Institute for governance
of private and public organizations

The Taming of Hostile Takeovers: Giving board of directors the power to do the job they are legally supposed to do!

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Submission of IGOPP to the Canadian Securities Administrators and the Autorité des marchés financiers in reply to request for comments on the proposal to modify the Canadian takeover regime.

Toward Value-Creating Governance™

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan ***VIA EMAIL***
Manitoba Securities Commission
Ontario Securtites Commission
Autorité des marchés financiers
Superintendent of securities, Prince Edward Island
Nova Scotia Securities Commission
New Brunswick Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut

Attention:
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Toronto, Ontario M5H2S8
Fax: 416-593-2318
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Attention:
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About IGOPP

Established in September 2005, the Institute for Governance of Private and Public Organizations (IGOPP) is a joint initiative of HEC Montréal and Concordia University (The John Molson School of Business). The Institute is committed to promoting sound corporate governance practices for private and public organizations in Quebec and the rest of Canada.

It achieves this through:

- **Policy papers**
- **Training**
- **Research**
- **Dissemination of information**

OUR MISSION

Help public and private organizations to adopt governance systems and practices that create value by offering training, adopting public positions, conducting research and disseminating ideas.

OUR VISION

Through its original contributions, the IGOPP seeks to become a reference organization on governance issues in Quebec, Canada and around the world.

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Hostile takeover operations carried out by new financial players, the leveraged-buy-out (LBO) funds, were an important feature of American financial markets during the decade 1980-1990. The phenomenon then waned as a result of criminal investigations of widespread insider trading, the jailing of some arbitrageurs and the incarceration of the king of junk bonds, Michael Milken, who was a key supplier of funds for LBO operations.

But the wave of LBOs also died on the shores of legal actions taken by several U.S. states in the period 1989-1992. More than twenty states enacted legislation granting boards of directors the power and authority to "just say no" to unwanted takeover of their company. These laws often included additional measures to thwart takeover operations even if the bidder had managed to circumvent the opposition of the board of the targeted company.

Of course, the financial community lamented these measures as early signals of the coming demise of free and efficient financial markets, a lament relayed ever since up by the "good" governance industry. LBO funds vanished from the financial stage to reappear a few years later as "private equity funds". These well behaved funds, bowing to the new legal context, rarely attempted a hostile takeover. In fact, the changes in executive (and board) compensation, largely a result of the lessons learned from LBO operations, made corporate senior management and boards of directors a lot more receptive to takeover offers.

Here are some enlightening statistical results about the U.S. experience (Table 1):

Table 1

Statistical facts about U.S. takeovers

1980-1999

	1980-1989	**1990-1999**
Number of M&A events	**1,232**	**2,582**
Percent successful	**77.5%**	**88.0%**
Percent hostile	**10.8%**	**3.9%**
Actual offer premium	**48.4%**	**54.4%**
Abnormal return premium	**16.3%**	**23.9%**

(Source: Gaspar, Massa, and Matos, 2005)

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These results provide clear evidence that the changes in U.S. state laws have indeed led to far fewer hostile takeovers; but the rate of successful takeovers actually increased and shareholders received a substantially better offer for their shares. ***Boards of directors with enhanced powers have extracted much better deals for their shareholders.***

The arguments for the 1986 regulation

Strangely, almost at the same time U.S. states were acting to place legal hurdles in the path of hostile takeovers, Canadian securities commissions were adopting (in 1986) rules to make hostile takeover operations easier to carry out successfully. Foremost among the reasons given for this Canadian initiative was the *"protection of the bona-fide interests of the shareholders of the target company"…"The take-over bid provisions…should leave the shareholders of the target company free to make a fully informed decision"* (CSA, NP 62-202).

It was a strongly-held belief of regulators and a premise of the 1986 regulation adopted by the Canadian securities commissions that management was always and henceforth in conflict of interest when faced with a hostile bid for their company. Management's fear of losing their jobs, the negative economic consequences for them of a takeover, it was believed, would motivate them to fight a takeover otherwise beneficial to shareholders. "*Management's conflict of interest position in a takeover context is…beyond dispute. It is a trite point that jobs and careers are often at stakes*", (Stanley Beck, Chairman of the Ontario Securities Commission in 1987, quoted in the AMF consultation paper)

Another argument invoked in 1986 was drawn from the gospel of market efficiency: "*The appropriate regulatory approach to takeover bids is to encourage unrestricted auctions"* (Quoted in the AMF consultation paper).

Whatever dubious merit there might have been to this regulation back in 1986 (and the statistics quoted above do raise doubts), it now smacks of a time and circumstance that have passed on. Contemporary financial markets are populated by high-speed traders, momentum traders, dark pools, arbitrage funds, hedge funds, none of which qualify for the ancient, hallowed title of an owner-shareholder. The notion that shareholders, whoever they are and whatever their nature and

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game, are the ultimate and only party to decide on the fate of a company appears, in the light of contemporary financial markets, as quaint and …illegal.

Quaint

Within days of a takeover offer becoming public, the abnormal trading volume indicates that 30% to 40% of the shares have now moved to new types of "shareholders" (Allaire, Y., Revue ***Forces***, June 2007). As a result of this market demand, the stock price rises to a level close to the offering price.

Any fund which has moved into the stock at that time has to be betting that the transaction will close at the offering price or at a higher price. The worst outcome would be for the transaction to abort and the stock price to return to its former level, inflicting large losses on any fund that moved in during the days after the announcement of a takeover bid. Arbitrage funds and some hedge funds specialize in these betting games.

It would be self-defeating, as is proposed by the CSA, to grant to these new "shareholders" the right to vote on whether the company should be sold or whether a poison pill should stay in place! The whole point of their actions is to get these companies sold out at the best price and as quickly as possible. That's how they make their money!

The fact that a large percentage of the shares has migrated to short-term shareholders of course means that other, longer-term shareholders have sold their position. There are good reasons in the current state of the investment and takeover market for this phenomenon to occur:

- If more than two thirds of the shares are turned in to the bidder, the shares that have not participated will eventually be acquired in a second step transaction; but this means that those shareholders will receive payment at a later date thus perhaps reducing their return; if the bid is deemed likely to succeed, it would be sub-optimal not to sell the shares as soon as the price moves close to the offer price;

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- Elementary financial calculus would incite an investment fund (mutual fund, pension fund, etc.) to sell its shares at the going price soon after the takeover offer; if the takeover bid were to fail (or be blocked by governmental bodies), the fund could buy back the stock at the pre-bid price and yet post a nice return boosting its performance. Suppose that a fund has bought shares at $100 and held them for the last three years when a takeover bid is made at a price of $130. Immediately after the announcement, the price of the share climbs, say, to $125. The fund could hold on to the shares until completion of the transaction at $130 in, say, six months (incurring the risk that the bid fails and the share price drops back to $100). For that fund, selling into the market at $125 means a return of 7.72% a year; holding on to the shares for another six months and getting $130 for them brings up the return to 7.78% a year, a negligible increase in yield to take the risk of the bid failing and the yield then dropping to 0%;
- For the arbitrage funds and like-minded “investors”, the calculus is far different. Buying the shares at $125 and holding them for six months generates a yearly yield of 8% if the bid closes at $130. That is the reward for taking the risk that the takeover bid will not be successful; there is also the possibility that a higher bid price might be forthcoming and thus push the yield to arbitrageurs even higher.

Thus, whenever the price moves close to the bid price, it is rational for an investment fund to sell its shares in the market; and the easier the takeover process, the closer will the bid price move to the market price and the faster. The submission by the Institute of Corporate Directors to the Canadian Securities Administrators includes some interesting data showing that between 2000 and May 2013, 86% of unsolicited (or “hostile”) takeover bids had been successful in Canada. (54% by the initial bidder; 32% by an alternative bidder). *(ICD letter to the CSA and the Autorité des marchés financiers, footnote 1, page 1)*. The risk of a failed bid (14%) is not compensated by the small increase in yield from holding on to the stock until the transaction closes. For an arbitrage fund, that 14% risk is rewarded by an expected minimum yield of 8% in 86% of cases.

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Illegal

The Canadian Business Corporation Act and the interpretation by the Supreme Court of Canada in two key judgments (Peoples Department Stores v. Wise, 2004; BCE Inc. v. debenture holders, 2008) explicitly grant authority and impute responsibility to the board of directors to act in the interest of the corporation and not that of any particular stakeholder, whether shareholders, debt holders, employees, or others. On what legal basis can the securities commissions strip board directors of their authority in matters of takeovers and enjoin them to singularly and solely act to "*protect the bona-fide interests of the shareholders of the target company*"?

In 2007, the federal government in response to public outcry at the takeovers in short succession of Alcan, Falconbridge, Inco and others, set up the ***Competition Review Panel***. In its report, the Panel recognized the untenable position of securities commissions and recommended that:

- "*Securities commissions should repeal National Policy 62-202 (The policy that stripped boards of directors of all authority in takeover situations).*
- *Securities commissions should cease to regulate conduct by boards in relation to shareholder rights plans ("poison pills").*
- *Substantive oversight of directors' duties in mergers and acquisitions matters should be provided by the courts.*
- *The Ontario Securities Commission should provide leadership to the Canadian Securities Administrators in making the above changes, and initiate action if collective action is not taken before the end of 2008*."

Nothing happened until recently. The Canadian securities commissions have now undertaken a process to review and modify the rules they set some 25 years ago whereby boards of directors were basically stripped of all authority and turned into sales agents seeking the highest bidder for the company. But only the Autorité des marchés financiers has tabled proposals to bring the Canadian takeover regime in line with Canadian corporate laws and jurisprudence as well as in line with the regulation of takeovers in the more moderate states of the United States.

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Conflicted management??

Canadian regulators believed in 1986 that management was always thrown in a conflict of interest when faced with a hostile bid for their company. Management's fear of losing their jobs, the negative economic consequences for them and their family of a takeover may, will motivate them to fight a takeover otherwise beneficial to shareholders.

That may have been so in 1987 but the times have changed. The issue now revolves around the large share-based compensation plan for executives (stock options, restricted shares, and so on), golden parachutes, special pension plans, contractual benefits in cases of change of control, etc. Then, board members also get paid in part with participating units linked to share price. All this variable compensation becomes payable and cashable at the takeover price whenever a change of control occurs.

Clearly, a takeover bid offering some 30-40% premium over the current stock price means a bonanza for executives and board members. The steadfast resistance of boards and management to hostile takeovers in the 1980s has been mollified by the huge pay-offs resulting from take overs, turning hostility into a welcome mat.

Indeed, the challenge for securities commissions has shifted by 180 degrees. It is not to make hostile takeovers easy or easier, to protect shareholders against conflicted, self-serving management; it is to ensure *that the reward system of board members and senior executives do not overly motivate them to seek out, or consent too easily to, a takeover that may not be in the long-term interest of the company.*

Of the thousands of takeovers over the last twelve years in Canada, ***less than one hundred were of the "hostile", unsolicited, kind.***

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Unrestricted auctions for taking over companies

That argument is all well and fine in theory; but the facts tell a different story. The Canadian business context is not such as to generate an abundance of credible bidders for a particular company. There is some evidence (quoted earlier) that over 60% of successful acquisitions in Canada were carried out by the original bidder. Therefore, the situation is likely to unfold as follows: an unwanted bid is made for taking over the company at a given price; the board disagrees and opposes the takeover; however under current regulations, all the board can do is to seek out an alternative bidder willing to offer a higher price; if the board is unsuccessful, the bidder will transmit the offer directly to shareholders, who will most likely take the money and run. The board does not have any leverage with which to bargain for a higher price!

Take the recent case of Inmet Mining Corp. and First Quantum Minerals. Inmet's board was dead set against a takeover by First Quantum. The latter made a bid; no other bidder has shown up. Despite the board's opposition, Quantum simply put its offer to the shareholders. As enough of them handed in their shares the deal has been done; the takeover was successful. Under Canadian regulations, the board of Inmet had no other recourse; they believed that it was not in the long-term interest of Inmet to be acquired by Quantum at the offered price but were powerless to act. That does not make any sense.

Canadian governance context

So regulation of takeovers by Canadian securities commissions makes it easier to carry out such operations successfully in Canada than is the case in the United States by constraining the role of poison pills and other defense mechanisms and limiting their duration. In addition, two governance features, which are the "bêtes noires" of U.S. activist institutional funds and proxy advisors, are non-issues in Canada:

1. Splitting the roles of Chair and CEO (Only 41% of S&P 500 companies have separate Chair and CEO position and in many cases that chair person is not an independent member but the former CEO; fully 85% of Canadian companies have divided the roles of Chair and CEO, an important principle in situations of conflicts with shareholders);

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2. Eliminating staggered boards and electing all members every year, a very effective means of blocking hostile takeovers. A third of the S&P 500 companies still have staggered boards (that is, only a third of members of staggered boards are up for election each year); *staggered boards are practically non-existent in Canada*; American academic activist, Lucian Bebchuk, and proxy advisors have been waging an all-out war against staggered boards, making slow progress in their campaign to *eradicate* this governance feature.

The result of all this is that Canadian boards are less empowered than the board of any run-of-the mill American corporation. ***American activist investors and hedge funds have discovered recently that Canada is the Promised Land for shareholder rights.***

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Conclusions and recommendations

The time has come to change/modernize the antiquated, obsolete regulations of takeovers in Canada. The provincial securities commissions, coordinated through the Canadian Securities Administrators, must bring forth a framework for takeover regulation that complies with Canadian laws and jurisprudence.

- Canadian corporate governance already complies with what the activist investors are fighting for in the United States; elimination of staggered boards and separation of power between the chair of the board and the CEO, both governance principles which make it easier to carry out a hostile takeover; combined with the widespread practice of majority voting for board members, these features of Canadian corporate governance provide shareholders with the means and tools to punish an errant board.
- The changes in shareholding since 1987 have been remarkable; as soon as a takeover offer is made public, the financial calculus of present shareholders coupled with the actions of specialized funds transform radically and swiftly the shareholder base of the target company; to consider these new shareholders as the "owners" of the corporation, the sole "deciders" of its fate, needing the benevolent protection of securities commissions against malevolent, conflicted management, seems like an imaginative scenario of times past.
- That concept of the role of securities commissions flies in the face of the Canadian Business Corporation Act and Supreme court jurisprudence; it is high time that the CSA align their regulations with what is Canadian law; securities commissions cannot, should not, thwart the authority and responsibility of directors to act in the long-term interest of the corporation in the case of takeovers, the quintessential decision about the long-term interest of the corporation and of all its stakeholders.
- The quaint notion that management is, *ipso facto*, against the takeover of their company because of inherent conflicts of interest must be updated; because of the changes in compensation system for executives and board members, the concern has become that

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management and boards may be too receptive to a takeover offer that may not be in the interest of the corporation and its stakeholders. The potential conflict of interest has switched side. Securities commissions should be alert to the appearance of that phenomenon and assess measures to limit this sort of conflict of interest.

For all these reasons, IGOPP and its board of directors[1] strongly support the proposals put forth by the AMF and urge other provincial securities commissions to join in this crucial effort to modernize the regulation of takeovers in Canada.

[1] However, as per the policy of the AMF, Mr. Louis Morisset of the Autorité des marchés financiers abstained.

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