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The OSC Decision in *Neo Material Technologies Inc.* – A Second Example of Keeping a Poison Pill Alive

Introduction

On May 11, 2009, the Ontario Securities Commission (the “OSC”) decided not to cease trade a tactical poison pill that had been approved by the shareholders of Neo Material Technologies Inc. (“Neo”), a Canadian corporation listed on the TSX, in the face of an unsolicited partial take-over bid made by Pala Investments Holdings Limited (“Pala”). *In the matter of Neo Material Technologies Inc. and Pala Investments Holdings Limited* represents the first time that the OSC has decided not to invoke its public interest jurisdiction to cease trade a shareholder rights plan, either immediately or on temporal conditions, upon application by a hostile bidder. This decision also appears to represent the adoption by the OSC of the principles established by the Alberta Securities Commission (the “ASC”) in *Pulse Data*,¹ which many observers had believed was an outlier in the Canadian poison pill landscape due to that decision’s self-professed “unique circumstances”.

with investments in various Canadian public companies, announced its intention to purchase up to 23 million Neo shares (representing approximately 20% of Neo’s outstanding shares) at a price of \$1.40 per share in cash. If successful, the offer would have increased Pala’s holdings to 40% of the Neo shares.

- On February 12, 2009, Neo adopted a second shareholder rights plan (the “New Rights Plan”), which was substantially similar to its existing rights plan (the “Old Rights Plan”) that had been originally adopted by Neo on February 5, 2004 and later approved by shareholders on two occasions, the last being in April 2007. The principal difference in the two plans was that the New Rights Plan required that any take-over bid for Neo’s shares be made to all Neo shareholders for all of their shares – in other words, no partial bid for Neo shares would qualify as a “Permitted Bid” under the New Rights Plan.
- On February 25, 2009, Pala formally commenced its offer, which qualified as a “permitted Bid” under the Old Rights Plan but did not under the new rights plan.

Key Background Facts

- On February 9, 2009, Pala, a Jersey, Channel Islands, investment company

¹ *Re Pulse Data Inc.* (2007), 2007 A.B.A.S.C. 895 (ASC).

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- On March 10, 2009, Neo announced that its board had unanimously determined that Pala's offer was inadequate from a financial point of view to the shareholders of Neo (other than Pala) and unanimously recommended that the Neo shareholders reject Pala's offer.
- On March 12, 2009, Neo's board announced that it would hold its annual general and special meeting of shareholders on Friday, April 24, 2009 to consider, among other things, approving the New Rights Plan.
- On April 8, 2009, ISS/RiskMetrics announced its recommendation that Neo shareholders vote against the approval of the New Rights Plan on the basis that it prohibited partial bids.
- On April 15, 2009, Pala brought an application to the OSC seeking an order to cease trade the Old Rights Plan and the New Rights Plan.
- On April 21, 2009, Pala amended its offer by increasing its offer price to \$1.70 per Neo share in cash and by decreasing the maximum number of shares subject of the bid to 10.6 million. If the amended partial offer were successful, Pala would have owned approximately 29.9% of the Neo shares – a threshold that, in Pala's view, would not give it legal or effective control of Neo.
- On April 24, 2009, Neo's shareholders approved the New Rights Plan with 82.74% of Neo's shares represented in person and by proxy at the meeting. Excluding Pala, 81.24% of the Neo shares were voted in favour of the New Rights Plan. A number of Neo's institutional shareholders, according to Neo, voted in favour of the New Rights Plan, even though the normal policy of those institutions would be to vote against a rights plan implemented in the face of a bid or that blocked partial bids.
- On May 7, 2009, the OSC heard Pala's application to cease trade Neo's rights plans. The OSC rendered its decision on May 11, 2009 with reasons to follow.

Pala's Submissions

Pala submitted that it was in the public interest for the OSC to cease trade Neo's rights plans for a number of reasons, including the following:

- Canadian securities law permits partial bids and there was no basis to deny Neo shareholders the right to tender their shares to Pala's offer simply because it was a partial bid. The ultimate decision to accept or reject an offer to acquire shares, such as Pala's offer, should be made by each individual shareholder and not by the directors or management of a target company;
- the continuation of Neo's rights plans would have had the effect of denying Neo's shareholders one of their inherent rights of ownership – to decide for themselves whether to tender to Pala's offer;
- Neo's rights plans did not serve either of the central purposes of shareholder rights plans under Canadian securities law, which are: to give a board more time to find an alternative value enhancing transaction and to ensure the equal treatment of shareholders;
- Neo's shareholders had been given sufficient time to consider Pala's offer and Neo's directors were not searching for any alternative value-enhancing transactions;
- Pala's offer was neither coercive nor part of a strategy to effect a creeping take-over of Neo. There was no evidence to suggest that the price of Neo shares would be discounted or that trading in the shares would become illiquid after a successful completion of Pala's offer; and
- the New Rights Plan was a tactical defensive rights plan made in direct response to Pala's offer as the plan prohibited partial bids entirely. Even with shareholder approval, the New Rights Plan was bid inhibiting and served no purpose other than to ward off all partial bids and further entrench management and the current Board.

In addition, Pala attempted to distinguish *Pulse Data*, a case where the ASC dismissed the offeror's application to cease trade a rights plan despite the absence of any potential competing offer after having run a process to find an alternative transaction. One argument put forth was that ISS/RiskMetrics had supported the rights plan in *Pulse Data* whereas, in the case at hand, ISS/RiskMetrics had publicly recommended against the New Rights Plan on the basis that it did not allow for partial bids. In addition, Pala argued that the decision in *Pulse Data* "has, in effect, amended existing securities legislation by requiring bids (whether partial or otherwise) to be supported by the majority of the minority and gone against many years of poison pill precedent."

Neo's Submissions

In response to Pala's arguments, Neo submitted that the principle issue on the application should not relate to the validity of partial bids or the application of the New Rights Plan, but rather "whether the business judgment of [Neo's] Board, ratified with full knowledge by Neo shareholders is susceptible to attack by the 'bitter bidder' Pala?" Neo further submitted that its management and board of directors, in the application of their fiduciary duties, determined, with the benefit of advice from their financial and legal advisors, among other matters, that:

- it was not a good time for the Neo shareholders to run an auction for a change of control transaction and that it would not be advantageous to the Neo shareholders to allow a partial Pala bid to put Neo "in play"; and
- a successful partial bid would provide Pala with effective control and a blocking position on future liquidity events without having paid an appropriate premium for that control.

Neo represented to the OSC that it was the expressed intention of the Neo board that the Old Rights Plan would prohibit the acquisition of more than 20% of the Neo shares, including by way of a partial bid. In Neo's board's view, the Old Rights Plan did not effectively

prohibit partial offers as intended, however, and the adoption of the New Rights Plan was designed to give effect to the intention of Neo's board and shareholders by prohibiting partial bids.

Neo further submitted that the owners of the business – the shareholders – had had an opportunity to make a fully informed decision and understood that a vote in favour of the New Rights Plan was a vote against Pala's offer. Neo argued that the OSC should not strike down the New Rights Plan because shareholders had spoken for themselves and there was no public interest basis for the OSC to intervene.

"What makes this situation unique," Neo argued, "is that the Board was able to consult the shareholders and, in effect, conduct a plebiscite on Pala's plans for Neo. The result of that vote was an overwhelming endorsement of the position of Neo's management and Board and a clear statement that the Neo shareholders do not want either Pala's partial bid to proceed or for it to provoke an auction at this time."

Neo submitted that its board also considered alternatives to maximizing shareholder value, including maintaining the *status quo* and pursuing the company's current business plan.

In addition, Neo submitted that in Canada, in the context of change of control transactions, there is no "Revlon duty" *per se* and that directors are not necessarily under an obligation to enter into a change of control transaction or put the company "in play" simply because it would immediately result in proceeds to shareholders above current market prices. Neo added that in Canada, a board of directors could "just say no" after due consideration of an offer.

The OSC Decision

The OSC dismissed Pala's application and refused to cease trade the New Rights Plan. In reaching its decision, the OSC panel stated that it was influenced by the following considerations:

- the New Rights Plan was adopted by Neo's board in the context of, and in response to, Pala's offer;
- there was no evidence that the process undertaken by Neo's board to evaluate and respond to Pala's offer, including the decision to implement the New Rights Plan, was not carried out in what Neo's board determined to be the best interests of the corporation and of the Neo shareholders, as a whole;
- an overwhelming majority of the Neo shareholders (excluding Pala) approved the New Rights Plan while Pala's offer remained outstanding;
- Neo shareholders were sufficiently informed about the New Rights Plan prior to casting their votes; and
- neither management nor Neo's board coerced or unduly pressured the Neo shareholders to approve the New Rights Plan.

The OSC indicated that full reasons for its decision would be provided in due course.

Conclusion

Prior to the ASC's decision in *Pulse Data*, shareholder rights cases in Canada were dominated by the maxim that in determining whether to set aside a rights plan, the question was not if, but when the rights plan would be set aside. With the OSC's decision in *Neo Material*, we now have two decisions supporting the proposition that Canadian securities regulatory authorities will not exercise their public interest jurisdiction to cease trade a rights plan that has been approved by a majority of shareholders in the face of an unsolicited take-over bid, where the views of shareholders are current and made on an informed basis. Market participants will most likely be looking for additional guidance in the OSC's full reasons that should be released in the next few weeks.

Although the OSC's reasons will no doubt shed more light on the developing poison pill landscape in Canada, it is interesting to note that the OSC supported the views of Neo's shareholders despite the fact that those views were contrary to the views of ISS/Risk Metrics which supports the proposition that partial take-over bids "are integral to rights plans in Canada since Canadian take-over legislation is premised on the right of shareholders to determine for themselves the acceptability of any bid for shares, partial or otherwise."

It appears self-evident that a target company can pursue the defensive strategy of seeking shareholder approval for a rights plan in the face of an unsolicited bid, be it partial or otherwise, only if the target is highly confident in receiving the support of its shareholders. Could there be an occasion where a target's board manages its shareholder constituency so successfully that shareholders could support board and management actions that would otherwise be contrary to the fiduciary duties owed to the corporation by managers? Even if such an occasion never develops, it would seem that the poison pill debate might now need to switch forums, from the commissions to the courts, in order to provide the setting to consider various legal rights of shareholders – including whether a majority of shareholders, by supporting a rights plan, can restrict minority shareholders from transferring their shares to a hostile bidder - and the appropriateness of shareholder rights plans apart from the more limited scope of securities regulators' public interest authority.

Please do not hesitate to contact one of the members of our Securities and Mergers & Acquisitions group if you have any questions regarding the OSC's decision in *Neo Material*.

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