

**IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S. 5, as amended**

AND

**IN THE MATTER OF
NEO MATERIAL TECHNOLOGIES INC. AND PALA INVESTMENTS
HOLDINGS LIMITED AND ITS WHOLLY-OWNED SUBSIDIARY
0833824 B.C. LTD.**

**MEMORANDUM OF FACT AND LAW
OF NEO MATERIAL TECHNOLOGIES INC. ("NEO")**

A. OVERVIEW

1. As in any area of law, the application of fundamental principles to specific or unusual facts determines the result. There is no predestined cookie-cutter formula. The undoubted fact is that in most cases when faced with a bid for all, a board of directors will be obliged to run an auction as a change of control transaction will be inevitable. The question of when is the time for "the pill to go" arises in those cases. However, in every case the directors have a duty to consider the best interests of the collectivity of shareholders and it is the particular facts that dictate whether the pill must go.

2. Equally, and accepting that Pala Investments Holdings Limited ("Pala") sincerely considers that it would be a positive contributor to Neo, management and the Board are also obliged to assess that question. If they conclude to the contrary, they are obliged to act on that assessment.

3. In the present circumstances, management and the Board of Neo in the application of their fiduciary duties, determined, with the benefit of advice from their financial and legal advisors, that: (i) now is 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”; (ii) that a successful partial bid would provide Pala with effective control and a blocking position on future liquidity events without the payment of a control premium; (iii) the consideration offered by Pala was inadequate; and (iv) they did not share Pala’s view of the contributions it could make.

4. What makes this situation unique 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 the Pala partial bid to proceed or for it to provoke an auction at this time.

5. The Commission is not called upon and would not be in a position to choose between the business assessments inherent in the two positions. Fortunately, the owners of the business - the shareholders - have had the opportunity to make an informed decision and have resoundingly done so.

6. The Commission also has the benefit of the opinion of James Baillie, an ex-chairman of the Commission and one of the most senior and sage individuals in the securities regulatory area in Canada. His assessment and considerations are hopefully of interest and assistance to the Commission.

B. FACTS

(i) Background and the Parties

(a) Neo Material Technologies Inc.

7. Neo is a public corporation continued under the laws of Canada. Neo is headquartered in Toronto and has approximately 1,300 employees in 15 locations, across 10 countries. Neo's shares are listed on the Toronto Stock Exchange.¹

8. Neo is a producer, processor and developer of neodymium-iron-boron magnetic powders, rare earths and zirconium based engineered materials and applications through its Magnequench and AMR Performance Materials business divisions. Neo's products are processed at plants in China and Thailand (which are close to both raw material sources and key Asian markets) into products used in the manufacture of a wide range of products such as micro motors, precision motors, sensors, catalytic converters, computers, television display panels, optical lenses, mobile phones and electronic chips.²

9. Neo's success is highly dependent on its government, business, joint venture and client relationships in its principal manufacturing and marketing regions, namely China, Thailand, Japan, and more recently Brazil, which relationships have been built over many years.³

(b) Pala Investments Holdings Inc.

10. Pala is an investment company registered in Jersey, Channel Islands and is indirectly beneficially owned by Vladimir Iorich. Pala has been an investor in Neo since July 2007. As at February 25, 2009 (the date of Pala's partial offer) Pala owned

¹ Affidavit of Constantine Karayannopoulos ("Karayannopoulos Affidavit") at para. 6

² Karayannopoulos Affidavit at para. 7

³ Karayannopoulos Affidavit at para. 10

and controlled a total of 23,640,600 common shares of Neo, representing approximately 21% of Neo's issued and outstanding common shares.⁴

11. Pala has investments in such companies as Avoca Resources Limited (Australian gold producer), Anatolia Minerals Development (Turkish gold development), Coalcorp Mining Inc. ("Coalcorp") (Colombian coal producer), Churchill Mining PLC (Indonesian coal development project) and Rockwell Diamonds Inc. ("Rockwell") (South African diamond producer). It thus appears that Pala, has limited, if any, experience in operating a business in Neo's industry and no particular relationships in Neo's regions of operation.⁵

12. Pala has increasingly taken on an activist role in its equity investments with some notable failures. Coalcorp and Rockwell are two recent Pala investments where Pala has failed to support management or the respective companies or add strategic value. Based on publicly available information, as of February 25, 2009 (the date of Pala's Offer and Take-over Bid Circular (the "Pala Circular")), the share prices of Coalcorp and Rockwell have declined by 93.7% and 86.4%, respectively, since Pala announced its increased shareholdings above 10% (in the case of Coalcorp), and launched an offer to shareholders (in the case of Rockwell). In addition, following Pala's increase in ownership in Coalcorp to above approximately 40%, Pala replaced a majority of the board members with its own appointees and replaced senior management (including the Chief Executive Officer) with its own appointees. Accordingly, it appears that Pala's role recently as a "cornerstone shareholder", which it purports to be, has led to devastating results for at least these two companies.⁶

⁴ Karayannopoulos Affidavit at para. 18; Pala Circular

⁵ Karayannopoulos Affidavit at para. 19; Pala Investments Presentation to Neo Shareholders, Exhibit "R" to the Karayannopoulos Affidavit

(c) Pala's Partial Offers

13. On February 9, 2009, Pala announced its intention to purchase up to a maximum of 23 million of Neo shares at a price in cash of \$1.40 per share (the "Partial Offer"). The Partial Offer was for approximately 21% of Neo's issued and outstanding shares and, if successful, would have resulted in Pala having control or direction over approximately 41% of the issued and outstanding shares. The Partial Offer was structured as a "Permitted Bid" under the shareholder rights plan, which was adopted by Neo on February 5, 2004 (the "Rights Plan"). Pala formally commenced the Partial Offer on February 25, 2009.

14. On April 21, 2009, Pala increased its offer price to \$1.70 per share (the "Amended Partial Offer", which together with the "Partial Offer" are hereinafter referred to as the "Pala Partial Offer"). Pursuant to the Amended Partial Offer Pala is seeking a 29.9% interest, which given historical shareholder voting levels, as outlined below, effectively constitutes an acquisition for effective control of Neo.⁷

15. The Amended Pala Offer was formally submitted to shareholders on April 29, 2009 via a Notice of Variation and Extension. The amended terms of the Pala Partial Offer include (1) an increase to the offer price from \$1.40 per share to \$1.70 per share, and (2) a decrease of the maximum number of shares to be taken up and paid for by Pala under the offer from 23,000,000 shares to 10,600,000 shares. The offer has also been extended and is now open for acceptance until May 15, 2009, unless withdrawn or extended. The Amended Partial Offer remains structured as a "Permitted Bid" under Rights Plan. It would not be a Permitted Bid under the shareholders rights plan adopted on February 12, 2009, and ratified on April 24, 2009 (the "New Rights Plan").

⁶ Karayannopoulos Affidavit at para. 19; Coalcorp News Release dated April 15, 2009, Exhibit "E" to the Karayannopoulos Affidavit

⁷ Karayannopoulos Affidavit at paras 19, 52 and 52; Pala's Offer Circular, Exhibit "M" to the Affidavit of Jan Castro

(ii) The History of Pala's Relationship with Neo

16. On April 8, 2008, Pala announced that it had acquired more than 10% of the then issued and outstanding shares of Neo. From April 8, 2008 until September 17, 2008, Pala steadily increased its ownership in Neo, taking its total ownership position to 23,640,600 shares, representing approximately 20% of the then issued and outstanding shares.⁸

17. From on or about April 8, 2008, when Pala announced that it had acquired more than 10% of the then issued and outstanding shares of Neo, until February 9, 2009 (the date Pala announced the Partial Offer) there were numerous meetings and discussions between Neo's management and Board, primarily Neo's President and CEO, Constantine Karayannopoulos, and representatives of Pala, primarily Jan Castro, the Managing Director of Pala Investments AG, the exclusive advisor to Pala.⁹ Pala's submission that "Neo has been reluctant to engage with Pala regarding strategic direction and other matters related to Pala's business"¹⁰ is disingenuous in light of the following evidence, which clearly indicates that Neo management and Board made themselves available and met with Pala representatives on a number of occasions.

18. On May 13, 2008, Mr. Karayannopoulos and Neo's Investor Relations representative met with Pala representatives, including Mr. Castro, at Pala's offices in Zug, Switzerland. During this meeting, the parties discussed Pala's shareholdings in Neo and potential opportunities for Neo and Pala to work together. Following the meeting, Mr. Castro requested a meeting with Neo's Board to introduce Pala, its strategy and investment philosophy. At the next Board meeting, a dinner was arranged with Pala representatives on August 11, 2008, which was attended by three members of Neo's Board and four members of Neo's management. During this

⁸ Karayannopoulos Affidavit at para. 26

⁹ Karayannopoulos Affidavit at paras 19 and 32.

meeting Mr. Castro stated to Mr. Karayannopoulos that Neo is one of ten companies in the Pala investment fund and that Pala intended to be a medium to long term investor in Neo.¹¹

19. At the request of Pala, representatives of Pala received tours of certain Neo manufacturing facilities located in China and met with Neo management on November 16, 17 and 18, 2008. Mr. Castro subsequently sent a letter to Mr. Karayannopoulos praising Neo's facilities and management: "we were impressed with the high calibre management, track record and operational performance, quality control programs and employee retention rates at all sites".¹²

20. Neo representatives subsequently met with Pala representatives during a conference in Hong Kong on November 19, 2008. During these meetings, Mr. Castro advised Mr. Karayannopoulos that Pala was not in the business of taking large holdings in companies for a lengthy period of time, such that Pala had only two options as far as Neo was concerned: (a) either increase its holdings in Neo to take a control position to take the company private or (b) exit its holdings in Neo. Mr. Castro also stated that Pala could not possibly launch a hostile take-over of Neo because Neo's management was doing a good job and there was nothing that Pala could criticize about them. Mr. Karayannopoulos advised Mr. Castro that due to the state of the economy, things would only be getting worse in 2009 and that he would be very reluctant to consider the privatization option as, among other reasons, that would require Neo to increase its debt. The conversation concluded with Mr. Castro stating that he would revisit this issue with Mr. Karayannopoulos in the middle of the first quarter of 2009.¹³

¹⁰ Footnote 12, p. 11 of Pala's Memorandum of Fact and Law

¹¹ Karayannopoulos Affidavit at para. 25

¹² Karayannopoulos Affidavit at paras. 27 and 28; Letter from Mr. Castro to Mr. Karayannopoulos dated November 24, 2008, Exhibit "H" to the Karayannopoulos Affidavit

¹³ Karayannopoulos Affidavit at para. 29

21. On various occasions in 2008, Mr. Castro stated to Mr. Karayannopoulos that Pala liked Neo's management and its strategy, that Pala could bring value to Neo and that Neo may operate better as a private company because public markets do not necessarily understand Neo and the nature of its business. The theme of privatizing Neo was regularly raised by Mr. Castro in their conversations on various occasions. Each time Mr. Castro raised the issue of privatization, he was clear that it would be conditioned on the retention of Neo's current management.¹⁴

22. Mr. Karayannopoulos and Mr. Castro subsequently met on Sunday, February 1, 2009. During this meeting:

- (a) Mr. Castro and Mr. Karayannopoulos agreed that a privatization of Neo did not make sense given the current economic conditions;¹⁵
- (b) Mr. Castro outlined Pala's rationale for a potential partial offer and presented to Mr. Karayannopoulos a document entitled "Neo Material Technologies Discussion Document" (the "Discussion Document"). The Discussion Document did not set forth any details regarding the consideration that would be offered by Pala to Neo's shareholders;¹⁶
- (c) Mr. Castro advised Mr. Karayannopoulos that Pala was no longer interested in privatizing Neo, but rather wanted to become a "cornerstone shareholder" at 40%. However, when Mr. Karayannopoulos asked how Pala would add value to Neo as a 40% shareholder, Mr. Castro did not provide a substantive response. Rather, Mr. Castro stated Pala needed to "average down" its holdings in Neo and that he was personally under pressure from Pala to do something with Pala's investment in Neo. At no time during this

¹⁴ Karayannopoulos Affidavit at para. 30

¹⁵ Karayannopoulos Affidavit at para. 32; Discussion Document, Exhibit "I" to the Karayannopoulos Affidavit

¹⁶ Karayannopoulos Affidavit at para. 32; Discussion Document, Exhibit "I" to the Karayannopoulos Affidavit

conversation did Mr. Castro provide a share price for Pala's proposed partial offer to Mr. Karayannopoulos;¹⁷

(d) Mr. Karayannopoulos' evidence is that the Discussion Document did not appear to require any immediate action on the part of Neo, particularly in light of Mr. Castro stressing to Mr. Karayannopoulos that the Discussion Document was an informal suggestion and that Pala was not putting forth a formal letter, but rather interested in getting Neo's thoughts on their proposal. When a copy of the Discussion Document was later sent to Mr. Karayannopoulos by email, the cover note referred to the document as merely "outlining the idea in concept."¹⁸

(e) Mr. Karayannopoulos advised Mr. Castro that he had difficulty seeing the benefit to Neo's shareholders of Pala becoming a 40% shareholder and that he thought the Board may have a problem with a partial bid, which would appear to be an attempt to buy effective control of Neo without paying an appropriate premium for that control. Nonetheless, he advised Mr. Castro that he would forward the Discussion Document to the Chairman of the Board, Mr. Jackson, and leave it to Mr. Jackson to contact Mr. Castro if interested.¹⁹

23. Mr. Karayannopoulos subsequently had a conference call with Mr. Jackson and members of senior management on February 4, 2009 to discuss Pala's proposal. It was agreed that the Board should meet to review the Discussion Document at the next upcoming Board meeting.²⁰

¹⁷ Karayannopoulos Affidavit at para. 33

¹⁸ Karayannopoulos Affidavit at para. 32; Discussion Document, Exhibit "I" to the Karayannopoulos Affidavit

¹⁹ Karayannopoulos Affidavit at para. 34

²⁰ Karayannopoulos Affidavit at para. 35

24. On February 4, 2009 Mr. Castro sent an email to Mr. Karayannopoulos following up on the timing of Neo's review of the Discussion Document. Mr. Karayannopoulos replied that management was aiming to set up a meeting with the Board and that the earliest available date for the meeting appeared to be February 23, 2009.²¹

25. On February 8, 2009, Mr. Castro advised Mr. Karayannopoulos that Pala intended to proceed with a formal partial offer, which was announced on February 9, 2009.²²

(iii) The Financial Position of Neo

26. As outlined in the Karayannopoulos Affidavit, Neo has over US\$50 million in cash and zero long term debt. For the year ended December 31, 2008, Neo reported increased revenues of US\$266.6 million and net income of US\$23.3 million, or US\$0.22 per share on a basic and fully diluted basis. Earnings before interest, taxes, depreciation and amortization ("EBITDA") for 2008 was US\$48.8 million. This compares to 2007 revenues of US\$240.5 million, net income of US\$28.2 million, or US\$0.32 and US\$0.30 per share on a basic and fully diluted basis, respectively, and EBITDA of US\$61.6 million.²³

27. In 2008, notwithstanding the current economic situation, Neo grew its top line, achieved strong EBITDA, net income and earnings per share and retired all of its long-term debt. In addition, Neo negotiated a new US\$20 million revolving credit facility, which in addition to other credit facilities provides approximately US\$40 million of readily available credit on favourable terms, further strengthening Neo's financial position. As a result, Neo is well positioned to continue to explore strategic

²¹ Karayannopoulos Affidavit at para. 36

²² Karayannopoulos Affidavit at para. 37

²³ Karayannopoulos Affidavit at para. 12; Neo's Consolidated Financial Statements for the years ended December 31, 2008 and 2007, Neo's Annual Information Form for the year ended December 31, 2008, and Neo's Management's Discussion and Analysis dated March 12, 2009, Exhibits "A", "B" and "C" to the Karayannopoulos Affidavit

growth opportunities that will complement its strong organic growth profile and create long-term shareholder value.²⁴

28. Neo's management and Board are confident that it has both the operational and financial flexibility to make the necessary adjustments in its operating practices as the global economic recession continues. Neo's strong balance sheet, with cash of over US\$50 million (and available credit facilities of US\$40 million), and its ability to generate positive cash flow position Neo uniquely to take advantage of both organic growth and, in particular, accretive acquisition opportunities to complement its existing businesses as part of its growth strategy, which is the primary focus of long-term shareholder value creation.²⁵

(iv) Effective Control of Neo

29. Two factors determine effective control of Neo. First, Neo has a wide shareholder base (to the knowledge of Neo, no shareholder other than Pala beneficially owns or exercises control or direction over more than 10% of the issued and outstanding shares). Second, voting levels of shares represented in person and by proxy at shareholder meetings in the last five years has ranged from approximately 53% to 76%:

- (a) June 28, 2004 - 65.9%
- (b) July 15, 2005 - 76%
- (c) April 19, 2006 - 71%
- (d) April 18, 2007 - 64.26%

²⁴ Karayannopoulos Affidavit at paras. 13 and 14

²⁵ Karayannopoulos Affidavit at para. 15

(e) April 28, 2008 - 53.04%.²⁶

30. Based on these voting levels, a 29.9% ownership position by Pala would amount to anywhere between approximately 39% to 56% of the shares represented in person and by proxy at shareholder meetings and give Pala effective control of Neo. This means that if the Pala Partial Offer is successful, Pala would effectively have a blocking position on special resolutions for fundamental changes involving Neo contemplated by the *Canada Business Corporations Act* ("CBCA"), including certain liquidity events, at the minimum, and the ability to pass ordinary resolutions of shareholders such as the election of directors, at a maximum.²⁷ Moreover, under the *Securities Act* (Ontario), the rebuttable presumption for a "control person" is 20%.

(v) Neo's Board Complied with its Obligations to Consider the Interests of all Shareholders: The Business Judgment of the Board

31. The steps taken by the Board and management in response to the Pala Partial Offer are fully set out in the Directors' Circular and in the Karayannopoulos Affidavit. By way of summary:²⁸

(a) On February 10, 2009, Neo's Board met to, among other things, receive an update on the announcement by Pala and decide on a preliminary course of action, including (i) confirming that a previously formed special committee of independent directors comprised of James J. Jackson, F. Michael Walsh and Peter E. O'Connor (the "Special Committee") was empowered, among other things, to consider the proposed Partial Offer, (ii) reviewing proposed advisors, and (iii) reviewing the Rights Plan and proposed courses of action to address the then proposed Partial Offer. Stikeman Elliott LLP was retained as

²⁶ Karayannopoulos Affidavit at para. 52

²⁷ Karayannopoulos Affidavit at para. 51

²⁸ Karayannopoulos Affidavit at paras. 40-45; Directors' Circular, Exhibit "K" to the Karayannopoulos Affidavit

the Special Committee's legal advisor. Fogler Rubinoff LLP is the Company's legal advisor;

- (b) On February 12, 2009, the Board retained GMP Securities L.P. ("GMP Securities") as financial advisor to the Board and the Special Committee. GMP Securities presented its preliminary views on the then proposed Partial Offer. The Board also received a presentation of Stikeman Elliott LLP regarding a proposed second shareholders rights plan aimed at responding to the Partial Offer (i.e. the New Rights Plan), which following such presentation and discussion, the Board resolved to adopt. The New Rights Plan is substantially similar to the Rights Plan except that it requires that any take-over bid be made to all Neo shareholders for all of their shares. The New Rights Plan was designed to prevent unfair attempts to make creeping takeovers of Neo (such as the Pala Partial Offer) and was in addition to the Rights Plan, which remains in effect following the adoption of the New Rights Plan;
- (c) On March 9, 2009, GMP Securities delivered an inadequacy opinion to the Board to the effect that, the consideration offered to Neo shareholders pursuant to the Partial Offer was inadequate from a financial point of view to shareholders other than Pala;
- (d) On March 10, 2009 the Board formally announced its unanimous recommendation that shareholders reject the Partial Offer and not tender their common shares, and set forth the detailed reasons for this recommendation in its Directors Circular;
- (e) By press release dated April 21, 2009, the Board announced that the New Rights Plan will only remain in effect until the 2010 annual meeting of shareholders; and

- (f) By press release dated April 22, 2009, the Board announced that the proxy deposit deadline was being waived to permit shareholders to deposit proxies until the commencement of the annual and special meeting on April 24, 2009.

(vi) Neo Shareholders Ratified the Board's Decision

32. At Neo's Annual and Special Meeting on April 24, 2009, Neo's shareholders overwhelmingly passed a resolution to approve, ratify and confirm the adoption of the New Rights Plan. Excluding Pala, 81.24% of the shares voted were in favour of the New Rights Plan. 82.74% of Neo's shares were represented in person and by proxy at the meeting, which is the highest voting level in five years.²⁹

33. The shareholder vote was held after the shareholders had received Pala's Partial Offer, Neo's Directors' Circular, and Pala's Amended Partial Offer. Accordingly, when the shareholders voted to implement the New Rights Plan, they were fully informed and understood that a vote in favour of the New Rights Plan was a vote against the Pala Partial Offer.

34. As the New Rights Plan is substantially similar to the Rights Plan, with the exception that it requires any take-over offer to be made to all shareholders for all of their shares, the April 24 vote also effectively ratifies the Rights Plan (in the face of the Pala Partial Offer and no other bids). In any event, the Rights Plan was approved at the annual and special meeting of shareholders in 2004 and later ratified by approximately 90% of the votes cast by shareholders at the annual and special meeting in April 2007.³⁰

²⁹ Karayannopoulos Affidavit at para. 46; Scrutineers' Final Report and the Computershare Report on Ballot, Exhibits "N" and "O" to the Karayannopoulos Affidavit

³⁰ Karayannopoulos Affidavit at para. 43

35. In his affidavit, Mr. Karayannopoulos provides evidence of his discussions with shareholders and their motivations in voting in favour of the New Rights Plan. In the days leading up to the shareholder vote on April 24, 2009, Mr. Karayannopoulos had numerous discussions with institutional shareholders, which hold millions of shares, about the Pala Partial Offer and the New Rights Plan. In these discussions a number of Neo's institutional shareholders advised him that although the normal policy of their institution would be to vote against a rights plan implemented in the face of a bid or that blocked partial bids, they would be voting in favour of the New Rights Plan or that they would be withdrawing their votes against the New Rights Plan and re-voting in favour of it. The basis for these shareholders' decisions was the belief that Pala does not add value (and may indeed destroy value based on Pala's track record as a disruptive shareholder) and ought to be making a bid for all shares and paying an appropriate control premium. For these shareholders, it is important to have the ability to exit their holdings entirely rather than remain a minority shareholder in a Pala-controlled Neo.³¹

(vii) The Danger to Shareholder Value Posed by Pala and the Pala Partial Offer

36. Neo's Directors' Circular outlines the reasons why the Partial Offer was not adequate and following a preliminary review and receipt of advice from its financial advisor, it is the Special Committee's view that all of those reasons apply with equal force to the Amended Partial Offer (such views will, once finalized, be expressed in an amended directors' circular). The reasons for continuing the New Rights Plan and upholding the will of Neo's shareholders include the following:

(a) The Pala Partial Offer Seeks to Provide Pala with Effective Control of Neo, without Offering an Appropriate Control Premium for the Shares Purchased

³¹ Karayannopoulos Affidavit at para. 47

37. If the Pala Partial Offer is successfully completed, Pala will have acquired effective control over Neo without having paid an appropriate premium for that control, and no premium for those shares that are not purchased. As disclosed in the Pala Circular, Pala currently exercises control or direction over 23,640,600 or approximately 21% of Neo shares. Through the Pala Partial Offer, Pala is seeking to increase the number of shares over which Pala exercises control or direction to approximately 29.9% of the issued and outstanding shares.³²

38. As noted above, given Neo's wide shareholder base and historical voting levels at meetings of shareholders, if the Pala Partial Offer is successful, the ability of Pala to vote (or control or direct the voting of) its shares would also virtually guarantee that Pala would have effective control of Neo. This would give Pala complete control of Neo and the Board and would provide Pala with effectively a blocking position on special resolutions for fundamental changes contemplated by the CBCA.

(b) The Pala Partial Offer does not Reflect Neo's Strong Financial Position, the Value of Neo's Recent Strategic Initiatives and Neo's Future Growth and Acquisition Opportunities

39. Neo's management and Board believe that Neo's financial condition is strong. As outlined above, in the face of challenging global and industry specific conditions, Neo benefits from a dramatically improved balance sheet, including a positive cash balance of US\$50.4 million as at January 31, 2009, and a further approximately US\$40 million available under its credit facilities on favourable terms. The lenders, however, would have the ability to terminate one of these available facilities (representing approximately US\$20 million) if the Pala Partial Offer is successfully completed. This liquidity could be deployed for accretive acquisitions and other

³² Karayannopoulos Affidavit at para. 50

strategic initiatives. In the past three years, Neo has improved from a net debt position of US\$91.4 million to a net cash position of US\$41.4 million.³³

40. The Pala Circular states that “Neo’s management has done an excellent job in creating a company with the potential for growth over the longer-term”. Pala recognizes the future upside value of Neo’s strategic initiatives and is seeking to gain control of Neo at a discount to fair value and at an opportunistic time, and if successful, the Pala Partial Offer will significantly impair management’s ability to effectively execute growth opportunities.³⁴

41. The Pala Partial Offer discounts Neo’s proven ability to successfully execute growth and acquisition strategies. In particular, the transformational merger of Neo and Magnequench in 2005 demonstrated management’s ability to execute and successfully integrate strategic acquisitions that lead to increased shareholder value. That merger locked in Magnequench’s neodymium supply while providing a secure outlet for Neo’s production. By successfully integrating Magnequench, Neo enhanced overall profitability, raised competitive barriers, consolidated market share and strengthened its strategic position. Additional accretive initiatives successfully executed by Neo are set out on pages 9 to 10 of the Directors’ Circular as well as in paragraph 14 of the Karayannopoulos Affidavit.³⁵

42. Further, Neo’s Board and management are currently reviewing a number of strategic opportunities and initiatives focused on increasing Shareholder value through organic and acquisitive growth. The organic growth opportunities include new applications for its products and vertical supply chain efficiencies. The

³³ Karayannopoulos Affidavit at para. 54

³⁴ Karayannopoulos Affidavit at para. 55

³⁵ Karayannopoulos Affidavit at para. 56

acquisitive growth opportunities include the acquisition of complementary and/or supplementary businesses and the expansion of Neo's product portfolio.³⁶

43. Neo's future organic and acquisitive growth initiatives could be compromised if Pala successfully completes the Pala Partial Offer. The Board, the management and most importantly, the shareholders of Neo through their support of the New Rights Plan, have rejected the Pala Partial Offer.³⁷

(c) Risks Associated with Potential Loss of Key Management Personnel and Pala's Lack of Operating Experience

44. Should Pala accomplish its objective of acquiring up to 29.9% (and therefore effective control) of the shares of Neo there is a substantial risk to Neo that there will be significant departures of senior management to the detriment of Neo.³⁸

45. The employment agreements of four key management personnel of Neo contain customary change of control provisions which could be triggered, in certain circumstances, by any of them if any person, including Pala, becomes the beneficial owner of more than 30% of the voting securities of Neo. This provision existed in all of the agreements well before the Pala Partial Offer and was disclosed in Neo's public filings (other than the 30% threshold). Pala was well aware of the existence of this provision before the Pala Partial Offer.³⁹ Given the 30% change of control threshold, if successful, the Pala Partial Offer limits the flexibility of Neo to the detriment of shareholders. For instance, with Pala at 29.9%, Neo would not be able to complete a Normal Course Issuer Bid without triggering the change of control threshold.

46. As outlined in the Directors' Circular, the loss of Neo's current management team, or any member thereof, could be extremely costly to Neo in terms of "change

³⁶ Karayannopoulos Affidavit at para. 57

³⁷ Karayannopoulos Affidavit at para. 58

³⁸ Karayannopoulos Affidavit at para. 61

of control” payments payable under management’s existing employment agreements. More importantly, the loss of Neo’s current management team, or any member thereof, would also deprive Neo of such management’s intellectual and operational expertise, which is at the core of Neo’s competitive advantage and success. Neo’s management has also spent a considerable amount of time and effort for Neo’s benefit in developing and cultivating government, business, joint venture and client relationships in its principal manufacturing and marketing regions, namely China, Thailand, Japan and more recently Brazil. The loss of Neo’s current management team, or any member thereof, would adversely affect these relationships.⁴⁰

47. As noted, Pala has limited, if any, experience in operating a business in Neo’s industry. Pala’s lack of experience and expertise in Neo’s highly specialized industry, combined with an exodus of senior, experienced management of Neo, would adversely affect the value of the shares after completion of the Pala Partial Offer and Neo’s ability to successfully operate its businesses.⁴¹

(d) The Timing of the Pala Partial Offer is Opportunistic

48. Neo management and Board are of the view that the Pala Partial Offer is opportunistically timed to take advantage of a recent period during which share prices generally, including those of specialty materials and metals companies, have declined as a result of the current global economic crisis. The Partial Offer was made at a point in time when Neo’s shares were trading near their lowest point since October 2003, and represents a 65.7% discount to the Neo trading price of \$4.08 on February 8, 2008 and a 55.3% discount to the Neo trading price of \$3.13 on February

³⁹ Karayannopoulos Affidavit at paras 59 and 60

⁴⁰ Karayannopoulos Affidavit at para. 62

⁴¹ Karayannopoulos Affidavit at para. 64

8, 2007. The Partial Offer was also made at the end of a 12 month period in which the S&P/TSX fell by 30.3%.⁴²

49. As outlined above, Neo has little debt, strong cash reserves and solid business relationships and at present is well positioned not only to survive the current economic situation but also to emerge a stronger and more valuable enterprise upon the eventual return of more normal conditions. It is clear that the Board, management and Neo's shareholders are confident that now is not an appropriate time for the collectivity of Neo's shareholders to run an auction or allow control of Neo to be acquired by any one shareholder as that would be an impediment to such a transaction in the future.⁴³

(i) Pala's Intentions for Neo are Unclear

50. Neo's Board believes there is no need for Pala to acquire an additional 10 or 20% of the issued and outstanding shares in order for Pala to become a "cornerstone shareholder" as it purports to be seeking. As outlined in the Directors' Circular, the Board questions Pala's stated motives for making the Pala Partial Offer and Pala's plans for Neo if it is successful in acquiring effective control of the company, particularly in light of Pala's contradictory statements about Neo's management and Pala's intentions for Neo.⁴⁴

51. In the Pala Circular, Pala states that the Partial Offer provides several benefits to Neo and its shareholders as a result of Pala becoming a "cornerstone shareholder", including that Pala is able to "assist management in delivering growth and long-term value for the benefit of all shareholders". Pala references Anatolia, a gold mining company with operations in Turkey, and Avoca, a gold mining company with operations in Australia, as examples of companies where Pala invested as a

⁴² Karayannopoulos Affidavit at para. 65

⁴³ Karayannopoulos Affidavit at para. 66

⁴⁴ Karayannopoulos Affidavit at para. 67

“cornerstone shareholder”. However, according to public filings, in the case of each of Anatolia and Avoca, Pala owns or controls less than its current shareholdings in Neo (i.e. less than approximately 20% of the issued and outstanding shares of those companies).

52. By its own definition, Pala is already a “cornerstone shareholder” of Neo and has to date not provided Neo with any identifiable assistance in terms of delivering growth and long-term value for the benefit of shareholders nor has it been able to identify what, if any, substantive value it can bring to Neo. Furthermore, notwithstanding Pala’s claims, it is unclear what benefits, if any, there would be for shareholders other than Pala through an increase in Pala’s current shareholdings in Neo.⁴⁵

53. As the Coalcorp and Rockwell experiences show, with effective control of Neo, Pala can act in a self-interested manner to the detriment of other shareholders. For example, Pala could force the Board to begin a process that would result in a sale of the whole company at a time of Pala’s choosing in order to provide it with a liquidity event for its Neo investment at an inopportune time for other shareholders. Given Neo’s cash-on-hand of over US\$50 million, Pala could potentially force the distribution of this cash to shareholders, of which approximately US\$14.95 million would be received by Pala as a holder of approximately 29.9% of the shares, effectively funding the Pala Partial Offer with Neo’s cash.⁴⁶ Pala could also transfer effective control of Neo to a third party at a premium, potentially, to the exclusion of other shareholders. This uncertainty may impose downward pressure on the share price if Pala acquires effective control.⁴⁷

⁴⁵ Karayannopoulos Affidavit at para. 68

⁴⁶ At the exchange rate effective as of the date of these submissions, \$US14.95 million is approximately equal to CDN\$18 million, which constitutes the entire cost of the Pala Partial Offer according to the Notice of Variation and Extension.

⁴⁷ Karayannopoulos Affidavit at para. 69

(j) The Pala Amended Offer is not a Permitted Bid under the New Rights Plan

54. The purpose of both Rights Plans is to provide the Board and shareholders with sufficient time to properly consider any take-over bid made for Neo, to allow enough time for competing bids and alternative proposals to emerge and be pursued, and to consider all appropriate alternatives. The Rights Plans also ensure that all shareholders are treated fairly in any transaction involving a change in control of Neo and have an equal opportunity to participate in the benefits of a takeover bid. The New Rights Plan is substantially similar to the Rights Plan, except that it requires that any take-over offer be made to all shareholders for all of their shares. The New Rights Plan was adopted in direct response to the Partial Offer and was intended to block the Pala Partial Offer if the shareholders so decided.⁴⁸

55. Under the New Rights Plan, any offer for less than all of Neo's issued and outstanding shares, including the Pala Partial Offer, will not be considered a "Permitted Bid", unless the Board waives this condition (which it may, as appropriate). As provided in the Directors' Circular, while the Board believes that there are better options available to the Neo at this time, it continues to be open to Pala to make a Permitted Bid under the New Rights Plan. The protections afforded by the Rights Plan and the New Rights Plan are designed for the benefit of all shareholders.⁴⁹

(viii) The "Straw Man" of Management Entrenchment

56. Pala suggests throughout its submissions on this Application that the Neo Board and management have taken steps in response to the Pala Partial Offer that have the effect of entrenching management.⁵⁰ With respect, not only are these allegations unfounded, they are completely illogical. Pala has consistently praised

⁴⁸ Karayannopoulos Affidavit at para. 70

⁴⁹ Karayannopoulos Affidavit at para. 71

the work of Neo's management and cited strong management of Neo as a reason for its investment and bid and is now attempting to raise the spectre of management entrenchment, after its advances were rebuffed, to invoke the public interest jurisdiction of the Commission.

57. Furthermore, Pala's submission that the Neo directors have adopted additional defensive tactics to entrench management is simply based on Pala's assertion that change of control provisions were implemented in certain executive employment agreements in the face of the Pala Partial Offer. However, as noted in the Karayannopoulos Affidavit, these provisions existed in all the agreements, and were disclosed years before the Pala Partial Offer.⁵¹ Mr. Castro was aware of the existence of change of control provisions, and payments, as evident from his inquiries of Mr. Karayannopoulos of whether management would be willing to turn their change of control payments into equity if Neo was privatized. In any event, Pala can pursue its corporate law remedies if it feels that Neo's Board has breached its duties.

C. ISSUES

58. Though Pala raises a variety of issues in its Application submissions, the issue on this Application is straightforward: whether the business judgment of the Board, ratified with full knowledge by Neo shareholders is susceptible to attack by the "bitter bidder" Pala?

59. Contrary to Pala's submissions, this application is not about the validity of partial bids and it is not about the application of the Rights Plan, though Neo's position on the latter is addressed at the conclusion of these submissions for the sake of completeness.

⁵⁰ For instance at paragraphs 36, 46, 47, 77, 80(e) and 97 of Pala's Memorandum of Fact and Law.

⁵¹ Proxy Circulars, Exhibits "P" and "Q" to the Karayannopoulos Affidavit

D. THE LAW

(i) The uniqueness and effect of informed shareholder approval

60. It is trite that corporations are governed by a majority of their shareholders. Nonetheless, in this Application Pala is implicitly attacking the informed decision of the majority of Neo shareholders (other than Pala) to implement the Rights Plans. The Commission has never second-guessed the judgment of such an overwhelming majority of shareholders as to their own interests and ought not to do so in the Neo situation.

61. The premise of take-over bid legislation in Canada is based on shareholder choice.⁵² In *Royal Host*, this Commission affirmed that shareholder approval was an important consideration in determining whether a rights plan is in the public interest.⁵³ In *Pulse Data*, the Alberta Securities Commission held that the interests of the shareholders of the target company are of primary importance, and the shareholders' views as to their interests are highly relevant, particularly when those views are current and informed.⁵⁴

62. In *MDC Corporation and Regal Greetings & Gifts Inc.*, the Commission stated:

Having answered the two principal questions, there remained a further fundamental question which we had to consider, namely, what were the wishes of the Regal shareholders as regards the plan? It is all very well for us to conclude that there is a real possibility that shareholder value will be increased as a result of our deciding that "time has not yet come", but we would not have

⁵² *Re Chapters Inc.* (2001), 24 O.S.C.B. 1657 (OSC) at 1662.

⁵³ *Re Royal Host Real Estate Investment Trust* (1999), 22 O.S.C.B. 7819 (OSC) at 7828; *Re Cara Operations Ltd.* (2002), 25 O.S.C.B. 7997 (OSC) at para. 65.

⁵⁴ *Re Falconbridge Ltd.* (2006), 29 O.S.C.B. 6783 (OSC) at paras. 43-46; *Re Pulse Data Inc.* (2007), 2007 A.B.A.S.C. 895 (ASC) at para. 101.

been prepared to do so if it was clear to us that the shareholders of Regal felt otherwise [emphasis added].⁵⁵

63. A significant majority of Neo's shareholders have recently made a clear choice: they want a tactical pill in place to prevent Pala from acquiring effective control of Neo. At Neo's annual and special meeting of shareholders held on April 24, 2009, over 80% of Neo's disinterested shareholders, who were present in person or represented by proxy, voted in favour of the New Rights Plan.

64. It cannot be said that Neo's shareholders have been deprived or have been precluded unreasonably from considering or responding to the Pala Partial Offer. The vote to approve the tactical pill was clearly a vote to reject Pala's offer. Over 80% of Neo's shareholders voted (a high turnout). The vote was informed. All shareholders knew that no competing or alternative bid was imminent. The vote was also active. Several sophisticated institutional shareholders whose normal internal policy is to follow *RiskMetrics'* voting recommendation, voted in favour of the New Rights Plan.⁵⁶

(ii) The duty of the Board where the facts dictate that the time and the bidder may not be right - can a partial bidder always put a company in play?

65. In *Cara Operations*, the Commission recognized that the two principles underlying the take-over bid rules are procedural fairness for all and the fiduciary

⁵⁵ *Re MDC Corporation and Regal Greeting & Gifts Inc.* (1994), 17 O.S.C.B. 4971 (OSC) at 4980.

⁵⁶ Karayannopoulos Affidavit at para. 47

duty of directors, which must be reflected in conduct and recommendations that are based upon the best interests of the shareholders generally.⁵⁷

66. Directors are in compliance with their fiduciary duties if they can demonstrate that the motivation behind their actions and decisions was a valid business purpose and that they exercised reasonable business judgement. Most Canadian courts have evaluated the actions of directors in the context of a change of control transaction with reference to the “business judgment rule” as set out by the Ontario Court of Appeal in *Maple Leaf Foods Inc. v. Schneider Corp.*:

The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a reasonable decision not a perfect decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board’s determination. As long as the directors have selected one of several reasonable alternatives, deference is accorded to the board’s decision. This formulation of deference to the decision of the board is known as the “business judgment rule.”⁵⁸

67. In Canada, in the context of change of control transactions, there is no “*Revlon* duty” *per se*; 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. Boards of directors can “just say no” after due consideration of an offer.⁵⁹

68. In response to Pala’s unsolicited Partial Offer, Neo’s Board acted properly and like any board of a Canadian public company would have in the context of a potential change of control transaction. The Board carefully reviewed and evaluated the Pala Partial Offer by establishing a special committee of independent directors

⁵⁷ *Re Cara Operations Ltd.* (2002), 25 O.S.C.B. 7997 (OSC) at para. 58 and 61.

⁵⁸ *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (Ont. C.A.) at para. 36.

and retaining independent financial and legal advisors. The Board and Special Committee considered the structure and form of Pala's offer, the identity of the offeror, the offer price, the impact or risk of the offer on Neo's stakeholders, strategic relationships and other relevant factors, such as industry dynamics, the economic environment and the state of capital markets. The Board received an inadequacy opinion from its financial advisors and mailed a Directors' Circular to all shareholders, in accordance with securities laws, recommending that shareholders reject the Partial Offer and providing supporting evidence. The Board also considered alternatives to maximizing shareholder value, including maintaining the *status quo* and pursuing the company's current business plan.

69. The Neo Board ultimately decided to recommend that shareholders reject the Partial Offer and to adopt, subject to shareholder approval, the New Rights Plan (which prohibits partial offers) as a direct defensive tactic to the Partial Offer. In addition to the opinion of its financial advisors that the Pala offer was inadequate from a financial point of view and that it provided Pala control at an insufficient premium, the Board considered the hostile attempt by Pala to acquire effective control to be a risk to Neo's business and not in the best interests of shareholders. The Board supported this argument by emphasizing Pala's track record as an equity investor in Canadian capital markets, the potential loss of management personnel which would invariably disrupt Neo's strategic relationships in its major markets and Pala's unclear and contradictory intentions.

70. Furthermore, the Neo Board has used the New Rights Plan to the advantage of shareholders; the defensive pill has already resulted in an increased offer price by Pala.

71. It is worth noting that even if Neo's Board had made an improper decision in implementing the New Rights Plan (which is strongly denied), under Canadian

⁵⁹ *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (Ont. C.A.) at para. 61.

corporate law, the impropriety could be waived by a majority of shareholders voting at a meeting. This ratio was established in *Bamford v. Bamford*, [1969] 2 W.L.R. 1107, in the context of a tactical move by directors to block a take-over bid. In that case the English Court of Appeal held that a voidable share allotment subsequently validated by shareholders had the effect of making the allotment valid.

72. The notion of shareholder supremacy under Canadian corporate law (as illustrated by *Bamford* in the context of a change of control transaction) is compatible with the Canadian take-over bid regime. National Policy 62-202 - *Defensive Tactics* ("NP 62-202") states that "prior shareholder approval of corporate action would, in appropriate cases, allay [concerns of tactics abusive of shareholder rights]". Indeed, pursuant to NP 62-202 Canadian securities commissions are primarily concerned with protecting shareholders - their "*bona fide* interests", their ability to "respond to a take-over bid" and their ability to make "a fully informed decision".

(iii) The established pill law other than *Pulse Data* is not determinative

73. Whether a tactical pill should be overturned is a matter of review by the Commission, based on the specific facts of each case. In *Royal Host*, the Commission emphasized that take-over bids and defensive tactics are fact specific; the relevant factors, and the relative importance to be attached to each factor always vary from case to case: "[a]fter reviewing these decisions and the fact patterns on which they were based, we have come to the conclusion that it is fruitless to search for the "holy grail" of a specific test, or series of tests, that can be applied in all circumstances.⁶⁰

74. As the Commission has stated, the paramount consideration in deciding whether a rights plan should be allowed to stand in the way of a take-over bid is the best interests of the shareholders generally. "What is in the best interests of the

⁶⁰ *Re Royal Host Real Estate Investment Trust* (1999), 22 O.S.C.B. 7819 (OSC) at 7828.

shareholders cannot be determined in the abstract, but must be ascertained in the context of our existing legal and business environment..." (emphasis added).⁶¹

75. To date, the general thrust of the decisions on whether the "pill must end" has been to treat the pills as a device whereby the target company board may require that the take-up of shares under the offer be delayed beyond the period required by statutory takeover bid legislation, in order to allow the Board a longer opportunity to "conduct an auction", i.e. to seek for an alternative transaction that delivers greater shareholder value. When the securities commission determines that this quest has gone on long enough, then it makes an order rendering the poison pill ineffective.⁶² As the decision in *Pulse Data* shows, and contrary to the assertions of Pala, these cases do not necessarily apply as a matter of course and the Commission will review the Neo situation in the context of the facts of the present Application:

- (a) Neo shareholders have overwhelmingly voted in favour of the New Rights Plan with full knowledge of the Pala Partial Offer. The reasoning in some of the securities commission decisions (for example, *Cara Operations*) indicates that the Commission sees its responsibility to be to act as surrogate for the shareholders of the target who, ideally, would make the decision to end the pill - or not to end it - for themselves. In this case, Neo shareholders have spoken for themselves;⁶³

- (b) The current economic circumstances are, if not unique, a once in a lifetime event, which have depressed the market prices of shares in a broad range of public companies, including Neo, such that the assessment of Neo's management, Board and shareholders is that now is not an appropriate time to auction the company. Unlike the

⁶¹ *Re Cara Operations Ltd.* (2002), 25 O.S.C.B. 7997 (OSC) at paras. 55-56.

⁶² Affidavit of James C. Baillie sworn April 28, 2009 ("Baillie Affidavit") at para. 11

circumstances in the pill cases, in the present circumstances the shareholders have decided that shareholder value is not necessarily maximized through an auction, but rather through a maintenance of the *status quo* and pursuing the company's current business plan; and

- (c) The New Rights Plan allows for "Permitted Bids", which is any offer for all of Neo's issued and outstanding shares, and is designed for the benefit of all shareholders.

(iv) *Pulse Data*: the Neo circumstances are, if anything, stronger for maintaining the Rights Plans

76. In *Pulse Data*, the Alberta Securities Commission considered whether it is appropriate to take action against a tactical pill approved by shareholders during the course of a pending hostile offer in the absence of any competing or alternative offer.⁶⁴ *Pulse Data* involved an offer for all the shares of the target which was not supported by a "majority of the minority" and thus prevented the offeror from acquiring a control position. The Alberta Securities Commission decided not to intervene and effectively allowed *Pulse Data*'s shareholders to "just say no" to the hostile offer following a shareholder vote in similar circumstances to those present in this Application:⁶⁵

- (a) The target's shareholders' recent and informed choice was to have the pill remain in effect;
- (b) At a special meeting of the target's shareholders, the shareholders voted in favour of the pill;

⁶³ Baillie Affidavit at paras. 12 and 24

⁶⁴ *Re Pulse Data Inc.* (2007), 2007 A.B.A.S.C. 895 (ASC)

⁶⁵ *Re Pulse Data Inc.* (2007), 2007 A.B.A.S.C. 895 (ASC) at para. 101.

- (c) The shareholders voted after receiving ample information and sufficient time to decide whether to approve or oppose the pill in the face of the offer;
- (d) There was no suggestion of managerial coercion or inappropriate managerial pressure being brought to bear on the target's shareholders to approve the pill; and
- (e) The Commission was reluctant to interfere with the decision of the target's board that has a fiduciary duty to act in the best interests of its shareholders, particularly when that decision was very recently approved by the informed shareholders.

77. Not only are the above facts present in this case, but the case for a corresponding exercise of discretion by this Commission seems even stronger than in *Pulse Data* because Pala's bid is for less than all of the shares of Neo and would give it a blocking position to preclude a subsequent offer for all of the shares, even on terms that are acceptable to all other shareholders.⁶⁶

78. The Commission in *Falconbridge* recognized that creeping bids can have harmful effects on the shareholders of the target company.⁶⁷ If successful, the Pala Partial Offer allows Pala to acquire effective control, blocking or minority position, which would reduce or eliminate the ability of other bidder to make an offer for all of Neo's shares, or for Neo to engage in other important transactions requiring a special resolution. This would likely reduce the value of the shares to non-tendering shareholders. It will also allow Pala to exploit its position for a while and then make a proposal to acquire the balance of the shares at a price of its choosing, secure in the

⁶⁶ Baillie Affidavit at para. 26

⁶⁷ *Re Falconbridge Ltd.* (2006), 29 O.S.C.B 6783 (OSC) at paras. 57-62.

knowledge that no competing bid will emerge after a sustained period of illiquidity.⁶⁸

(v) The Commission should uphold the decision of Neo shareholders to “just say no” to Pala

79. In the right circumstances the Canadian take-over bid regime supports the use of a shareholder-approved tactical pill as a “just say no” approach to a partial bid. For the reasons set out below, the Commission at the behest of Pala ought not interfere with the informed and current choice of Neo’s shareholders and should uphold the New Rights Plan.⁶⁹

80. First, as the New Rights Plan was approved by a majority of Neo’s shareholders, it neither denies nor limits severely shareholders’ ability to respond to the offer, which would otherwise be a concern of Canadian securities regulatory authorities as stated in NP 62-202. Further, the Commission stated in *Re Cara Operations* that “in the last analysis the decision to accept or reject a bid should be made by the shareholders ...”⁷⁰ There is no doubt that Neo’s shareholders have responded to, and rejected the Pala offer through the vote on the New Rights Plan. There is no need for the Commission to provide shareholders another opportunity to do so.

81. Secondly, the New Rights Plan has not outlived its usefulness. Canadian securities regulatory authorities expressly recognize in NP 62-202 that a board may adopt defensive tactics in a genuine attempt to obtain a better bid. Since Pala announced its intention to launch its partial offer, Pala has since raised its offer price by over 20% in the absence of any competing bid (while remaining inadequate from a financial point of view). The Commission should not adopt a premature or arbitrary timeline for when the tactical pill must be set aside. By voting the New Rights Plan

⁶⁸ Baillie Affidavit at paras. 20-23

⁶⁹ Baillie Affidavit at para. 25

in place (on the undertaking of the Company to reconfirm shareholder support for the New Rights Plan at the 2010 annual meeting of shareholders), Neo's shareholders have entrusted the board of the Company to evaluate any increased or revised offers by Pala (or third parties) and waive the application of the New Rights Plan to any offer that is fair from a financial point of view and provides shareholders equal entitlement to any appreciable change of control. The Commission should respect the will of Neo's shareholders and show deference to the Board's business judgement.

82. Should the Commission decide in favour of Pala and set aside the New Rights Plan, now or at an arbitrary future date, the Commission would effectively be substituting its business judgment for that of Neo's shareholders and the Board. Canadian courts and securities commissions have consistently said that they cannot and will not do that.

83. The New Rights Plan (and effectively the Rights Plan) have received the current support of an overwhelming majority of the voting Neo shareholders who were fully informed by Pala's offer and the above assessment of Neo's management and Board. There is significant evidence that Pala has a track record as a disruptive shareholder. While no doubt Pala disputes this assessment, the shareholders have effectively endorsed it. Neo shareholders lack confidence in Pala as "cornerstone investor" and have said so in the face of the Pala Partial Offer. Given this evidence, there is no basis to overturn the overwhelming and informed vote of Neo shareholders on the basis that it is necessary for the protection of the best interests of Neo shareholders. In the words of the Alberta Securities Commission, there is no "public interest reason to override the clear expression of shareholder democracy

⁷⁰ *Re Cara Operations Ltd.* (2002), 25 O.S.C.B. 7997 (OSC) at para. 53

manifested by the very recent and fully informed Shareholder approval of the Rights Plan in the face of the Offer.”⁷¹

84. In summary, Neo states that:

- (a) The issue of whether a tactical pill should stay is first and foremost a decision of the shareholders of the company. Companies are governed by shareholder democracy and through the exercise of that democracy, shareholders have the ability to implement a rights plan designed to prevent a creeping or coercive bid;
- (b) In exercising their fiduciary duties, the business judgment of Neo’s Board and management is that now is not the right time to run an auction or allow control of Neo to be acquired by any one shareholder as that would be an impediment to such a transaction in the future;
- (c) Neo’s shareholders have “just said no” to Pala; they have ratified the business judgment of the Board and management and have, with full knowledge of Pala’s bid, sanctioned the New Rights Plan;
- (d) There is no public interest basis for the Commission to override the informed decision of Neo’s shareholders; to do so would offend well established principles of corporate governance and securities regulation.

(vi) The Rights Plan

85. Pala is seeking a permanent order pursuant to subsection 127(1) of the Act that, among other things, trading cease in respect of any securities issued, or to be

⁷¹ *Re Pulse Data Inc.* (2007), 2007 A.B.A.S.C. 895 (ASC) at para. 87.

issued, under or in connection with the Rights Plan. For the following reasons, the relief sought by Pala in respect of the Rights Plan is entirely without merit.

86. The Pala Offer and the Amended Pala Offer constitute a "Permitted Bid" under the Rights Plan. Indeed, on the face page of the Pala Circular, Pala states that "The Offeror believes the Offer constitutes a "Permitted Bid" for the purposes of the First Shareholder Rights Plan." The Pala Circular goes on to say in the same paragraph "If the Neo Board of Directors refuses to waive this requirement [the minimum tender condition], the Offeror intends to comply with all Permitted Bid requirements under the First Shareholder Rights Plan in making the Offer, or may seek an order to cease trade or enjoin the First Shareholder Rights Plan, or otherwise seek an SRP Applicability Event." This can be distinguished from Pala's reference to the New Rights Plan, in respect of which "the Offer is not, and will not be, a "Permitted Bid".⁷²

87. As both Pala and Neo are of the view that the Pala Partial Offer constitutes a "Permitted Bid" under the Rights Plan, there is no basis for the Commission to entertain Pala's application in respect of the Rights Plan. The Pala Partial Offer irrevocably complies with the "Permitted Bid" requirements of the Rights Plan and the rights issued thereunder cannot separate or become exercisable. Pala is now effectively saying that the Commission ought to amend the terms of its offer so that it ceases to be a "Permitted Bid". Pala's clear purpose in seeking to do so is to avoid the minimum tender condition that it has irrevocably agreed to include in its Partial Offer (and which is required by the Rights Plan). There is no jurisdiction for Pala to ask the commission to make an offer it chose not to make, but could.

88. It is open for Pala to make a new offer that is not a Permitted Bid under the Rights Plan. Unless and until that is done, there is simply nothing for the

⁷² Pala Circular, Exhibit "M" to the Castro Affidavit, Application Record, Tab 1M

Commission to consider. The Commission cannot and should not make an offer that the offeror could, but chose not to make.

89. Leaving aside that there is no jurisdiction for Pala to invoke section 127, there is no precedent that we are aware of for the Commission to hold a hearing or grant any order under subsection 127(1) of the Act in respect of a "Permitted Bid" such as the Pala Partial Offer. Accordingly, Neo requests that the Commission dismiss the relief sought in paragraph 2(a) of Pala's Memorandum of Fact and Law without any hearing on the merits thereof.

E. ORDER REQUESTED

90. Neo respectfully requests that the Pala Application be dismissed.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

April 28, 2009



STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9

Peter F.C. Howard

Tel: (416) 869-5613 / phoward@stikeman.com

Edward J. Waitzer

Tel: (416) 869-5587 / ewaitzer@stikeman.com

David Weinberger

Tel: (416) 869-5515 / weinberger@stikeman.com

Fax: (416) 947-0866

Lawyers for Neo Material Technologies Inc.

IN THE MATTER OF NEO MATERIAL TECHNOLOGIES INC. AND PALA INVESTMENTS
HOLDINGS LIMITED AND ITS WHOLLY-OWNED SUBSIDIARY 0833824 B.C. LTD.

IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c.S.5, AS AMENDED

AND

IN THE MATTER OF NEO MATERIAL
TECHNOLOGIES INC. AND PALA INVESTMENTS
HOLDINGS LIMITED AND ITS WHOLLY-OWNED
SUBSIDIARY 0833824 B.C. LTD.

**MEMORANDUM OF LAW AND ARGUMENT
OF NEO MATERIAL TECHNOLOGIES INC.**

STIKEMAN ELLIOTT LLP
Barristers & Solicitors
5300 Commerce Court West
199 Bay Street
Toronto, Canada M5L 1B9

Peter F.C. Howard
Tel: (416) 869-5613 / phoward@stikeman.com
Edward J. Waitzer
Tel: (416) 869-5587 / ewaitzer@stikeman.com
David Weinberger
Tel: (416) 869- 515/ weinberger@stikeman.com
Fax: (416) 947-0866

Lawyers for Neo Material Technologies Inc.