.1; *Securities Act*, R.S.O 1990, c. S5 s.89(1).
[15] *See MI 62-104*, *ibid* Part 4.

This definition of a takeover bid is clearly aimed at capturing offers that might likely result in a change of controlling interest, and works in tandem with two important duties placed on the bidder captured by this definition. The first is the duty placed on the takeover bidder to make the bid to all holders of the class of security subject to the bid.[16] The second is the duty to offer identical consideration to all holders of the same class of security.[17] These duties are imposed on takeover bidders captured by this definition to ensure that any potential control premium is shared *pro-rata* by all tendering target shareholders, and not just the controlling shareholder. Part 2 Division 1 of *Multilateral Instrument 62-104* supports this *pro-rata* division of control premium by placing restrictions on the acquisitions of the takeover bidder before during and after the takeover bid.[18] This protection provided to the minority shareholders is aimed at protecting the integrity of the voting rights attached to the voting (equity) shares, safeguarding the financial interest of the minority shareholders, and the integrity of the Canadian capital market.[19] This regulation is also consistent with the primary objective of takeover bid legislation in Canada, namely the protection of the bona fide interests of the target shareholders as a group.[20]

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[16] *See MI 62-104*, *ibid* at s.2.8.

[17] *See MI 62-104*, *ibid* at s.2.23(1).

[18] *See MI 62-104*, *ibid* at s.2.1-2.7. It should be noted that *MI 62-104* applies in every province in Canada except in Ontario where the *Securities Act*, *supra* note 14 at s.93-102 performs an identical function. These restrictions on the acquisitions of the takeover bidder aims to ensure that all target shareholders tendering 90 days prior to the takeover bid, during the takeover did, and 20 days after the takeover bid, receive equal consideration for their shares.

[19] The financial interest of minority shareholders is protected because the voting shares were not discounted as non-voting shares when they were first issued. The integrity of the Canadian capital market is strengthened for the same reason. I will use an example to demonstrate this point: Corporation ABC issues 1,000,000 common shares with voting rights. The same corporation issues 1,000,000 non-voting common shares for a discounted price (because they carry no voting rights). If Person Z buys 500,001 voting shares and Person Y buys 499,999 voting shares, then Person Z will have complete control of the corporation and the fact that Person Y's shares have voting rights will be merely academic. Person Y will have bought voting shares with a premium attached because of the theoretical voting rights, without actually being able to affect the control of the corporation. In the absence of the takeover protection provided above, Person Z could then sell his majority block of shares and control of the corporation to a third party, completely excluding Person Y from the control premium.

[20] *347883 Alberta Ltd. v Producers Pipelines Inc.* (1991), 80 D.L.R. (4th) 359 (Sask. C.A.) at para 37; *National Policy 62-202*, s.1.1(2).

2.2.3 The central pillars of securities law related regulation of defensive tactics

> "The primary objective of the take-over bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. The take-over bid provisions should favour neither the offeror nor the management of the target company, and should leave the shareholders of the target company free to make a fully informed decision. …the Canadian securities regulatory authorities wish to advise participants in the capital markets that they are prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporate action would, in appropriate cases, allay such concerns..."[21]

This excerpt from *National Policy 62-202* not only sets out the objectives of Canadian takeover law but also alludes to some of the central pillars of securities law related regulation of takeover defences. These central principles relate to time, information, voting, valuation, public interest, and partiality. In this section, I will discuss these central regulatory principles.

2.2.3.1 Information: The disclosure requirements during a takeover bid

The primary goals of the *Ontario Securities Act* are as follows:

a. To provide protection to investors from unfair, improper or fraudulent practices;

b. To foster fair and efficient capital markets and confidence in capital markets; (and)

c. The primary means for achieving the goals of this Act, consists of setting requirements for timely, accurate and efficient disclosure of information,[22]

[21] See *NP 62-202*, *ibid* at s.1.1(2).

[22] *Securities Act*, *supra* note 14 at s.1.1, 2.1(2)(i); Examples of similar provisions in other Canadian provinces include; *Securities Act*, RSQ, c V-1.1 s.276, *Securities Act*, SNB 2004, c S-5.5 s.2, *Securities Act*, RSNS 1989, c 418 s.1A(1), and *Securities Act*, 1988, SS 1988-89, c S-42.2 s.3.1.

The legislature thus sets the mandatory dissemination of information as the primary means of achieving its (the legislature's) goals of investor protection and capital market efficiency.[23] In this regard, Canadian securities law protects investors by mandating full periodic disclosure of material facts, timely disclosure of a material change,[24] and adequate dissemination of these facts and changes through SEDAR.[25] These mandates are aimed at ensuring that market participants have the necessary information with which to evaluate investment decisions. This form of investor protection is founded on the premise that market participants are better able to protect themselves from loss, if they are fully informed with regard to the possible risks and rewards associated with each investment decision. This same approach to investor protection (described above) is followed with regard to the regulation of takeover defences.

Arguably, one of the most important regulatory obligations placed on target directors in a takeover situation relates to the mandatory distribution of information through the directors' circular. In this regard, target directors are required to prepare and distribute a target directors' circular[26] to all target security holders within 15 days of the takeover bid.[27] In this director's circular, the target directors must evaluate the terms of the takeover bid and[28] recommend

[23] *347883 Alberta*, *supra* note 20 at para 37.

[24] General test for materiality: Would the reasonable investor find the information useful with regard to his investment decision to buy or sell the securities of the issuer. Material change relates to a material change in the business, operations or capital of the corporations that can reasonably be expected to have an effect on the share price of the corporation. Material change is evaluated by looking at the internal factors of the corporation not the external factors, and is thus a result driven analysis on the effect of internal factors on the price of the corporations' securities. Material facts are considered a broader form of material change.

[25] See *National Instrument 41-101* for the general prospectus requirements of reporting issuers; SEDAR is an electronic database containing mandatory disclosure information of reporting issuers.

[26] *MI 62-104*, *supra* note 14 at s.2.17(4): A target directors' circular must be in the form of "Form 62-104F3 Directors' Circular".

[27] *See MI 62-104*, *ibid* at s.2.17(1) and 2.8 for the specific persons that the target directors' circular must be sent to.

[28] *See MI 62-104*, *ibid* at s.2.17(2).

acceptance or rejection of the bid, with the reasons for their recommendation.[29] As target directors are responsible for the management of the target corporation, they are in possession of crucial information regarding the current and likely future value of the corporation. It is thus of vital importance that directors share this information with target shareholders, who are at an information disadvantage, and thus might not be able to make an informed decision regarding the tendering of their shares. The directors' circular requirement forces target directors to publicize this crucial information regarding firm value, allowing target shareholders to make an informed choice. This requirement is thus entirely in accordance with the information-based form of investor protection advanced by securities law.

Although this thesis focuses exclusively on the directors' duties and rules imposed on target directors, it is nonetheless worth noting that Canadian securities law also requires that a bidder's circular be sent out to all target security holders of the class that is sought. This bidder's circular requirement again follows the perspective that if shareholders are fully informed with regard to the possible risks and rewards associated with each investment decision, they will be better able to protect themselves. In this regard, the bidder's circular must set out the terms of the offer and other relevant information on the bidder. The bidder's circular must also be written so that readers are able to understand its contents and make fully informed investment decisions based on it.[30]

[29] *See MI 62-104*, *ibid* at s.2.17(2)(a).
[30] *Multilateral Instrument 62-104F1* Part 1(c) and Part 2.

2.2.3.2 Voting: Shareholder democracy during a takeover bid and the majority of the minority

Although *Multilateral Instrument 61-101* requires a vote by the majority of the minority security holders when implementing a business combination[31] or related party transaction,[32] this is not required when implementing a defensive tactic in response to a takeover bid. In terms of corporate law, target directors have the responsibility and power to manage the affairs of the target corporation[33] and are not the agents of shareholders (in a legal sense) during a takeover.[34] Since directors are not considered to be the agents of shareholders,[35] and "the directors have the power to manage the affairs of the company" even if their decisions contravene the express wishes of the majority shareholder", there is no requirement for a shareholder vote when implementing takeover defences.[36] Defensive tactics, such as a break fees and asset purchase options can thus be instituted without the need for a shareholders' vote.

Notwithstanding the abovementioned, this does not mean that a shareholders' vote on the implementation of a defensive tactic would be entirely inconsequential. Although shareholder approval is not required when implementing a defensive tactic, shareholder approval may play an

[31] A business combination is also called a "squeeze out" or a "going private transaction".
[32] *Multilateral Instrument 61-101* s.4.5; *Multilateral Instrument 61-101* has been incorporated into the TSX rules giving it national application.
[33] Canada Business Corporations Act (R.S., 1985, c. C-44) s.102(1); Business Corporations Act, SBC 2002, c 57 s.136.
[34] *Peoples Department Stores Inc. (Trustee of) v Wise*., [2004] 3 SCR 461 interpreting the CBCA, *supra* note 33 at s.102(1).
[35] *Ibid*.
[36] *Teck Corp. v Millar* (1972), 33 D.L.R. (3d) 288 (B.C. S.C.) at 307 as cited in *Pente Investment Management Ltd. v Schneider Corp*., [1998] CarswellOnt 4035, 113 O.A.C. 253 (Ont. C.A.) at para 34.

important role in maintaining the validity of some defensive tactics when faced with possible invalidation by the securities regulators, or courts.[37]

2.2.3.3 Valuation: Independent valuation (or "fairness opinion") requirements during a takeover bid

As stated above, the target directors have the responsibility and power to manage the affairs of the target corporation during a takeover bid.[38] Additionally, target directors are required to prepare and distribute a target directors' circular[39] to all target security holders,[40] evaluating the terms of the takeover bid,[41] and recommending acceptance or rejection with reasons.[42] During this evaluation target, directors are encouraged to establish an independent special committee to conduct a formal valuation of all potential offers and evaluate any prospective defensive tactics.[43]

Although *Multilateral Instrument 61-101* requires a formal valuation[44] when implementing an insider bid, issuer bid, business combination, and related party transaction[45] this is not required

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[37] The Canadian securities regulatory authorities have explicitly advised capital markets participants that they (the regulators) are prepared to examine target company tactics to determine whether they are abusive of shareholder rights, and that prior shareholder approval of corporate action would, in appropriate cases, allay such concerns; See *NP 62-202*, *supra* note 20 s.1.1(3); *Securities Act*, *supra* note 14 s.127. For the same provision in British Columbia see: *Securities Act*, R.S.B.C 1996, c.418 s.89(1) and 161(1); See *Lions Gate Entertainment Corp. v Icahn Partners LP* [2010] CarswellBC 1433 (B.C.C.A) for more detail on the effect of a shareholder vote on the validity of a shareholders rights plan.

[38] CBCA, *supra* note 33 s.102(1).

[39] *MI 62-104*, *supra* note 14 s.2.17(4): A target directors' circular must be in the form of "Form 62-104F3 Directors' Circular".

[40] See *MI 62-104*, *ibid* s.2.17(1), 2.8 for the specific persons that the target directors' circular must be sent to.

[41] *See MI 62-104*, *ibid* s.2.17(2).

[42] *See MI 62-104*, *ibid* s.2.17(2)(a).

[43] *Re CW Shareholdings Inc. and WIC Western International Communications Ltd. et al*., 1998 CanlII 14838 (Ont. S.C.) at para 45.

[44] See *Magna International Inc. (2011), 34 O.S.C.B. 1290, 78 B.L.R. (4th) 94 (Ont. Securities Comm.)* at para 250 where it was found that a "fairness opinion" was not required under *MI 61-101*.

when implementing a defensive tactic, such as a break fee or asset purchase option. Although a formal valuation of the bid is not required when implementing defensive tactics, it (the formal valuation) may again play an important role in maintaining the validity of some defensive tactics when faced with possible invalidation by the securities regulators or courts.

2.2.3.4 Public interest jurisdiction of the securities regulators

The securities act of each province empowers its respective provincial securities commission with public interest jurisdiction. This legislation imbues the securities commission's with broad and far-reaching discretion to make orders in the public interest.[46] Arguably, the order with the most relevance with regard to the regulation of defensive tactics is the cease trade orders. In the matter of *Canadian Tire Corporation Ltd et al*., ("*Canadian Tire*") both the Securities Commission and Court had the opportunity to evaluate the commissions' discretion to implement a cease trade order in the public interest. In this case, the majority shareholder instituted a sizable reorganisation of *Canadian Tire's* share capital. This reorganisation included the sale of 83 million Class A non-voting shares with anti-takeover protection provided in the form of a coattail provision. The terms of the coattail provision were as follows:

> "If a majority of the outstanding common shares (of the corporation) are purchased as pursuant to an offer made generally to all holders of common shares, the Class A Shares will become voting in all circumstances unless the same offer is made to the holders of the Class A Shares."

Sometime after this reorganisation had been implemented, CTC Dealer Holdings Ltd and the majority shareholder of *Canadian Tire* struck up an agreement to sell the majority shareholders'

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[45] *MI 61-101*, *supra* note 31 at part 2 to 5.

[46] *Securities Act*, *supra* note 14 s.127(1). For the same provision in British Columbia see: *Securities Act* (R.S.B.C), *supra* note 37 s.89(1), 161(1).

shares to CTC Dealer Holdings Ltd. One of the key provisions in this intended sale was that CTC Dealer Holdings Ltd would only purchase up to 49% of the common shares of *Canadian Tire*. The goal of the 49% offer was to bypass the coattail provision attached to the Class A shares allowing CTC Dealer Holdings Ltd to gain control of *Canadian Tire* through the acquisition of approximately 2% of the participating shares for a premium of 400% over the market price. The majority shareholder in *Canadian Tire* agreed to tender its shares to the Bid and the directors of *Canadian Tire* signed a support agreement in favour of the CTC Dealer Holdings Ltd bid.

The staff of the Ontario Securities Commission found that although there was no breach of the act or any rule, it would nonetheless be contrary to the public interest[47] to allow the transaction to continue. Commission staff argued that the bidder and majority shareholder should not be allowed to structure the offer in a way that would purposefully avoid engaging the takeover protection, with the goal of excluding the majority of shareholders from the control premium.[48] The Commission thus issued a cease trade order in terms of its public interest jurisdiction, preventing the takeover based on the possible negative effect the transaction could have on the integrity of the Canadian capital market.[49] On appeal to the Ontario Securities Commission, the Commission found that the public interest jurisdiction would usually be implemented when a securities law rule was breached, but could also be employed in the absence of such a breach. The Commission also found that unfairness alone would be an insufficient foundation on which to implement the public interest jurisdiction of the Commission, as abuse in the form of a

[47] *Securities Act*, R.S.O. 1980, c. 466, s.123(1). The current equivalent section is contained in *Securities Act*, *supra* note 14 s.123(1).
[48] *Canadian Tire Corp. v C.T.C. Dealer Holdings Ltd*. (1987), 35 B.L.R. 56, 10 O.S.C.B. 857 (Ont. Securities Comm.) at para 149-150.
[49] *Ibid* at para 151.

negative effect on the broader public would also be required. In this case, there was both unfairness and abuse, and the staff of the Securities Commission had thus correctly instituted the cease trade order. The following test thus applies to the implementation of the public interest jurisdiction of the commissions:

1. There must be a breach of the act, regulations or a policy statement (or)
2. The conduct of the transaction must clearly be abusive of shareholders in particular (and)
3. The conduct of the transaction must clearly be abusive of the capital markets in general (and)
4. The abuse must be such that it has a broader impact on the operation of the capital markets (and thus be in the public interest).[50] The Supreme Court of Canada has subsequently held that the public interest of securities regulation includes investor protection, capital market efficiency, and the maintenance of confidence in the Canadian capital markets.[51]

The court of appeal confirmed these findings, and made it clear that although the commission does not have an unfettered discretion to implement its public interest jurisdiction, it does have a broad discretion, and it acted within that discretion when implementing the cease trade order.[52] The fact that the securities commissions have a broad but not unfettered discretion to intervene in the securities market was confirmed by the Supreme Court ruling.[53]

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[50] *Re Cablecasting Ltd.,* [1978] O.S.C.B. 37 (Ont. Securities Comm.) applied in *Canadian Tire*, *supra* note 48 at para 155. Note that "abuse" goes beyond a mere complaint of unfairness.

[51] *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)* (2001), 2 SCR 132.

[52] *Re CTC Dealer Holdings Ltd et al and Ontario Securities Commission et al*., (1987) 59 O.R. (2d) 79 (Ont. Div. Ct.).

[53] *Committee for the Equal Treatment of Asbestos Minority Shareholders*, *supra* note 51.

This case illuminates the non-rule-based regulation of Canadian securities markets through the public interest jurisdiction of the securities commissions. Although this case does not deal directly with the use of defensive tactics in a takeover situation, it is nevertheless significant for the regulation of defensive tactics, as this case provides authority for the fact that no breach of law is required to trigger the commission's public interest jurisdiction.[54] It demonstrates that even if the defensive tactics implemented in response to a takeover bid are, strictly speaking, legal, the commission could still invoke invalidate the defensive tactics, if it is found to be unfair and abusive. All provinces and territories have incorporated a form of this consumer protection jurisdiction into its local securities legislation.[55]

2.2.3.5 Partiality: The duty to auction/canvass, the special committee requirement and the placement of the burden of proof

Pente Investment Management Ltd. v Schneider Corp ("*Pente*") case[56] deals with a corporate law remedy, namely oppression. Notwithstanding this fact, the *Pente* case clearly examines several securities law related principles in the evaluation of the oppression remedy. Furthermore, the *Pente* case employs the oppression remedy in direct fulfillment of the primary goal of Canadian securities (takeover) law provisions, namely "the protection of target shareholder interests".[57] For this reason, I include the *Pente* case under this section dealing with directors' duties related to securities law. It should however be noted that the *Pente* case would find application with

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[54] *Canadian Tire*, *supra* note 48 at para 26

[55] For examples of this consumer protection jurisdiction in other provinces, see the *Securities Act* of the following provinces: Alberta s198(1), British Columbia s89(1) and s161(1), Manitoba s61(1) and s148(1), New Brunswick s184(1), Newfoundland s127(1), Nova scotia s134(1), Nunavut s60, North West Territories s60, Ontario s127(1), Prince Edward Island s60, Quebec s262.1 and s264-267 and s270-273.3 and s316, Saskatchewan s134(1), Yukon s60.

[56] *Pente*, *supra* note 36.

[57] *NP 62-202*, *supra* note20 s.1.1(2); *347883 Alberta*, *supra* note 20 at para 37.

equal merit, under corporate law duties (discussed below). This once again stands testament to the concurrent application of corporate and securities law, during takeover situations.

In the *Pente* case,[58] Maple Leaf initiated a hostile takeover bid for the shares of Schneider Corporation. The Schneider Corporation had a large majority shareholder (the Schneider Family) that owned 75% of the voting securities. Target management appointed a special committee to consider the Maple Leaf offer and an alternative offer from Smithfield. At this point, the Schneider Family informed the special committee that they would not tender their large majority block of shares to any offer other than the Smithfield offer. The special committee responded to this information by exempting only the Smithfield offer from the shareholders rights plan, keeping the poison pill in place with regard to the Maple Leaf bid. This allowed the Smithfield offer to continue without allowing Maple Leaf the opportunity to make a higher value bid to Schneider shareholders, as any such offer by Maple Leaf would still trigger the poison pill. In response to these actions taken by target management, a group of minority shareholders brought an oppression remedy application under the *Ontario Business Corporations Act*, R.S.O. 1990, c. B.16. These minority shareholders claimed that the failure to allow an auction was unfairly prejudicial or unfairly disregarded the minority shareholders' interests.[59]

The Court made the following findings with regard to securities and corporate law related directors' duties:

1. <u>The duty to auction/canvass:</u> When a Canadian corporation is faced with a bid, the target directors or special committee members appointed by the directors have a duty to

[58] *Pente*, *supra* note 36.
[59] Business Corporations Act, R.S.O. 1990, c. B.16 s.248.

"canvass the market". While the *Revlon*-duty imposes an auction mandate in certain U.S. takeover situations, no such dogmatic obligation exists in the Canadian context.[60] Target directors are thus not required to institute an auction for the target company, which would have the exclusive goal of realising the highest value offer for target shares. As a requirement of the market canvass, target directors must seek out and assess potential higher value offers for the target corporation's shares.[61] It should thus be clear that the search for an alternative higher value bid[62] is not only a legally viable option, but is rather an obligatory requirement. This canvassing mandate allows target directors the freedom to evaluate the original bid as well as any other solicited bid, based on several factors outside of bid value including; who is seeking control, why they are seeking control, the history of the control seeker, and the consequences of the offer on the employees, wider community, corporation's shareholders and security holders.[63] Although the best interest of the corporation must remain the primary concern in the minds of the directors, these additional factors could be highly indicative of what will be in the best interest of the corporation. The aim of the canvassing mandate is thus to ensure that target directors get

[60] *Pente*, *supra* note 36 at para 59-63: "The decision in *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (U.S. Del. Super. 1985), stands for the proposition that if a company is up for sale, the directors have an obligation to conduct an auction of the company's shares. *Revlon Inc.* is not the law in Ontario. In Ontario, an auction need not be held every time there is a change in control of a company". "An auction is merely one way to prevent the conflicts of interest that may arise when there is a change of control by requiring that directors act in a neutral manner toward a number of bidders"; *Barkan v. Amsted Industries Inc.*, 567 A.2d 1279 (U.S. Del. Super. 1989) at 1286. "When it becomes clear that a company is for sale and there are several bidders, an auction is an appropriate mechanism to ensure that the board of a target company acts in a neutral manner to achieve the best value reasonably available to shareholders in the circumstances. When the board has received a single offer and has no reliable grounds upon which to judge its adequacy, a canvass of the market to determine if higher bids may be elicited is appropriate, and may be necessary"; *Barkan*, citing *Fort Howard Corp. Shareholders Litigation, Re*, Doc. Civ. A. 9991 (U.S. Del. Ch. August 8, 1998).
[61] *Pente, supra* note 36.
[62] *Pente*, *supra* note 36 at para 59-63.
[63] See *Teck*, *supra* note 36 at para 109, 106 and 117; BCE Inc. v 1976 Debentureholders, 2008 SCC 69, [2008] 3 SCR 560; CBCA, *supra* note 33 s.192.

the best price for the shares of the target corporation with thorough cognisance to the potential collateral effects of each bid.

2. The special committee requirement: The target directors must attempt to minimise their conflict of interest and act as impartially as possible in the evaluation of alternative offers and implementation of defensive tactics. This might be done through the retention of independent legal and financial advisors, and the establishment of an independent special committee to assess, evaluate and solicit alternative offers.[64] These independent persons must inform themselves properly and act independently based on reasonable grounds in the maximization of corporation and shareholder value.[65] The appointment of an independent (non-management) special committee usually alleviates concerns regarding any conflict of interest that might exist between the target directors and shareholders.[66] In acknowledgement of this fact, courts will usually show deference to the findings of a truly independent special committee, but will tend to show less deference to the findings of less independent special committees.[67]

3. Director impartiality and the burden of proof: "The burden of proof may not always rest on the same party when a change of control transaction is challenged. The real question is whether the directors of the target company successfully took steps to avoid a conflict of interest. If so, the rationale for shifting the burden of proof to the directors may not exist. If a board of directors acted on the advice of a committee composed of persons having no conflict of interest, and that committee acted independently, in good faith, and made an informed recommendation as to the best available transaction for the

[64] *Re CW Shareholdings*, *supra* note 43 at para 45.
[65] *Ibid*.
[66] *Pente*, *supra* note 36 at para 37.
[67] *Ibid* at para 46; *First Boston Inc. Shareholders Litigation, Re, Fed. Sec. L. Rep.* (1990), P 95,322 (Del. Ct Ch).

shareholders in the circumstances, the business judgment rule applies. The burden of proof is not an issue in such circumstances."[68] The inclusion of the CEO and other non-independent management in the special committee reduces the independence of the special committee. The less independent the special committee, the less reliance will be placed on its recommendations by the courts.[69]

These three corporate and securities law related directors' duties deal with the problem of target director partiality in a takeover situation. "Directors and officers of a corporation whose shares are subject to a hostile takeover bid face a serious conflict of interest… Often the managers' jobs are at stake. There is a temptation to find that what is best for oneself is also best for the corporation and shareholders… The temptation to spend corporate resources extravagantly in an attempt to fend off the raider and thus sacrifice shareholders' interests must be overwhelming."[70] This passage from Professor Clark describes a basic problem with regard to the potential conflict of interest inherent in defensive tactic implementation. The target directors must attempt to minimise this conflict of interest and act as impartially as possible in the evaluation of alternative bids and the implementation of defensive tactics.[71] In this regard, the *Pente* case contrasted the duty to auction with the duty to canvass the market, and held that Canadian law did not require target directors to turn a "market canvass" into an "auction".[72] Although this case does not dogmatically require target directors to initiate an auction for the shares of the target corporation, it similarly does not allow them to act as complainant, judge, jury, and executioner: by mandating that directors canvass the market for potential higher value bids. In this regard, these

[68] *Pente*, *supra* note 36 at para 38.
[69] *Re CW Shareholdings*, *supra* note 43 at para 77.
[70] R Clark, *Corporate Law,* (Boston: Little Brown, 1986) at 588-589.
[71] *Re CW Shareholdings*, *supra* note 43 at para 43.
[72] *Pente*, *supra* note 36 at para 59-63.

three duties set by the Court pertaining to partiality require target directors to act impartially with regard to the implementation of defensive tactics by encouraging them to retain independent legal and financial advisors, and establish an independent special committee.[73] The courts encourage this behaviour by showing deference to the findings of a truly independent special committee in terms of the business judgment rule,[74] and showing little or no deference where target directors failed to take active steps to avoid a conflict of interest.[75] A serious failure to take active steps to avoid a conflict of interest may even result in a shift in the burden of proof requiring the directors to prove that they implemented the defensive tactic "with a view to the best interest of the corporation.[76] These three corporate and securities law related directors' duties (related to partiality) can thus be seen as an anti-entrenchment mechanism promoting investor protection and fostering efficient capital markets in compliance with *National Policy 62-202*.[77] In fact, the Court has specifically confirmed this compliance mechanism in *347883 Alberta Ltd. v Producers Pipelines Inc.* (1991), 80 D.L.R. (4th) 359 (Sask. C.A.) where it stated the following:

> "National Policy No. 38 of the Canadian Securities Administrators (The predecessor of *National Policy 62-202*) accurately reflects the policy considerations behind the securities legislation and must have a substantial impact in any review of defensive tactics against take-overs. Just as the securities law provisions were intended to prevent abusive, coercive or unfair tactics by persons making take-over bids, they were equally intended to limit the powers of directors to use defensive tactics which might also be abusive, coercive or unfair to shareholders, or tactics which unnecessarily deprive the shareholders of the right to decide to whom and at what price they will sell their shares. The primary role of the directors in respect of a take-over bid is to advise the shareholders, rather than to decide the issue for them. As noted in the policy statement, the primary

[73] *Re CW Shareholdings*, *supra* note 43 at para 45.
[74] *Pente*, *supra* note 36 at para 37; *First Boston*, *supra* note 67.
[75] *Pente*, *supra* note 36 at para 38.
[76] *Ibid.*
[77] *NP 62-202*, *supra* note 20 s.1.1(2). *347883 Alberta*, *supra* note 20 at para 37; *Teck*, *supra* note 36 at para 109, 106 and 117; BCE, *supra* note 63; CBCA, *supra* note 33 s.192.

> objective of the legislation is to protect the bona fide interests of the shareholders of the target company and to permit take-over bids to proceed in an open and even-handed environment. Unrestricted auctions produce the most desirable results in take-over bids. Accordingly, defensive measures should not deny to the shareholders the ability to make a decision, and it follows that, whenever possible, prior shareholder approval of defensive tactics should be obtained. There may be circumstances where it is impractical or impossible to obtain prior shareholder approval, such as lack of time, but in such instances, delaying measures will usually suffice to give the directors time to find alternatives. The ultimate decision must be left with the shareholders, whether by subsequent ratification of the poison pill, or by presentation to them of the competing offers or other alternatives to the take-over bid, together with the take-over bid itself."[78]

2.3 Corporate law regulation of defensive tactics

2.3.1 Introduction to corporate law regulation of defensive tactics

Two main subsections of the law regulate the implementation of defensive tactics in takeover situations, namely securities law and corporate law. In this section, I will examine the corporate law duties placed on target directors in a takeover situation. These directors' duties are described as more purely associated with corporate law than securities law as they relate less directly to the primary goal and functioning of Canadian securities (or takeover) law provisions.[79]

2.3.2 The central pillars of corporate law regulation of defensive tactics: Fiduciary duties and the duty of care, skill and diligence

Corporate law regulates the use of defensive tactics by setting fiduciary duties and duties of care skill and diligence for target directors to comply with in a takeover situation. In this regard, the *Canada Business Corporations Act Section 122(1)* states the following:

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[78] *347883 Alberta*, *supra* note 20 at para 37.

[79] Namely "the protection of target shareholders' interests in terms of *NP 62-202*, *supra* note 20 s.1.1(2); *347883 Alberta*, *supra* note 20 at para 37.

"**122.** (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall:
(a) act honestly and in good faith with a view to the best interests of the corporation; and
(b) exercise the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances."[80]

In addition to the securities law related rules and directors' duties, namely the auction/canvassing requirement, special committee requirement and placement of the burden of proof described above, the *Pente* case[81] also considered the application of general corporate law directors' duties. More specifically the Court considered the application of the general corporate fiduciary duty and the duty of care, skill, and diligence on the actions of target directors in a takeover situation. In this regard, the Court made the following findings:

1. <u>The application of the business judgment rule:</u> The Court clearly indicated that the proper standard for evaluating compliance with corporate law directors' duties is the business judgment rule[82] and not the enhanced scrutiny standard employed in the United States. [83] In terms of the business judgment rule, the directors have the discretion to manage the affairs of the corporation and the courts will tend to show deference their business judgment, if they comply with the conditions set out below. The directors of a target corporation will not be in breach of their fiduciary duties, if they implement a defensive tactic in response to a hostile takeover bid in compliance with the following preconditions:

[80] CBCA, *supra* note 33 s.122(1).
[81] *Pente*, *supra* note 36. For the facts of this case see page 18 of this thesis (heading 2.2.3.5).
[82] *Torstar supra* note 3 at 9-11; *Pente*, *supra* note 36 at para 33-34.
[83] *Re CW Shareholdings*, *supra* note 43 at para 63-66: In Canada target directors do not need to demonstrate the entire fairness of the transaction.

i. Firstly, the directors must properly inform themselves with respect to the decisions they are making;[84]

ii. Secondly, the directors must base their decision on reasonable grounds[85] with the understanding that such reasonable grounds may include the advice of experts.[86] As long as the directors selected one of several reasonable alternatives, the court will not dictate which reasonable alternative the directors should have chosen. The courts require a reasonable decision in this regard, not a perfect decision.[87] If however it can be shown that one of the reasonable alternatives was clearly more beneficial and definitely available, the directors would have to choose the more beneficial alternative in compliance with their fiduciary duties.[88]

iii. Thirdly, the directors must act honestly, fairly and in good faith in the best interest of the corporation in compliance with their fiduciary duties. "One way of determining whether the directors acted in the best interests of the company, is to ask what was uppermost in the directors' minds after a reasonable analysis of the situation".[89]

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[84] *Pente*, *supra* note 36 at para 33-34. Also see *Teck*, *supra* note 36 at para 315-316, adopted as the law in Ontario by Montgomery J. in *Olympia & York Enterprises Ltd. v Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254 at para 255 (Ont. H.C.), affirmed (1986), 59 O.R. (2d) 254 (Ont. Div. Ct.). *Brant Investments Ltd. v KeepRite Inc*. (1987), 60 O.R. (2d) 737 (Ont. H.C.), aff'd (1991), 3 O.R. (3d) 289 (Ont. C.A.) at para 301 regarding the business judgment rule.

[85] *Ibid*.

[86] *Pente*, *supra* note 36 at para 123.

[87] *Pente*, *supra* note 36 at para 36; *Brant*, *supra* note 84 at para 754; *Paramount Communications Inc. v QVC Network Inc.* (1994), 637 A.2d 34, 62 U.S.L.W. 2530, Fed. Sec. L. Rep. P 98,063 (Del. Sup Ct).

[88] *Brant*, *supra* note 84 at para 314-315.

[89] *Pente*, *supra* note 36 at para 34; Also see *820099 Ontario Inc. v Harold E. Ballard Ltd.* (1991), 3 B.L.R. (2d) 113 (Ont. Gen. Div.), at para 123, affirmed (1991), 3 B.L.R. (2d) 113 (Ont. Div. Ct.); CW Shareholdings, *supra* note 43.

2. Director agency in a takeover situation: The Court expressly found that the target directors are not the agents of the shareholders (in a legal sense) during a takeover[90] and "the directors have the power to manage the affairs of the company even if their decisions contravene the express wishes of the majority shareholder".[91] This is the case because there might be a conflict of interest between the interests of a specific shareholder and the interests of the corporation as a whole.[92] "If the directors however unfairly disregard the interests of a group of shareholders they will not have acted reasonably in the best interest of the corporation, and the courts will intervene".[93]

3. Placement of fiduciary duties: Although target directors owe their fiduciary duties to the corporation, they may also take additional factors into consideration when considering defensive tactics. These additional considerations include factors such as, who is seeking control, why they are seeking control and the impact of the offer on the corporation, shareholders, security holders, employees, and wider community.[94] Although the best interest of the corporation must be the primary concern, these additional factors could be highly indicative of what will be in the best interest of the corporation.[95] If for example directors unfairly disregard the interests of a group of shareholders (or security holders), they will not have acted reasonably in the best interest of the corporation.[96]

[90] *Ibid.*
[91] *Teck*, *supra* note 36 at para 307 as per *Pente*, *supra* note 36 at para 34.
[92] *Brant*, *supra* note 84 at para 301 as per *Pente*, *supra* note 36 at para 34.
[93] *820099 Ontario*, *supra* note 89; CW Shareholdings, *supra* note 43 as per *Pente*, *supra* note 36 at para 34. Although the quotation only makes reference to the intervening actions of the courts, the securities regulators would likely have similar jurisdiction to intervene as per their public interest jurisdiction. The public interest jurisdiction of the securities regulators is described further below at page 64 of this thesis (heading 3.3.3.1).
[94] *Teck*, *supra* note 36 at para 109, 106 and 117; BCE, *supra* note 63; CBCA, *supra* note 33 s.192.
[95] *Ibid.*
[96] *820099 Ontario*, *supra* note 89; CW Shareholdings, *supra* note 43 as per *Pente*, *supra* note 36 at para 34.

These corporate law directors' duties function as an anti-entrenchment mechanism promoting investor protection and fostering efficient capital markets in compliance with *National Policy 62-202*.[97]

2.3.3 Interaction between securities law and corporate law directors' duties

2.3.3.1 The *Torstar* case: Securities law expands on corporate law directors' duties

Although the *Torstar* case[98] (presented below) focused on the breach of a stock exchange rule, not on the implementation of a defensive tactic, it provides a useful background to the integration and dual application of corporate law and securities law related directors' duties. The Toronto Stock Exchange ("TSE") general by-law 19.06 requires every company having its securities listed on the TSE to give prompt notice to the TSE of a proposal to issue treasury securities. This rule also gives the TSE the right to require shareholder approval of such a transaction involving the issue treasury securities.[99] On May 7, 1985, the TSE issued a news release warning the companies listed on the TSE that the exchange would seek sanctions against any directors who knowingly breached the provisions of general by-law 19.06. On August 26, 1985, Southam and Torstar management knowingly concluded a share exchange agreement in direct contravention of By-law 19.06. Southam and Torstar management explained that they feared a takeover bid by another corporation and wanted to "insulate Torstar from that possibility through the share exchange transaction" without the risk that the TSE would require a shareholder vote".[100] Following this breach of the TSE-rules, the exchange requested that the O.S.C. take

[97] *NP 62-202*, *supra* note 20 s.1.1(2). *347883 Alberta*, *supra* note 20 at para 37.
[98] *Torstar supra* note 3.
[99] *Ibid* at 2.
[100] *Ibid* at 9.

action against the management of Southam and Torstar under section 124 of the *Securities Act*[101] (current section 127).[102]

The Ontario Securities Commission made the following findings:

1. In terms of the *Ontario Business Corporations Act* and the *Canadian Business Corporations Act*, the directors of the corporation have the power to manage the corporation free from shareholder interference. This power includes the power to issue share capital.
2. The main corporate law check on this almost unfettered discretion of the directors to manage the corporation is the duty of the directors to "act honestly and in good faith in the best interests of the corporation".
3. This limited corporate law check on the discretion of directors does not provide adequate protection to the shareholders of the corporation. The securities acts, policies issued by the commissions, and by-laws of the self-regulatory organisations such as the TSX expand on these fiduciary duties set by corporate law. These expanded rules promote the fairness and efficiency of Canadian capital markets.
4. General By-law 19.06 is an example of such an expansion of fiduciary duties allowing the TSE to monitor the issue of shares in an attempt to ensure fairness to all shareholders especially when it will cause a change in control.
5. The directors of Southam and Torstar violated their expanded directors' duties under securities law.[103]

[101] *Securities Act* 1980, supra note 47 s.124(1).
[102] *Securities Act*, *supra* note 14 s.127(1).
[103] *Torstar supra* note 3 at 9-11.

The conclusion that should be drawn from this case is that both corporate law and securities law related directors' duties apply to target directors when they are faced with a takeover bid, and considering the implementation of defensive tactics. While corporate law regulates the foundational requirements for director actions as is generally the case, securities law rules expand on these general directors' duties with the goal of increasing investor protection.

2.3.3.2 The *Olympia* case: The effect of complying with corporate law duties but not securities law related duties

In the *Olympia & York Enterprises Ltd* case ("*Olympia*"),[104] the Court had the opportunity to consider the application of corporate law and securities law related directors' duties on the validity of an elaborate defensive tactic, employed in response to a hostile takeover bid. In this case, Olympia & York Enterprises made an unsolicited takeover bid, for the shares of Hiram Walker Resources. In response to the unsolicited bid from Olympia, the directors of Hiram Walker instituted a two-tiered defensive tactic. Firstly, they sold an asset representing 47% of the total value of Hiram Walker (for fair value). They then created a subsidiary company "Fingas" (in which Hiram Walker owned 49% of the voting securities) and bought back Hiram Walker shares through a third party bid. The directors of Hiram Walker attained independent legal advice that Hiram Walker and its shareholders would gain a $300 million tax benefit if it used a third party bid, as opposed to an issuer bid.

[104] *Re Olympia & York Enterprises*, *supra* note 84.

The Court made the following findings with regard to the defensive actions taken by the target directors that complied with corporate law duties but may have violated securities law related duties:

1. If target directors act honestly, in good faith, in the best interest of the corporation, and based on reasonable grounds when implementing a defensive tactic they would not be in breach of their fiduciary duties.[105] Directors may rely on the advice of experts in establishing whether their actions are based on reasonable grounds.[106]
2. Purity of purpose and compliance with fiduciary duties however will not render a plainly illegal action legal. Even if all the bona fide factors mentioned above have been complied with, the defensive action will still be struck down if it is clearly against the law. In coming to this conclusion, the Court rejected the finding in *Norlin Corporation v Rooney et al* ("*Norlin*")[107] where it was held that a board of directors could take any action to defeat the bid, once it was established that a particular takeover offer was not in the best interest of the corporation.[108] In the *Olympia* case, the action was not plainly illegal and as such was not invalidated.[109]
3. If target directors implement a defensive tactic in compliance with their fiduciary duties under corporate law, but it is unclear whether the action is legal under securities law, the question will be answered with reference to the purpose of securities law. "The primary purpose of the take-over bid provisions of Canadian securities legislation is the protection of the *bona fide* interests of the shareholders of the target company and the fostering of an

[105] *Re Olympia & York Enterprises*, *supra* note 84 at para 63, 65-68.
[106] *Re Olympia & York Enterprises*, *supra* note 84 at para 123.
[107] *Norlin Corp. v Rooney et al.,* [1984] 744 F.2d 255, 264 (2d Cir).
[108] *Re Olympia & York Enterprises*, *supra* note 84 at para 58.
[109] *Re Olympia & York Enterprises*, *supra* note 84 at para 124-125.

efficient capital market."[110] In cases where there exists uncertainty regarding the compliance or non-compliance with securities law requirements, purity of purpose and compliance with corporate law fiduciary duties will thus likely render the directors defensive actions valid. In the *Olympia* case however, the actions of the target directors were not plainly illegal and as such, no reference was needed to the primary purpose of the relevant securities law provisions.

This case has important consequences since it stands for authority that compliance with corporate law directors' duties shall not validate patent violation of securities law provisions. Stated differently, target directors cannot simply hide behind their corporate law directors' duties as a shield to compliance with securities law related directors' duties, since courts concurrently apply both regulatory frameworks during a takeover situation. This concurrent application, although logical, is not easily implemented in practice. The reason for this stems from the fact that corporate law largely defers to target directors under the business judgment rule whereas securities law mandates certain behaviour from target directors irrespective of their business judgment. In this regard, clearer guidance is needed from the legislature with regard to the preferential nature of either the corporate law business judgment rule or the securities law rules and duties, during a takeover situation.

[110] *NP 62-202*, *supra* note 20 s.1.1(2); *Re Olympia & York Enterprises*, *supra* note 84 at para 71.

2.4 The effect of *bona fide* defensive actions resulting in management entrenchment

2.4.1 Introduction to the legality of *bona fide* defensive tactics causing entrenchment as secondary effect

The final aspect to be examines with regard to the general directors' duties regulating the implementation defensive tactics concerns the legality of *bona fide* defensive tactics causing entrenchment as secondary effect. This aspect has general application to all defensive tactics but also has very clear specific application to the regulation of break fees and asset purchase options as the use of these contractual devices can easily result in management entrenchment. In this section I will thus evaluate the legality of implementing a defensive tactic such as a break fee or asset purchase option, with the *bona fide* goal of benefitting target shareholders, but with the indirect effect of management entrenchment. In other words, will the court invalidate a defensive tactic if it is employed by target directors in full compliance with their corporate law and securities law related directors' duties, but while also indirectly benefit themselves through entrenchment.

2.4.2 The legality of *bona fide* defensive tactics causing entrenchment as secondary effect

2.4.2.1 Development and background: The *Hogg* case[111]

In *Hogg, v Cramphorn*[112] ("*Hogg*") the British Court had to decide whether it was legal for the directors of a target firm to create an employee-share-trust as a defensive tactic against a hostile bid. The Court agreed that the acceptance of the hostile bid would not be in the best interest of the corporation, that the directors of the target corporation had been given the power to create a

[111] *Hogg v Cramphorn Ltd. et al.*, [1967] Ch. 254, [1966] 3 All E.R. 420 (High Ct).
[112] *Ibid.*

share-trust in the normal course of business. Additionally the court accepted that the creation of the share-trust would benefit the shareholders in the normal course of business, and that the use of the trust as a defensive tactic would protect shareholders from an unfavourable bid. Having accepted the abovementioned factors the Court nonetheless came to the following conclusion:

1. Defensive tactics must be evaluated according to the proper purpose test;
2. According to the proper purpose test the Court must evaluate two factors namely:
   a. Why the particular power was originally granted to the directors; (and)
   b. Whether the directors exercised their power for the purpose, it was granted.
3. The Court found that although the defensive action was legal, approved by the target shareholders, and beneficial to the target shareholders, it should never the less be invalidated because the power to create the trust was not exercised for the "proper purpose".[113] In other words, the directors were not granted the power to use the share trust as a defensive action and thus did not create the trust for a "proper purpose".

The *Hogg* case follows a very restrictive method for evaluating compliance with directors' duties in a takeover situation. Not only do directors have to be permitted to act, act legally, and act in the best interest of the corporation, but they also have to be permitted to take the specific action in the specific situation for a specific reason. Instituting a defensive tactic such as a break fee or asset purchase option with the primary *bona fide* goal of increasing shareholder value, but with the secondary effect of entrenchment, would thus be invalidated by the proper purpose test as directors are not empowered to act in their own best interest. In such a situation, directors would be acting partially for an improper purpose, and their defensive actions would have to be invalidated.

[113] *Ibid*.

2.4.2.2 Cases validating *bona fide* defensive tactics causing entrenchment

2.4.2.2.1 The *Teck* case

In *Teck Corp. v Millar* ("*Teck*"), the Canadian Court had the opportunity to evaluate the legality of a *bona fide* defensive tactic instituted with the primary goal of increasing target corporation value, but with the secondary effect of causing management entrenchment. In this case, Teck Corp made a hostile bid for the shares of Afton. In response to this hostile bid, the directors of Afton concluded an agreement with Canex (its white knight). This agreement provided that Afton would issue shares to Canex in the event that Teck attained a majority of Afton's voting securities.[114] The primary goal of this defensive tactic was to prevent the success of the undervalued Teck bid, by preventing Teck from gaining a controlling interest in Afton. A secondary consequence of this agreement was clearly management entrenchment.

In this case, the Court rejected the *Hogg* case's ratio as not being the law in Canada, substituting the proper purpose test for the "business judgment rule".[115] Thus, if directors implement defensive measures in order to defend the company against an unfavorable bid, the directors acted in good faith, in the best interest of the corporation, and based on reasonable grounds, then target directors will not be in breach of their fiduciary duties.[116] In such circumstances, the court will not invalidate the defensive actions of target management even if the directors personally

[114] The requirement that all shareholders be treated equally would most likely invalidate this type of defensive tactic if employed today.
[115] *Teck*, *supra* note 36 at para 99.
[116] *Ibid* at para 163: The burden of proof to prove that the directors did not comply with these fiduciary duties rests on the complainant.

benefitted from the defensive measures as shareholders[117] or through continued employment.[118] When evaluating whether defensive tactics would be in the best interest of the corporation the target directors may consider several factors including:

1. Who is seeking control, the bidders' history and its reason for seeking control;[119]
2. The consequences of the offer on the employees and wider community; (and)[120]
3. The impact of the offer on the corporation and the shareholders[121]

This change of focus should result in courts allowing the implementation of *bona fide* defensive tactic regardless of indirect or secondary director benefit through entrenchment.[122]

2.4.2.2.2 The *Olympia* case: (Expansion of the *Teck* principle)

In the *Olympia* case, the Court again had the opportunity to assess the validity of implementing a *bona fide* defensive tactic, which also indirectly benefits directors through entrenchment. The Court found that, director benefit through entrenchment or otherwise would not render the defensive action invalid, as long as the maximization of target corporation and shareholder value remained the primary objective of the defensive action. The *Olympia* case thus affirmed the conclusion reached in the *Teck* case; focussing the evaluation on whether target directors implemented the defensive tactics in compliance with their directors' duties. The application of the findings in the *Olympia* case has the following consequences: If target directors implement

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[117] *Ibid* at para 148.

[118] *Ibid* at para 110 and 315 as applied in *Re Olympia & York Enterprises*, *supra* note 84 at para 53-55.

[119] *Teck*, *supra* note 36 at para 109 and 117.

[120] *Ibid*, at para 106-107 but note that it would be a breach of fiduciary duties to disregard entirely the interests of a company's shareholders in order to confer a benefit on employees or the wider community.

[121] *NP 62-202*, *supra* note 20 s.1.1(2). *Re Olympia & York Enterprises*, *supra* note 84 at para 67; CW Shareholdings, *supra* note 43 at para 41 and 97; *Corona Minerals Corp v CSA Management Ltd.* (1989), 68 O.R. (2d) 425 (Ont. Sup Ct) at para 429.

[122] *Teck*, *supra* note 36 at para 315 and 110 and as applied in *Re Olympia & York Enterprises*, *supra* note 84 at para 53-55.

defensive actions with the primary goal of benefitting themselves through entrenchment, they will not have "acted honestly and in good faith in the best interests of the corporation based on reasonable grounds" and the court will likely invalidate the defensive action. If on the other hand the directors implement defensive tactics with the primary *bona fide* goal of benefitting the target corporation based on reasonable grounds, the target directors will have complied with their directors' duties. In such circumstances, the court will not deem management entrenchment as a secondary benefit to directors, a determining factor in considering whether to invalidate the defensive action. This view is consistent with the recent finding in *Lions Gate Entertainment Corp. v Icahn Partners LP*[123] ("*Lions Gate"*). In the *Lions Gate* case, the Supreme Court held that the target directors did not act oppressively by diluting a hostile takeover bidder's minority shareholding for the primary purpose of benefitting target shareholders,[124] even though this resulted in management entrenchment.[125] The *Teck* and *Olympia* cases thus do not require target directors to act perfectly impartially, but rather require them to "take all reasonable steps to avoid and/or reduce any conflict of interest".[126]

2.4.2.3 Case invalidating a *bona fide* defensive tactic causing entrenchment: (Conflicting judgment)

In *Exco* Corp. v Nova Scotia Savings & Loan Co ("*Exco*")[127] the Court evaluated the same question considered in the *Teck* and *Olympia* cases and came to the complete opposite conclusion, aligning itself with the *Hogg* case from the United Kingdom. In this case, Exco (the

[123] *Lions Gate supra* note 37.
[124] The primary benefit gained from the diluted shareholding, was a reduction in company debt.
[125] *Ibid*
[126] *Re CW Shareholdings*, *supra* note 43 at para 43.
[127] *Exco Corp. v Nova Scotia Savings & Loan Co.* (1987), 35 B.L.R. 149, 78 N.S.R. (2d) 91, 193 A.P.R. 91 (N.S. SC TD).

target corporation) issued shares to its white knight with the goal of defeating an unfavorable hostile bid from another corporation. This action would inevitably also cause management entrenchment as a secondary effect. With regard to the effect of management benefit on the legality of defensive tactics, the Court made the following findings:

1. If shares are issued with the primary goal of affecting the control of the corporation, the directors would be acting contrary to their fiduciary duties;
2. Directors must act exclusively in the best interest of the corporation, completely ignoring all other interests;[128] (and)
3. The burden of proof should rest on the directors to prove that they complied with their fiduciary duties when a defensive tactic is challenged on grounds of director bias.

The finding in the *Exco* case "that shares should not be issued purely for the purpose of affecting the material control of the corporation" is a well-established legal precedent, consistent with *Teck* and *Olympia*, and is not controversial.[129] Note that in the *Teck* case the shares were to be issued with the primary goal of defending the company against an unfavourable hostile bid benefitting target shareholders, and not "purely for the purpose of affecting the material control of the corporation." With regard to the second finding, namely "that directors must act exclusively in the best interest of the corporation ignoring all other interests when implementing defensive tactics" the Court takes a radically different line from the *Teck* and *Olympia* cases, and overreaches itself for the following reasons:

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[128] *Ibid* at para 345.

[129] *Howard Smith Ltd. V Ampol Petroleum Ltd. Et al*., [1974] A.C. 821 (P.C.) at para 837 on appeal from the supreme court of New South Wales to the Privy Council as applied in *Re Olympia & York Enterprises, supra* note 84 at para 52-53: Even if the target directors act honestly and within their powers their actions will not be saved if they issued shares with the primary purpose of altering the majority shareholding. The "issue of shares purely for the purpose of creating voting power has repeatedly been condemned" and will result in the invalidation of the allotment.

1. This requirement is inconsistent with the corporate law and securities law related directors' duties, as presented in this chapter. Corporate law and securities law related directors' duties require directors to "take all reasonable steps to avoid or reduce their conflict of interest"[130] not to act perfectly-impartially.[131] This case would force courts to invalidate a defensive tactic instituted with any secondary director benefit, even if it primarily and substantially benefits target shareholders. This approach would be contrary to primary purpose of Canadian takeover law provisions.[132]
2. This case furthermore reduces the relevant considerations to one factor, namely the best interest of the target corporation. This finding is inconsistent with the judgment in the *BCE* (and *Teck*) cases where it was held that the best interest of the corporation should be the primary concern, but that target directors may consider external factors when contemplating the use of defensive tactics.[133]
3. Finally, the requirement "that target directors should be required to prove that they complied with their fiduciary duties when a defensive tactic is challenged on grounds of bias" represents an improper application of the enhanced scrutiny standard required in the United States. Under Canadian law, the burden of proof generally lies with the

[130] *Re CW Shareholdings*, *supra* note 43 at para 43.

[131] I will use director remuneration as an unrelated example to illustrate this point. As a statutory example of the fact that perfect director selflessness is not required I point to the fact that corporate law statute exempts directors from their conflict of interest provisions when voting on their own remuneration – see CBCA, *supra* note 33 s.120: Directors are remunerated for the services they provide to the corporation. The primary goal of remuneration (from the perspective of the corporation) is to maximise shareholder value through greater profits as result of effective management. The secondary goal of the remuneration is to benefit the directors who are providing the services. If the idyllic requirements that are set in the *Exco* case are followed through, it would also require target directors to work for little or no remuneration in order to exclusively benefit the corporation (not themselves).

[132] *NP 62-202*, *supra* note 20 s.1.1(2).

[133] Factors that can be considered when evaluating defensive tactics include the following: Who is seeking control, what is their history, why are they seeking control, the consequences of the offer on the employees and wider community, and the impact of the offer on the corporation and the shareholders and security holders. The best interest of the corporation and its shareholders remain the primary consideration however. See *Teck*, *supra* note 36 at para 109, 106 and 117; BCE, *supra* note 63; CBCA, *supra* note 33 s.192.

complainant, unless it is clear that the directors did not take all reasonable steps to avoid or reduce their conflict of interest. Only in such a case, where the directors failed to take all reasonable steps to avoid or reduce their conflict of interest, does the burden of proof shift to the directors.[134]

2.4.2.4 Conclusion to the legality of *bona fide* defensive tactics causing entrenchment as secondary effect

From the cases presented above it should be clear that there exists ambiguity in the handling of *bona fide* defensive tactics causing indirect management benefit. In light of the cases described in this section of the thesis, I advocate rejection of the *Hogg* case, and the proper purpose test it applies to the evaluation of directors' duties. I also argue that the principles laid down in the *Exco* case should only find application "where there is an arbitrary issue of shares with the primary goal of affecting control of the target corporation". *National Policy 62-202*, asserts that the protection of the *bona fide* interests of target shareholders is the primary purpose of Canadian takeover law provisions.[135] Any invalidation of a legal, *bona fide* defensive tactic that benefits the target corporation and shareholders will thus run contrary to the goal of Canadian takeover law objectives. I suggest that the *Hogg* and *Exco* cases misplace the emphasis of evaluation and encourage results that are clearly opposed to the general goals of Canadian securities law. I propose that the court should focus on compliance with corporate law and securities law related directors' duties, which already incorporates a good faith provision, rather than focussing on whether the directors exercised their power for the "proper purpose". Target corporation and shareholder value maximisation should be the primary factors in the minds of the directors, not

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[134] *Pente*, *supra* note 36 at para 38; *Re CW Shareholdings*, *supra* note 43 at para 43.
[135] *NP 62-202*, *supra* note 20 s.1.1(2).

the establishing the "proper purpose" of their mandate.[136] Finally, I argue that the findings in *Teck* and *Olympia* cases, relating to the evaluation of *bona fide* defensive tactics causing indirect management entrenchment, should be accepted. More specifically, I argue that indirect director benefit should not be a determining factor in establishing the validity of a defensive tactic, as long as the defensive tactic was instituted with the primary goal of benefitting the target corporation, in compliance with corporate law and securities law related directors' duties. It should however be noted that the appointment of a truly independent special committee usually alleviates concerns regarding any conflict of interest that might exist between the target directors and shareholders. It is thus highly recommended that target directors make use a truly independent special committee when evaluating the use of defensive tactics in a takeover situation.

2.5 Conclusion

This chapter established examined the first part of the regulatory regime governing break fees and asset purchase options. More specifically this chapter examined the directors' duties and rules that apply generally to the implementation of all defensive tactics, including break fees and asset purchase options. In conducting the examination this thesis focussed explicitly on:

1. Information dissemination requirements;
2. Voting and shareholder democracy duties;
3. Partiality and valuation duties;
4. The canvassing duty;
5. The public interest jurisdiction of the securities regulators;
6. The fiduciary duty and the duty of care skill and diligence;

[136] *Ibid.*

7. The application of the business judgment rule; (and)
8. The effect of management entrenchment as secondary effect

The following section of the thesis (Chapter 3) will complete the examination of the regulatory regime by analysing the specific directors' duties and rules governing the implementation of break fees and asset purchase options.

Chapter 3: The regulatory regime part 2: Specific directors' duties and rules applicable to the implementation of break fees and asset purchase options, and the regulatory doctrine

3.1 Introduction and importance of break fees and asset purchase options

3.1.1 Introduction

This chapter builds naturally on the preceding chapter by examining the second ("specific") part of the regulatory regime governing the use of break fees and asset purchase options. In conducting this analysis, I firstly describe the two main approaches to regulatory design of directors' duties, namely agency theory and stewardship theory. I then continue to argue for the remainder of the chapter and thesis that Canada actually employs a third approach to the regulation of break fees and asset purchase options. Following this, I examine some of the basic economic consequences of break fees and asset purchase options. Finally, I evaluate the specific directors' duties and rules applicable exclusively the implementation of break fees and asset purchase options. This chapter then concludes by integrating the general directors' duties (discussed in Chapter 2) with the specific directors' duties discussed in this chapter.

3.1.2 Importance of break fees and asset purchase options

Break fees and asset purchase options are relatively recent additions to the repertoire of defensive tactics available to target directors.[137] These two types of contracts originated as an obscure form of insurance policy, but quickly evolved into a dominating force in takeovers. Notwithstanding the relatively recent development of these contracts, break fees are currently

[137] P. Andr´e, *supra* note 2 at 542; M.S. Officer, "Termination fees in mergers and acquisitions" (2003) 69 Journal of Financial Economics 431 at 441.

practically employed as the norm in Canadian takeover proceedings.[138] Even more surprising than the frequency at which these contracts are negotiated in the Canadian context, is the stark difference in the quantum of these fees compared to other jurisdictions. Where countries like the U.K., Germany, France, and Australia apply a 1% limit to the quantum of break fees asset purchase options,[139] the Canadian regulatory regime has developed a generally accepted range of between 3 and 5 percent of target corporation value.[140]

3.2 Agency theory, stewardship theory and the broad welfare function theory

3.2.1 The structure of analysis

This thesis aims to establish the doctrine underlying the currently regulatory regime governing break fees and asset purchase options. The aim here is simply to discover the underlying doctrine, not to advocate doctrinal change. This investigation has one specific goal, namely to aid in linking the regulatory regime governing break fees and asset purchase options with its empirical results. It should thus be clear that activist theories of analysis that aim to change (liberalise) the doctrine underlying the regulatory regime would be inappropriate within the scope of analysis conducted in this thesis. Kent Greenfield presents one example of such an activist theory, in his article *New Principles of Corporate Law*.[141] In this article, Professor Greenfield persuasively argues what he deems to be good doctrinal underpinnings of a corporate law regulatory regime. He then imposes these good doctrinal underpinnings on the regulatory regime, describing what the law should be if the reader accepts his good doctrinal theories. This

[138] A. Gregory, "Discussion of Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers?" (2007) 34:3-4 Journal of Business Finance & Accounting 567 at 567.
[139] *Ibid.*
[140] M. Condon, *supra* note 11 at 561.
[141] K. Greenfield, "New Principles of Corporate Law" (2005) 1 Hastings Business Law Journal 87.

approach is ill suited for current purposes as it describes what the foundational doctrine should be, not what it currently is.[142] This methodology is also inappropriate for current analytical purposes based on the stakeholder approach it subscribes to, as described below.

As demonstrated in the *Torstar* and *Olympia* cases above, the implementation of break fees and asset purchase options are subject to concurrent corporate and securities law regulation.[143] While corporate law largely defers to target directors under the business judgment rule, securities law mandates certain behaviour from target directors irrespective of their business judgment.[144] Furthermore, securities law acknowledges the interests of target shareholders as the predominant consideration in takeover situations.[145] Thus, for better or worse, the regulatory regime dictates either "shareholder primacy" or "enlightened shareholder value" during a takeover situation.[146] Any theory advocating a "stakeholder" perspective will thus fail to describe the doctrine currently underlying the regulatory regime governing break fees and asset purchase options. As these stakeholder-based theories fail to describe the current Canadian takeover regime, they provide no aid in linking the regulatory regime to its empirical effects. I thus specifically reject

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[142] *Ibid.*

[143] *Re Olympia & York Enterprises*, *supra* note 84 at para 58; *Torstar supra* note 3 at 9-11.

[144] See page 28 and 3035 of this thesis (headings 2.3.3.1 and 2.3.3.2).

[145] *NP 62-202, supra note 20 s.1.1(2); 347883 Alberta*, *supra* note 20 at para 37; *Teck*, *supra* note 36 at para 109, 106 and 117. Although the primary objective of Canadian takeover bid legislation is the protection of the bona fide interests of the target shareholders, the court in BCE, *supra* note 63 also allows target directors to consider other subservient factors. It should be clearly understood though that these secondary considerations are subordinate to the main consideration, which remains the best interest of target corporation and its shareholders. Subservient considerations may thus be considered to the extent that they are consistent with the best interest of the corporation and its shareholders.

[146] *Ibid. and* A. Keay, "Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach" (2007) 29 Sydney Law Review 577 at 589-590: According to the "enlightened shareholder value approach" directors must manage the corporation in the best interest of the shareholders, but may take other (stakeholder related) factors into consideration. These other stakeholder related considerations are however always subordinate to shareholder interests and may only be advanced in the furtherance of long term shareholder welfare. Directors thus remain the agents of shareholders in the economic sense. The shareholder primacy theory on the other hand contends that shareholder interests are the exclusive issue of concern to target directors. *NP 62-202, supra* note 20 s.1.1(2); read together with BCE, *supra* note 63; seems to advocate an enlightened shareholder value approach to takeover law.

the application of these stakeholder-based theories as inappropriate in the current context of evaluation. One specific example of such a stakeholder-based approach is the "*Team Production Theory*" advanced by M.M. Blair and L.A. Stout.[147] This theory advances the idea that directors (acting impartially) are free to allocate rents among various stakeholders. According to this theory, shareholders are simply one of many stakeholders contributing to team production, and directors are free to allocate rents to them or other stakeholders as the directors see fit. This theory could conceivably be a useful method for analysing exclusive corporate law relationships, where directors enjoy a great degree of deference in terms of the business judgement rule. It however, fails to take account of the specific compliance standards set by securities law within a takeover context, and is thus inappropriate with regard to the analysis of takeover situations.[148]

The theoretical approach that will be followed in this thesis, focusses on the normative aspects of the principal agent relationship. This analysis focusses on how the principal agent relationship is structured, and why it is structured in that way. Furthermore, this theoretical approach examines whether legislative inducements and disincentives in the form of directors' duties and rules are being employed in order to harmonise principal-agent interests. Even more fundamentally, it examines whether these legislative inducements and disincentives serve any purpose whatsoever. This approach has clear advantages compared to the before-mentioned theoretical approaches. Firstly, this is not a stakeholder-orientated theory and as such is conducive to analysing takeover situations, where securities law mandates a "shareholder primacy" or "enlightened shareholder

[147] M.M. Blair, L.A. Stout, "A Team Production Theory of Corporate Law" (1999) 85:2 Virginia Law Review 247 at 253; R. Yalden, et al. *Business Organizations: Principles, Policies and Practice*, 1st ed. (Toronto: Emond Montgomery Publications, 2008) at 43; L.L. Lan, L. Heracleous, "Rethinking Agency Theory: The View From Law" (2010) 35:2 Academy of Management Review 294 at 298; J.T. Mahoney, "Towards a Stakeholder Theory of Strategic Management" (2006) Paper presented at professional development workshop at the Academy of Management, August meetings in Atlanta, GA at 9.
[148] *Ibid.*

value" approach.[149] This approach thus assumes that there is one particular decision making body considering the use of break fees and asset purchase options, namely the directors. The approach furthermore assumes that this decision making body is principally responsible for advancing the interests of shareholders.[150] Within this theory, the regulator will theoretically aim to constrain any problematic behavior of the decision making group, and encourage the behaviour the regulator deems positive. What is, and what is not, problematic is defined by the regulatory regime itself. In this regard, *National Policy 62-202*, asserts that the protection of the *bona fide* interests of target shareholders is the primary purpose of Canadian takeover law provisions.[151] The approach followed in this thesis is thus consistent with the approach described by Professor Ronald B. Davis in his article "*Fox in S-OX North, A Question of Fit: The Adoption of United States Market Solutions in Canada*".[152]

Broadly speaking this theoretical framework falls within the neoclassical variant of law and economics, analysis.[153] The approach employed in this thesis assumes that directors are rational actors in line with the school of law and economics, as advanced by Richard A. Posner, but ignores all reference to the fact that efficiency forms the foundation of law.[154] In line with the neoclassical variant, the broad director welfare function (described below) assumes that directors act rationally to maximise their own utility, which could potentially result in agency costs.[155] Also in line with the neoclassical variant, the broad director welfare function assumes that

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[149] *Supra* note 146.
[150] *Ibid.*
[151] *NP 62-202*, *supra* note 20 s.1.1(2).
[152] R.B. Davis, "Fox in S-OX North, A Question of Fit: The Adoption of United States Market Solutions in Canada" (2004) 33 Stetson Law Review 950 at 951.
[153] W.W. Bratton, "The New Economic Theory of the Firm: Critical Perspectives from History" (1988-1989) 41 Stanford Law Review 1471 at 1478; R. Yalden, *supra* note 147 at 41.
[154] R.A. Posner., *Economic analysis of law*, 7th ed. (New York: Aspen Publishers, 2007).
[155] *Supra* note 153.

directors act as the agents of shareholders in an economic sense, with the goal of maximising shareholder wealth during a takeover situation.[156] A second advantage of utilising this theoretical framework is that is allows us to examine the doctrine underlying the current regulatory regime without an external theory of what the law should be. In other words, this approach does not describe what the underlying doctrine should be; it simply examines the relationship at issue. Once again, it should be noted that the aim of this thesis is not to evaluate the moral correctness of the regulatory regime governing the use of break fees and asset purchase options. The aim is simply to establish the underlying doctrine, so that it may aid in determining if there exists a logical correlation between the regulatory regime and the empirical effects of break fees and asset purchase options.

3.2.2 The agency theory: Literature review and analysis

At its core, the positivist agency theory has long focussed on identifying situations where a principal and an agent are likely to have conflicting interests.[157] In this regard, agency theory does not require true (legal) agency in order to apply. This theory simply requires a delegation of discretionary power from a principal actor to an agent actor where the agent is required to act

[156] *Ibid.*

[157] M.C. Jensen, W.H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 Journal of Financial Economics 305 at 305; K.M. Eisenhardt, "Agency Theory: An Assessment and Review" (1989) 14:1 The Academy of Management Review 57 at 58-60; J.H. Davis, F.D. Schoorman, L. Donaldson, "Toward a Stewardship Theory of Management" (1997) 22:1 The Academy of Management Review 20 at 22; L. Donaldson , J.H. Davis, "Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns" (1991) 16:1 Australian Journal of Management 49 at 50, 51, 60; T.W. Bates, M.L. Lemmon, "Breaking up is hard to do? An analysis of termination fee provisions and merger outcomes" (2003) 69:3 Journal of Financial Economics 469 at 475; J. Curtis and S. Pinder, "Break Fee Restrictions: Where's the Harm?" (2007) 14:2 Agenda 111 at 113-117; L. Chapple, B. Christensen "Termination fees in a 'bright line' jurisdiction" (2007) 47 Accounting and Finance 643 at 644, 648; J. Coates, J. Cogan, "M&A Break Fees: US Litigation vs. UK Regulation" (2009) Harvard Public Law Working Paper No. 09-57, 0 at 6-11; A. Gregory, *supra* note 138 at 570; P. Andr´e, *supra* note 2 at 545; M.S. Officer, *supra* note 137 at 439; M. Harris, A. Raviv, "Some Results on Incentive Contracts with Applications to Education and Employment, Health Insurance, and Law Enforcement" (1978) 68:1 The American Economic Review 20 at 20-23.

in the best interest of the principal.[158] Modern Canadian corporate statutes delegate discretionary power to directors to manage or supervise the affairs of the target corporation,[159] generally acting free from shareholder interference.[160] The organisational structure of the modern Canadian corporation has thus largely separated the owners (i.e. shareholders) from the controllers (i.e. directors and officers).[161] From an agency perspective, shareholders thus act as "principals" while directors serve as their "agents" in economic terms.[162] Within this corporate management structure, agency theory assumes that both shareholders (principals) and directors (agents) are rational self-serving utility maximizers.[163] This naturally leads this school to the conclusion that both shareholders and directors are motivated to participate in the abovementioned corporate structure based on opportunities for personal gain.[164]

Agency costs are defined as the returns shareholders would have earned if they had exercised direct control over the corporate assets, less the returns earned by the directors in practice. Agency costs would thus be absent if directors and shareholders had perfectly coinciding utility functions, while agency problems would arise if these utility functions diverged.[165] At its core, agency theory argues that the strong personal gain motive of both actors, combined with the divorce of ownership and control, and a misalignment of principal-agent interests, culminate in

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[158] *Supra* note 157.
[159] CBCA, *supra* note 33 s.102(1). BCBCA, *supra* note 33 s.136.
[160] *Peoples Department Stores*, *supra* note 34 interpreting the CBCA, *supra* note 33 s.102(1).
[161] J.H. Davis, *supra* note 157 at 23, 42.
[162] *Supra* note 157.
[163] J.H. Davis, *supra* note 157 at 22; J. Curtis, supra note 157 at 113-115; M.C. Jensen, supra note 157 at 5; M. Harris, *supra* note 157 at 21; L. Donaldson, *supra* note 157 at 50; K.M. Eisenhardt, *supra* note 157 at 59-60; L. Chapple, *supra* note 157 at 650; J. Coates, supra note 157 at 7; A. Gregory, *supra* note 138 at 570; P. Andr´e, *supra* note 2 at 545; M.S. Officer, *supra* note 137 at 437.
[164] *Supra* note 163.
[165] L. Donaldson, *supra* note 157 at 49-50; M.S. Officer, *supra* note 137 at 432; M.C. Jensen, supra note 157 at 7. J.H. Davis, *supra* note 157 at 22; J. Curtis, supra note 157 at 113-115; L. Chapple, *supra* note 157 at 649-650; P. Andr´e, *supra* note 2 at 545.

agency problems.[166] When focussing on takeover situations, this school argues that the agency costs emanate from the fact that target managers negotiate both the acquisition price, and the future management composition of the target corporation.[167] As this theory assumes directors to be rational self-interested wealth maximizers, directors are presumed to negotiate takeovers in their own best interest, to the detriment of shareholders. With reference to the scope of this thesis, this school argues that target directors will tend to employ break fees and asset purchase options in order to protect the bid most beneficial to themselves[168] serving as an entrenchment mechanism.[169] In this regard, it should be noted that break fees and asset purchase options always assume the presence of a friendly bidder. This is the obvious conclusion to the fact that the target board negotiates contractual break fees and asset purchase options.

Agency theory advances the use of extensive governance mechanisms and director compensation schemes aimed at aligning shareholder and director interests, thereby mitigating agency costs.[170] Financial incentive schemes provide rewards and punishment that aim to aligning principal-agent interests while governance mechanisms such as audits, non-management board requirements, shareholder communication obligations, and performance evaluations provide external control and enforcement.[171] The *Hogg* and *Exco* cases described in the preceding chapter may be described as two examples of the agency approach to regulatory design at work. In these two cases, the Court noted the potential agency problems inherent in a takeover situation, and

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[166] *Supra* note 165157; *Supra* note 157; *Supra* note 163.
[167] *Supra* note 157 and R Clark, supra note 70 at 588-589.
[168] J. Curtis, supra note 157 at 113-115; L. Chapple, *supra* note 157 at 649-650; J. Coates, supra note 157 at 7; A. Gregory, *supra* note 138 at 567-568; P. Andr´e, *supra* note 2 at 545; M.S. Officer, *supra* note 137 at 437.
[169] Ibid; supra note 163.
[170] *Supra* note 157.
[171] K.M. Eisenhardt, *supra* note 157 at 59.

attempted to provide a strict governance mechanism aimed at limiting the agent's potential self-serving behaviour.

For completeness sake, it should be mentioned that there exists another strain of agency school called the principal-agent approach. This form of agency theory operates in conjunction with, and has much in common with, the positivist agency theory described above. These strains however diverge with regard to the subject matter of analysis. While the positivist school has focussed almost exclusively on examining the agency problems inherent in the relationship between shareholders and directors of public corporations, the principle agent approach has focussed on examining a general theory of principal-agent relationships.[172] In this regard, the principle agent approach examines agency problems in a broad array of relationships including employer-employee, lawyer-client, buyer-supplier, insurer-insured, owner-man-ager and other agency relationships.[173] As the positivist approach applies itself more directly to the subject matter of evaluation, this will be the predominant doctrine considered in the remainder of this thesis.

3.2.3 The stewardship theory: Literature review and analysis

The stewardship school, also called the "efficient contracting hypothesis" or the ‘‘shareholder interest’’ theory, stands opposed to the agency school discussed above.[174] While agency theory

[172] K.M. Eisenhardt, *supra* note 157 at 58-65.
[173] M. Harris, *supra* note 157 at 20-23.
[174] L. Donaldson, *supra* note 157 at 51; Davis, *supra* note 157 at 24-25; L. Chapple, *supra* note 157 at 644; P. Andr´e, *supra* note 2 at 546; M.A. Fox, R.T. Hamilton, "Ownership and Diversification: Agency Theory or Stewardship Theory" (1994) 31:1 Journal of Management Studies 69 at 69, 78; M. Hernandez, "Promoting Stewardship Behavior in Organizations: A Leadership Model" (2008) 80:1 Journal of Business Ethics 121 at 122; M. Muth, L. Donaldson, "Stewardship Theory and Board Structure: A Contingency Approach" (1998) 6 Corporate Governance: An International Review 1 at 5.

advocates the existence of a significant conflict between director-shareholder interests,[175] stewardship theory contends that director-shareholder interests largely converge.[176] The stewardship school argues that directors develop a high preference for organisational success based on organisational psychology and other sociological factors, promoting internally motivated alignment of director-shareholder interests.[177] The organisational psychology and sociological factors aligning director-shareholder interests include; director self-actualization, peer prestige, increased authority, personal duty, future employment opportunities and respect.[178] At its core, agency theory and stewardship theory are distinguishable with regard to one key assumption. Agency theory unequivocally assumes that directors will tend to act in their own narrow self-interest,[179] whereas stewardship theory assumes that directors will tend act in the organisation's best interest.[180]

In its most simplistic form, stewardship theory simply contends that directors act as shareholder utility maximizers, with little or no regard for their own welfare.[181] From a more meticulous perspective, stewardship theory implicitly accepts that directors are self-interested utility maximizers, but dispute the weighting of factors included in the director's utility function. While agency theory bestows little or no weight to a director's preference for organisational success,[182] stewardship theory bestows a very high weighting to this preference for

[175] *Supra* note 163.
[176] Ibid.
[177] L. Donaldson, *supra* note 157 at 51; J.H. Davis, *supra* note 157 at 24; M. Hernandez, *supra* note 174 at 121; Muth, *supra* note 174 at 6.
[178] L. Donaldson, *supra* note 157 at 51; J.H. Davis, *supra* note 157 at 27; Muth, *supra* note 174 at 6;
[179] *Supra* note 163.
[180] L. Donaldson, *supra* note 157 at 51; J.H. Davis, *supra* note 157 at 22; L. Chapple, *supra* note 157 at 644; P. Andr´e, *supra* note 2 at 546; R.T. Hamilton, *supra* note 174 at 78, M. Muth, *supra* note 174 at 5-6; Muth, *supra* note 174 at 6.
[181] L. Donaldson, *supra* note 157 at 51; Hernandez, *supra* note 174.
[182] *Supra* note 163.

organisational success.[183] In this regard, stewardship theory assumes that the agent places such a high value on organisational advancement that it overwhelms any utility that he may gain from purely individualistic profiteering.[184] Under this assumption the rational director will act in the organisations' best interest, even if that particular action decreases the director's individual profit, as this will maximize the director's welfare function.[185] Stewardship theory thus largely rejects the conclusions reached in agency theory, that the separation of ownership and control will create agency costs in takeover situations. With regard to the scope of this thesis, the stewardship school contends that break fees and asset purchase options will be utilised by target directors as competitive bid stimulating mechanisms, as opposed to an entrenchment devices.[186]

As stewardship theory largely rejects the presence of agency costs associated with the modern management structure, the takeover regime, and the use of break fees and asset purchase options, they also reject the use of governance mechanisms aimed at mitigating these costs. Stewardship theory contends that this form of regulation is either unnecessary or counterproductive, potentially undermining the internally motivated pro-organisational behaviour of the agent.[187] In opposition to these governance mechanisms advanced by the agency school,[188] the stewardship school recommends the encouragement of psychological and sociological factors, which they see as inspiring internally motivated alignment of director-shareholder interests.[189] Stewardship theory thus advocates for the removal of regulatory barriers that inhibit director performance.[190]

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[183] J.H. Davis, *supra* note 157 at 24-25.
[184] *Ibid.*
[185] *Ibid.*
[186] L. Chapple, *supra* note 157 at 644; P. Andr´e, *supra* note 2 at 546; Muth, *supra* note 174 at 6.
[187] L. Donaldson, *supra* note 157 at 51-52; J.H. Davis, *supra* note 157 at 25; Muth, *supra* note 174 at 6.
[188] *Supra* note 157.
[189] J.H. Davis, *supra* note 157 at 24; L. Donaldson, *supra* note 157 at 51; M. Hernandez, *supra* note 174.
[190] *Supra* note 187.

3.2.4 The broad director welfare function theory

This thesis suggests that the welfare function of target directors is more complex than the pure agency or stewardship theory would suggest, and includes elements of both theories. The broad welfare function theory accepts the proposition advanced by both the agency and the (meticulous) stewardship school that agents are self-interested wealth maximizers.[191] This theory however departs from the agency and stewardship schools with regard to the weighting of the agent's welfare function. On the one hand, this theory rejects agency theory's assertion that the welfare function of the agent includes little or no preference for corporate success.[192] On the other hand, this theory also rejects the stewardship theory's claim that the welfare function of the agent includes such a high preference for organisational success that it overwhelms any utility he may gain from individual profit.[193]

I propose that target directors have a broad welfare function including highly weighted preferences for both pure-individualised-advancement and organisational success. I propose that the agent's preference for organisational success may greatly mitigate the agent's preference for individual welfare but only to the extent that it could potentially provide current or future, tangible or non-tangible individual welfare advancement. One example of this would be investment in training, research, and development. If an officer's compensation scheme is linked only to current performance and the officer believes that an investment in training, research, and

[191] *Supra* note 163.
[192] *Ibid.*
[193] *Supra* note 180.

development[194] would benefit the corporation in the long term, the officer may decide to forsake current individual benefit in favour of long-term organisational success. The reason for this decision is not based on altruism, as some descriptions of stewardship theory would suggest,[195] but rather a cognisant choice to forsake current compensation[196] for future compensation in the form of prestige, future remuneration, limited philanthropy, and expansion of management-employment-opportunities.[197] In this regard, it should however be noted that the rational actor will only forsake current gain for potential future gain, if the potential future gain is greater than the forsaken current gain.[198]

The broad director welfare theory advocates the use of both governance mechanisms as well as compensation schemes aimed at limiting the agent's self-serving behaviour, when building a policy framework intended to provide externally motivated alignment of principal-agent interests. The inclusion of governance mechanisms in the policy framework contrary to the recommendations of the stewardship school[199] is justified by the hypothesis that agents do not act in the best interest of the "principal" based on internally motivated altruism but rather out of the potential for future personal gain. Since this theory assumes that agents are acting in their own perceived future best interest, even when forsaking personal benefit in favour of organisational welfare, governance mechanisms aimed at aligning principal-agent interests will not have the demotivating effect suggested by the stewardship school. Stated differently, mandating

[194] High investment in training, research, and development could likely cause short-term reduction in profits, and thus management compensation.
[195] *Supra* note 181.
[196] Here the director could choose to forsake current compensation in the form of additional directors' remuneration.
[197] *Supra* note 183.
[198] In economic terms, rational actors prefer current consumption to future consumption.
[199] *Supra* note 187.

governance mechanisms aimed at limiting agency problems may demotivate an altruist because it could detract from the good feeling he associates with making altruistic choices, since it is no longer an altruistic "choice" if regulation mandates it. This disincentive effect of governance mechanisms will however be muted for a non-altruist, who is acting in a third party's best interest, with the aim of advancing his own interests. It should however be noted that the governance mechanisms advanced in terms of the broad director welfare approach differs somewhat from that advocated by the agency school. The agency school tends to advocate for extensive governance mechanisms aimed at eliminating what they perceive to be strongly individualistic preferences of directors.[200] The broad director welfare approach however does not subscribe to the same assumption of directors' as exclusively self-serving. As the broad director welfare function incorporates organisational success into the welfare function of the director, this theory allows directors a large degree of leeway in exercising their business judgment. As such, the broad director welfare function imposes less stringent and more flexible governance mechanisms on target directors than that advocated by the agency school.[201] These less stringent, more flexible governance mechanisms aim to mitigate potential agency costs without stifling natural stewardship orientated behaviour.

The *Teck* and *Olympia* cases examined in the preceding chapter may be described as two examples of this broad welfare function theory at work. These two cases improved on the pure agency school approach followed in the *Hogg* and *Exco* case where the Court excessively limited director discretion, aimed at preventing agency costs. In the *Teck* and *Olympia* cases, the Court acknowledged the business judgment rule as the proper standard for evaluating directors' duties

[200] *Supra* note 157.
[201] *Ibid.*

during a takeover situation. This acknowledgement grants directors a great degree of deference, allowing them to take a broad range of factors into consideration when considering the implementation of defensive tactics. This deference however applies subject to the governance constraint, that defensive tactics must be instituted with the primarily goal of benefitting the target corporation and its shareholders, as opposed to the directors themselves.[202]

3.3 Break fees and asset purchase options

3.3.1 Functioning and basic economics of break fees and asset purchase options

3.3.1.1 Functioning and basic economics of break fees

A break fee defence is based on a contractual agreement between the target corporation and a third party friendly bidder usually called a white knight.[203] The contractual break fee represents the amount of money that the target corporation will be liable to pay the other contracting party (friendly bidder) for failing to conclude a takeover agreement.[204] The directors of a target corporation may choose to offer a break fee to a friendly bidder with the aim of stimulating an initial bid. Target directors may also choose to offer a break fee to a friendly bidder after an original bid had already been made, with the aim of soliciting an additional higher value bid from the break fee beneficiary.[205]

A break fee has two significant consequences: Firstly, it serves as an inducement to the recipient encouraging them to make a bid. In this regard, it is important to note that a rational bidder will

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[202] See page 35 of this thesis (heading 2.4.2.2.1).
[203] The fact that the target board negotiates this defensive tactic, leads to the natural conclusion that a break fee always requires the presence of a friendly bidder.
[204] M. Condon, *supra* note 11 at 561.
[205] *Ibid* at 559.

not enter into a bid, if the risk of loss outweighs the potential for gain.[206] The break fee thus serves as an inducement to the recipient by reducing the risk of loss associated with the bid. In essence, the target corporation contractually agrees to carry a substantial amount of the financial risk associated with the bid on behalf of the friendly bidder, in return for the takeover bid. The second significant consequence of the break fee defence is that it increases the cost of a third party hostile or neutral takeover bid, both in relative and absolute terms. If the hostile or neutral bidder successfully acquires the target corporation, that bidder inherits the contract between the target corporation, and the break fee recipient and is liable for the debt created by the break fee. If the white knight successfully acquires the target corporation, no break fee is payable. It thus costs the hostile or neutral bidder relatively more to make exactly the same offer, because the break fee is directly added into the cost structure of that bidder, as a dead-weight-cost. The quantum of the break fee thus represents the competitive advantage that the friendly bidder will have over the hostile or neutral bidder.

3.3.1.2 Functioning and basic economics of asset purchase options:

Break fees and asset purchase options are both variants of a broader inducement based defence[207] and are both based on a contractual agreement between target management and a friendly bidder. An asset purchase option is only distinct from a break fee in that, the target corporation undertakes to sell an asset to the friendly bidder,[208] conditional on the failure of those two parties

[206] Weighted to the amount of potential loss and gain.
[207] *Re CW Shareholdings*, *supra* note 43 at para 53; M.G. Hatch, "Clearly Defining Preclusive Corporate Lock-ups: A Bright-Line Test For Lock-up Provisions In Delaware" (2000) 75 Washington Law Review 1272, describe break fees and asset purchase options as both falling under the definition of lock-up devices; M.S. Officer, *supra* note 137 at 433, confirms the view that break fees and asset purchase options are fundamentally the same defence. Officer *supra* note 137 at 433 also expresses the view that data pertaining to break fees are highly relevant to asset purchase options (and vice versa).
[208] As opposed to paying a fee.

to conclude a takeover agreement. This contractual agreement usually stipulates the specific asset to be sold, as well as the exact price for which it will be sold, in the event that the friendly bid is unsuccessful.

As with the break fee, the directors of a target corporation may choose to offer an asset purchase option with the aim of stimulating an initial bid or to generate an additional opposing bid.[209] As break fees and asset purchase options are both variants of a broader inducement based defence,[210] it is not surprising that these two defensive tactics share the same two potential consequences. Firstly, asset purchase options may serve as an inducement to the recipient encouraging them to make a bid. Secondly, it may discourage offers from bidders that did not receive the assert purchase option. Both defensive tactics encourage higher value bids by offering an inducement, but function slightly differently with regard to their influence as bid discouragement mechanisms. The break fee functions as bid discouragement mechanism by increasing the cost of acquisition, whereas the asset purchase option creates this result by reducing the utility that the hostile bidder could potentially gain from the acquisition. The current and future utility that the hostile bidder would have gained from the asset subject to the asset purchase option, minus the current and future value of the remuneration gained from the sale of the asset, represents the reduced utility (of the hostile bidder) resulting from the implementation of the asset purchase option.[211]

In conclusion, it should thus be clear that although the substances of break fee and asset purchase option contracts differ, their economic behavioural effects are largely similar.

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[209] M. Condon, *supra* note 11 at 559.
[210] *Supra* note 207.
[211] M. Condon, *supra* note 11 at 559.

3.3.2 Specific directors' duties and rules governing break fee and asset purchase option legality in a takeover situation

Unlike many other jurisdictions such as the U.K., Germany, France, and Australia, the use of break fees and asset purchase options are not statutorily regulated in Canada. In this regard, Canada has largely followed the example set by the U.S., where courts conduct a complex *ex post facto* evaluation of the contractual device, as opposed to a simple, pre-emptive statutory capping rule."[212] In the absence of clear statutory guidance by the legislature, it has fallen to the Canadian courts and commissions to consider the validity of these contractual devices. In the *WIC Western International Communications* ("*WIC*") case, the Court had just such an opportunity, and laid down key standards for conducting this evaluation.

CanWest the largest non-voting shareholder in WIC Western made an offer for all outstanding shares of WIC at a price of $39 per share. The target directors responded to the CanWest bid by appointing a special committee to evaluate the original bid (made by CanWest) and canvass the market for potential alternative bidders. In fulfillment of its canvassing and bid, solicitation mandate the special committee concluded a pre-acquisition agreement with Shaw Communications. In terms of the pre-acquisition agreement, Shaw would make a competing offer of $43.50 per share for all non-voting WIC securities in exchange for a contractual break-fee of $30 million as well as an asset purchase option on WIC radio assets. CanWest challenged the legality of the break fee and the asset purchase option granted to Shaw Communications and applied for relief under the oppression remedy.[213] In responding to this question regarding the

[212] J. Coates, supra note 157 at 0.

[213] CBCA, *supra* note 33 s.241.

legality of implementing a break fee or asset purchase option in a takeover situation, the Court declared that the use of these contractual devices would not be illegal per se, and will be evaluated based on the following criteria:[214]

1. Whether the contractual device is required to induce a competing bid;[215]
2. Whether the competing bid might represent better value for the shareholders; In other words; whether the granting of the benefit associated with the contractual device represents enough additional value to the shareholders to justify its use;[216]
3. Whether the contractual device represents a reasonable commercial balance between its potential negative effect as an auction inhibitor and its potential positive effect as an auction stimulator;[217]
4. Whether the directors complied with their directors' duties in the execution of their decision to institute the contractual device;[218]
5. With regard to asset purchase options only: Whether the price that was offered for the asset corresponds to a reasonable degree to the value of the 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";[219] (and)
6. With regard to break fees only: The quantum of the break fee.[220] Although the quantum of the break fee could have a significant effect on the legality of the defensive tactic, it will not be the exclusive determining factor. In this case, the break fee represented 2.6%

[214] *Re CW Shareholdings*, *supra* note 43 at para 50 and para 54-57.
[215] *Ibid* at para 55.
[216] *Ibid* at para 55.
[217] *Ibid* at para 51.
[218] *Ibid* at para 55.
[219] *Ibid* at para 55.
[220] *Ibid* at para 50.

of the total Shaw offer, and since this percentage was well within the normal parameters for such inducements, the Court allowed it.[221]

It should be clear from what was discussed in Chapter 2 that shareholder approval is generally not required to validate a defensive tactic. Although this general rule holds true with regard to break fees there are certain peculiarities with regard to asset purchase options that warrant further elaboration, as this device deals with the sale of property. Theoretically the quantum of the asset purchase option could have important consequences with regard to the requirement of shareholder approval since "a sale, lease or exchange of all or substantially all the property of a corporation other than in the ordinary course of business requires the approval of the shareholders"[222] via a special resolution.[223] The following question thus beckons; what constitutes all or substantially all of the assets of a corporation? In the U.S. case of *Hollinger Inc. v Hollinger* the Court laid down the following test for answering this question: If a corporation is incapable of continuing with its normal business as result of the sale of an asset, that asset is deemed substantially all of the corporation's assets.[224] The Canadian Court has also had an opportunity to deal with this question in the *Olympia*[225] case where the Court assessed the validity of a significant asset sale, in response to a hostile takeover bid. In this case, Olympia launched an unsolicited takeover bid for Hiram Walker through its holding company Gulf Canada. In response to the unsolicited bid, the directors of Hiram Walker sold an asset representing 43% Hiram Walker assets, with the goal of generating enough funds to buy back its

[221] *Ibid* at para 107.
[222] CBCA, *supra* note 33 s.189(3).
[223] See CBCA, *ibid* s.189(8).
[224] *Hollinger Inc v Hollinger International Inc*. (2004), 858 A.2d 342 (Del. Ct Ch); Also see Business Corporations Act [SBC 2002] c. 57 s.301 and CBCA, *supra* note 33 s.189(3).
[225] *Re Olympia & York Enterprises*, *supra* note 84.

own shares through a subsidiary company called "Fingas".[226] With regard to the sale by Hiram Walker of its distilling business, the Court found, that the "unloaded" asset representing 43% of total assets, "did not come close" to constituting "the sale of all or substantially all of Hiram Walker's assets", and as such did not require a shareholder vote.[227] Secondly, the Court indicated that it would be reluctant to interfere in a sale of an asset, if the asset was sold for a fair value based on reasonable financial advice.[228]

Although the *Olympia* case dealt with an asset sale as opposed to an asset purchase option, the key question, regarding the meaning of the words "substantially all assets", remains the same in both circumstances. This case may thus find direct application to the use of an asset purchase option in a takeover situation, relating to the requirement of shareholder approval for this contract. The application of this case to the use and defensibility of asset purchase options has the following results. This judgment imposes an exceptionally high burden of proof on any hostile or neutral bidder asserting the invalidity of an asset purchase option, based on lack of shareholder consent. It is truly hard to conceive of a situation where the asset purchase option would be so large in scope as to trigger the definition of "all or substantially all assets" (provided above) and it may thus be concluded that shareholder approval will almost never be required to validate an asset purchase option. This conclusion is supported by the second finding presented in this case namely that that the court will be loath to interfere in a sale of an asset, if the asset was sold for a fair value based on reasonable financial advice.

[226] Fingas was a subsidiary company of Hiram Walker, in which Hiram Walker owned 49% of the voting equity but almost all of the economic interest.

[227] *Re Olympia & York Enterprises*, *supra* note 84 at para 82; In terms of the CBCA, *supra* note 33 s.189(3), "the sale, lease or exchange of all or substantially all the property of a corporation other than in the ordinary course of business of the corporation requires the approval of the shareholders". If the sale does not constitute the sale of all or substantially all of the corporation's assets no shareholder vote is required.

[228] *Re Olympia & York Enterprises*, *supra* note 84 at para 87, 90, 64, 48 read in conjunction.

3.3.3 Final conclusion and analysis of break fees and asset purchase options: Synthesis of general and specific directors' duties relating to break fees and asset purchase options

3.3.3.1 Final conclusion and analysis of general duties relating to break fees and asset purchase options

As described in Chapter 2 of this thesis, target directors are bound by a number of "general" corporate and securities law related directors' duties in a takeover situation. These "general" directors' duties regulate the actions of target directors with regard to the implementation of all defensive tactics, including the use of break fees and asset purchase options in the following significant ways:

1. *Information: Break fees, asset purchase options and the director's circular:* The regulatory regime promotes investor protection by mandating the distribution of a director's circular. This requirement functions as a governance mechanism, in line with the agency and broad director welfare function theory,[229] discouraging the misalignment of principal-agent interests. Alignment of interests is achieved by compelling the dissemination of crucial information held by management to shareholders. This promotes investor protection by allowing shareholders to make a fully informed decision with regard to the possible risks and rewards associated with tendering. With regard to break fees and asset purchase options, this governance mechanism ensures that target directors give a clear account of why they believe one bid to be superior to another, and thus why they concluded a break fee or asset purchase in the solicitation of that bid.

[229] *Supra* note 157.

2. *Voting: Break fees, asset purchase options, and shareholder democracy:* As discussed earlier, shareholder approval will almost never be required with regard to the implementation of break fees and asset purchase options.[230] This being said it should be noted that target shareholder approval might play a limited role in maintaining the validity of defensive tactics with regard to possible invalidation by the securities regulators or courts. For the most part however, shareholder democracy does not play a material part in the framework of corporate governance mechanisms ensuring principal-agent interests are aligned with regard to the implementation of break fees and asset purchase options. Stewardship theory may theoretically apply in this regard, as directors are allowed to function free from governance mechanisms relating to shareholder oversight.[231]
3. *Partiality and Valuation: Break fees, asset purchase options, and conflict of interest. The independent valuation requirement, special committee requirement and the placement of the burden of proof:* Although *Multilateral Instrument 61-101* requires a formal valuation[232] when implementing an insider bid, issuer bid, business combination, or related party transaction;[233] this is not specifically required when implementing a defensive tactic in response to a takeover bid. As long as directors "take all reasonable steps to avoid a conflict of interest",[234] the use of a break fee or asset purchase option will not be invalidated simply because no independent valuation was conducted or special committee appointed. In this regard, it should be noted that the establishment of an independent special committee comprised of non-management directors might be one of

[230] See page 13 and of this thesis above (heading 2.2.3.2 and 3.3.2.2.1).
[231] *Supra* note 157; *Supra* note 187.
[232] See *Magna*, *supra* note 44.
[233] *MI 61-101*, *supra* note 31 at part 2 to 5.
[234] *Re CW Shareholdings*, *supra* note 43 at para 43-45.

the steps required to ensure that directors "have taken all reasonable steps to avoid a conflict of interest".[235] Moreover, the appointment of a truly independent special committee usually alleviates concerns regarding any conflict of interest[236] leading to greater deference by the courts.[237] Notwithstanding the before mentioned, the question regarding the independent valuation and special committee requirement is only answerable in light of the facts of each specific case. The materiality of this corporate governance mechanism in evaluating the legality of break fees and asset purchase options, will thus depend greatly on whether the target directors were able to mitigate their conflict of interest with means other than the use of an independent special committee. This form of regulation adopts the broad director welfare function approach to regulatory design, not mandating an independent valuation, as the agency school would propose,[238] nor abandoning all external governance in favour of complete director deferral, as the stewardship school would recommend.[239] Instead, this design follows a flexible approach allowing directors to consider a variety of factors applicable to the particular takeover situation, as either mitigating-against or in-favour-of, an independent valuation. Directors may thus determine that the use of an independent special committee is not required with regard to the implementation of a break fee or asset purchase option. Directors however take this decision with the full knowledge that the court could potentially shift the burden of proof from the claimants to themselves, if it is found that they (the directors) did not "take all reasonable steps to avoid or sufficiently

[235] *Ibid.*
[236] *Pente*, *supra* note 36 at para 37.
[237] *Ibid* and *First Boston*, *supra* note 67.
[238] *Supra* note 157.
[239] *Supra* note 187.

reduce their conflict of interest".[240] In such circumstances, the court will tend to show very little deference to the directors in terms of the business judgment rule, likely requiring the directors to prove that the break fee or asset purchase option "was granted with a view to the best interest of the corporation". This interesting method of regulation thus sets out from a broad welfare function approach but adjusts itself either toward agency or stewardship theory depending on the actions of the target directors.

4. *Auction/canvassing: Break fees, asset purchase options, and the duty to auction/canvass:* The Canadian mandatory canvassing requirement has several important effects: Firstly, it compels target directors to inform themselves properly with regard to potential higher value offers promoting director compliance with their corporate law duties of care, skill and diligence. Directors owe their fiduciary duties to the corporation, but they owe duties of care, skill, and diligence to the shareholders themselves.[241] These duties require that each "director and officer of a corporation in exercising their powers and discharging their duties shall exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".[242] This objective duty requires that directors inform themselves adequately,[243] with regard to their corporate decisions, including the use of break fees and asset purchase options in a takeover situation. Directors thus cannot evade responsibility for their actions in terms of the business judgment rule, if they fail to properly inform themselves with regard to potential higher value offers.[244] Secondly, this requirement ensures that directors have reasonable

[240] *Re CW Shareholdings*, *supra* note 43 at para 43-45.
[241] *Peoples Department Stores*, *supra* note 34.
[242] CBCA, *supra* note 33 s.122(1)(b).
[243] "Adequately" refers to the way in which a reasonably prudent person would inform themselves, in comparable circumstances.
[244] *UPM-Kymmene Corp. v UPM-Kymmene Miramichi Inc*. (2002), 27 BLR (3d) 53 (Ont. SCJ) affirmed by [2004] O.J.

grounds[245] for asserting that their defensive actions were taken honestly and in good faith, in the best interest of the corporation.[246] Directors must act honestly, fairly and in good faith in the best interest of the corporation in compliance with their fiduciary duties to the corporation. "One way of determining whether the directors acted in the best interests of the corporation, is to ask what was uppermost in the directors' minds after a reasonable analysis of the situation".[247] When instituting defensive tactics such as break fees or asset purchase options, the market canvass allows directors to justify their actions based on reasonable grounds. The mandatory canvassing duty thus aids directors in compliance with their fiduciary duties to the corporation.[248] Thirdly, this mandatory search for higher value offers advances the primary goal of Canadian takeover bid regulation, by protecting the bona fide interests of target shareholders.[249] In the absence of a canvassing duty imposed on target management, the director-shareholder interests may not be aligned. In this regard, target management may seek to advance a low value bid favourable to incumbent target management, to the detriment of the corporation and its shareholders. The imposition of the canvassing mandate serves as a governance mechanism limiting the

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No. 636 (C.A.) and *Smith v Van Gorkom* (1985), 488 A2d 858 (Del. Sup Ct). It should however be noted that subsequent to this case (*Smith v Van Gorkom*) being decided, the Delaware legislature enacted a provision making director liability for breach of duty of care optional in that jurisdiction. This optional director liability for the breach of the duty of care is however not a feature of the Canadian regulatory regime.

[245] As described in chapter 2 of this thesis, target directors must have reasonable grounds for asserting that their defensive actions are taken with a view to the best interest of the corporation. Potential higher bids found through the canvassing of the market could serve as reasonable grounds for the implementation of these defensive tactics.

[246] *Pente*, *supra* note 36 at para 33-34. Also see *Teck*, *supra* note 36 at para 315-316, adopted as the law in Ontario by Montgomery J. in *Olympia & York Enterprises*, *supra* note 84 at para 255; *Brant*, *supra* note 84 at para 301 regarding the business judgment rule. *Re Olympia & York Enterprises*, *supra* note 84 at para 63 and 65-68. *Torstar supra* note 3 at 9-11.

[246] *Brant*, *supra* note 84 at para 314-315.

[247] *Pente*, *supra* note 36 at para 34. Also see *820099 Ontario*, *supra* note 89; CW Shareholdings, *supra* note 43.

[248] *Pente*, *supra* note 36 at para 33-34. Also see *Teck*, *supra* note 36 at para 315-316, adopted as the law in Ontario by Montgomery J. in *Olympia & York Enterprises*, *supra* note 84 at para 255; *Brant*, *supra* note 84 at 301 regarding the business judgment rule. *Re Olympia & York Enterprises*, *supra* note 84 at para 63 and 65-68. *Torstar supra* note 3 at 9-11.

[249] *NP 62-202*, *supra* note 20 s.1.1(2).

agent's (directors') self-serving behaviour by mandating the search for alternative higher value bids. This canvassing duty may be seen as complying with the broad welfare function theory and agency theory in that it identifies a situation where a principal and an agent are likely to have conflicting goals and then providing a governance mechanism that may serve to limit the agent's potential self-serving behaviour.[250] This governance mechanism however deviates from the agency model in favour of the broad welfare function theory, in that it allows target directors a great degree of deference with regard to the implementation of the canvassing mandate. In contrast to the broad welfare function theory, the agency school would tend to advocate the imposition of an auctioneering mandate, as this governance mechanism would tend to limit any potential self-serving behaviour of directors to the fullest extent.[251] The thorough and effective application of the canvassing mandate has a significant impact on the use of break fees and asset purchase options since break fees and asset purchase options are used to solicit an original bid or other competing higher value bids from canvassed bidders. This search for potential bidders that could potentially be solicited, is thus of utmost importance with regard to the functioning of these two defensive tactics.

5. *Public Interest: Break fees, asset purchase options and public interest jurisdiction of the securities regulators:* The securities commissions have a broad and far-reaching discretion with regard to potential orders in the public interest. The effect of this special interest jurisdiction is muted to a large degree however, because of the contractual nature of break fees and asset purchase options. The contractual nature of these defensive tactics places the regulation of break fees and asset purchase options outside the

[250] Supra note 163.
[251] Ibid.

regulatory authority of the commissions in favour of courts, unless the defensive tactic would prevent target shareholders from receiving a higher value offer.[252]

6. *Fiduciary duties and the duty of care skill and diligence with regard to break fees, asset purchase options:* Target directors are bound by corporate law fiduciary duties and duties of care skill and diligence in the implementation of break fees and asset purchase options. The courts and commissions will tend to show deference to a break fee and asset purchase option in terms of the business judgment rule if the directors act impartially, honestly, in good faith, in the best interest of the corporation, based on reasonable grounds and having informed themselves properly.[253] The application of the business judgment rule, once again indicates the application of the broad welfare function approach to regulatory design. This regulatory framework may be contrasted with the agency school approach followed in the U.S. where directors are required to demonstrate the entire fairness of the transaction when instituting defensive actions in a takeover situation (i.e. the enhanced scrutiny standard).[254]

7. *Business judgment rule and alternative choices with regard to break fees, asset purchase options:* Notwithstanding the application of the business judgment, if more than one reasonable alternative is open to the directors and one option is clearly available and more beneficial than the others, the directors would have to select the more beneficial alternative.[255] In this regard, a break fee or asset purchase option may not be offered in

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[252] A Anand, "Break Fees: Loathed but Legal" *National Post*, (March 5, 2002) FP11.
[253] *Torstar supra* note 3 at 9-11.
[254] *Re CW Shareholdings*, *supra* note 43 at para 63-66: In this case the Canadian Court contrasted the Canadian and U.S. approaches with one-other in order to emphasise the difference. Cede & Co. and Cinerama Inc. v Technicolor Inc., 1993 Fed. Sec. (CCH) 92,418 (2nd Cir. January 6, 1986) and Hanson Trust PLC v ML SCM Acquisition Inc., 781 F.2d 264 (2nd Cir. 1986) were cited (in the before-mentioned case) as two examples of U.S. authorities employing the "entire fairness" onus on directors; *supra* note 163.
[255] *Brant*, *supra* note 84 at 314-315.

the advancement of an inferior offer. In considering the merits of each offer, target directors may rely on the advice of experts, in their bona fide search for what will represent the best value for the corporation.[256] This governance mechanism simply provides an additional safety feature to the "broad welfare function approach", guarding against the use of break fees and asset purchase options to absurd effect.

3.3.3.2 Final conclusion and analysis of specific duties relating to break fees

As described above, target directors are bound by both general and specific directors' duties constraining the use of defensive tactics. The general directors' duties were described and evaluated in the preceding section and I now turn to the application of the specific duties, applicable exclusively to break fees and asset purchase options. In this regard, the courts have identified the following "specific" considerations in establishing whether a break fee is appropriate in a particular takeover situation:[257]

1. *Firstly, the contractual device must be required to induce a competing bid:*[258] This requirement is the natural continuation of the canvassing mandate and attempts to ensure that target directors comply with their fiduciary duties. Compliance with fiduciary duties is advanced by preventing directors from implementing the break fee or asset purchase option with the mala fide goal of benefitting one bidder over another, for personal gain.
2. *Secondly, there must be a reasonable probability that the competing bid would represent better value for the target shareholders, and this better value bid must be in proportion to*

[256] BCE, *supra* note 63; CBCA, *supra* note 33 s.192; *Re Olympia & York Enterprises*, *supra* note 84 at para 123.
[257] *Re CW Shareholdings*, *supra* note 43 at para 50 and 51.
[258] *Ibid*.

the benefit granted by the contractual device.[259] If the granting of an auction-ending provision is appropriate, it must confer a substantial benefit upon the stockholders in order to withstand scrutiny by the courts. This requirement also attempts to ensure that target directors comply with their fiduciary duties, by preventing them from artificially supporting a lower value bid with the goal of entrenching themselves. The value by which the competing bid drives up the takeover price might serve as an economic measure of the successful use of the break fee or asset purchase option.

3. *Thirdly, the contractual device must represent a reasonable commercial balance between its potential negative effect as an auction inhibitor and its potential positive effect as an auction stimulator:*[260] As indicated above the use of a break fee or asset purchase option in a takeover situation has two important economic consequences. Firstly, it serves as an inducement to the recipient, encouraging them to make a competing takeover bid by reducing the risk of loss associated with the potential failure of the bid. Secondly, it artificially increases the cost of acquisition or reduces the utility that the hostile or neutral bidder would gain from a successful acquisition, potentially inhibiting higher offers from those bidders. In requiring target directors to strike a balance between these two economic factors, the Court gives effect to *National Policy 62-202* in that it encourages an open and even-handed bidding process conducive to an unrestricted auction for the target company.[261]

4. *Fourth, directors must have complied with their general and specific directors' duties in the execution of their decision to institute the contractual device:*[262] Here the Court

[259] *Ibid*.
[260] *Re CW Shareholdings*, *supra* note 43 at para 50 and 51.
[261] *NP 62-202*, *supra* note 20 s.1.1(2),(4) and (5).
[262] *Re CW Shareholdings*, *supra* note 43 at para 55.

directly imports and expressly integrates the general directors' duties (discussed in Chapter 2) with the specific directors' duties (discussed in this chapter) relating to the evaluation of break fees and asset purchase options. This consideration requires that target directors implement these two contractual devices acting, impartially, honestly, in good faith, in the best interest of the corporation, and based on reasonable grounds. In the event that the decision of the directors, concluding the contractual device, was not informed or was induced by breaches of fiduciary duties, the contractual device will likely not survive scrutiny by the regulators".[263]

5. *Fifth, with regard to asset purchase options exclusively, there must be reasonable value offered for the asset in question.*[264] Where the price that was offered for the asset "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" the contractual device will likely be invalidated by the regulators. On the other hand, the courts have indicated that they would be loathed to interfere in the sale of an asset, if the sale represented fair value for the true worth of the asset.[265] This consideration again encourages target directors to comply with their fiduciary duties in the implementation of the asset purchase option.

6. *Sixth, with regard to break fees exclusively, the quantum of the break fee must fall within the reasonably acceptable range:* The Canadian courts have established what they consider to be a generally acceptable range, namely 3 to 5 percent of target corporation value.[266] A break fee in this range seems to suggest that target directors struck a

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[263] *Mills Acquisition Co. v MacMillan, Inc. (1989), 559 A.2d 1261 (Del. Sup Ct)* at para 69; *Revlon*, *supra* note 60 at para 183-84; see also Thompson v Enstar Corp., Del. Ch., 509 A.2d 578 (1984).
[264] *Re CW Shareholdings, supra note 43 at para 55.*
[265] *Re Olympia & York Enterprises*, *supra* note 84 at para 87, 90, 64 and 48 read in conjunction.
[266] M. Condon, *supra* note 11 at 561.

reasonable commercial balance between bid stimulation and inhibition.[267] This will however only function as a guideline and explicit consideration must be given to the facts of each case, specifically the risks associated with the particular bid and the benefits gained from the granting of the break fee.[268] It is thus important to note that, although the quantum of the break fee could have a significant effect on the legality of the defensive tactic, it will not be the exclusive determining factor.[269]

These specific regulatory rules are consistent with both the agency school and broad welfare function approach to regulatory design, as it institutes a set of governance mechanisms (rules) aimed at aligning principal-agent interests.[270] The broad welfare function approach to regulatory design contends that the agent's preference for organisational success may greatly mitigate the agent's preference for short term individual profiteering, but only to the extent that it could potentially advance his future individual welfare. A takeover situation however threatens to sever all ties between incumbent management and the target firm. Directors may thus have a diminished expectation of future gain from the target firm and as such may rather seek to advance short-term individualistic gain. As such, the imposition of these specific governance mechanisms limits the agent's potential self-serving behaviour, by constraining the use of break fees and asset purchase options to situations where it could advance a higher value bid.

[267] *Pacifica Papers Inc. v Johnstone* 2001 BCSC 1069, (2001) 15 B.L.R. (3d) 249 at para 118, 152; *Re CW Shareholdings*, *supra* note 43 at para 107.
[268] Pacifica Papers, *supra* note 267 at para 118 and 152.
[269] *Re CW Shareholdings*, *supra* note 43 at para 50.
[270] Supra note 163.

3.4 Conclusion

This chapter primarily analysed the second part of the regulatory regime governing the implementation of break fees and asset purchase options, namely the specific duties applicable exclusively to these two contractual devices. This examination concentrated explicitly on:

1. The bid inducement requirement;
2. The requirement that the solicited bid represent higher value to target shareholders;
3. The proportionality requirement (between bid stimulation and inhibition);
4. The requirement that target directors comply with their directors' duties when implementing the contractual device;
5. The requirement that reasonable value be offered for the asset subject to the asset purchase options; (and)
6. The requirement that the quantum of the break fee fall within the reasonably acceptable range determined by the court.

This chapter also applied the general directors' duties to the context it would function in, when applied to break fees and asset purchase options. Finally, this chapter examined the doctrine underlying the regulatory regime of general and specific directors' duties and rules regulating the implementation of break fees and asset purchase options. This analysis was aimed at describing and analysing the current regulatory regime of directors' duties as employing either an agency or stewardship perspective. The failure of either one of these theories to adequately describe the doctrine underlying the regulatory regime lead me argue that a third perspective, namely the "broad director welfare function theory" forms the actual basis of the regulatory regime.

The general and specific directors' duties examined in Chapter 2 and 3 along with the doctrine underlying these duties, will now be used in Chapter 4, to evaluate whether there exists a correlation between the regulatory regime and the empirical effects created by break fees and asset purchase options.

Chapter 4: Correlation between the regulatory regime and the empirical effects created by break fees and asset purchase options

4.1 Introduction to the empirical evaluation of break fees and asset purchase options

In this chapter of the thesis, new empirical evidence collected through a major study on the effects of Canadian break fees is examined.[271] After briefly describing these empirical findings, I proceed to analyse these empirical economic effects created by the Canadian regulatory regime governing break fees and asset purchase options. In conducting this analysis, I will attempt to show a logical correlation between the imposed Canadian directors' duties and the empirical outcomes created by Canadian break fees and asset purchase options, as demonstrated by the study. This is one of the key novel elements presented in this thesis. Past research, much of which I refer to in this chapter, simply examined the causational effects of break fees and asset purchase options. Stated differently, these articles provide substantive data on the effect of break fees and asset purchase options in practice, but do not evaluate the link between this data and the regulatory regime governing these two contractual devices. The aim of this chapter and thesis is to expand on this empirical research by providing a correlational link between the established empirical effects of break fees and asset purchase options, and the imposed Canadian directors' duties applicable to break fees and asset purchase options.

A secondary central idea presented in this chapter and thesis is that the broad director welfare function approach to regulatory design is applied in the regulation of Canadian break fees and asset purchase options. I will thus critically evaluate the role that this theory plays in creating the empirical outcomes produced by break fees and asset purchase options, in practice. It will be argued that much of the "positive" findings arising from the Canadian and U.S. studies on the

[271] P. Andr´e, *supra* note 2.

effects of break fees and asset purchase options stem from this approach to regulatory design. Based on the abovementioned findings, I will propose slight alterations to the current regulatory regime of directors' duties that might produce outcomes that are more desirable. Finally, I will explain the divergence of findings with regard to the empirical effects of break fees across jurisdictions. The aim of this section is two-fold. Firstly, it supports the validity of the empirical findings I rely on, regarding the effects of Canadian break fees and asset purchase options. Secondly, it supports the argument that the effects of break fees and asset purchase options are strongly tied to the regime regulating them.

4.2. Correlation between Canadian directors' duties and the empirical effects of break fees and asset purchase options

4.2.1 Introduction to the empirical effects of break fees and asset purchase options in Canada

In this section of the thesis, I will firstly describe the empirical economic effects of break fees and asset purchase options in the Canadian context. These findings are based almost entirely on the findings of *P. Andr´e, S. Khalil and M. Magnan, (2007) "Termination Fees in Mergers and Acquisitions: Protecting Investors or Managers"*[272] as this represents the only authoritative study on the empirical effects of break fees and asset purchase options within the Canadian regulatory framework.[273] The major conclusions of the study conducted by *P. Andr´e* are based on regression tests, specifically Multivariate Regression Analyses: Ordinary Least Squares ("OLS"). The study examined a sample of 262 completed and uncompleted mergers and acquisitions involving Canadian public firms with assets worth more than $15 million CAN as targets, over

[272] P. Andr´e, *supra* note 2.
[273] J. Coates, *supra* note 157 at 7.

the period 1997 to 2004. Out of this sample, 218 transactions included break fees while 44 included no break fees.[274] In examining the determinants of the relative level of break fees, they employ three models: The first model uses dummy variables for cash, ownership-measures, and toehold. The second model includes the level of cash used and of the toeholds as well as introducing ownership levels. The third model controls for potential non-linearities in the ownership variables. Clustered robust standard error estimates, control for multiple acquirers. These models are significant with an F –statistics of 4.26,[275] 4.08,[276] and 4.87[277] respectively, and an intercept of 3.525, 3.218, and 3.101 respectively.[278] Finally, these models explain 27–29% of the variation in the relative termination fees.[279] For brevity, and since all three models yield very similar results, I only refer to the combined results of all three models, for each area of analysis.[280]

I also utilise findings from a second authoritative study by *Officer*, (2003) "*Termination fees in mergers and acquisitions*" examining the empirical effects of U.S. break fees. This very authoritative study was based on a sample of 2,511 successful and unsuccessful U.S. mergers

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[274] P. Andr´e, *supra* note 2 at 559.

[275] This is the F-statistic (fixation indices) of Model 1. This indicates that the model fits the population from which the data was sampled.

[276] This is the F-statistic (fixation indices) of Model 2. This indicates that the model fits the population from which the data was sampled.

[277] This is the F-statistic (fixation indices) of Model 3. This indicates that the model fits the population from which the data was sampled.

[278] Simply put, the intercept explains what the break fee would be if all factors were held constant. I will demonstrate its significance with an example. If one unit change in the relative bidder merger costs, resulted in a positive change of 0.216 in the relative percentage break fee granted to the bidder (all other factors held constant), this indicates that the break fee would be 3.741 for model 1 (3.525 + 0.216 = 3.741). This is however, unnecessary detail for present purposes and I will not refer to this any further.

[279] P. Andr´e, *supra* note 2 at 559.

[280] Stated differently, I do not describe the results of model 1, model 2, and model 3 individually for each area of analysis, as this would obscure the results themselves with unnecessary detail. I simply refer to the maximum and minimum effect of the three models combined. E.g. if model 1, model 2 and model 3 indicated a change of 14%, 17% and 15% respectively, I simply state that the results from the three models indicated a change of between 14% and 17%.

and acquisitions between1988 and 2000. This U.S. study also employed Multivariate Regression Analyses (OLS) similar to that employed by the Canadian study described above.[281] As this thesis focusses exclusively on examining Canadian break fees and asset purchase options, the U.S. findings are only employed for two purposes. Firstly, the U.S. findings are used to test the Canadian empirical findings. Secondly, the U.S. findings serve as a potential proxy for Canadian results, where the Canadian study failed to examine the particular issue in question. In this regard, I do not argue that Canadian and U.S. takeover law is similar. I merely argue that the Canadian and the U.S. regulate break fees and asset purchase options in a similar way.[282] As the U.S. and Canada regulate their break fees and asset purchase options in a very similar way, it is conceivable that they would have the same empirical outcomes.[283] It will be thoroughly argued later in this chapter that the empirical effect of Canadian break fees and asset purchase options cannot be tested against findings from other jurisdictions employing a "bright line"[284] approach to the regulation of break fees and asset purchase options. For the moment, it is sufficient that the reader simply notes this fact.

Following this description of the empirical economic effects of Canadian break fees and asset purchase options, this chapter will examine the logical correlation between the Canadian directors' duties and the empirical outcomes created by break fees and asset purchase options.

[281] M.S. Officer, *supra* note 137 at 449-467.
[282] See P. Andr´e, *supra* note 2 at 544; A. Gregory, *supra* note 138 at 568 and 571; J. Coate, *supra* note 212 at 5: The U.S. regulatory system regarding break fees and asset purchase options resembles the Canadian regulatory system (regarding break fees and asset purchase options) to a sufficient degree that U.S. empirical findings can effectively be used to verify Canadian empirical findings. In addition to corresponding directors' duties, the U.S. is also a statutory uncapped ("non-bright-line") jurisdiction.
[283] *Ibid.*
[284] "Bright line" jurisdictions "cap" break fees and asset purchase options at 1% of deal value (or target firm value). "Bright line" jurisdictions include the U.K., Australia and Germany whereas statutory uncapped ("non-bright line") jurisdictions include Canada, the U.S. and New Zealand: see A. Gregory, *supra* note 138 at 567-568 and 571 and J. Coates, *supra* note 157 at 5.

This examination will be conducted with reference to the proposed doctrine underlying the Canadian regulatory regime, namely the broad director welfare function theory (as detailed in Chapter 3).

To date there seems to have been no study done on the empirical effects of Canadian asset purchase options. This is likely the result of the fact that asset purchase options are significantly harder to collect data on than break fees. It should thus be clearly understood that this empirical research focussed exclusively on break fees, as opposed to asset purchase options. I contend that this does not represent a significant obstacle since break fees and asset purchase options are both variants of a broader inducement based defence.[285] As described in Chapter 2 of this thesis the only difference between a break fee and asset purchase option is that an "asset sale" serves as the primary inducement and potential disincentive rather than cash. I thus contend that the same results would likely be observed for both asset purchase options and break fees, and that the break fee results would thus likely hold true for asset purchase options.

4.2.2 Analysing the correlation between Canadian directors' duties and the empirical effects of break fees and asset purchase options: Findings and analysis

4.2.2.1 Break fees, asset purchase options and high merger costs

Empirical Findings: The multivariate regression analyses revealed a positive and statistically significant correlation between the relative merger costs incurred by the bidder and relative break fee granted to the bidder. Controlling for all other factors, one unit change in the relative bidder merger costs, resulted in a positive change of between 0.216 and 0.246 in the relative percentage

[285] *Supra* note 207.

break fee[286] granted to the bidder. These findings were statistically significant at the $p < 0.01$ (or 1%) level.[287] In other words, the higher the anticipated, reported and actual cost of the merger to the bidder, the higher the break fee that was negotiated between the target and bidder. High break fees were thus more prevalent in industries with independently high merger costs.

Canadian directors' duties with a potential causal link to the empirical findings:

The first governance mechanism that relates to this finding pertains to voting and shareholder democracy. As described in Chapter 2 and 3 of this thesis, shareholder approval is not required in order to institute a defensive tactic such as a break fee or asset purchase option. I argue that the removal of shareholder democracy from this aspect of the takeover process culminates in the efficient empirical findings demonstrated below. This is the case because the target shareholders who are at an information disadvantage with regard to the cost of the potential future merger to the bidder are less likely to approve the granting of the break fee or asset purchase option, as the empirical findings demonstrate. The potential bidder in-turn will be unlikely to reveal the information relating to its intention to initiate the bid and/or its high merger cost to the market, prior to concluding negotiation pertaining to the bid. The governance mechanism removing shareholder democracy from the implementation of break fees and asset purchase options, thus allows target and bidder directors to reach terms with regard to the bid, that would not have been possible if a shareholder vote was required at this preliminary stage of the bidding process.

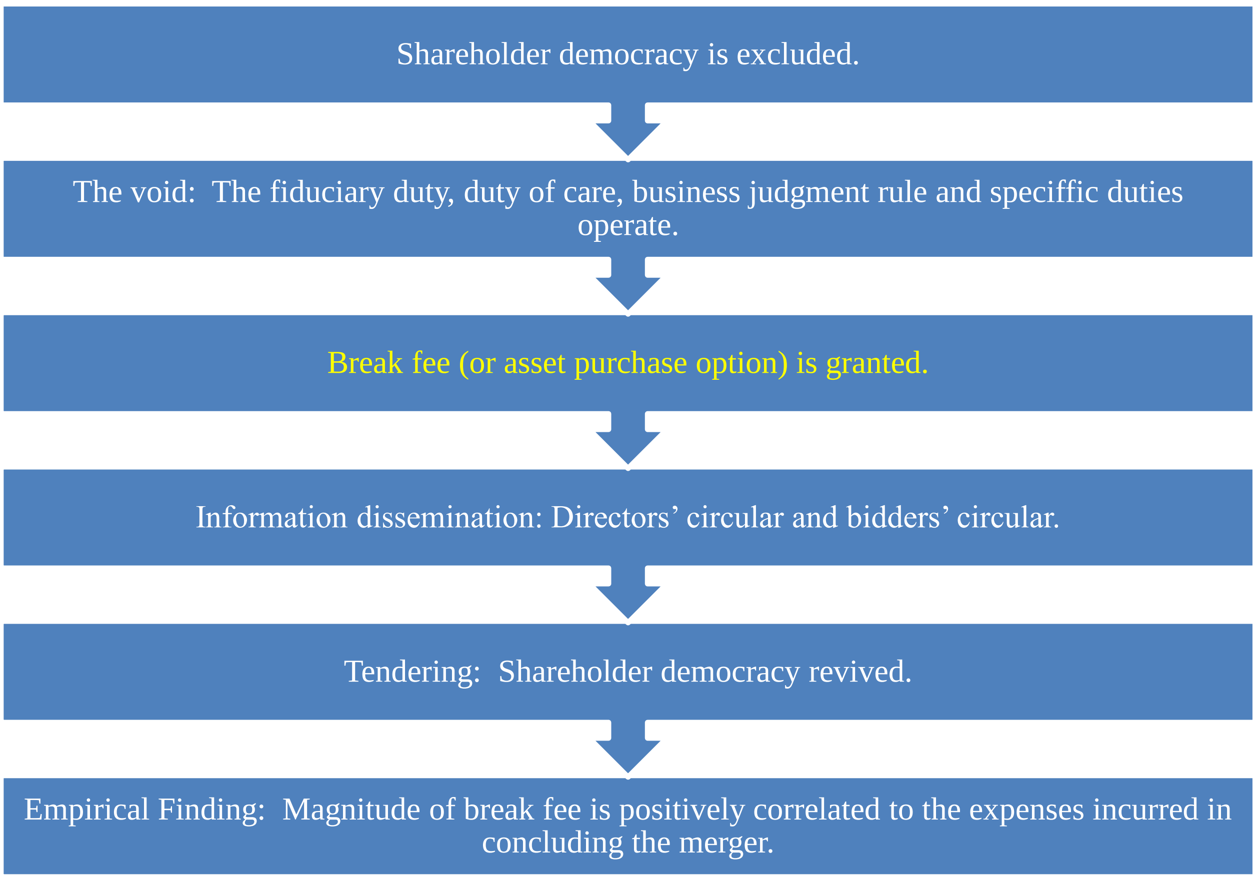
A second governance mechanism that ties directly into this correlation deals with information dissemination. As described earlier in this thesis directors are required to publish a directors'

[286] This is a relative percentage of target firm value.
[287] P. Andr´e, *supra* note 2 at 559; M.S. Officer, *supra* note 137 at 431–467 confirms.

circular and bidders' circular relating to the proposed merger. These directors' duties provide directors with the opportunity to inform target shareholders of the (previously unknown) high bidding costs associated with the particular merger. This governance mechanism relating to disclosure, allows directors to substantiate the efficient use of the break fee or asset purchase option to their shareholders, as a bid-stimulating device in a market with high bidding costs. Secondarily, these governance mechanisms serve as a mechanism for improving the transparency of the takeover process. Shareholder democracy plays a key role after the directors' and bidders' circular is issued, as shareholders need to decide if they will tender their shares to the break fee or asset purchase option beneficiary. There is thus a logical causal link between the directors' duty relating to shareholder democracy and information-dissemination and the result obtained by the Canadian empirical study.

The third and fourth governance mechanisms relevant to the empirical findings flow naturally from the (above-mentioned) first two mechanisms. As indicated in Chapter 2 and 3 of this thesis, the target directors operate free from the constraints of shareholder democracy when implementing a break fee or asset purchase option. The third broad governance mechanism namely the fiduciary duty, duty of care and the business judgment rule regulates the actions of directors in this "figurative void", where directors are not subject to shareholder democracy. This governance mechanism aims to ensure that directors act in the best interest of the corporation. A fourth related group of duties operating in temporal conjunction with the abovementioned duties are the specific directors' duties applicable to break fees and asset purchase options. This governance mechanism requires directors to ensure that the break fee or asset purchase option is necessary to induce a better value bid, that it strikes a balance between bid stimulation and inhibition, the break fee falls within an acceptable range, and the asset subject to the asset purchase option, is sold for fair value. This fourth set of directors' duties, again aims to ensure that the best interests of the shareholders serve as the preeminent consideration, even though shareholder information-dissemination and democracy is excluded during this stage of the takeover process.

Table 2: Timing within the regulatory regime



4.2.2.2 Break fees, asset purchase options and operating synergies[288]

Empirical Findings: The multivariate regression analyses revealed a positive and statistically significant correlation between the revealed operational synergies and the relative break fee granted to the bidder. Controlling for all other factors, reporting clear operating synergies in the takeover circular as a benefit of the takeover, was correlated with a positive change of between 0.265 and 0.318 in the relative percentage break fee[289] granted to the bidder. These findings were statistically significant at the $p < 0.10$ (or 10%) level.[290] Higher break fees were thus granted to bidders who revealed their private operational information to the market regarding expected operating synergies with the target. High break fees were thus more prevalent in industries with significant expected operating synergies.

Canadian directors' duties with a potential causal link to the empirical findings:

As explained in the preceding section, a potential bidder is unlikely to reveal personal information regarding its own management and logistics structure, related to operating synergies, before finalising its bid. Similarly, the bid process is less likely to be initiated in the absence of a break fee or asset purchase option serving as inducement. The governance mechanism removing shareholder democracy from the implementation of break fees and asset purchase options thus allow bidder directors to privately inform target directors of expected operating synergies. These

[288] P. Andr´e, *supra* note 2 at 546: Operating synergies arise from the target corporation and bidding corporation combining and integrating unequal managerial capabilities and infrastructure, providing the superior management and infrastructure to the newly combined entity. Financial synergies arise when firms having large internal cash flows and small investment opportunities combine with firms with low internal fund generation and large growth opportunities, thus providing the latter with lower cost internal funds.

[289] *Supra* note 286.

[290] P. Andr´e, *supra* note 2 at 559; M.S. Officer, *supra* note 137 at 431–467 confirms. The empirical findings also revealed that the magnitude of a Canadian break fee was negatively correlated to the disclosure of expected financial synergies. It is peculiar that a Canadian break fee would be positively correlated to expected operational synergies but would be negatively correlated to expected financial synergies; also see and A. Gregory, *supra* note 138 at 572.

privately disclosed operational synergies then function to increase the quantum of the break fee in relation to the measure of expected synergy. The more synergy that is expected, the more benefit target shareholders will derive from the merger, through the increase in bid price associated with the expected synergies, and thus the greater the justifiability of the break fee or asset purchase option. This governance mechanism providing for private information exchange between target and bidder directors thus creates a logical causal link with the empirical findings. This is the case because target directors with private information relating to expected synergies are able to tailor the break fee to the measure of expected benefit that their shareholders stand to gain from the takeover. If the governance mechanism required shareholder approval of the break fee or asset purchase option earlier, this result would likely not be achieved for the reasons mentioned above.

4.2.2.3 Break fees, asset purchase options, the percentage toehold and large family block shareholding[291]

Empirical Findings: The multivariate regression analyses revealed a positive and statistically significant correlation between the relative percentage toehold and the relative break fee granted to the bidder. Controlling for all other factors, one unit change in the relative proportion toehold resulted in a positive change of between 0.055 and 0.057 in the relative percentage break fee[292] granted to the bidder. These findings were statistically significant at the $p < 0.10$ (or 10%) level.[293] In other words, the higher the amount of shares that the bidder purchased in the target

[291] A toehold represents the amount of shares that the bidder procures in the target corporation before announcing its formal takeover bid.
[292] *Supra* note 286.
[293] P. Andr´e, *supra* note 2; M.S. Officer, *supra* note 137 at 431–467 confirms. It should however be noted that this finding was reached based on a significantly reduced sample of only 31 takeover situations where toeholds were found to be present. Of these 31 takeover bids with toeholds, 18 contained break fees and 13 did not.

corporation prior to the takeover bid, the higher the break fee that was eventually negotiated between the target and bidder.

Secondly, the multivariate regression analyses revealed a positive and statistically significant correlation between large family block shareholding[294] in the target firm, and the relative break fee granted to the bidder. Controlling for all other factors, the presence of a large family block shareholding, was correlated with a positive change of 0.404 in the relative percentage break fee[295] granted to the bidder. This finding was statistically significant at the $p < 0.10$ (or 10%) level.[296] Additionally, all other variables held constant, one unit change[297] in the relative proportion of family block shareholding, resulted in a statistically significant and positive change of between 1.014 (significant at the 5% level) or 2.003 (significant at the 10% level) in the relative percentage break fee[298] granted to the bidder.[299] In other words, the break fee granted increased when a large family block shareholder was present in the target firm and increased in proportion to the relative dominance (percentage shareholding) of that family block shareholder.

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[294] "Large family block shareholding" is defined as a shareholding of 10% or more held by a family block. The sample revealed that 38.1% of targets have a large family shareholder with an average holding of 32.8% and a median of 27.5%.
[295] *Supra* note 286.
[296] P. Andr´e, *supra* note 2 at 459-562; M.S. Officer, *supra* note 137 at 431–467 confirms.
[297] Please note that this is one "unit" change in the relative proportion of family block shareholding, not one "percentage" change in the relative proportion of family block shareholding.
[298] *Supra* note 286.
[299] P. Andr´e, *supra* note 2 at 559; M.S. Officer, *supra* note 137 at 431–467 confirms. When introducing the actual percentage of ownership and ownership squared to account for potential nonlinearities, family ownership is again found to be positively related to relative break fees. However, it should be noted that break fees starts decreasing at a certain point of family block shareholding. In this regard, the break point seems to be where the large family block holdings represent around 65% (with only eight cases observed above this threshold).

Canadian directors' duties with a potential causal link to the empirical findings:

Firstly, if you follow a pure stewardship school of thought, one would expect a break fee or asset purchase option and toehold to serve as substitutes for one another, and thus to be inversely correlated. In other words, target directors with interests closely aligned with the target firm would likely be hesitant to grant a bidder owning a substantial toehold, a further break fee. This is the case because a substantial toehold already offers the bidder an alternate means for capturing value, in return for the private information it reveals to the market. However, the empirical findings have proven the opposite to be true. Break fees or asset purchase options and toeholds are positively correlated to one another. One likely explanation for the positive correlation might be that the toehold allows the bidder sufficient representation on the board to extract a larger break fee. It should also be noted that empirical results have shown that high initial-bidder-toeholds deter competing bids and lower the probability of target managerial resistance.[300] These findings combined with the explanation provided above would therefore be consistent with break fees being employed as a target-management entrenchment device, in line with the agency[301] and broad director welfare function theories.

The primary directors' duties meant to counteract this problem is the fiduciary duty, duty of care, business judgment rule, the canvassing duty and the specific duties applicable to break fees and asset purchase options. As explained in Chapters 2 and 3 of this thesis, target directors are bound by corporate law fiduciary duties and duties of care, skill, and diligence, in the implementation of break fees and asset purchase options. In this regard, the courts and commissions tend to show deference to break fees and asset purchase options if instituted in

[300] M.S. Officer, *supra* note 137 at 458-460.
[301] Supra note 157.

compliance with the above-mentioned directors' duties.[302] Notwithstanding this, if more than one reasonable bid is open to the directors and one bid is clearly available and more beneficial than the others, the directors would have to select the more beneficial bid in order to comply with their fiduciary duties.[303] In this regard, a break fee or asset purchase option may not be offered in the advancement of an inferior offer. Here the canvassing duty again plays a key role in requiring target directors to search for alternative higher value bids. In considering the merits of each offer, target directors may rely on the advice of experts, in a bona fide search for what will represent the best value for the corporation and its shareholders.[304] In line with this limitation on the business judgment rule; target directors cannot issue a break fee or asset purchase option if it is not required to induce a better value bid, if it does not strike an appropriate balance between bid stimulation and bid inhibition or if the asset purchase option is not offered for fair value. These safeguards are all in line with the broad director welfare function approach to regulatory design where directors are allowed a large degree of leeway in exercising their business judgment, but are still subject to constraints aimed at limiting potential agency problems.

Secondly, the correlation between break fee quantum and family block shareholders could simply denote the crucial role plaid by large block shareholders in deal success. This correlation could however equally likely be indicative of an agency problem, where family shareholders protect a favoured deal at the expense of others shareholders.[305] As shareholder democracy is excluded (as a regulatory measure) when negotiating the break fee or asset purchase option, large family block shareholders do not have a direct vote on its implementation. I would argue that

[302] *Torstar supra* note 3 at 9-11.
[303] *Brant*, *supra* note 84 at para 314-315.
[304] BCE, *supra* note 63; CBCA, *supra* note 33 s.192; *Re Olympia & York Enterprises*, *supra* note 84 at para 123.
[305] A. Gregory, *supra* note 138 at 570 and 571.

this exclusion of shareholder democracy, during this stage of the takeover process, again has a positive effect, in that it reduces the direct influence of coordinated large family block shareholders on the use of break fees and asset purchase options. This governance measure excluding shareholder democracy from this stage of the takeover process does not however provide complete protection to target shareholders, from the indirect coercive effects of large family block shareholders. Large family block shareholders will tend to appoint a significant amount of the target board. Agency problems arise in this regard, because target directors may be tempted to grant a break fee or asset purchase option to a company who is affiliated or friendly with the large family block shareholders, in a bid to entrench themselves. As the *Pente* case[306] clearly demonstrates, even independent target directors would likely give a significant amount of consideration to the bidder most preferred by the family block shareholder. This is the obvious conclusion to the fact that this shareholding block could prevent any takeover, if they held more than 50% of the voting stock in the target company. The empirical finding is thus logically correlated to the existence of an agency problem related to large family block shareholders. As in the toehold section above the primary directors' duties meant to counteract this problem is the fiduciary duty, duty of care, business judgment rule, the canvassing duty and the specific duties applicable to break fees and asset purchase options. These safeguards are in line with the broad welfare function approach to regulatory design, where directors are allowed a large degree of leeway in exercising their business judgment, but are still subject to constraints aimed at limiting potential agency problems.

An empirical correlation still exists between the relative percentage toehold and large family block shareholding on the one hand and the quantum of the break fee on the other hand. This

[306] For the facts of this case see page 18 of this thesis (heading 2.2.3.5); *Pente*, *supra* note 36.

likely indicates that the abovementioned directors' duties are not entirely sufficient to eliminate these agency problems. If it is clear that the bidder has a substantial toehold, or that a large family block shareholding dominates the target firm, and a break fee or asset purchase options was granted to the bidder, I advocate the following changes to the current regulatory regime. I recommend that courts place a higher degree of weight on, or mandate the use of a special committee in these limited circumstances.[307] I also recommend that the courts place a higher degree of weight on, or mandate an independent valuation of the proposed takeover bid and break fee or asset purchase option, in these limited circumstances. I recommend that these considerations be inserted into the process during which a court considers whether target directors took all reasonable steps to mitigate their conflict of interest. These governance mechanisms would still allow the directors a great degree of deference, but subject to the consideration that they inform themselves properly with regard to the decision that they are making, with the use of an independent valuation or special committee. This approach is still in line with the flexible broad director welfare function theory, but allows greater mitigation of the agency problems that still crop up when large family block shareholdings or toeholds are present. The placement of the burden of proof will thus still depend on the facts of each case and particularly on whether the directors were able to mitigate the conflict of interest inherent in a takeover situation. Secondly, I recommend an expansion of the directors' duties associated with the directors' circular. In this regard, I suggest that target directors could be required to declare the extent to which the bidder is represented on the board (as well as the extent of its control). It

[307] Although the court currently considers the use of an independent special committee to be a highly relevant factor in examining the validity of defensive tactics, I recommend that an even higher degree of weight should be placed on this particular factor in these circumstances. In this regard see *Re CW Shareholdings*, *supra* note 43 at para 43-45; *Pente*, *supra* note 36 at para 37.

could also be required that target directors explain the steps taken to offset this influence.[308] Requiring target directors to declare who elected them during this crucial stage of the takeover process could militate against agency problems that are still associated with large toeholds and family block shareholdings. It could be argued that both of these governance mechanisms could only serve as *ex post facto* solutions to the agency problems described above. I would however contend that the knowledge of having to eventually comply (or account) with these two governance mechanisms will weigh on the minds of the directors as they are making the decision of whether or not to grant the break fee or asset purchase option. This approach is again entirely consistent with the broad director welfare function theory.

4.2.2.4 Break fees, asset purchase options, independent board members and CEO retention

Empirical Findings: The multivariate regression analyses revealed a negative and statistically significant correlation between the relative proportion of independent target board members and the relative break fee granted to the bidder. Controlling for all other factors, one unit change in the relative proportion of independent target board members resulted in a negative change of between 1.042 and 1.079 in the relative percentage break fee[309] granted to the bidder. These findings were statistically significant at the $p < 0.05$ (or 5%) level.[310] In other words the more independent directors serving on the board of the target firm, the lower the break fee that was eventually negotiated between the target and bidder.

[308] Although some of these requirements are indirectly incorporated in *MI 62-104*, *supra* note 14, most are not and as such, I recommend inclusion of these additional declarations in the director's circular.
[309] *Supra* note 286.
[310] P. Andr´e, *supra* note 2 at 561; M.S. Officer, *supra* note 137 at 431–467 confirms.

Secondly, the multivariate regression analyses revealed a positive and weak-statistically significant correlation between relative CEO retention[311] and the relative break fee granted to the bidder. All other variables held constant, CEO retention resulted in a positive change of between 0.378 and 0.396 in the relative break fee[312] granted to the bidder. These findings were weak-statistically significant at the $p < 0.10$ (or 10%) level.[313] In other words, break fees are likely to be larger when the CEO of the target firm retains his position after the merger. However, no evidence was found of a statistically significant correlation between break fees and high golden-parachute[314] provisions.[315]

Canadian directors' duties with a potential causal link to the empirical findings:

The inverse relationship between the quantity of independent directors on the board and the quantum of the break fee clearly indicates that outside board members have a moderating effect on the quantum of break fees and asset purchase options. This moderating effect of outside board members suggest that there likely still exists an agency problem with regard to non-independent directors and the use of break fees and asset purchase options.[316] The fact that CEO retention is (albeit weakly) correlated with the quantum of the break fee is also consistent with the presence of this agency problem.[317]

[311] "CEO retention" is defined as "the CEO retaining his/her position in the acquiring firm"
[312] *Supra* note 286.
[313] P. Andr´e, *supra* note 2 at 561; M.S. Officer, *supra* note 137 at 431–467 confirms. The relationship between these two variables are described as being "weak" because it failed to achieve statistical significance in one of the three multivariate regression analyses (but did achieve significance in the other two at a 10% level).
[314] "Golden parachute" is defined as "a high severance provision greater than twice the CEO's current compensation or the industry norm in the year preceding the deal".
[315] P. Andr´e, *supra* note 2 at 562.
[316] A. Gregory, *supra* note 138 at 561 and 570.
[317] Ibid at 570 and 571.

The current Canadian regulatory regime of directors' duties aims to mitigate these agency problems with governance practices relating to partiality and bid valuation. These good governance practices require that directors "take all reasonable steps to avoid a conflict of interest".[318] The use of a break fee or asset purchase option will not be invalidated simply because no independent valuation was conducted or special committee appointed. In this regard, it should be noted that the establishment of an independent special committee comprised of non-management directors might be one of the steps required to ensure that directors "have taken all reasonable steps to avoid a conflict of interest".[319] Moreover, the appointment of a truly independent special committee usually alleviates concerns regarding any conflict of interest[320] leading to greater deference by the courts.[321] Notwithstanding the aforementioned, the question regarding the independent valuation and special committee requirement is only answerable in light of the facts of each specific case. The materiality of this corporate governance mechanism in evaluating the legality of a break fee or asset purchase option will thus depend on the extent to which target directors are able to mitigate the conflict of interest inherent in a takeover situation.

This broad director welfare function approach to regulatory design once again acknowledges the potential agency problems with regard to non-independent directors, but allows these directors a great degree of freedom in deciding how to mitigate this problem. Directors may thus determine that the use of an independent special committee is not required with regard to the implementation of a break fee or asset purchase option. However, directors take this decision with the full knowledge that the court could potentially shift the burden of proof from the

[318] *Re CW Shareholdings*, *supra* note 43 at para 43-45.
[319] *Ibid* at para 45-45.
[320] *Pente*, *supra* note 36 at para 37.
[321] *Ibid* and *First Boston*, *supra* note 67.

claimants to themselves, if it is found that they (the directors) did not "take all reasonable steps to avoid or sufficiently reduce their conflict of interest".[322] This flexible model of regulation thus sets out from a broad director welfare function approach but adjusts itself either toward agency or stewardship theory depending on the actions of the target directors. I believe that this innovative method of regulating directors' duties is beneficial to target shareholders as it allows more freedom to directors who are naturally stewardship-orientated, while providing stricter regulation over directors who are strongly self-enriching.

The empirical results however indicate that a significant agency problem still exists with regard to the deficient use of independent directors on the one hand and CEO retention on the other. In this regard, I suggest the following alterations to the current regulatory regime of directors' duties relating to the implementation of break fees and asset purchase options. Independent directors serve a key role in ensuring that non-independent directors comply with their fiduciary duties, duties of care skill and diligence, canvassing duties, and the specific duties pertaining to the implementation of break fees and asset purchase options. I therefor recommend that courts place a high emphasis on the proportion of independent directors on the target board and special committee when considering the extent to which the target directors succeeded in mitigating their conflict of interest during the takeover situation.[323] This approach is thus still in line with the flexible broad director welfare function, but allows greater mitigation of the agency problems that still arise in this regard. Secondly, I recommend requiring all target directors to disclose (in

[322] *Re CW Shareholdings*, *supra* note 43 at para 43-45.

[323] It should however be noted that the court already encourages target directors to make use of an independent special committee during a takeover situation. I advocate an added emphasis on this requirement when the court evaluates the use of break fees and asset purchase options. In this regard see *First Boston*, *supra* note 67; *Pente*, *supra* note 36 at para 37; *Re CW Shareholdings*, *supra* note 43 at para 45.

the directors' circular) whether any tentative arrangements or negotiations have been undertaken with regard to their potential future employment in a firm to which they offered a break fee or asset purchase option. It is again expected that the knowledge of having to eventually comply (or account) with these two governance mechanisms will weigh on the minds of the directors as they are making the decision of whether or not to grant the break fee or asset purchase option. This approach is again entirely consistent with the broad director welfare function theory.

4.2.2.5 Break fees, asset purchase options, bid success, bid premiums, and bid incidence

Empirical Findings on Bid Success: The Canadian research does not seem to have evaluated the link between the quantum of the break fee and the likelihood of the bid's success. In the absence of Canadian empirical findings on this question, I turn to the findings of the closest related regulatory regime (the U.S.). The "probit regression analysis" on U.S. break fees revealed a positive and statistically significant correlation between the granting (and proportion) of a break fee, and the relative likelihood of a successful bid being concluded with the break fee beneficiary. In this analysis, the granting of a break fee was correlated with a positive change of nearly 20% in relative chance of a takeover bid being successfully concluded. This finding was statistically significant at the $p < 0.10$ (or 10%) level. Even when all of the control variables were included, the point estimate, of the effect to of a break fee, indicated an 11% increase in the predicted success rate of the bid,[324] significant at the 1% level.[325] "Significantly higher success rates in break fee deals are potentially the result of the bidders making more substantial investments in the bid process, including the release of non-public information about post-bid strategies for the target's assets, because such investments are protected with a break fee, from

[324] This was from a base of 84%.
[325] P. Andr´e, *supra* note 2 at 456-457.

free riding by other bidders".[326] As almost all merger agreements in Canada now include either a break fee or asset purchase option, this could serve as a strong indication that the market appreciates the value of these devices in advancing bid success, and/or risk management.[327]

Empirical Findings on Bid Premium: The Canadian study seems to have lumped break fees, that were offered to first and second bidders together, when considering the effect of break fees on bid premiums. In this regard, the multivariate regression analysis conducted on the empirical effects of Canadian break fees, failed to establish a statistically significant relationship between the magnitude of a break fee and the premium paid for target shares.[328] The author of this study thus suggests that break fees and premium levels are jointly determined in an efficient manner during the negotiation process.[329] The U.S. study however followed a more nuanced approach of examination. More specifically, the U.S. study split their analysis into two categories. In the first category, they examined the effect of a break fee offered to a primary (first) bidder on bid premiums. In the second category, they examined the effect of a break fee offered to a secondary bidder on bid premiums.[330] This stands in contrast to the Canadian study which seems to have lumped first and second bidders together when considering whether break fees increased bid premiums. In this regard, the multivariate regression analysis on U.S. data revealed a positive and statistically significant correlation between break fees offered to the first bidder, and the relative bid premium paid for target shares. Controlling for all other factors, the granting of a

[326] M.S. Officer, *supra* note 137 at 431, 433 and 457. The prior study by J.C. Coates and G. Subramanian, "Buy-Side Model of M&A Lockups: Theory and Evidence" (2000-2001) 53 Stanford Law Review at 307 confirms these findings with regard to the effect of U.S. break fees.
[327] P. Andr´e, *supra* note 2 at 564.
[328] P. Andr´e, *supra* note 2 at 560.
[329] *Ibid* at 564.
[330] M.S. Officer, *supra* note at 462.

break fee to the first bidder resulted in a positive change of between 4%[331] and 7% in relative bid premiums received by target shareholders, depending on the inclusion of correlated deal characteristics. These finding were statistically significant at the $p < 0.01$ (or 1%) level.[332] However, U.S. empirical findings[333] corresponded with Canadian findings when a break fee was offered to a second bidder; as having no statistically significant effect on the premium paid.[334] Stated differently U.S. results indicated that the size of the break fee increased the premium paid for target shares when it was offered to the original first bidder, but not when offered to a subsequent second bidder.[335]

A break fee will thus either have no effect on the premium paid, irrespective to whom it is offered (as suggested by the single Canadian study) or will have a positive effect when offered to the first bidder, but will have no effect when offered to the secondary bidder (as suggested by the U.S. study). It should however be clearly understood that the Canadian study did not differentiate between first and second bidders when evaluating the effects of break fees on bid premiums. As the Canadian study did not differentiate between first and second bidders, it is unable to distinguish between the possibly diverging results between these two groups. I thus propose that the US study merely represents a more nuanced version of the Canadian study in this regard and is not inconsistent with the Canadian study at all. Based on the before mentioned I propose that the results obtained by the U.S. study likely holds true in the Canadian context.[336]

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[331] This was the conclusion of a second-stage multiple regression analysis controlling for correlated deal characteristics.
[332] M.S. Officer, *supra* note 137 at 461, 433-434, 461, 463.
[333] Dealing with univariate averages (which is somewhat different from multivariate regression analysis).
[334] M.S. Officer, *supra* note at 462.
[335] Notwithstanding this fact, offering a break fee to a second bidder will still increase the chance of bid success (as demonstrated above).
[336] As almost all merger agreements in Canada now include either a break fee or asset purchase option this could make it more difficult to recognise a statistical trend in the causation between the use of break fees and higher bid

I conclude that the U.S. regulatory regime specifically governing break fees is similar enough to the Canadian regulatory regime governing break fees, that U.S. findings can effectively be applied to the Canadian context in this narrow regard, concerning first bidders.[337]

Empirical Findings on Bid Incidence: The Canadian research does not seem to have evaluated the link between the quantum of the break fee and bid incidence. In the absence of Canadian empirical findings on this question I thus again turn to the findings of the closest related regulatory regime (the U.S.). The U.S. multivariate regression analysis indicated that offering a break fee to an initial bidder was weak-statistically significant and negatively correlated to competitive secondary bidding. Controlling for all other factors, one unit change in the relative break fee resulted in a negative change of 3%[338] in relative secondary bid competition.[339] The results are however described as being only weakly correlated as the statistical significance ranges from the $p < 0.01$ (or 1%) level, when several control variables were excluded, to no statistical significance, when all the control variables are included.[340] "Several factors further diminish the importance of competing bid deterrence of this magnitude. First, this effect appears to be largely driven by correlated deal and bidder characteristics rather than the nature of the fees per se. Second, the economic impact on the value of the target's shares (from a 3% lower probability of receiving a competing offer) is small when second bid jumps only average around

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premiums. It should also be noted that the almost universal use of these devices in Canadian takeover situations[336] is strongly indicative of the value that the market and especially the target firms attach to these contracts as premium increasing devices.

[337] Supra note 282.

[338] The average transaction that did not include a break fee had a 5% chance of receiving a competing bid, compared to 2% for transactions that included a break fee.

[339] M.S. Officer, *supra* note 137 at 454-457.

[340] *Ibid.*

14% of the target's market value of equity. Thus the average expected loss of premium resulting from the diminished probability of an auction is roughly 0.4%".[341]

Canadian directors' duties with a potential causal link to the empirical findings:

In the following section of this chapter, I will argue that the predominantly "positive" empirical findings associated with bid success, premiums and bid incidence has a causal connection with the absence of a particular governance mechanism. This governance mechanism relates to the bright line nature of some jurisdictions. Both the U.S. and Canada employ a non-bright line principle regarding break fees and asset purchase options. For now, it is sufficient if the reader notes the following argument. Since non-bright line jurisdictions such as the U.S. and Canada do not "cap" break fees and asset purchase options at an arbitrarily low level, this allows break fees and asset purchase options to be set at a high enough level to affect bid success, premium and incidence. I will argue that the predominantly "positive" empirical findings revealed from the U.S. study is likely correlated to the (U.S. and Canadian) principle of allowing break fees and asset purchase options to be set high enough[342] to effectively induce successful (a better value) bids. I conclude that this approach strikes a better balance between bid stimulation and inhibition than the bright line approach.

The lack of causation between the use of break fees or asset purchase options and secondary bidder premium extraction necessitates the following policy recommendations: The public interest jurisdiction of the securities regulators should be expanded to include a thorough review of break fees and asset purchase options offered to second bidders, where a primary offer had

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[341] M.S. Officer, *supra* note 137 at 431, 433, 454 and 462. The prior study by John C. Coates, *supra* note 326 at 307 confirms these findings with regard to the effect of U.S. break fees (1988-2000 data).

[342] M. Condon, *supra* note 11 at 561.

already been made. One of the functions of break fees and asset purchase options is to compensate the original bidder for the time and effort put into finding a target firm with sufficient value to justify a takeover bid, and revealing this information to the market. A restrictive approach to the granting of break fees and asset purchase options to secondary bidders is thus simply a logical acceptance of this fact, as secondary bidders simply take advantage of the research done by the initial bidder.

4.2.3 The capping effect: Explaining the conflicting findings on the effects of break fees and asset purchase options across international jurisdictions

4.2.3.1 Introduction to the capping effect

The primary theory advanced in this thesis is that there exists a crucial causal link between the duties imposed on target directors and the empirical effects of break fees and asset options. When canvassing the substantial amount of literature on the empirical effects of break fees and asset purchase options, one is immediately struck with the extent of directly conflicting findings between foreign jurisdictions. This bewildering array of conflicting findings would be entirely consistent with the theory that diverging directors' duties across jurisdictions would inevitably end up affecting the empirical results of break fees and asset purchase options in different ways. I thus attempted to isolate the jurisdictions with predominantly "positive" empirical findings on the use of break fees and asset purchase options, and those with predominantly "negative" empirical findings. Following this separation of countries with predominantly "positive" and predominantly "negative" empirical findings, I searched for a key similarity in directors' duties that was present in countries with predominantly "positive" empirical findings but was absent from the countries with predominantly "negative" empirical results. This search revealed that the countries with a governance mechanism capping the use of break fees and asset purchase options at 1% of deal value, was present in all of the canvassed countries with predominantly "negative" empirical results, but was absent from all the canvassed countries with predominantly "positive" empirical results.

In this section of the chapter, I will argue that the predominantly "positive" U.S. and Canadian empirical findings associated with break fee and asset purchase option quantum, success, deterrence and bid incidence has a causal connection with the absence of a governance mechanism capping these devices at 1% of deal value. This argument will also indirectly advance the idea that the imposed directors' duties play a crucial role in affecting the empirical effect of break fees and asset purchase options. Finally, this analysis demonstrates the advantages of a broad director welfare function approach to regulatory design, as opposed to an agency approach.

4.2.3.2 The capping effect

The U.K., Australian, and German regulators have adopted a 'bright line' approach to break fee and asset purchase option regulation, effectively capping it at 1% of target firm (or deal) value.[343] This corporate governance mechanism was implemented with the goal of ensuring that break fees and asset purchase options are not implemented in an anticompetitive or coercive fashion.[344] A secondary benefit flowing from this form of regulation is that it provides certainty to the market and thus marginally lowers both litigation costs and fees associated with the

[343] L. Chapple, *supra* note 157 at 644. *Supra* note 343.
[344] *Ibid*.

takeover process.[345] It should be clear that this restrictive governance mechanism is entirely consistent with the strict agency school approach to regulatory design, where director discretion is severely impaired with the goal of rigorously mitigating agency problems.[346]

In contrast to the bright line jurisdictions described above, New Zealand, Canada, and the U.S. have decided not to implement a statutory barrier capping break fees and asset purchase options to a set arbitrary percentage.[347] These non-bright line jurisdictions have chosen to regulate their break fees and asset purchase options with a more flexible approach, where courts and other regulatory bodies conduct an *ex post facto* evaluation of the concluded contractual devices.[348] This *ex post facto* approach has led to the development of a generally acceptable range of break fees and asset purchase options as opposed to a "cap". One negative element of this regulatory system is that it does create a certain degree of uncertainty in the market and moderately raises litigation costs and fees associated with the takeover process.[349] This flexible approach is clearly consistent with the broad director welfare theory advanced in this thesis, where directors are granted a significant degree of freedom to implement their business judgment, but are still subject to regulatory limitations.

Before looking at the empirical findings, it is important to first address the issue of logical correlation. In other words, are we comparing apples with apples when comparing the bright line jurisdictions such as the U.K. and Australia with non-bright line jurisdictions such as Canada and the U.S.? If these countries had vastly diverging regulatory regimes pertaining to break fees

345 J. Coates, *supra* note 157 at 0-1, page 26 and page 30.
346 *Supra* note 157; *Supra* note 163.
347 A. Gregory, *supra* note 138 at 567.
348 Coates, *supra* note 157 at 0-1.
349 *Ibid* at 10.

and asset purchase options it would be illogical to conclude that the capping rule was chiefly responsible for the predominantly "negative" findings observed in bright line jurisdictions. The following passage however clearly demonstrates that that there exists sufficient broad similarity between these regularity regimes to conduct a meaningful comparison of cross-jurisdictional findings from these countries based on one key diverging variable, namely the capping rule.

> "U.S. and U.K. have similarly active M&A markets, with a large number of bids for public companies comprising 75% of worldwide bid volume (Rossi & Volpin 2004). They have similar corporate governance systems (e.g., Kraakman et al. 2009), with large companies and dispersed ownership (e.g., La Porta et al. 1999), which (as discussed below) generates the need for deal protection. And they have shared political, legal, and cultural traditions (U.S. State Department 2009), including M&A practitioners that work in both nations.[350] Canada is characterised by highly concentrated ownership, many large companies still being controlled by their founders or their families. However, Canada exhibits the typical corporate governance mechanisms and minority shareholder protections found in most English origin countries. Unlike the underlying bid, the target's promise to pay a break fee (oft en included in the deal agreement) is not generally subject to shareholder approval, in either the U.S. or the U.K. or Canada."[351]

The following empirical findings thus reveal the likely result of this regularity divergence:

1. ***Break fee and asset purchase option quantum:*** 95% of U.S. and Canadian break fees are greater than the "1%-limit" set by the bright line jurisdictions, while over 60% of U.K. fees fell between 0.9% and 1.1%. U.S. and Canadian break fees ranged between 2% to 6% of deal value in over 80% of cases with a Canadian mean of 3.553%[352] and a U.S. mean of 3.8% of deal value.[353] U.S. and Canadian break fees are thus between 3 and 4 times larger than U.K. break fees.[354] It is worth noting that both Canadian and U.S.

[350] *Ibid* at 0-1.
[351] *Ibid* at 6.
[352] A. Gregory, *supra* note 138 at 567.
[353] *Ibid.*
[354] J. Coates, *supra* note 157 at 15 and P. Andr´e, *supra* note 2 at 552.

courts have indicated that fees of up to 5% would likely be considered reasonable.[355] I argue that in this regard, the relative size of the break fee or asset purchase options is not just one measure of its likely empirical effect but is rather a fundamental measure. The larger the break fee or asset purchase option is, the more exaggerated all of its characteristics will be (e.g. bid inducement and deterrence). In contrast the smaller the break fee or asset purchase option is, the less material all of its characteristics will be (e.g. bid inducement and deterrence). Every positive and negative effect of the break fee thus depends on its size. The minimisation of the characteristics of break fees and asset purchase options likely causes the under-provision of insurance to primary bidders who reveal private information on deal value and potential operating synergies. I thus argue that the arbitrary limit placed on break fees and asset purchase options prevent these devices from fulfilling its mandate of higher value bid inducement.

2. ***Bid success:*** U.S. bids involving a break fee or asset purchase option were 10% more likely to be completed, than U.K. bids[356] made under similar terms.[357] In Australia, the findings were even starker, as empirical results demonstrated that Australian break fees correlated inversely with bid completion by the break fee beneficiary.[358] For our purposes it is enough to assume that in Australia (a bright line jurisdiction), break fees are at the very least not correlated to bid success as it is in the U.S. where no bright line exists. Overall, the evidence suggests that U.S. and Canadian break fee use is at least

[355] M. Condon, *supra* note 11 at 561; L. Chapple, *supra* note 157 at 645.
[356] U.K. bids had a success rate of 79% compared to 89% in the U.S.
[357] J. Coates, *supra* note 157 at 22.
[358] L. Chapple, *supra* note 157 at 644. *Supra* note 343.

"not harmful", and is "likely beneficial", to target shareholders.[359] This finding is consistent with the theory advanced in this section, namely that break fees are statutorily set so low in bright line jurisdictions that they have no potential of actually performing their intended goal increasing bid success.

3. ***Total takeover bid incidence:*** The total incidence of takeover bids was 20% less in the U.K. than in the U.S. when comparing the total quantity of listed companies in each nation with the total number of control bids,[360] from 1990 through 2008.[361] This finding is also consistent with the theory that break fees are statutorily set so low in bright line jurisdictions that they are incapable of performing their intended goal of inducing takeover bids.

4. ***Deterrence effect:*** U.S. empirical research has demonstrated that the use of break fees or asset purchase options reduces the probability of an alternate offer emerging by 3%.[362] Stated differently, an alternative competing bid is half as likely to immerge if a break fee or asset purchase option was granted to an initial bidder in the U.S. as opposed the U.K. (consistent with agency theory).[363] Australian empirical findings correlate with its U.K. bright line counterpart, in revealing that break fees do not act to deter competitive bidding in bright line jurisdictions.[364]

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[359] M.S. Officer, *supra* note 137 at 431.
[360] This method controls for the quantity of companies in each nation, allowing accurate comparison.
[361] J. Coates, *supra* note 157 at 22-23. In the absence of Canadian empirical findings on this question it is assumed that Canadian empirical results would closely correlate to the U.S. findings as the two countries regulate break fees and asset purchase options in a similar way.
[362] M.S. Officer, *supra* note 137 at 454-457.
[363] L. Chapple, *supra* note 157 at 650.
[364] *Ibid*. *Supra* note 343.

This finding reveals one of the key problems associated with high break fees and asset purchase options, namely the discouragement of competing bids. This is however less of a problem than one would imagine it to be. Empirically U.S. bids that included a break fee were only 3% less likely[365] to receive a competing secondary bid. "Several factors diminish the importance of competing bid deterrence of this magnitude. First, this effect appears to be largely driven by correlated deal and bidder characteristics rather than the nature of the fees per se. Second, the economic impact on the value of the target's shares from a 3% lower probability of receiving a competing offer is small when second bid jumps only average around 14% of the target's market value of equity. Thus the average expected loss of premium resulting from the diminished probability of an auction is roughly 0.4%".[366] Additionally, given that 95% of U.S. break fees exceed the 1% cap applicable in the U.K., it is unlikely that all of these fees represent target agency costs.[367]

4.2.3.3 Conclusion to the capping effect

The abovementioned findings contrast the empirical effects created by break fees and asset purchase options from bright line jurisdictions to the empirical effects created by non-bright line jurisdictions with much of the other governance mechanisms being constant. The findings reveal that the implementation of a stringent cap effectively reduces the quantum of break fees and removes the nominal deterrence effect but sharply reduces total takeover bid incidence and success. The findings ultimately reveal that the cap likely reduces the characteristics of break

[365] The average transaction that did not include a break fee had a 5% chance of receiving a competing bid, compared to 2% for transactions that included a break fee.
[366] M.S. Officer, *supra* note 137 at 431, 433, 454 and 462. The prior study by John C. Coates, *supra* note 326 at 307 confirms these findings with regard to the effect of U.S. break fees (1988-2000 data).
[367] J. Coates, *supra* note 157 at 30.

fees and asset purchase options to such an extent that it becomes ineffective in performing its function as an initial bid stimulation and premium-generating device[368] (resulting in the reduction of target shareholder value). These findings presented above are confirmed by another study where only the Australian and U.S. regulatory regimes were compared.[369]

Based on these findings I reject the agency theory approach followed in the bright line jurisdictions, where director discretion is severely impaired with the goal of rigorously mitigating agency problems.[370] I thus propose the continued employment of broad director welfare function approach to regulatory design (implemented in the U.S. and Canada) where directors are allowed a large degree of leeway in exercising their business judgment, but are still subject to constraints aimed at limiting potential agency problems (i.e. the generally acceptable range and other directors' duties). I do however reiterate the call for the courts to give clearer guidance with regard to the "generally acceptable range" by establishing a clearly articulated presumption that a break fee or asset purchase option falling within a certain range would be acceptable (and those falling outside of that range would be unacceptable). If the break fee or asset purchase option fell inside this range it would be deemed to be legitimate unless it could be expressly proven that it was not. If the break fee or asset purchase option fell outside of this range it would be deemed to be illegitimate unless it could be expressly proven that it was not.[371] Such guidance would still adhere to the broad director welfare function approach to regulatory design wile mitigating some of the uncertainty problems associated with litigation-based-regulation of break fees and asset purchase options.

[368] J. Curtis, supra note 157 .

[369] L. Chapple, *supra* note 157 at 665; *Supra* note 343.

[370] T.W. Bates, supra note 157 at 469-504 confirms this approach.

[371] J. Coates, *supra* note 157 at 34.

In conclusion, the predominantly "positive" U.S. and Canadian empirical findings associated with bid success, premiums and bid incidence has a causal connection with the absence of the capping governance mechanism. I thus conclude that the predominantly "positive" empirical findings revealed from the U.S. study in the preceding section is likely correlated to the (U.S. and Canadian) principle of allowing break fees and asset purchase options to be set high enough[372] to effectively induce a better value bid. I conclude that this approach strikes a better balance between bid stimulation and inhibition than the bright line approach. Finally, I conclude that the break fee or asset purchase option is not simply a measure of its likely empirical effects but is rather the key determining factor. As was demonstrated above; every effect (positive and negative) of the break fee or asset purchase option depends on its size.

4.2.4 Conclusion

Firstly, this chapter successfully established a clear logical correlational between the regulatory regime governing break fees and asset purchase options and the empirical effects of break fees and asset purchase options. This correlation was established by linking the empirical results with aspects of the governance model pertaining to it. I have also expanded on the establishment of correlation, by suggesting limited changes to the regulatory regime that preserve the essential elements of the broad director welfare model, while improving areas where the empirical results indicate weakness. Correlation was specifically established between the following variables:

1. The empirical finding of high merger costs and regulatory regime rules relating to:
    a. Voting and shareholder democracy exclusion;
    b. Information dissemination; (and)

[372] M. Condon, *supra* note 11 at 561.

c. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options.

2. The empirical finding relating to the disclosure of operating synergies and regulatory regime rules relating to voting and shareholder democracy exclusion.
3. The empirical finding relating to the percentage toehold and large family block shareholding and the regulatory regime rules relating to:
    a. Voting and shareholder democracy exclusion;
    b. The canvassing duty;
    c. Partiality and valuation; (and)
    d. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options.
4. The empirical finding relating to the proportion of independent board members and CEO retention and the regulatory regime rules relating to:
    a. Partiality and valuation;
    b. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options
5. The empirical finding relating to bid success, bid premiums and bid incidence and the regulatory regime rules relating to the bright line (generally acceptable range) principle

Secondly, this chapter again clearly demonstrated that the broad director welfare function approach to regulatory design forms the basis for the regulation of break fees and asset purchase options. In this regard, the chapter also demonstrated that the broad director welfare function model is responsible for much of the “positive” empirical effect associated with break fees and asset purchase options in the U.S. and Canada.

Chapter 5: Conclusion

This thesis set out to evaluate whether there existed a logical correlation between the regulatory regime governing break fees and asset purchase options, and the empirical effects of break fees and asset purchase options. Secondarily this thesis sought to examine whether this potential correlation provided "positive" results. The first step in this evaluation naturally entailed examining the general directors' duties applicable to all defensive tactics, which was done in Chapter 2. This analysis established the foundational requirements of the regulatory regime governing break fees and asset purchase options. In conducting this examination this chapter focussed on information dissemination requirements, voting and shareholder democracy duties, partiality and valuation duties, the canvassing duty, the public interest jurisdiction of the securities regulators, the fiduciary duty, the duty of care skill and diligence, the application of the business judgment rule and the effect of management entrenchment as secondary effect.

Following this analysis, Chapter 3 examined the second part of the regulatory regime governing the use of break fees and asset purchase options; namely the specific directors' duties and rules applicable exclusively to break fees and asset purchase options. This chapter also integrated the general and specific directors' duties and investigated the doctrine underlying the entire regulatory regime. This investigation concluded that neither the agency school nor the stewardship school adequately described this regulatory regime. The novel "broad director welfare function theory" was then advanced as a likely doctrine underlying the Canadian regulatory regime.

Finally, Chapter 4 drew from new empirical evidence collected through a major study on the effects of Canadian break fees, and examined the correlation between the regulatory scheme governing break fees and asset purchase options, as examined in Chapter 2 and Chapter 3 and the empirical effects of break fees and asset purchase options, as demonstrated by the study. This examination specifically established correlation between the following variables:

1. The empirical finding of positive correlation between high merger costs and high break fees and regulatory regime rules relating to:
    a. Voting and shareholder democracy exclusion;
    b. Information dissemination; (and)
    c. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options
2. The empirical finding of positive correlation between the disclosure of operating synergies and high break fees and the regulatory regime rules relating to voting and shareholder democracy exclusion.
3. The empirical findings of positive correlation between the percentage toehold and/or large family block shareholding and high break fees and the regulatory regime rules relating to:
    a. Voting and shareholder democracy exclusion;
    b. The canvassing duty; (and)
    c. Partiality and valuation;
    d. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options

4. The empirical findings of negative correlation between the proportion of independent board members and/or positive correlation between CEO retention and high break fees and the regulatory regime rules relating to:
    a. Partiality and valuation duties;
    b. The fiduciary duty, duty of care, business judgment rule and the specific directors' duties applicable to break fees and asset purchase options
5. The empirical finding relating to bid success, premiums, bid incidence, and the regulatory regime rules relating to the bright line (generally acceptable range) principle.

The establishment of this correlation is an entirely novel element presented in this thesis, which expands on the existing literature, that simply examined the causational effects of break fees and asset purchase options. This thesis thus adds another layer to the examination of break fee and asset purchase option regulation, by linking the substantive data on the effects of break fees and asset purchase options to the regime regulating it. This new layer of examination is tremendously important as it directly dictates the end (real-world) results of the particular components of the regulatory regime.

Secondarily this thesis sought to examine whether this correlation provided "positive" results. This examination concluded that the broad director welfare function approach to regulatory design is being (and should be) applied to the regulation of Canadian break fees and asset purchase options. In this regard, it was established that much of the "positive" findings arising from the Canadian and U.S. studies on the effects of break fees and asset purchase options stem from this approach to regulatory design. Finally, this thesis proposed limited changes to the regulatory regime governing break fees and asset purchase options that preserve the essential elements of the broad director welfare model, while improving areas where the empirical results indicated weakness. These proposed changes include:

1. Regarding substantial toeholds and large family block shareholding:
    a. I recommend that courts either place a high degree of weight on, or mandate the use of a special committee and/or independent valuation (of the proposed takeover bid and break fee or asset purchase option) if it is clear that the bidder has a substantial toehold or family block shareholding in the target firm.
    b. Secondly, I recommend adding a directors' circular requirement, compelling target directors to declare the extent to which the bidder is represented on the board (and the extent of their control) as well as explaining the steps taken to offset this influence.
2. Regarding independent directors and CEO retention:
    a. I recommend that courts place a high emphasis on the proportion of independent directors on the target board and the use of a special (independent) committee when considering the extent to which the target board succeeded in mitigating their conflict of interest during the takeover situation.
    b. Secondly, I recommend requiring all target directors to disclose (in the directors' circular) whether any tentative arrangements or negotiations have been undertaken with regard to their potential future employment in a firm to which they offered a break fee or asset purchase option.
3. Regarding the lack of causation between the use of break fees or asset purchase options and secondary bidder stimulation and premium extraction, I recommend that the public

interest jurisdiction of the securities regulators be expanded to include a thorough review of break fees and asset purchase options offered to secondary bidders.

This thesis has thus succeeded in proving correlation, established the doctrine underlying the regulatory regime governing break fees and asset purchase options, and suggested alterations to the scheme that preserve the essential elements of the broad director welfare model while improving areas where the empirical results indicated weakness.

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