Corporate Governance Report

Volume 7 • Number 1 March 2012

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POISON PILLS IN CANADA: TIME TO PAVE A NEW PATH FORWARD

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This article proposes a new regulatory framework for dealing with shareholder rights plans ("poison pills")[1] in Canada that aims to balance the competing interests of bidders, directors and shareholders. The central thesis of this article is that an effective legal regime governing poison pills must have two key elements (1) a corporation's directors must have the legal tools necessary to act in accordance with their fiduciary obligations in dealing with unsolicited bids; and (2) shareholders should have reasonable protection to defend against management entrenchment and have a mechanism to tender their shares to a desirable take-over bid given that they are the ultimate owners of the corporation.

The proposed framework sets out three changes to the current regime with respect to poison pills that would help achieve these objectives. These changes are as follows:

1. reduce the need for companies to adopt poison pills by restricting existing take-over bid exemptions;
2. affirm the primacy of a director's fiduciary duties to the corporation in dealing with take-over bids; and
3. implement an effective shareholder referendum mechanism.

Corporate Governance Report

The **Corporate Governance Report** is published quarterly by LexisNexis Canada Inc., 123 Commerce Valley Drive East, Suite 700, Markham, Ont., L3T 7W8, and is available by subscription only.

Web site: www.lexisnexis.ca

ISBN 0-433-45174-2 **ISSN 1718-2476**
ISBN 0-433-45172-6 (print & PDF)
ISBN 0-433-45173-4 (PDF)
ISSN 1718-2581 (PDF)

Subscription rates: $305.00 (print or PDF)
$380.00 (print & PDF)

The first section of this article describes the existing regulatory background governing the law of take-over bids and poison pills, the confusing and inconsistent decisions by the different provincial securities commissions and the resulting problems for market participants. The second section of this article provides certain proposals to strengthen the legal regime governing poison pills—and, in particular, to clarify the rights of bidders, directors and shareholders.

The confusing and inconsistent law of poison pills in Canada

Historical position of securities commissions: Power to the Shareholders

The regulatory regime regarding take-over bids and defensive tactics (including poison pills) is set out in National Policy 62-202 *Take-Over Bids—Defensive Tactics* ("NP 62-202"), which came into effect in 1997 and was predated by an almost identical national policy statement, National Policy Statement No. 38 *Take-Over Bids—Defensive Tactics* ("NP 38"), which came into effect in 1986. According to Beck and Wildeboer, NP 38 represented an "attempt by the provincial securities commissions to regulate, but not to prohibit, target company defensive tactics. And it attempt[ed] to regulate in such a way that the interest of the target shareholders are maximized."[2] In other words, NP 38 was primarily focused on protecting the *bona fide* interests of target shareholders.[3] This was consistent with the conclusion of the Ontario Government-commissioned Kimber Report,[4] which held that "the primary objective of any recommendations for legislation with respect to the take-over bid transaction should be the protection of the *bona fide* interests of the shareholders of the offeree company."[5]

This shareholder-centric perspective of NP 38 and NP 62-202 in turn influenced the decisions of the various Canadian securities commissions. Historically, the position of Canadian securities commissions has been that a target board of directors could not "just say no" and that "there comes a time when the poison pill has got to go." This position was first articulated by the Ontario Securities Commission (the "OSC") in *Jorex*.[6] The decision was rooted in the notion that the "public interest lies in allowing shareholders of a target company to exercise one of the fundamental rights of share ownership—the ability to dispose of shares as one wishes—without undue hindrance from ... defensive tactics that may have been adopted by the target board with the best of intentions, but that are misguided or, as here, have outlived their usefulness ..."[7] Effectively, the OSC's view was that shareholders should not be denied their right to freely tender their shares.

After a number of decisions dealing with poison pills following *Jorex,* the securities commissions of British Columbia, Alberta and Ontario noted in *Re Royal Host Real Estate Investment Trust and Canadian Income Properties Real Estate Investment Trust*[8] that it would be fruitless to search for the "holy grail" of a specific test, or series of tests, that could be applied in all circumstances to determine whether the poison pill should be terminated. The commissions said that the challenge is "finding the appropriate balance between permitting the directors to fulfil their duty to maximize shareholder value in a manner that they seem fit and protecting the right of the shareholders to decide whether to tender their shares to the bid."[9] The commissions said that the decision to maintain or terminate the poison pill should be made in accordance with the primary objective of the regulatory scheme regarding take-over bids based on NP 62-202: the protection of the *bona fide* interests of the target shareholders.[10]

For many years after *Royal Host*, decisions of the various securities commissions in Canada remained relatively settled on the matter of poison pills;[11] the ultimate decision to accept or reject a bid would be made by shareholders. However, after an intense resurgence of mergers and acquisitions activity leading up to the 2008 credit crunch, a number of destabilizing and conflicting decisions concerning poison pills ensued.

The destabilizing decisions: More power to the directors?

The first destabilizing decision came from the Alberta Securities Commission (the "ASC") in *Pulse Data.*[12] In its decision, and in an unexpected departure from the traditional approach of Canadian securities commissions, the ASC suggested that a poison pill may remain in place for an extended period of time if approved by a group of fully informed shareholders, even in the absence of a potential competing offer. The ASC stated that the "very recent and informed Pulse Shareholder approval, given in the absence of any imminent alternatives to the Offer, demonstrated that the continuation of the Rights Plan ... was in the *bona fide* interests of Pulse Shareholders …"[13] The ASC permitted the poison pill to remain in place, thereby suggesting that it was no longer a question of when, but if, the poison pill should be terminated.

Following *Pulse Data* was the decision of the OSC in *Neo Materials*.[14] In *Neo Materials*, the bidder had requested that the target board remove the minimum tender condition in a poison pill confirmed by shareholders in 2007, and announced a "partial" take-over bid on February 9, 2009. Rather than removing the minimum tender condition from its original poison pill, the directors instead adopted a second poison pill that prohibited partial bids. In the face of board efforts to reject its bid and a refusal to submit a proposal to shareholders to terminate the first poison pill, the bidder applied for a cease-trade order over both poison pills. In its decision, the OSC noted that a measure of deference was owed to the target board and its shareholders. A cease-trade order would require the commission "to proactively intervene with, and, in fact, reverse the manifest intention of the Neo Board, which is accountable to the shareholders as a whole."[15] Something more than unfairness would be required to warrant such intrusion, such as manifest abuse.[16]

The OSC chose to uphold the second poison pill on the grounds that it had been approved by an "overwhelming majority" of disinterested shareholders (81.24%), who, in the context, were fully informed of the situation and their options. In support of its position, the OSC noted that: 82.74% of the target's shares were represented in person and by proxy; all shareholders had the benefit of disclosure in several circulars and press releases regarding the target's financial position and the offer; and the vote in favour of the second poison pill went against the recommendation of RiskMetrics.[17] Finally, the OSC went on to find that there was no basis upon which to impugn the actions of the board as coercive or not in the best interests of the corporation.[18]

Two additional aspects of the *Neo Materials* decision should be noted. First, the OSC expressed its view that poison pills are not exclusively a tool for the target board to gain additional time to pursue alternative value-enhancing transactions;[19] they also may bear other legitimate purposes, depending on the best interests of the corporation.[20] Second, the OSC took the opportunity to consider the Supreme Court of Canada's views regarding a board's fiduciary duties as they relate to poison pills, including its decision in *BCE Inc.*[21]

Accordingly, based on *Neo Material* and *Pulse Data*, it could no longer be definitively said that there comes a time when the "poison pill must go." Based on these decisions, a target board need no longer only be concerned about using the poison pill to buy time in order to seek out alternative bidders and maximize shareholder value in all circumstances.[22] Instead, the poison pill "may be adopted for the broader purpose of protecting the long-term interests of the shareholders, where, in the directors' reasonable business judgment, the implementation of a rights plan would be in the best interests of the corporation."[23] Moreover, in determining whether the target directors have discharged their fiduciary obligations, the securities commissions must "give effect to the business judgement rule."[24]

More confusion ensues: Returning to the traditional approach?

In contrast to the decisions discussed above, the decision of the British Columbia Securities Commission ("BCSC") in *Lions Gate Entertainment*[25] suggested a return to the traditional approach of *Jorex* taken by Canadian securities commissions. The BCSC struck down the poison pill in question on the ground that the target shareholders should be allowed to decide the fate of the offer. In doing so, it highlighted a number of concerns with the decisions in *Pulse Data* and *Neo Materials*. First and foremost, the BCSC re-affirmed the role of poison pills as a temporary tool to buy time for an appropriate response by a company targeted for takeover.[26] Permitting a poison pill to be maintained absent a board intention to seek alternatives could be viewed as instituting a "just say no" policy for take-over bids targeting that company.[27] Such a policy would, in the BCSC's view, be contrary to the public interest policy principles of Canadian securities regulation as articulated in NP 62-202.

In contrast to the significant weight given to the directors' fiduciary duty to act in the best interests of the corporation in *Pulse Data* and *Neo Materials*, the BCSC noted in *Lions Gate* that a director's discharge of his fiduciary duties is a *neutral factor*.[28] Similarly, the BCSC noted that shareholder approval is a relevant, but not determinative, factor.[29] The BCSC also reviewed the voting record for both *Pulse Data* and *Neo Materials*, noting that in the former case only a minority of shareholders (73% of the 56% voting, meaning 44% of all shareholders) approved the poison pill. In the latter, 67% of all shareholders voted in favour. In both cases, a significant portion of shareholders were deprived of the opportunity to decide whether or not to tender to the bid.[30] Finally, the BCSC noted that the informed nature of a shareholder vote is a neutral factor, like the discharge of directors' fiduciary duties.[31]

In sum, while the decisions in *Pulse Data* and *Neo Materials* appear to give more powers to the target directors to "just say no" and maintain a poison pill indefinitely, the decision in *Lions Gate* and the more recent decisions in *Baffinland*[32] and *Mosaid Technologies*[33] support the historical position that "there comes a time when the poison pill has got to go." This inconsistency is problematic; it is difficult to confidently predict how the Canadian securities commissions will decide next.[34] How is a board of directors to act? What can shareholders do? How are lawyers to advise their clients? The role of directors and shareholders is unclear. Uncertainty prevails and continues in dealing with poison pills in Canada. This uncertainty should be immediately addressed by the Canadian Securities Administrators.

A new approach to poison pills

An effective legal regime governing poison pills should provide: (1) a corporation's directors with the legal tools necessary to act in accordance with their fiduciary obligations in dealing with unsolicited bids; and (2) shareholders with reasonable protection to defend against management entrenchment and have a mechanism to tender their shares to a desirable take-over bid. What follows are certain proposals for re-focusing the legal regime governing poison pills—and, in particular, clarifying the rights of bidders, directors and shareholders.

Reduce the need for poison pills

- *Amend the normal course purchase exemption (the "normal course exemption")*[35] *to lower the percentage from 5% to 2% and not available if above 30%.*
- *Amend the private agreement exemption*[36] *to require board or shareholder approval if above 30%.*[37]

Poison pills in Canada are generally adopted to address two situations. The first situation occurs when a company is not facing an unsolicited offer but would like to prevent a potential creeping take-over by one of its existing shareholders. This is commonly referred to as a non-tactical poison pill. The second situation occurs when a company implements a poison pill in the face of an unsolicited offer. This is commonly referred to as a tactical poison pill. The following proposal is meant to reduce the need for boards to implement non-tactical poison pills.

The current normal course exemption and the private agreement exemption from the formal take-over bid requirements facilitates creeping take-overs without board or shareholder review and approval. These exemptions enable parties to obtain control of a public company without board involvement and potentially without paying any control premium to existing shareholders. Since this may result in a fundamental change in direction of the company, a board of directors should have greater involvement in any transaction that could lead to such a change of control. It is a curious situation in Canada that these take-over bid exemptions allow for change of control transactions without board or shareholder approval but boards can easily adopt non-tactical poison pills, with minimal regulatory intervention, that deny acquirers the ability to rely on these exemptions. One may ask, why the inconsistency in the framework? If these exemptions force companies to adopt poison pills to stop creeping take-over bids, maybe we should re-examine whether these exemptions still make sense in our capital markets.

The normal course exemption should be reduced from 5% to 2% and not be available if an acquirer exceeds 30% of the outstanding shares of the target company. This would significantly extend the time period for an acquirer to obtain a significant control position in a target company and limit the maximum amount an acquirer could obtain under this exemption. The private agreement exemption also should be amended to require board or shareholder approval if a bidder wants to exceed 30%. The current Institutional Shareholder Services ("ISS") approved formulation of the poison pill effectively requires shareholder approval for a "permitted bid" to proceed.[38] As this formulation has existed in the Canadian market place for a number of years, the markets seems to have accepted that shareholders should have a voice in determining who controls their companies. If this is the case, an unrestricted private agreement exemption is counter to this approach.

These proposed amendments to normal course and private agreement exemptions would make it more difficult for bidders to make a creeping take-over bid without making a formal bid to all shareholders which would, in turn, reduce the need for directors to implement non-tactical poison pills.

Affirm the primacy of directors' fiduciary duties to the corporation in securities laws

- *Reformulate NP 62-202 so that it is consistent with the Supreme Court of Canada's decision in BCE and Canadian corporate law statutes.*
- *Securities commissions should defer to the business judgment of the board of directors.*
- *The board of directors should not be required to obtain shareholder approval for implementing a poison pill.*

Under corporate statutes in Canada the directors of a corporation owe a fiduciary duty to the corporation.[39] This fiduciary duty to the corporation continues in the face of an unsolicited bid as confirmed by the Supreme Court of Canada in *BCE Inc., Re*.[40] However, in the context of poison pills Canadian securities laws do not allow a corporation's board of directors free reign to act in accordance with their fiduciary duties. The corporation's board of directors lack a clear mechanism in place to respond to take-over bids it deems harmful to the best interests of the corporation.[41]

In contrast to affirming the primacy of directors' fiduciary duties to the corporation, NP 62-202 provides that "[t]he primary objective of the take-over bid provisions of Canadian securities legislation is the protection of the *bona fide* interests of the shareholders of a target company." But what happens when this principle collides with the fiduciary duty owed by directors to the corporation?

The directors are the gatekeepers of corporation;[42] an unsolicited take-over bid should not turn the directors into mere passive objects. Directors should not be required to ignore other stakeholders to obtain a higher offer for shareholders. Directors must have the clear legal ability to consider the long-term interests of the corporation,[43] which includes, in certain circumstances, looking at the interests of a broad-range of the corporation's stakeholders—not just shareholders. As the Supreme Court in *BCE* also noted

> *... although directors must consider the best interests of the corporation, it may also be appropriate, although not mandatory, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders. As stated by Major and Deschamps JJ., at para. 42:*
>
> > *We accept as an accurate statement of law that in determining whether they are acting with a view to the best interests of the corporation it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, inter alia, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment ...*[44]

Canadian securities commissions should recognize the Supreme Court of Canada's decision in *BCE* and recognize the primacy of the directors' fiduciary duties to the corporation in responding to unsolicited take-over bids as the Supreme Court has done in the context of other corporate transactions.

It is not enough, however, for securities commissions to embrace *BCE*. NP 62-202 should explicitly recognize that the corporation's directors have a fiduciary duty to act in the best interests of the corporation. NP 62-202 places significant emphasis on shareholder choice with little recognition of the board's duties to other stakeholders. NP 62-202 should, therefore, be re-formulated so that it is consistent with the Supreme Court of Canada's decision in *BCE* and corporate statutes in Canada.[45] In turn, the Canadian securities commissions should defer to the business judgment of the board of directors[46] while always retaining the power granted to them under securities legislation to act if required in the public interest. If the corporation's directors believe that implementing and maintaining a poison pill are in the best interests of the corporation, they should have the powers to act accordingly.[47] Moreover, given that the large majority of unsolicited bids in Canada result in change of control,[48] it is even more essential for directors to have sufficiently powerful and robust legal tools at their disposal to ensure the best interests of the corporation, including, but not limited to, the interests of shareholders, are well protected. A sale of a Canadian company should not be a foregone conclusion simply because an unsolicited bid has been made. Unfortunately, the current formulation of NP 62-202 has resulted in this being the case in Canada to a large degree.

Giving greater deference to the business judgment of the corporation's directors and affirming the primacy of the directors' fiduciary duties to the corporation would have an additional benefit: it would align Canadian securities laws on poison pills closer to that of its most important trading partner, the United States. The treatment of poison pills in U.S. courts has created a take-over atmosphere that, to a large extent, defers to the business judgement of the directors of target corporations.[49] Boards can implement poison pills easily and once in place, a poison pill can successfully deter unsolicited bids for an indefinite period. Bringing Canadian securities laws closer in line to U.S. securities laws would create a level playing field for bidders and targets on both sides of the border. The more consistent the approach to dealing with poison pills the better for all market participants.[50]

Part and parcel of deferring to the directors' business judgment, the directors should not be required to obtain shareholder approval for implementing and maintaining a poison pill.[51] In *Neo Materials* and *Pala*, the board of directors sought shareholder approval for a poison pill in the face of an unsolicited bid. This was a key basis for each of the OSC's and ASC's decisions to not cease trade the poison pill in these situations.[52] Not only should this be unnecessary, it is also potentially problematic. The timing of take-over bids may preclude the ability of a board to go to shareholders for approval of a poison pill every time a bid is made.[53] If the corporation's directors believe that it is in the best interests of the corporation to implement and maintain a poison pill, then they should not be required to ask shareholders for approval. They should have the powers to act in the best interests of the corporation without prior shareholder approval. The shareholders retain the ultimate power to remove directors if they as a group feel this is warranted. However, this can be a timely and costly process for a shareholder to undertake if it disagrees with the directors' actions in responding to a potentially attractive take-over bid and in the end, may not result in a new board removing the offending rights plan. In the following section, I propose an efficient and timely mechanism to provide shareholders with a voice in determining whether a poison pill should stay or go.

Protection for shareholders: A new shareholder referendum mechanism for poison pills[54]

- Amend securities laws to provide for a new shareholder referendum mechanism for poison pills.

- Two per cent of holders of outstanding shares can force the board of directors to call a shareholder meeting regarding the termination of a poison pill.
- The poison pill would be terminated if two-thirds of shareholders—excluding the bidder and management—vote in favour of termination.

Removing shareholders from the decision to tender or not to an unsolicited bid would be unfair to shareholders and would effectively expropriate a fundamental right of share ownership, the right to dispose of one's shares. Shareholders should be entitled to reasonable protection against decisions by management that affect their ability to freely tender their shares and have recourse against management entrenchment. Therefore, Canadian securities laws should be amended to ensure shareholders have reasonable protection and to ensure their rights to sell their shares are sufficiently safeguarded by providing for a shareholder referendum mechanism whereby holders of two per cent of the outstanding shares can require the board of directors to call a shareholder meeting to consider whether a poison pill should be terminated. [55]The meeting could be called at any point until the take-over bid expires and should be required to take place within 25 days after the request is made.[56] The question put before shareholders would be very direct and straightforward—*i.e.*, should the poison pill be terminated? If two-thirds of shareholders present at a meeting—excluding the bidder and management—vote in favour of terminating the poison pill, the poison pill should be removed.[57]

This new approach would work as follows: the board of directors would have the legal ability to respond to an unsolicited bid by implementing a poison pill without having to go to shareholders for approval, as long as the directors were acting in accordance with their fiduciary duties. At this point, the onus would shift to the shareholders. If holders of 2%[58] of the outstanding common shares wanted to have the poison pill terminated, they could require the board to call a shareholder meeting. If two-thirds of the shareholders at a meeting voted in favour of terminating the poison pill, the board of directors would be required to remove the poison pill and allow the bid to go forward. This shareholder proxy mechanism would empower shareholders, serve as a check on management and discourage management entrenchment.

Conclusion

The current Canadian landscape regarding poison pills is beset by several problems. First, there is too much uncertainty as to how securities commissions will deal with poison pills in response to an unsolicited bid. Second, there is no clear mechanism in place for directors to respond to take-over bids they deem harmful to the best interests of the corporation. Third, Canadian securities laws are inconsistent with Canadian corporate laws and the Supreme Court of Canada's decision in *BCE*. Fourth, shareholders do not have a clear and efficient mechanism in place to defend against management entrenchment and to ensure they can freely tender their shares they feel is in their best interests. Fifth, proxy advisory firms have unduly influenced the regulation and structuring of poison pills in Canada because of the need for shareholder approval.

These problems can and should be addressed. My proposed framework is relatively simple:

- First, the normal course and private agreement exemptions to the formal take-over bid rules should be amended to restrict the ability of bidders to obtain control without making a formal take-over bid to all shareholders, which should reduce the need to implement a non-tactical poison pill.
- Second, securities regulators must affirm the primacy of directors' fiduciary duties to the corporation and NI 62-202 should be reformulated, so that it is consistent with Cana-

dian corporate law and the Supreme Court of Canada's decision in *BCE*.

- Third, there should be a new shareholder referendum mechanism whereby a small percentage (my suggestion is 2%) of holders of outstanding shares can require the board of directors to call a referendum on any poison pill. If two-thirds of shareholders, excluding the bidder and management, vote in favour of terminating the poison pill, the poison pill should be removed.

Directors should be able to address change of control transactions in a manner consistent with their fiduciary duties. If management entrenchment is an issue, which is a historical concern in dealing with change of control transactions, then the proposed framework provides an expedient and effective manner to counter balance this power.

An additional benefit of these proposals is that it would reduce the role of proxy advisory firms, as shareholder approval would not be required to implement a poison pill. The role of proxy advisory firms in change of control transactions should be limited, if any.

In addition to minimizing the role of proxy advisory firms, the proposed framework would also reduce the need for every unsolicited bid going before a securities commission, as the commissioners would not be the final arbiter as to whether a poison pill should be terminated. Commission hearings should be limited to circumstances that deal with inappropriate behaviour of market participants that requires a timely response from the regulators pursuant to their public interest jurisdiction.

Although the Competition Policy Review Panel and other commentators recommend that securities commissions should cease to regulate conduct by boards in relation to poison pills and that substantive oversight of directors' duties in mergers and acquisitions matters should be provided by the courts,[59] similar to the framework in the U.S., in my view, the Canadian securities commissions are the appropriate bodies to review matters dealing with take-over bids. The Canadian securities commissions and staff of the securities commissions have developed a specialized expertise for dealing with take-over bids and, as a result, they are well-equipped to play an important role in regulating market participants involved in take-over bids. Overall, the commissions have played the role of an unbiased referee in the take-over bid landscape. The "public interest" power allows it a freedom of action to address potential power imbalances and abuses that may be lost in a court review. If an acquirer or boards take actions that are perceived to be abusive to the capital markets, then the securities commission have shown that they can address these abuses in a timely and equitable manner. Aggrieved bidders and shareholders will always retain the ability to seek redress in the Courts for perceived abusive actions through the oppression remedy or breach of fiduciary duties claim if they so desire.

In this period of financial turbulence and market uncertainty, bidders, corporations, advisors, directors and shareholders need clarity and consistency in Canadian securities laws now more than ever. This new regulatory approach paves a new path forward for dealing with poison pills in Canada. It clarifies, simplifies and better balances the competing rights of bidders, directors and shareholders. It ensures the corporation's directors have the legal tools necessary to act in accordance with their fiduciary obligations and it provides reasonable protection to shareholders so they have a mechanism in place to freely tender their shares and defend against management entrenchment. Market participants deserve no less.

[*Editor's note*: Grant McGlaughlin is a partner of Goodmans LLP in Toronto, Ontario in the corporate finance and mergers and acquisition practice groups and is the head of the Mining and Natural Resources practice group in Toronto. The views expressed in this article are solely the views of the author and do not represent the views of Goodmans LLP.

A special thanks to Jordie Saperia, associate at Goodmans LLP, and Adrian Frank, articling student, for their assistance in preparing this article.]

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1 Poison pills were first developed in the United States by Martin Lipton in 1982 during a period of hostile takeover activity as a means to block a hostile bid. The earliest poison pills in the United States provided rights to existing shareholders to purchase additional shares of the acquiror or the merged entity at a significant discount. These rights would be triggered and "flip-over" upon the completion of a defined merger event, such as the completion of a merger agreement or sale of assets. However, the emerging response of acquiring companies to engage in "self-dealing" transactions that avoided the "flip-over" trigger necessitated an evolution of poison pills. A second generation thus included "flip-in" rights of shareholders to purchase discounted shares in the target simply upon a bidder acquiring a significant portion of common shares (such as 20 per cent or more), even in the absence of a merger event. This new generation of pills thus had the potential to derail acquisitions even in the absence of "two-tier" transactions, requiring aspirant acquirors to either negotiate directly with the target board or to initiate a proxy fight to remove the existing directors.

In the Canadian context, poison pills have taken on a more "chewable" form. The first Canadian poison pill was approved by shareholders of Inco Limited in 1988 (Gordon Coleman, "Poison Pills in Canada" (1989) 15 Can. Bus. L.J. 1, at 1). Since then, Canadian companies have seen a proliferation of poison pills as a tool to defend against hostile and creeping take-overs, although with key differences from the pills implemented by their American counterparts. Most significantly, Canadian poison pills have developed the concept of a "permitted bid", allowing prospective bidders to comply with certain requirements that would avoid triggering the toxic effects of the pill. Generally, a "permitted bid" must be a formal bid made to all shareholders, conditional upon the tender of at least 50 per cent of the shares held by disinterested shareholders, and remain open for a significant period of time, generally 60 days and at least 10 further days after the first take-up of shares. By including these "permitted bid" provisions, current Canadian poison pills ensure that an interested bidder can always make a bid, even if the particular terms of the bid are not palatable to management of the target.

2 Stanley M. Beck and Rob Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics", MEREDITH Memorial Lectures, 1987, Faculty of Law, McGill University at p. 120.

3 The regulatory philosophy embodied in NP 38 has been summarized in six maxims (Stanley M. Beck and Rob Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics", MEREDITH Memorial Lectures, 1987, Faculty of Law, McGill University at p. 121)

1. Takeover bids have an important role in the economy, for both economic and legal reasons.
2. Target management is in a conflict-of-interest situation when facing a hostile bid.
3. The primary objective of takeover bid legislation is the protection of the *bona fide* interests of target company shareholders. A secondary objective is to provide regulatory neutrality between the offeror and target management.
4. Target company shareholders have the right to make the takeover bid decision. As such, target management has no valid reason to (unilaterally) deny them that right. Target management motivation effectively becomes irrelevant.
5. The appropriate regulatory approach to takeover bids is to encourage unrestricted auctions.
6. It is inappropriate to design a specific set of rules regulating target director conduct, other than those imposed by corporate law fiduciary standards. However, even without specific rules, it is possible to develop presumptions as to what conduct may be proper or improper.

4 In October 1963, the Ontario Government appointed a Committee on Securities Legislation with the following terms of reference: "To review and report upon, in the light of modern business conditions and practices, the provisions and working of securities legislation in Ontario and in particular to consider the problems of take-over bids and of 'insider' trading, the degree of disclosure of information to shareholders, the requirements as to proxy solicitation, procedures as to primary distribution of securities to the public and like matters, and generally to recommend what, if any, changes in the law are desirable."(See 1.01, Kimber Report).

5 The Kimber Report, para. 3.10. At the same time, however, the Kimber Committee said that it "attempted to ensure that its recommendations would not unduly impede potential bidders or put them in a commercially disadvantageous position vis-a-vis an entrenched and possibly hostile board of directors of an offeree company."

6 *In the Matter of Canadian Jorex*, 1992 LNONOSC 9, 15 OSCB 257 at 263 [*Jorex*].

7 *Ibid.* at 266-267.

8 1999 LNONOSC 594, 22 O.S.C.B. 7819 [*Royal Host*].

9 *Ibid.* at 7828 [emphasis added].

10 Determining what constitutes the *bona fide* interests of the target shareholders and deciding whether the securities commissions should terminate the pill requires looking at several factors: "[w]e can make this determination only after considering all of the relevant factors in that particular case. While it would be impossible to set out a list of all of the factors that might be relevant in cases of this kind, they frequently include:

- whether shareholder approval of the Rights Plan was obtained;
- when the plan was adopted; whether there is broad shareholder support for the continued operation of the plan;
- the size and complexity of the target company; the other defensive tactics, if any, implemented by the target company;
- the number of potential, viable offerors;
- the steps taken by the target company to find an alternative bid or transaction that would be better for the shareholders;
- the likelihood that, if given further time, the target company will be able to find a better bid or transaction;
- the nature of the bid, including whether it is coercive or unfair to the shareholders of the target company;
- the length of time since the bid was announced and made; and the likelihood that the bid will not be extended if the rights plan is not terminated." *Ibid.* at 7828.

11 In *Re Cara Operations Limited*, 2002 LNONOSC 716, 25 O.S.C.B. 7997 [*Cara Operations*], the OSC revisited the factors set out in *Royal Host* to determine whether a pill should be terminated. The OSC clarified that the guiding principles when determining whether to maintain a pill are: (a) procedural fairness for all involved; and (b) the fiduciary duty of the target directors to act in the best interests of shareholders generally. With respect to procedural fair-

ness, the OSC said that poison pills should not: (a) discourage bidders from coming forward; and (b) deny shareholders the opportunity to realize upon their investment at a premium. As a result, "the longer the period [a poison pill remains in effect], the higher the onus is on those alleging the Rights Plan still serves the interest of shareholders." Regarding the fiduciary duties of the target board, the commission said that "adherence to this principle should be reflected in conduct and recommendations that are based upon the best interests of shareholders generally and not those of any group of shareholders, bidders, potential bidders or others." However, the OSC concluded that "in the last analysis the decision to accept or reject a bid should be made by the shareholders, and not by the directors or others."

12 *In the Matter of Pulse Data Inc.*, 2007 A.B.A.S.C. 895 [*Pulse Data*].

13 *Pulse Data,* at para. 102. The ASC noted the "unique circumstances" of the case and that the primary objective of take-over bid rules, as set out in NP 62-202, was the protection of the *bona fide* interests of Pulse shareholders. *Pulse Data*, at para. 101.

14 *In The Matter of Neo Material Technologies Inc.*, 2009 LNONOSC 638, 32 OSCB 6941 [*Neo Materials*]. The author of this article was counsel for the bidder in this decision.

15 *Ibid.* para. 32.

16 *Ibid.*

17 Now Institutional Shareholder Services.

18 *Ibid*. para. 121.

19 *Ibid*. paras. 107 and 112-114.

20 *Ibid*. para. 112.

21 [2008] S.C.J. No. 37, [2008] 3 S.C.R. 560 [*BCE*].

22 The OSC stated that "[w]e acknowledge that in many instances a primary purpose for adopting a shareholder rights plan is to allow the board to pursue alternative value-enhancing transactions, which includes seeking an alternate bid. In fact, we recognize that in the circumstances of many of the cases referred to, and considered by us, that obligation may have crystallized. However, we do not see this as the only legitimate purpose for a shareholder rights plan." *Neo Material,* at para. 107.

23 *Neo Material,* at para. 112.

24 *Ibid.* at para. 103. In support of this proposition, the OSC in *Neo Material* cited the Ontario Court of Appeal in *Schneider*, when it stated that "[t]he 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'."

More recently, the OSC confirmed its *Neo Materials* position through its decision in *In the Matter of Cliffs Resources Inc. and Spider Resources Inc.*, 2010 LNONOSC 449, 33 OSCB 6187. Spider Resources Inc. ("Spider"), a resource and exploration company in Ontario, had embarked on certain joint ventures with KWG Resources ("KWG"), which had culminated in a merger agreement in May 2009. A competing offer was launched by Cliffs Natural Resources ("Cliffs") shortly afterward, along with an application to cease trade Spider's pill. The OSC chose to let the pill stand. While its decision was offered without reasons, the commission noted in its order that the application to cease trade was premature, given the ongoing auction between Cliffs and KWG for Spider.

25 *In the Icahn Partners LP and Lions Gate Entertainment*, 2010 LNBCSC 398, 2010 BCSECCOM 432 [*Lions Gate*]. Leave for appeal was dismissed by the British Columbia Court of Appeal on May 7, 2010: *Lions Gate Entertainment Corp. v. Icahn Partners LP*, [2010] B.C.J. No. 1086, 2010 BCCA 231.

26 *Ibid*. paras 33, 71-89. The commission noted that both *Pulse Data* and *Neo Materials* included references to alternate circumstances under which a pill would no longer be allowed to continue. Absent further guidance on what those circumstances might be, the BCSC suggested that the usefulness of *Pulse Data* and *Neo Materials* as precedents may be limited, paras. 84, 87.

27 *Ibid*. para. 89.

28 *Ibid*. para. 62.

29 *Ibid*. paras. 90-112.

30 *Ibid*. paras. 96-100.

31 *Lions Gate*., paras. 101-102.

32 On November 19, 2010, the OSC cease traded the poison pill of Baffinland Iron Mines Corporation, appearing to support the traditional approach that there comes a time when the pill has to go, see *In the Matter of Baffinland Iron Mines Corp. (Re),* 2010 LNONOSC 904, 33 OSCB 11385. On December 18, 2010, the Baffinland Board of Directors adopted another poison pill. However, on December 22, 2010, the OSC ordered that the pill should be cease traded on December 29, 2010.

33 On October 13, 2011, the OSC cease traded the poison pill of MOSAID Technologies Incorporated as of November 1, 2011. As of the date of this article, written reasons of the OSC have not been released.

34 In addition it is difficult to reconcile the differences in the decisions of the BCSC in *Lions Gate*, the ASC in *Pulse Data* and *Re 1478860 Alberta Ltd. and Canadian Hydro Developers, Inc.,* 2009 LNABASC 355, 2009 ABASC 448 and the OSC decisions in *Neo, Baffinland,* and *Spider Resources.*

35 The normal course exemption under s. 100 of the Ontario *Securities Act*, R.S.O. 1990, c. S.5, provides that a take-over bid is exempt from the formal bid requirements if certain conditions are satisfied (a) the bid is for not more than 5 per cent of the outstanding securities of a class of securities of the issuer; (b) the total number of securities acquired in reliance on this exemption within any period of 12 months does not exceed 5 per cent of the outstanding securities of that class at the beginning of the 12-month period; and (c) the value of the consideration paid for any of the securities acquired is not in excess of the market price at the date of acquisition as determined in accordance with the regulations, plus reasonable brokerage fees or commissions actually paid.

36 The private agreement exemption under s. 100.1 of the Ontario *Securities Act* provides that a take-over bid is exempt from the formal bid requirements if the purchaser purchases target securities from a maximum of five vendors including persons outside of Ontario and the value of the consideration paid for any securities, including brokerage fees or commissions, cannot exceed 115% of the market price of the securities at the date of the bid, as determined in accordance with the regulations.

37 The 30% threshold was chosen by the author for two reasons (i) it provides some room for a shareholder to increase its position in a reporting issuer above the current 20% take-over bid threshold (as opposed to simply removing these take-over bid exemptions and limiting all shareholders to 20%), and (ii) it does not provide a shareholder with negative control of a reporting issuer, i.e., the ability to

veto any “fundamental” transaction under corporate law which requires $66^{2/3}$% shareholder approval.

[38] One of the conditions for an ISS-approved “permitted bid” is that at least 50% of the shareholders, excluding the bidder, have tendered their shares to the bid. This is effectively a shareholder proxy on the bid.

[39] For example, see s. 122(1) of the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 [*CBCA*], and s. 134(1) of the Ontario *Business Corporations Act*, R.S.O. 1990, c. B.16 [*OBCA*].

[40] In *BCE Inc., Re, supra* note 21, the Supreme Court of Canada discussed the fiduciary duty of directors as follows: “[t]he fiduciary duty of the directors to the corporation originated in the common law. It is a duty to act in the best interests of the corporation. Often the interests of shareholders and stakeholders are co-extensive with the interests of the corporation. But if they conflict, the directors’ duty is clear—it is to the corporation: *Peoples Department Stores*.”

[41] It is an interesting contradiction between Canadian corporate law and securities law in that a board of directors plays a fundamental role in change of control transactions under the corporate statute, such as amalgamations, plans of arrangement, sale of all or substantially all assets, but is relegated to the side lines, to a great extent, in dealing with hostile take-over bids.

[42] As Martin Lipton has argued, “the board of directors is the gatekeeper for significant business transactions. As such, the board must evaluate any such transaction in accordance with its fiduciary duties and must have the ability-and indeed the obligation in all circumstances to take actions that it deems necessary and in the best interests of the corporation and its shareholders.” (Martin Lipton, “Twenty-Five Years After *Takeover Bids in the Target's Boardroom:* Old Battles, New Attacks and the Continuing War”, 60 Bus. Law 1369 2004-2005 at 1370.)

[43] As the Supreme Court of Canada noted in *BCE*, the “fiduciary duty of the directors to the corporation is a broad, contextual concept. *It is not confined to short-term profit or share value. Where the corporation is an ongoing concern, it looks to the long-term interests of the corporation* …” *BCE Inc., Re*, *supra* note 21, para. 37 [emphasis added].

[44] *Ibid.* para. 39.

[45] NP 62-202 expressly notes that the “Canadian securities regulatory authorities recognize that take-over bids play an important role in the economy ... as a means of reallocating economic resources to their *best* uses.” The statement suggests that NP 62-202 is, at least, partially rooted in the efficient market theory. According to some, the theory posits that “shareholder wealth could be maximized by outlawing most forms of takeover defences. Starting from the premise that share prices at all times accurately reflect the intrinsic value of a corporation, efficient market theory partisans contended that the willingness of a bidder to offer a premium price reflects a bidder’s ability to manage the assets better or more efficiently.” (Martin Lipton, “Pills, Polls, and Professors Redux” (2002) U. Chicago L. Rev. 1037 at 1041). Proponents of efficient market theory have “contended that board reluctance to accept a premium price necessarily reflects an instinct of self-preservation rather than conviction that the tender price is inadequate. Defenses, in this view, serve only to entrench incumbents and necessarily to harm shareholders.” (Martin Lipton, “Pills, Polls, and Professors Redux” (2002) U. Chicago L. Rev. 1037 at 1041.) Warren Buffett has written that “[M]any of the professors who write textbooks today ... argue that the stock market is efficient; that is, that stock prices reflect everything that is known about a company’s prospects and about the state of the economy. There are no undervalued stocks, these theorists argue, because there are smart security analysts who utilize all available information to ensure unfailingly appropriate prices. Investors who seem to beat the market year after year are just lucky.” (Warren Buffett, “The Superinvestors of Graham-and-Doddsville, edited transcript of a talk given at Columbia University in 1984”, The Intelligent Investor, Appendix 1, p. 537). However, opponents of the efficient market theory have pointed out that “inefficiencies in the market could exist at any given point in time, meaning that share prices did not always reflect intrinsic values.”(Martin Lipton, “Pills, Polls, and Professors Redux” (2002) U. Chicago L. Rev. 1037 at 1041-1042.) Warren Buffett has been a particularly articulate and persuasive opponent of efficient market theory. (See Warren Buffett, “The Superinvestors of Graham-and-Doddsville, edited transcript of a talk given at Columbia University in 1984”, The Intelligent Investor, Appendix 1, p. 537). This criticism of the efficient market theory appears to be particularly true in light of the most recent global financial meltdown, spurred by the sub-prime mortgage crisis. As Lipton also has argued, the “1987 market ‘break,’ and the 1990 collapse of Drexel Burnham Lambert, one of the most prominent financier of hostile bids in the 1980s, further damaged the prestige and persuasiveness of the efficient market theory.” (Martin Lipton, “Pills, Polls, and Professors Redux” (2002) U. Chicago L. Rev. 1037 at 1049.) Thus, given that NP 62-202 appears to be partially premised on the efficient market theory, there is all the more reason to reformulate NP 62-202.

[46] Provided the directors have acted free of conflict and after careful and informed deliberation.

[47] Furthermore, Martin Lipton makes the point that directors are best suited to prevent coercion. As he writes, “the special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion—they will tender, therefore, it is misleading to speak of a free shareholder choice at all. The existence of an offer to acquire a controlling interest in a company makes it almost impossible for a shareholder in the target to prudently retain his shares unless he does so for the purpose of exchanging them in a promised subsequent tax-free exchange. Once a raider has acquired control—and target shareholders must assume that the raider will acquire control—it is highly unlikely that shareholders will receive a higher price than that initially offered: since there is no possibility of a competing offer at a higher price, the public trading market (if one still exists) will have been capped at the price offered in the tender offer and the raider is not likely to offer more for the target's shares once it has achieved control. Retaining the target's shares in the face of a tender offer will bring the shareholder no benefit. He is likely to be forced out through a merger at a later date for the same price he could have realized upon the initial offer. The outcome of a shareholder referendum conducted in the form of a tender offer cannot realistically be said to reflect a careful appraisal of the merits or demerits of the offer. Each individual shareholder must look to his own interest and must pragmatically assume that most other shareholders will tender with the result that the nontendering shareholder will be left in a minority, illiquid investment position. Thus, any uncoerced decision *against* acceptance of a tender offer can *only* be made at the board of directors level.” (Takeover Bids in the Target’s Boardroom, Martin Lipton, 35 Bus. Law. 101 1979-1980 at 113-114).

[48] Approximately 80% of the 100 hostile bids over the last ten years have resulted in a change of control. This information is based on an informal survey of recent M&A transactions.

[49] This approach has been confirmed by recent decisions of the Delaware Chancery in *Selectica v. Versata Enterprises*, 2010 WL 703062 (Del. Ch. 2010); *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, C.A. No. 5465-VCS (Del. Ch.

Aug. 11, 2010) and *Airgas et al v. Air Products & Chemicals, 8 A. 3d 1182 (Del. Sup Ct 2010)*.

50 Indeed, in the June 2008 report "Compete to Win", the Canadian Competition Policy Review Panel wrote that "the new global context in which mergers and acquisitions (M&As) occur requires that Canada update its regulatory framework to place the directors of Canadian companies on the same footing as their counterparts at Delaware companies." (Compete to Win, p. 78). However, the U.S. approach is not without its problems. Staggered boards can make it very difficult for shareholders to replace directors. It can take three full years to remove a board of directors. To counter this problem, this article provides for a new shareholder referendum mechanism, which will strengthen shareholders' ability to defend against efforts by management to prevent shareholders from tendering their shares. The new shareholder referendum mechanism will be discussed later on in this article.

51 Lipton writes that "[t]here is no reason to remove the decision on a takeover from the reasonable business judgment of the directors. On the contrary, the policy considerations are overwhelmingly in favor of specific recognition that the directors not only have the right to make takeover decisions based on their reasonable business judgment, but that macrosocioeconomic issues must be considered along with the long-term interests of the shareholders and the company as a business enterprise. If the shareholders are dissatisfied with the directors' rejection of a takeover bid, they have the right, through the normal proxy machinery, to replace the directors or to instruct the directors to accept a takeover bid. *This right, however, should not be translated into an absolute requirement that the directors pass to the shareholders the direct right to accept or reject any takeover bid*. To do so would be the equivalent of mandating sale whenever an unsolicited takeover bid is made." [emphasis added] (Takeover Bids in the Target's Boardroom, Martin Lipton, 35 Bus. Law. 101 1979-1980 at 115-116.)

52 Further, during the OSC 2011 dialogue, Naizam Kanji, (Manager, Mergers and Acquisitions OSC), expressed the view that OSC staff considers recent and informed shareholder approval of a poison pill to be persuasive, but not determinative, when determining if staff would take the position that a poison pill should be cease traded.

53 One can envision the situation where the bidder increases an offer immediately after a poison pill has been approved by shareholders and would then argue that such approval is not informed (since the shareholders didn't have the benefit of considering the recent price increase) and therefore, the securities commissions should not take that the shareholder approval into account when determining if a poison pill should be cease traded.

54 During the 2011 OSC Dialogue held in Toronto, Naizam Kanji announced that the CSA is revisiting how the commissions deal with poison pills. The recently proposed approach is to remove poison pills from the ambit of 62-202 and implement a new rule in respect of poison pills which would allow poison pills to remain in place in response to a hostile bid provided they are approved by "independent" shareholders on a yearly basis. The author is of the view that this proposal is inadequate for a number of reasons being (1) shareholders will be asked to approve a rights plan without the context of any offer or potential offer, (2) the yearly approval does not allow shareholders to address a hostile bid in a timely fashion, (3) the yearly approval maintains the unregulated power of proxy services, such as Institutional Shareholder Services, over the form and function of poison pills (which restricts a board's ability to respond in a manner it see fit), (4) the yearly approval does not allow the board to exercise their fiduciary duties in an unrestricted manner, (5) securities commission hearings to cease trade a pill will still be made by bidders for tactical pills adopted by target companies, and (6) the form of acceptable rights plan will likely include a "permitted bid" concept which does not mechanically work well for partial bids (for instance, in those circumstances where a shareholder wants to approve a partial bid but not tender to the partial bid, the "permitted bid" condition requires a shareholder to tender to a bid to voice its approval of a bid). In addition, this proposed approach will likely have the unintended consequence of take-over bids being made at the end of the year and turning the annual approval process for a rights plan into a proxy contest in respect of the take-over bid.

55 Only independent shareholders (non-management and non-bidder) should have the ability to requisition the referendum on the rights plan and there should be a meaningful quorum requirement for the referendum (at least 50%) to ensure the views of most shareholders are taken into consideration. This would also be consistent with the "permitted bid" condition under most rights plans today which requires more than 50% of the outstanding shares be tendered to the bid.

56 This 25-day time period would be considerably shorter than the time it currently takes—at least 30 to 40 days—to call a shareholder meeting. The reasoning behind 25 days is to allow shareholders to react to bids in as close to real time as possible. The shareholder proposal would be implemented through an amendment to securities laws as a "referendum" by shareholders so as to not require a "special" meeting under securities laws and not require an amendment to the various corporate statutes.

57 The two-thirds voting requirement is consistent with other approval levels for special matters and fundamental changes required under corporate law. On the other hand, the rules of the Toronto Stock Exchange require only a majority shareholder approval if a share issuance would materially affect control and the standard "permitted bid" definition under existing rights plans requires more than 50% of the outstanding shares held by independent shareholders to have tendered to the bid (effectively, majority shareholder approval of the bid). I am of the view that more than majority shareholder approval should be required to override a proper board decision made in exercise of their fiduciary duties.

58 The author felt the existing 5% threshold under Canadian corporate law to requisition a shareholder meeting to be too high but still felt that a shareholder (or group of shareholders) should have a "material interest" in the target company to be able to requisition a referendum on a rights plan.

59 "Compete to Win", *supra* note 50, p. 78.

BOARD PAPERS IN THE CLOUD

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It is impossible to ignore the trend towards increased use by boards, in Australia and elsewhere, of cloud-based information technology services to create paperless board rooms, reducing the need for traditional email and paper-based communications. These services allow board papers and other information to be securely uploaded by management and then accessed remotely by directors through dedicated applications and the use of mobile devices, such as laptops and iPads.

Evolving concepts of communications

Efficient and effective communication has become an increasingly difficult task at the board level, where companies and their directors are expected to manage complex and voluminous quantities of information.

Recent Australian cases such as *Centro*[1] have demonstrated the need for directors to have continual access to company information and be able to analyze the information presented to them. In *Centro,* the Court provided little comfort to the company's directors, who relied on the quantity and complexity of the information supplied to them as a defense to allegations of negligence, reasoning that the board could control the amount and format of information received. Consequently, the standard of information oversight now expected can create problems for companies and their directors, and highlights the growing importance placed on managing the manner in which information is provided to directors, not only in terms of content but also in terms of presentation and accessibility.

Cloud-based information technology services will potentially revolutionize the manner in which management communicate with directors and directors communicate with each other. Depending on the services provided, there are many advantages associated with using the more popular devices such as iPads to distribute board papers to directors. For example, there are cost savings and efficiencies associated with reduced paper consumption, courier fees and time spent on document preparation. Directors have immediate access to current documents, regardless of their location. Further, with documents being stored in a central document repository (*i.e.*, the cloud), there is a corresponding reduction of physical storage space.

These services can vary substantially from a customized service developed to meet the needs of a particular company, to an "off-the-shelf" service where a company has no control over the hardware or software that provides the service. Accordingly, given these technologies are relatively new and continuously evolving, it is important for companies to remain vigilant to

1. ensure that any chosen cloud service is compatible with their corporate governance and operational policies; and
2. take all appropriate actions to minimize risks associated with a variety of new legal and regulatory challenges arising from the use of cloud services.

Some of the more apparent legal and regulatory issues are discussed in detail below.

Confidentiality and security

When talking about confidentiality and security, there are a number of questions that must be asked of service providers. First, is your confidential information more secure by being hosted online with other companies or offline on the company's own local network? What harm would it cause your company if confidential information fell into the wrong hands? Consider what type of, and how much, information you want to upload to these services—this is sensitive information and it is important to ensure that you have control over, and can restrict access to, that information.

Ownership concerns also need to be considered and appropriately addressed. In *Kriewaldt*,[2] the Court considered whether board papers become the property of a director when provided to that director. Justice de Jersey held that when the company provided board papers to directors it was to be taken as surrendering its right to them. His Honour reached this decision because the company had not reserved its rights to recall the papers when sending them to the directors, the papers had never been recalled by the company, the directors had been free to mark and annotate the papers, and the papers had been sent without any conditions attached to their disposal. However, importantly, His Honour stated that "this is apparently not a case, I would add, where at the end of meetings, the papers are recalled." Consequently, you should consider whether you wish to implement policies to ensure that board papers are recalled at the end of meetings—discuss these options with your information technology service provider before rolling out the services at a board level.

You also need to consider whether it is appropriate to place restrictions on whether board papers may be printed or saved locally (*i.e.*, to the memory of the device), or annotated with notes. While personal notes made by directors on board papers can serve as useful reminders to busy directors, directors' notes can be requisitioned as evidence in court. This may be helpful if the notes show that the directors adequately informed themselves, appropriately questioned and considered issues, and used proper care and diligence; however, this practice can also create risk if the notes are ambiguous, incomplete or inconsistent with other records, such as the formal minutes of meetings.

Directors' duties

These issues can lead to tensions between a company and its directors. While a company will naturally be concerned with confidentiality and security issues, directors will be motivated to ensure that their access to board papers, as well as their ability to annotate the board papers with notes, will enable them to satisfy their duties as directors, particularly their duty of care and diligence.

For a start, the board papers must be presented in a manner which allows the directors to review them to a level required to discharge their duties. From a practical perspective, it may be difficult for directors to view lengthy documents (such as financial reports) on a mobile device (where, for example, they cannot have multiple pages in front of them, as they could with hard copies). Further, those directors who are not very computer literate may find using a mobile device difficult, and until they become comfortable with the technology, it may be more time consuming and less efficient for them to review board papers using mobile devices.

Privacy

Australian privacy laws generally require personal information (or other sensitive information such as health information) collected by certain organizations to remain within Australian borders unless, among other exceptions, the individual consents to the transfer or the organization believes the recipient of the information is subject to laws that are substantially similar to the National Privacy Principles. Therefore, it is important to be aware of the types of information which directors will have access to online, as well as to consider whether or not that information will be held or accessed overseas by either the service provider or directors.

The company should also consider the risk that their data may be disclosed to the government of the jurisdiction in which their data is held by the service provider, possibly without their knowledge or consent. For example, the United States government is permitted under the *USA Patriot Act*[3] to seek a court order for disclosure of electronic records, often without permitting notice to the user.

Reliability of access

Timely access to information is vital for directors. It is important to remember that directors have both general law and statutory rights of access, and may also have contractual rights of access, to certain company documents, including board papers, which may be primarily accessible through your chosen technology.

At common law, directors have rights of access to company documents in order to facilitate the performance of their duties, together with corresponding rights to make copies.[4] Directors also have a statutory right of access to certain documents (including board papers) in the circumstances afforded under ss. 198F and 290 of the *Corporations Act 2001*. A contractual right of access may also have been granted to directors under a Deed of Access, Indemnity and Insurance with the company, together with a corresponding right to make copies.

Technology isn't always reliable. Accordingly, it is important to not only ensure that you meet the general law, statutory and contractual rights of access, but that you also implement appropriate standards of data protection, security, back-up, redundancy and disaster recovery processes—these standards should be documented both internally within the company as well as by agreement with the relevant information technology service provider.

Document retention

Subject to individual company document retention policies, some cloud services also offer the ability to permanently purge documents upon deletion. This includes the ability to irrevocably purge email messages uploaded on cloud servers, or electronic notes made by directors on uploaded documents, such as board papers.

Take the time to ensure that your document retention policies are up to date. If documents are held online by service providers, consider adopting and maintaining a robust records management policy to ensure that you are aware of what and where documents are located.

While most people engaged in business activities understand the need to keep proper records, many are unaware of the plethora of Federal and State laws that impose document retention and production obligations. This is particularly important given the emerging trend, in Australia and elsewhere, to criminalize poor document management practices. Organizations which destroy documents relevant to a Court hearing may be prosecuted for obstructing justice or be held in contempt of Court. Potential penalties include fines for the company and the individual, and in extreme cases, jail for the individual.

Concluding remarks

There is no doubt that the use of paperless board rooms by Australian companies is increasing—numerous services are being marketed which provide better ways to manage board processes in an environment where a company's compliance responsibilities are continually evolving.

The issues raised in this article are not intended to be exhaustive, although companies must ensure that they stay alert to critical issues, such as confidentiality, security, directors' duties, privacy, access to information and document retention. This means that, before making the decision to move towards a paperless board room, you should take a few moments to consider your company's risk profile as well as its corporate governance and operational policies, so that you continue to protect your company's information and are well prepared to incorporate these technological changes into your business practices.

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1. *ASIC v. Healey & Ors*, [2011] FCA 717.
2. *Kriewaldt & Ors v. Independent Direction Ltd.*, (1995) 14 ACLC 73.
3. *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism [USA PATRIOT ACT] Act of 2001.*
4. *Edman v. Ross*, (1922) 22 SR (NSW) 351.