THE FIDUCIARY OBLIGATIONS OF DIRECTORS OF A TARGET COMPANY IN RESISTING AN UNSOLICITED TAKEOVER BID

*Michael St. Patrick Baxter**

Recent years have shown increased activity in the area of corporate takeovers in both Canada[1] and the United States.[2] At the same time, an ever-increasing number of takeover bids[3] are being resisted by the directors of the target companies[4] (such directors are sometimes referred to herein as "target directors"). A successful defence by the target directors generally results in a loss by the shareholders of the target company

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* Of the District of Columbia and Ontario Bars.
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[1] *See, e.g.*, A. Malcolm, "The Canadian Conglomerates: Monopoly by Oligarchy?" *The New York Times* (23 March 1980) sec. 3, p. 1. *See also* J.G. Coleman, *Take-Over Bids, Insider Bids and Going-Private Transactions — Recent Developments* in LAW SOCIETY OF UPPER CANADA SPECIAL LECTURES: CORPORATE LAW IN THE 80s (Toronto: Richard De Boo, 1982) 155 at 156-59.

[2] Tender offers for publicly-traded companies rose 78% in 1986 over the figure for 1985. W.T. Grimm & Co., MERGERSTAT REVIEW — 1986 (Chicago: The Company, 1987) at 77-78 [hereinafter MERGERSTAT REVIEW].

[3] The term "takeover bid" is used interchangeably throughout this article with its American counterpart, "tender offer". The term "takeover bid" is defined in the Ontario *Securities Act*, R.S.O. 1980, c. 466, s. 88(1)(k), *as am. Securities Amendment Act*, S.O. 1987, c. 7, s. 8. It essentially involves, subject to exceptions, an offer to acquire voting or equity securities where the securities subject to the offer to acquire, together with the offeror's securities, constitute in the aggregate 20% or more of the outstanding securities of that class of securities at the date of the offer to acquire. The term "tender offer" is not defined by American federal legislation. However, it is generally understood to be a public solicitation to purchase, during a fixed period, all or part of the securities of a company at a specified price. *See generally* Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934* (1973) 86 HARV. L. REV. 1250 and E. Aranow & H. Einhorn, TENDER OFFERS FOR CORPORATE CONTROL (New York: Columbia University Press, 1973) at 69-76.

[4] One U.S. survey showed that in 1986, 40 of a total of 150 tender offers for publicly-traded companies were contested. This represented the highest number of contested takeover bids ever recorded. MERGERSTAT REVIEW, *supra*, note 2 at 77-78.

of an opportunity to tender their shares at what is often a substantial premium above the prevailing market price.[5] Not surprisingly, in the United States, it has been said that "almost every successful takeover defense results in shareholder lawsuits against the directors of the target".[6]

It was not until the seminal decision of Berger J., of the British Columbia Supreme Court, in *Teck Corp.* v. *Millar*[7] that any framework for the analysis of the fiduciary obligations of target directors that was consistent with the functional structure and operation of the modern public corporation was articulated by a Canadian court. Before that decision, Canadian courts, taking their lead from the English courts, applied a test which required either the divining of the true purpose of a directorial power, or the plumbing of the minds of the target directors to determine their primary purpose.[8] It is arguable whether either of these approaches yielded (or is capable of yielding) results that are consistent with the operation of a public corporation in the twentieth century.[9]

Notwithstanding the Berger decision in *Teck*, there has been remarkably little progress in the development of this area of Canadian law.[10] This is so despite the intense takeover activity in recent years. Moreover, it is unclear whether *Teck* in fact represents the state of Canadian corporate law.[11] The United States, on the other hand, has a wealth of experience in this area of law from which to draw. Recent Canadian experience has demonstrated the growing influence of American corporate law.[12] In the

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[5] One American study revealed that the average premium in an unsolicited takeover bid during 1977 was 72%. *See* W.E. Chatlos, *The SEC v. Investors on Tender Offers* (Sept.-Oct. 1978) HARV. BUS. REV. 6 at 7.

[6] M. Lipton, *Takeover Bids in the Target's Boardroom* (1980) 35 BUS. LAW. 101 at 101.

[7] (1972), 33 D.L.R. (3d) 288, [1973] 2 W.W.R. 385 (B.C.S.C.) [hereinafter *Teck*].

[8] *See infra*, text accompanying notes 69-78.

[9] *See infra*, text accompanying notes 120-125.

[10] *See infra*, text accompanying notes 40-50.

[11] *See, e.g., EXCO Corp.* v. *Nova Scotia Savings & Loan Co.* (1987), 78 N.S.R. (2d) 91 at 163-65, 35 B.L.R. 149 at 259-61 (S.C.T.D.) [hereinafter *EXCO*], which criticizes *Teck*.

[12] For example, several provisions of the *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, were adopted from American state-corporations statutes. *See* J.L. Howard, *Directors and Officers in the Context of the Canada Business Corporations Act* in Faculty of Law, McGill University, MEREDITH MEMORIAL LECTURES (Toronto: Richard De Boo, 1975) 282 at 293. The Ontario *Securities Act*, R.S.O. 1980, c. 466, was heavily influenced by the U.S. federal securities laws and has itself served as a model for the securities statutes of other provinces. Finally, American case law in several areas of corporate law has received recognition by Canadian courts and has already affected some Canadian decisions. *See, e.g., Re Olympia & York Enterprises and Hiram Walker Resources Ltd.* (1986), 59 O.R. (2d) 254, 37 D.L.R. (4th) 193 (H.C.), *aff'd* (1986), 59 O.R. (2d) 280, 37 D.L.R. (4th) (Div. Ct.) [hereinafter *Re Olympia & York*]; *Teck, supra*, note 7; *Bellman* v. *Western Approaches Ltd.* (1982), 33 B.C.L.R. 45, 130 D.L.R. (3d) 193 (C.A.).

takeover area, it is apparent that Canadian judges are looking to American case law for assistance.[13]

This article examines the fiduciary obligations of directors of a corporation that is the subject of an unsolicited takeover bid. An attempt is made in this article to avoid the emotion-charged terminology that has become common parlance in the mergers and acquisitions industry. Terms like "raider" to describe a takeover bidder suggest that the bidder's intentions are less than honourable; a "hostile" takeover bid suggests that the takeover would be adverse to the interests of the target corporation or its shareholders. It is unfair to prematurely characterize bidders or takeover bids by the use of such terms.

Part I briefly examines the nature of the fiduciary duty of directors.[14] It is asserted in Part I that the modern public corporation has evolved into an entity that is greater than the sum of its parts. It has, for all intents and purposes, become a corporate republic,[15] the citizens of which elect their representatives, who are given the mandate (usually by statute) to govern as the representatives see fit. In Part II, the fiduciary obligations of the target directors in the context of an unsolicited takeover bid are examined. It is argued in Part II that directors confronted with a takeover bid are thrust into a position where their personal interests may conflict with the interests of the shareholders, and, as a result, the burden of proof that Berger J. (in *Teck*) placed on a shareholder who challenges the defensive actions of target directors should instead be placed initially on the target directors. Part III offers some suggestions on how target directors can discharge their fiduciary obligations.

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[13] *See, e.g., Re Olympia & York, ibid.* at 262, 37 D.L.R. (4th) at 201; *Teck, ibid.* at 316-17, [1973] 2 W.W.R. at 415-16. *See also* B. Welling, CORPORATE LAW IN CANADA: THE GOVERNING PRINCIPLES (Toronto: Butterworths, 1984) at 714-15:

> Canadian corporate statutes underwent revolutionary changes during the 1970s, changes that have brought our corporate law closer to that of most American states than at any other time in the past 150 years. . . . [I]t is anticipated that this is where corporate precedent must increasingly be found in the near future and we can expect to see American cases being cited and followed a great deal more than has been traditional.

[14] The scope of this article is limited to the consideration of directors of publicly-held corporations. The issues raised by a director who is also a significant shareholder of the corporation is beyond the scope of this article.

[15] The concept of the corporation as a republic is not new. Other writers have recognized the similarities between the two entities. *See* A.A. Berle & G.C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY, rev'd ed. (New York: Harcourt, Brace & World, 1968) at 244-45 (the corporation as a sovereign); Welling, *supra*, note 13 at 298-99 (directors as democratically elected parliamentarians); J. Howard, *Takeover Battles and the Business Judgment Rule: Recent American Case Law Development* (1986) CAN. BUS. L.J. 445 at 446-47 (the corporation as a limited-purpose republic); W. Blackstone, COMMENTARIES ON THE LAWS OF ENGLAND, 1st ed., vol. 1 (Oxford: Clarendon Press, 1765) at 456 (the corporation as a republic).

I. General Nature of a Director's Fiduciary Duty

The directors, as managers of the corporate entity, are ultimately responsible for handling the business affairs of the corporation.[16] The status of a corporate director is that of a fiduciary. While the term "fiduciary" and the concept of fiduciary duty are widely used as though they had precise meanings, they are in reality amorphous concepts.[17] To use the classic formulation of Frankfurter J., "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?"[18]

This Part will briefly examine the question: to whom is the director a fiduciary? Put differently, does a director owe a fiduciary duty to the corporation, to its shareholders, or to both? The response of the American law, after some evolution, appears to be that a director owes a fiduciary duty to both the corporation and its shareholders.[19] The American case law, however, has not focussed on the problem that arises when a fiduciary is required to serve more than one beneficiary. Since this is an American problem, it is noted here and will not be discussed further. The response of the Canadian law is unclear, but it appears to be evolving.[20] Like the American case law, the Canadian case law has not focussed on the problem created by a bifurcated fiduciary duty. This will be discussed later, but the comprehensive treatment which this issue deserves is beyond the scope of this article.

A. *The American Position*

While the American courts were divided on the issue of whether the fiduciary duty imposed on the directors ran in favour of shareholders,[21]

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[16] *See, e.g.*, Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4, s. 115(1); *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, s. 97(1).

[17] P.D. Finn, Fiduciary Obligations (Sydney: Law Book, 1977) at 1: "the term 'fiduciary' is itself one of the most ill-defined, if not altogether misleading terms in our law". *See also* Comment, *Panter v. Marshall Field & Co.: Unbridled Discretion of Management to Resist Hostile Tender Offer* (1982) 33 Mercer L. Rev. 647 at 649-50; S.R. Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Measures* (1981) 66 Iowa L. Rev. 475 at 476-77; V. Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control* (1966) 65 Mich. L. Rev. 259 at 259. Several other books have been written on the nature and obligations of a fiduciary. *See, e.g.*, J.C. Shepherd, The Law of Fiduciaries (Toronto: Carswell, 1981).

[18] *Securities and Exch. Comm'n v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943).

[19] *See infra*, notes 21-26 and accompanying text.

[20] *See infra*, note 44.

[21] The majority rule at common law held that directors had a fiduciary duty only to the corporation. *See, e.g.*, *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); *Connolly v. Shannon*, 105 N.J. Eq. 155, 147 A. 234 (Ch. 1929), *aff'd* 107 N.J. Eq. 180, 151 A. 905 (1930); *Gladstone v. Murray Co.*, 314 Mass. 584, 50 N.E.2d 958

most jurisdictions[22] now hold that directors owe a fiduciary obligation to both the corporation and its shareholders.[23] The classic statement of the fiduciary position of directors is contained in *Guth* v. *Loft, Inc.*:[24] "While technically not trustees, [the directors] stand in a fiduciary relation to the corporation and its stockholders."[25] Thus, under American law, it may be said that directors stand in a fiduciary relationship to the corporation and its shareholders and have a duty to protect the interests of both.

The fiduciary duty imposed on corporate directors requires directors in the performance of their duties to act in good faith, in a manner they reasonably believe to be in the best interest of the corporation.[26]

1. *The Business Judgment Rule — Generally*

As fiduciaries, directors enjoy the protection provided by the business judgment rule.[27] The business judgment rule is a "presumption that

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(1943); *Board of Commissioners of Tippecanoe County* v. *Reynolds*, 44 Ind. 509 (1873). The minority view, on the other hand, held directors to be fiduciaries to both the corporation and its shareholders. *See, e.g.*, *Oliver* v. *Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Hotchkiss* v. *Fischer*, 139 Kan. 333, 31 P.2d 37 (1934); *King Mfg. Co.* v. *Clay*, 216 Ga. 581, 118 S.E.2d 581 (1961). A third approach, known as the "special facts" doctrine, followed by a number of jurisdictions, imposed a duty upon the directors to disclose information to shareholders whenever special facts or circumstances existed which made it inequitable to withhold the information from a shareholder. *American Trust Co.* v. *California W. States Life Ins. Co.*, 15 Cal.2d 42, 98 P.2d 497 (1940). The leading case supporting this approach is *Strong* v. *Repide*, 213 U.S. 419 (1909).

[22] *See, e.g.*, *Hanson Trust PLC* v. *ML SCM Acquisition Inc.*, 781 F.2d 264, 278 (2d. Cir. 1986) [hereinafter *Hanson*] (directors obligated to protect financial interest of the corporation and thereby the shareholders); *Radol* v. *Thomas*, 772 F.2d 244, 258 (6th Cir. 1985) (directors are trustees for the corporation and the shareholders are beneficiaries of the trust), *cert. denied* 106 S.Ct. 3272 (1986); *Samuel M. Feinberg Testamentary Trust* v. *Carter*, 652 F. Supp. 1066, 1080 (S.D.N.Y. 1987) (directors owe a duty of care and diligence to a corporation and its shareholders); *Buckhorn, Inc.* v. *Ropak Corp.*, 656 F. Supp. 209, 226 (S.D. Ohio 1987), *aff'd without published opinion* 815 F.2d 76 (6th Cir. 1987) [hereinafter *Buckhorn*] (directors owe an unyielding fiduciary duty of care to the corporation and its shareholders); *Panter* v. *Marshall Field & Co.*, 486 F. Supp. 1168, 1186 (N.D. Ill. 1980) (when directors act in the best interest of the company and its shareholders they act within the law), *aff'd* 646 F.2d 271 (7th Cir. 1981), *cert. denied* 454 U.S. 1092 (1981) [hereinafter *Panter*].

[23] *But see Treadway Cos.* v. *Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (a director does not owe a fiduciary obligation directly to the shareholders with respect to the shares of stock owned).

[24] 5 A.2d 503 (Del. 1939).

[25] *Ibid.* at 510. *See also Yasik* v. *Wachtel*, 17 A.2d 309, 313 (Del. Ch. 1941) ("It is fundamental that directors stand in a fiduciary relation to the corporation and its shareholders."), *approv'd in Condec Corp.* v. *Lunkenheimer Co.*, 230 A.2d 769, 775 (Del. Ch. 1967) [hereinafter *Condec*]; *Berman* v. *Gerber Prods. Co.*, 454 F. Supp. 1310, 1319 (W.D. Mich. 1978) ("Under the applicable Michigan law, it is clearly recognized that directors and officers are fiduciaries, and their dealings with the corporation and its stockholders are rigorously scrutinized.").

[26] *See, e.g.*, *Radol* v. *Thomas*, *supra*, note 22 at 256. *See also* the American Bar Association's MODEL BUSINESS CORP. ACT §8.30 (rev. 1984).

[27] A majority of the American jurisdictions apply the business judgment rule. *See, e.g.*, *Hanson*, *supra*, note 22 (applying New York law); *Radol* v. *Thomas*, *ibid.* (applying Ohio law); *Buckhorn*, *supra*, note 22 (applying Delaware law).

in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company".[28]

The business judgment rule consists essentially of five elements,[29] each of which is assumed to be satisfied when the rule is applied. They are as follows: (1) the directors exercised a business judgment, in that there was an affirmative act by the directors as opposed to inaction (although a conscious decision to refrain from acting may be a valid exercise of business judgment);[30] (2) the directors did not have a personal interest in the challenged directorial action;[31] (3) the directors made a reasonable effort to ascertain and consider all information relevant to their action;[32] (4) the directors acted with the belief that their action was in the best interests of the corporation and its shareholders; and (5) the directors' action did not constitute gross overreaching or an abuse of discretion.[33]

Two basic policy considerations underlie the business judgment rule. First, the courts recognize that they are ill-suited to evaluate business judgments made by directors.[34] Second, there is a recognition that the imposition of liability for mere good faith errors of business judgment would deter many individuals from serving as directors and inhibit those who are willing to serve from risk taking.

The burden of persuasion that the directors have breached their fiduciary duties is on the plaintiff. Once a plaintiff demonstrates that the directors had a personal interest in the challenged transaction, or that the directors did not believe that their action was in the best interest of the corporation and its shareholders, or that the action of the directors constituted gross overreaching or an abuse of discretion, the presumption of the business judgment rule is overridden or the rule is rendered inapplicable and the burden shifts to the directors to prove that the transaction

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[28] *Aronson* v. *Lewis*, 473 A.2d 805, 812 (Del. 1984). For a review of the history and development of the business judgment rule, *see* Sparks, Balotti & Abrams, *Directors' Fiduciary Duties in Corporate Control Contests* in D. Block & H. Pitt, eds., HOSTILE BATTLES FOR CORPORATE CONTROL, vol. 2 (New York: Practising Law Institute, 1987). *See also* D. Block, N. Barton & S. Radin, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS (Clifton, N.J.: Prentice Hall, 1987) at 1-22; S.S. Arsht, *The Business Judgment Rule Revisited* (1979) 8 HOFSTRA L. REV. 93.

[29] Block, Barton & Radin, *ibid.* at 9-17.

[30] *See, e.g.*, *Aronson* v. *Lewis*, *supra*, note 28 at 813.

[31] *See, e.g.*, *Norlin Corp.* v. *Rooney, Pace Inc.* 744 F.2d 255, 264 (2d Cir. 1984).

[32] *See, e.g.*, *Hanson*, *supra*, note 22 at 274-75.

[33] *See, e.g.*, *Aronson* v. *Lewis*, *supra*, note 28 at 812.

[34] The business judgment rule is grounded in the prudent recognition that courts are ill-equipped and infrequently called on to evaluate what are and must be essentially business judgments. . . . [T]he responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility.

Crouse-Hinds Co. v. *InterNorth, Inc.*, 634 F.2d 690, 702 (2d Cir. 1980).

was fair to the corporation and its shareholders.[35] However, in contests for corporate control, the application of the business judgment rule is modified.[36]

B. *The Canadian Position*

Under Canadian law, to whom is the director a fiduciary?[37] Professor Welling has counselled that this question is "better left unasked".[38] The wisdom of this counsel is readily apparent if the purpose of the question is to determine who has standing to legally challenge the actions of directors. As Professor Welling points out:

> Nowadays the typical statutory regime sets up two opposing groups: the management on the one hand, the shareholders on the other hand. The two groups tend to have different political and financial interests and they are given legal remedies to allow them to control one another in appropriate situations. Whether the directors owe a direct obligation to the corporate entity, to the shareholders as a group, to particular groups of shareholders, or to each individual shareholder becomes a moot point, except as specified in the appropriate statute.[39]

It would appear, however, that the answer to this question may be useful in the context of an unsolicited takeover bid. Why? Because, in the determination of whether target directors have discharged their fiduciary obligations, the defensive measures of target directors should be judged in light of both the interests that the directors are required to protect and the interests that they in fact sought to protect. If, for example, the directors owe a fiduciary duty to only the corporation, the effect of defensive measures on the shareholders of the target company becomes far less relevant than the effect on the corporate enterprise in the determination of whether the target directors have discharged their fiduciary obligations. The implications of this are more readily apparent when the defensive measure is the sale of the company. Once a decision is made to sell the company, the price of the sale generally becomes the only relevant factor to the shareholders. For the corporate enterprise, however, price is only one, and not necessarily the most important, of many other factors, including the reputation of the buyer and his plans for the target company. Thus, if the duty is owed solely to the corporation, the target directors in the proper exercise of their fiduciary duty may reject an unsolicited takeover bid in favour of a takeover bid at a significantly lower price by a third party whose reputation and plans for the target company are, in the directors' judgment, more consistent with the interests

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[35] *See, e.g.*, *Aronson* v. *Lewis*, *supra*, note 28 at 812.

[36] *See infra*, Part II.

[37] *See, e.g.*, Welling, *supra*, note 13 at 372-441 for a more detailed discussion of this subject.

[38] *Ibid.* at 300.

[39] *Ibid.*

of the corporation. On the other hand, if the directors' duty is owed solely to the shareholders, once the target directors decide to sell the company the primary, if not the only, consideration should be obtaining the highest price for the shareholders. In a sale of a target company, the reputation and plans of the buyer, and other considerations not directly related to the maximization of the shareholders' return on their investment are irrelevant to the interests of the shareholders. Thus, to discharge their fiduciary duty, the directors must attempt to maximize the return to the shareholders. The acceptance of a lower bid would generally not be consistent with the discharge of the directors' fiduciary duty to the shareholders.

Unfortunately, the answer to the question — to whom is the director a fiduciary? — raises some difficult issues, the resolution of which is beyond the intended scope of this article. The issues are themselves worthy of independent study. The fundamental issue raised by this question, and the one most relevant to our purpose, is: if a director owes a duty to both the corporation and its shareholders, how does he act in the face of conflicting interests among these beneficiaries?

The question (to whom is the director a fiduciary?) should be addressed in the context of the functional structure of the modern public corporation.[40] The modern public corporation, not unlike a republic, is essentially a collection of individuals, often with different interests, each of whom believes, in theory, that his interest will best be served if he is part of the corporate republic. This collection of individuals in turn, in an exercise of shareholder democracy, elect their representatives, namely, the directors. Canadian corporations statutes typically confer upon these elected representatives the mandate to manage the business and affairs of the corporate republic. Once formed, the corporation, like a true republic, takes on a life of its own, independent of its shareholders. In recognition of this (and perhaps also in recognitition of the difficulty of requiring directors to answer on an on-going basis to many masters), the position of the early law was that the directors owed their fiduciary duty to the corporation and not to their constituents, the shareholders.[41]

The problem with accepting the proposition that a director owes a fiduciary duty to the corporation and not to the shareholders is that it appears to be nonsensical that directors could completely disregard the interests of shareholders so long as they believe that they are acting in

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[40] *See ibid.* at 297-304.

[41] *See, e.g., Percival* v. *Wright* (1902), [1902] 2 Ch. 421, 71 L.J. Ch. 846; *Pelling* v. *Pelling* (1981), 130 D.L.R. (3d) 761, [1982] 2 W.W.R. 185 (B.C.S.C.). The legislatures did little to change this situation. *See, e.g., Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, s. 117(1); and Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4, s. 134(1). *See also* Howard, *supra*, note 12 at 293.

the best interests of the corporation.[42] Surely, directors must have a duty to consider the interests of the shareholders as well as those of the corporation.[43] It appears that Canadian courts have recently moved towards acceptance of the proposition that directors owe a fiduciary duty to the shareholders as well as to the corporation.[44] But, therein lies the rub. Such a bifurcated duty would seem to thrust directors into the difficult position of being required to serve beneficiaries whose interests may, and in the context of corporate control contests are likely to, conflict.

If a director is a fiduciary to each shareholder, it would be virtually impossible for the director to serve the interests of each shareholder unless each interest is identical, which, of course, is rarely the case. Similarly, it would be inappropriate for a director, as a fiduciary, to attend to only the common interests of the shareholders to the exclusion of their conflicting interests. And even assuming that the shareholders each have identical interests, there is much room for divergence between the interests of the shareholders on the one hand and the interests of the other beneficiary, the corporation, on the other hand. This is exemplified in the context of an unsolicited takeover bid. Shareholders who wish to tender their shares in a takeover bid are generally interested in obtaining the highest price. On the other hand, the interests of the corporation as well as those shareholders who (for whatever reason) have chosen not to sell their shares, are usually in the bidder's reputation, quality of management and intentions regarding the target.

Some courts, in an apparent attempt to side-step the problem of divergent interests among the beneficiaries of the directors' fiduciary duty, have defined the "interests of the company" so as to mean the "interests of the shareholders as a whole" in contradistinction to the interests of the company as a legal and commercial entity. In *Martin* v.

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[42] Professor Louis Loss has described *Percival* v. *Wright*, *ibid.*, the leading case for the proposition that the directors' fiduciary duty is owed only to the corporation, as "a monument to the ability of lawyers to hypnotise themselves with their own creations". L. Loss, *The Fiduciary Concept as applied to Trading by Corporate "Insiders" in the United States* (1970) 33 MOD. L. REV. 34 at 40-41. *See also* Ontario, *Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen's Printer, 11 March 1965) (Chair: J.R. Kimber) (Kimber Report) at 16; U.K., "Report of the Company Law Committee", Cmnd. 1749 (London: H.M.S.O., 1972) (Chair; The Rt. Hon. Lord Jenkins) (Jenkins Report) at para. 99(b).

[43] *See* Loss, *ibid.* at 40; Finn, *supra*, note 17 at 11, 74; Shepherd, *supra*, note 17 at 335-36.

[44] *See Re Olympia & York*, *supra*, note 12 at 271, 37 D.L.R. (4th) at 210 ("What options did the directors have? If they did nothing, it would be a breach of duty to shareholders."); *First City Fin. Corp.* v. *Genstar Corp.* (1981), 33 O.R. (2d) 631 at 646, 125 D.L.R. (3d) 303 at 319 (H.C.) ("The right and indeed the obligation of directors to take steps that they honestly and reasonably believe are in the interests of the company and its shareholders in a take-over contest or in respect of a take-over bid, is perfectly clear and unchallenged."). *See also* Shepherd, *ibid.* at 356 ("What is clear is that Anglo-Canadian jurisprudence is rapidly following the path trod by the United States courts on this issue and, if it is still arguable that the directors are not the shareholders' fiduciaries, the trend is decidedly against that argument.").

Gibson,[45] Boyd C., in discussing for whose benefit the directors' power to issue shares should be exercised, stated:

> [T]he persons to be considered and to be benefited are the whole body of shareholders — not the majority, who may for ordinary purposes control affairs — but the majority plus the minority — all in fact who, being shareholders, constitute the very substance (so to speak) of the incorporated body.[46]

On reflection, this attempt fails since, even assuming the unlikely event that the interests of the shareholders are identical, for the reasons discussed above the interests of the corporation may not be identical to those of the shareholders.

It has also been asserted in support of the bifurcated duty that "the interests which should be weighed against those of the company are those of the shareholders collectively and not the individual interests of any one or more shareholders".[47] This argument has immediate appeal. To be sure, shareholders have common interests (for example, the financial success of the corporation) and their common interests usually tend to align with the interests of the corporation. In this regard, a separate duty to the shareholders may well be duplicative of the duty to the corporation. But shareholders also have different interests and this is dramatized in context of an unsolicited takeover bid. Surely a director, as a fiduciary, must also consider those interests that are not in common. To do otherwise would not be consistent with the duty of a fiduciary to treat beneficiaries of the same class equally.[48]

Notwithstanding its difficulties, it would seem that the bifurcated approach to the directors' fiduciary duty is the correct approach.[49] Perhaps the reason for this lies in the statutory mandate of the directors to manage the business and affairs of the corporation. Shareholders, by investing in a corporation, have for all intents and purposes consented to the conferral of authority over the day-to-day control of the corporation on the directors. Thus, the directors manage the business and affairs of the corporation as they see fit, with the imprimatur of the shareholders. Consequently, shareholders, like citizens of a democratic republic, cannot

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[45] (1907), 15 O.L.R. 623, 10 O.W.R. 66 (H.C.).

[46] *Ibid.* at 632, 10 O.W.R. at 69. *See also Greenhalgh* v. *Arderne Cinemas, Ltd.* (1950), [1951] Ch. 286 at 291, [1950] 2 All E.R. 1120 at 1126 (C.A.) Lord Evershed M.R. (in connection with members voting in general meetings): "[T]he phrase, 'the company as a whole', does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body." *See also* Finn, *supra*, note 17 at 66-68; H. Ford, PRINCIPLES OF COMPANY LAW, 3d ed. (Sydney: Butterworths, 1982) at 367.

[47] *See* Finn, *ibid.* at 67.

[48] *Ibid.* at 56 (When a fiduciary exercises his discretionary power for beneficiaries, "it is well settled that he must treat them all equally.").

[49] I am confident that others will be able to demonstrate this.

directly control the actions of their elected representatives.[50] To be sure, directors must ultimately answer to their electoral constituents. At that time, shareholders will have the opportunity to change directors if they so desire. Until then, however, the directors have the mandate to direct as they see fit in the exercise of their business judgment.[51]

Thus, the directors are charged with the duty of responding on behalf of the corporation to an unsolicited takeover bid. The directors, in responding to the bid, must act in what they (not the courts and not the individual shareholder) believe to be the best interests of the corporation and its shareholders. However, special problems are created in contests for corporate control due to the apparent conflict of interest of target directors that is inherent in the nature of the transaction. This will be examined in Part II.

II. Directors' Fiduciary Obligations in Resisting an Unsolicited Takeover Bid

The decision of an offeror to initiate an unsolicited takeover bid, and the ultimate success of the bid, often depend on the actual and

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[50] *See Teck*, *supra*, note 7 at 307, [1973] 2 W.W.R. at 405:

> The directors' power to manage the affairs of the company is complete. . . . The directors are not the agents of the shareholders. Once given the power to manage the company, they can exercise the power according to their best judgment, until removed from office.

Compare Berle & Means, *supra*, note 15 at 244:

> The shareholder in the modern corporate situation has surrendered a set of definite rights for a set of indefinite expectations. The whole effect of the growth of powers of directors and "control" has been steadily to diminish the number of things which a shareholder can count; the number of demands which he can make with an assurance that they must be satisfied.

[51] Admittedly, many shareholders vote with their feet and the proxy process has often been criticized as perpetuating incumbent management. However, voter apathy is not unique to corporate shareholders. This trait is endemic to democratic systems generally. However, the power of shareholders to effect or influence change in management should not be underestimated. A recent example of the influence of the collective will of shareholders was the removal of the chief executive officer of Allegis Corporation, the parent company of United Airlines, and the former parent of Westin Hotels, Hilton International and Hertz Rent-a-Car, and the abrupt shift in the long-term Allegis strategy of creating an integrated travel concern to focussing on the airline industry. This change in chief executives and business strategy was effected, at least in part, by mounting dissatisfaction by several large shareholders (holding less than 20 percent of the total outstanding shares) over the relatively low market price of the company's stock in relation to the company's break-up value. *See* J. Dobrzynski, "Allegis Will Live On — In the Nightmares of CEOs" *Business Week* (29 June 1987) at 29; R. Dallos, "Allegis to Sell Half of Lucrative Reservation Unit" *Los Angeles Times* (26 June 1987) Part 4, p. 1; R. Cole, "Allegis Goes Under the Knife" *The New York Times* (11 June 1987) D1.

anticipated behaviour of the directors of the target company.[52] Directors confronted with an unsolicited takeover bid are thrust into a situation where their personal interests may, or may appear to, diverge from or conflict with those of the shareholders. It has been said that, in a takeover bid, "directors may look to the maintenance of the benefits of their control — the ability to make use of management uses of control, their salaries, perquisites and prestige — and the . . . shareholders to their opportunity to realise their investment at a substantial profit".[53] Therefore, the danger inherent in a contest for corporate control is that the directors' decision to resist the takeover bid may be motivated more by a desire to preserve their control than by the consideration of the best interests of the corporation and its shareholders.[54]

A. *The American Position*

It is well established under American law that directors, as managers of the corporation, possess the authority to oppose or approve takeover attempts. However, as fiduciaries, the directors' response to an unsolicited takeover bid cannot be motivated by self-interest. A director has the duty[55] to oppose only those takeover attempts determined to be detrimental to the corporation's interests.[56] "[T]arget directors must make a fully informed and reasoned response to a pending offer, and . . . the decision to oppose a takeover proposal must be made in good faith."[57]

The danger that the directors' decision to resist a takeover bid will be motivated more by their desire to preserve control than by the best

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[52] One study indicates that in 1986 63% of all tender offers made in the U.S. for publicly-traded targets which were contested by the target's management were subsequently cancelled by the offeror. MERGERSTAT REVIEW, *supra*, note 2 at 78. *See also* M.A. Stegemoeller, *The Misapplication of the Business Judgment Rule in Contests for Corporate Control* (1982) 76 NW. U.L. REV. 980 at 980; R.L. Gelfond & S.B. Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer* (1980) 60 B.U. L. REV. 403 at 403; P.D. Walsh, *Defensive Tactics and the Fiduciary Obligations of the Target Board of Directors* (1982) 7 J. CORP. L. 579 at 579.

[53] M.A. Weinberg, M.V. Blank & A.L. Greystoke, TAKE-OVERS AND MERGERS, 4th ed. (London: Sweet & Maxwell, 1979) at 575.

[54] *See ibid.*; N.R. Fenno, *Tender Offer Decisions: Effect of the Business Judgment Rule* (1981) 45 ALB. L. REV. 1122 at 1122-23.

[55] "Directors have an 'affirmative duty' to protect the financial interests of the corporation and its stockholders." Sparks, Balotti & Abrams, *supra*, note 28 at 45-46.

[56] *See Treadway Cos.* v. *Care Corp.*, 490 F. Supp. 668, 684 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, *supra*, note 23.

[57] Sparks, Balotti & Abrams, *supra* note 28 at 47. *See Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) [hereinafter *Unocal*]; *Ivanhoe Partners* v. *Newmont Mining Corp.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,552 (Del. 1987), *aff'g* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,503 (Del. Ch. 1987) [hereinafter *Ivanhoe*]. *See also* Lipton, *supra*, note 6 at 122-23 (reasonable grounds for rejecting a takeover bid are inadequate price, illegality, wrong time to sell, adverse impact on those other than shareholders, risk of nonconsummation, failure to provide equality for all shareholders and doubt as to the quality of the bidder's securities in an exchange offer).

interests of the corporation and its shareholders was recognized earlier in *Bennett* v. *Propp*.[58] In that case, the Delaware Supreme Court stated:

> We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.[59]

Therefore, the question for consideration is whether this inherent conflict of interest prevents a director from conducting a dispassionate assessment of the merits of a takeover, with a view to the best interests of the shareholders and the corporation.

"Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the [presumption] of the business judgment rule may be conferred" to protect the actions of the directors.[60] Accordingly, most American jurisdictions have modified the application of the business judgment rule in the context of control contests by shifting to the target directors the initial burden of proving that their actions did not constitute a breach of their fiduciary duties.[61] The directors satisfy this burden by showing: (1) they had reasonable grounds for believing that the takeover bid presented a danger to corporate policy and effectiveness; (2) the defensive measures adopted were a result of an informed business judgment based on an evaluation of all material information; and (3) the defensive measures adopted were a reasonable response to the threat posed by the takeover bid.[62] The burden of proving breach of the directors' fiduciary duty shifts to a plaintiff-shareholder only upon a showing by the target directors of reasonable grounds, reasonable investigation and reasonable defence measures.

Another approach, which was used in some of the less recent American cases, is the so-called "primary purpose test".[63] Like the Canadian proper purpose doctrine,[64] the primary purpose test requires a subjective

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[58] 187 A.2d 405 (Del. 1962).

[59] *Ibid.* at 409.

[60] *Unocal*, *supra*, note 57 at 954.

[61] *See. e.g.*, *Buckhorn*, *supra*, note 22 at 226-27; *Danaher Corp.* v. *Chicago Pneumatic Tool Co.*, 633 F. Supp. 1066, 1070 (S.D.N.Y. 1986); *Revlon, Inc.* v. *McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986), *aff'g* 501 A.2d 1239 (Del. Ch. 1985) [hereinafter *Revlon*]; *Unocal*, *ibid.* at 954-55. *But compare Hanson*, *supra*, note 22 at 273 (initial burden of proving directors' breach of fiduciary duty rests with the plaintiff).

[62] *Ivanhoe*, *supra*, note 57; *Buckhorn*, *ibid.*; *Revlon*, *ibid.*; *Unocal*, *ibid.*

[63] *See generally* A. Fleischer Jr., TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING (Clifton, N.J.: Prentice Hall, 1985) at 184-94.

[64] *See infra*, text accompanying notes 69-78.

evaluation of the motives of the target directors.[65] It must be determined whether the primary purpose of the target directors was a proper corporate purpose or the perpetuation of their control.

There appears to be little distinction, however, between the effect of the business judgment rule and the primary purpose test. This is so because if the primary purpose of the target directors in opposing a takeover bid is to perpetuate themselves in power, it would be inconsistent for a court to find that the target directors had reasonable grounds for believing that the takeover presented a danger to corporate policy and effectiveness since they obviously did not hold that belief. Conversely, to determine whether the primary purpose of the target directors is to achieve a corporate goal or to maintain itself in power, the courts examine the business reason asserted by the directors for the defensive action. Only if the directors' alleged justification for resisting the takeover bid is implausible (for example, if reasonable grounds do not exist) will the court find that the directors' primary purpose was improper.[66]

In sum, the primary purpose test appears to be a minority view in the United States[67] and it may be that this approach has been supplanted by the business judgment rule. In any event, the primary purpose test offers a less desirable analytical framework in which to examine directorial actions than the business judgment rule. The principal weakness of the primary purpose test, like all motive-based tests, lies in the difficulty of its application, which requires a court to determine which among several business motivations was the primary one. The difficulty of this task is further enhanced by the fact that the motivations being assessed may vary from director to director. Thus, the court must discover the primary purpose of each director and, from that, divine the primary purpose of the board.

B. The Canadian Position

Unlike the American experience, there are not many Canadian cases dealing with directors' fiduciary obligations in resisting an unsolicited takeover bid. Of those few cases on point, even fewer of them have thoughtfully addressed the issue.

This section will first examine the state of the Canadian law prior to the landmark case of *Teck Corp.* v. *Millar*.[68] The *Teck* case will then be examined, followed by a discussion of the law after *Teck*.

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[65] *See, e.g., Cummings* v. *United Artists Theatre Circuit, Inc.*, 237 Md. 1, 204 A.2d 795 (1964); *Heit* v. *Baird*, 567 F.2d 1157 (1st Cir. 1977); *Northwest Indus., Inc.* v. *B.F. Goodrich Co.*, 301 F. Supp. 706 (N.D. Ill. 1969); *Condec, supra*, note 25. The application of the primary purpose test seems to be characterized by the target directors issuing or repurchasing stock of the target company in the face of a takeover bid.

[66] Fleischer, *supra*, note 63 at 165-66.

[67] Block, Barton & Radin, *supra*, note 28 at 77.

[68] *Supra*, note 7.

1. *The Proper Purpose Doctrine*

The proper purpose doctrine[69] was founded on the premise that directors' powers were conferred upon them to be exercised for a particular purpose or purposes. Thus, the directors' exercise of a power for a purpose other than for which it was conferred was invalid.[70] The test involves a two-part inquiry. First, the proper purpose for which the power was conferred must be ascertained. Second, it must be determined whether the power was exercised for that proper purpose. The proper purpose analysis is applied only to the substantial or primary purpose of the directors in exercising their power. Thus, so long as the directors' primary purpose is a proper purpose, a secondary or subsidiary improper purpose will not invalidate their action.[71] The burden of proof is on the plaintiff to establish that the directors' primary motive was an improper purpose.[72]

The leading Canadian case is *Bonisteel* v. *Collis Leather Co.*[73] There, the plaintiff, a shareholder in a closely-held corporation, arranged to purchase the shares of another shareholder, thus giving him a majority of the outstanding shares of the company. The general manager of the company, who was credited with the company's success, made it known that, if the plaintiff acquired control, he would not be disposed to continue his employment with the company. At a subsequent meeting of the board, the directors resolved to offer the balance of the authorized but unissued shares to the existing shareholders. Shares were issued to the subscribing shareholders in amounts that bore no relation to each subscribing shareholder's previous holdings. The plaintiff requested his *pro rata* amount but was instead offered a much lesser amount. The effect of the share issue was to dilute the plaintiff's holdings to a minority position.

The Court found that the purpose of the directors was to deprive the plaintiff of the controlling position which he had acquired. It was also found that the directors had acted in good faith and in what they believed to be in the best interests of the company. In invalidating the share issues, Rose J. held that, notwithstanding the directors' belief

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[69] This is also known as the collateral purpose rule. *See* Welling, *supra*, note 13 at 335-51, for an excellent, detailed discussion of the proper purpose doctrine.

[70] *See Fraser* v. *Whalley* (1864), 2 H. & M. 10 at 30, 71 E.R. 361 at 369, 144 R.R. 7 at 19 (V.C. Ct.); *Rudolph* v. *Macey* (1906), 12 B.C.R. 80 at 91, [1906] 3 W.L.R. 52 at 54 (S.C.); *Re Smith and Fawcett, Ltd.* (1942), [1942] Ch. 304 at 306, 11 L.J. Ch. 265 at 266 (C.A.); *Punt* v. *Symons & Co.* (1903), [1903] 2 Ch. 506 at 515-17, 72 L.J. Ch. 768 at 773-74.

[71] *See Harlowe's Nominees Pty. Ltd.* v. *Woodside (Lakes Entrance) Oil Co.* (1968), 121 C.L.R. 483 at 493, 42 A.L.J.R. 123 at 125 (Austr. H.C.) [hereinafter *Harlowe's Nominees*]; Ford, *supra*, note 46 at 365.

[72] *Australian Metropolitan Life Assurance Co.* v. *Ure* (1923), 33 C.L.R. 199, 30 Austr. Argus L.R. 53 (Austr. H.C.).

[73] (1919), 45 O.L.R. 195, 15 O.W.N. 465 (H.C.).

that they were acting in the best interests of the company, "they [had] no right [to make] a one-sided allotment of stock with a view to the control of the voting power".[74]

The English decision in *Hogg* v. *Cramphorn Ltd.*[75] is probably the leading case with respect to the application of the proper purpose doctrine. The directors of Cramphorn Ltd. established a trust for the benefit of the company's employees. Shares of the company were allotted to the directors as trustees for the employees. The Court found that the directors had established the trust for the primary purpose of preventing a Mr. Baxter, who was seeking to acquire control of the company, from acquiring a majority of the shares. The Court also found that the directors had acted in good faith, believing that their actions were in the best interests of the company, its employees and its customers.

The Court held that the power to issue shares was a fiduciary power. It was granted primarily for the purpose of enabling the directors to raise capital when required.[76] The stock issue was liable to be set aside since the power was exercised with the primary purpose of retaining control, which was an improper purpose. Buckley J. stated:

> It is not, in my judgment, open to the directors . . . to say, "We genuinely believe that what we seek to prevent the majority from doing will harm the company and therefore our act in arming ourselves or our party with sufficient shares to outvote the majority is a conscientious exercise of our powers under the articles, which should not be interfered with."
>
> *Such a belief, even if well founded, would be irrelevant.* A majority of shareholders in general meeting is entitled to pursue what course it chooses within the company's powers, however wrong-headed it may appear to others, provided the majority do not unfairly oppress other members of the company.[77]

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[74] *Ibid.* at 199, 15 O.W.N. at 466, *applying Martin* v. *Gibson*, *supra*, note 45. *But compare Spooner* v. *Spooner Oils Ltd.* (1936), [1936] 2 D.L.R. 634 at 636, [1936] 1 W.W.R. 561 at 562 (Alta. S.C.A.D.), Harvey C.J.A.:

> There is nothing in the authorities cited that would stand in the way of upholding an issue of shares for the sole purpose of giving someone control of the company if the directors honestly believed on reasonable grounds that it was for the interest of the company that that should be done.

[75] (1963), [1967] Ch. 254, [1966] 3 All E.R. 420, criticized in L.S. Sealy, *Company-Directors' Powers — Proper Motive But Improper Purpose* (1967) 25 CAMBRIDGE L.J. 33.

[76] *Hogg* v. *Cramphorn Ltd.*, *ibid.* at 267, [1966] 3 All E.R. at 427-28, *approving Punt* v. *Symons & Co.*, *supra*, note 70 at 515-17, 72 L.J. Ch. at 773-74. *See also Bernard* v. *Valentini* (1978), 18 O.R. (2d) 656 at 658-59, 83 D.L.R. (3d) 440 at 441-43 (H.C.).

[77] *Hogg* v. *Cramphorn*, *ibid.* at 268-69, [1966] 3 All E.R. at 428-29 (emphasis added).

Buckley J. reaffirmed a principle from two earlier English cases that the court will not concern itself with the merits of the dispute between the directors and the offeror.[78]

2. *Teck Corp. v. Millar*

Teck Corp. v. *Millar*[79] is probably the most significant Canadian case in the last sixty years on the subject of directors' fiduciary obligations in resisting a takeover bid. Its significance is in part due to the thoughtful and well-reasoned judgment of Mr. Justice Berger.

The facts of the case are as follows. The defendant, Millar, was the president and a director of Afton Mines, a junior mining company. Afton was financially unable to carry on an extensive drilling program on its claims, so it sought to interest major mining companies ("majors"). A major usually provides capital, personnel, technical assistance and managerial and marketing assistance in return for an allotment of the junior's shares.[80] Afton raised money through a public underwriting of its shares which enabled it to continue drilling. The assays aroused great interest in Afton and Millar was beseiged by majors each seeking to obtain the ultimate deal.

At this point, Afton required additional financing. However, the previous underwritings had been unsatisfactory and Millar did not yet want to conclude an ultimate deal. Millar decided to try to issue a bloc of shares to a major because he believed that he could obtain a greater net return to Afton, that he would not have to relinquish control of the company and that the participation of a reputable major would enhance the value of the shares. An agreement was reached between Millar and Placer for the sale of shares with a right of first refusal on any future financing including the ultimate deal.

Another major, Teck, was eager to obtain the ultimate deal. Teck offered to purchase from Afton a bloc of Afton shares at four dollars per share if it received a right of first refusal on future financing. However, even though Placer was willing to pay only three dollars per share, Millar preferred to deal with Placer because of its excellent reputation in the industry and its phenomenal record of successful ventures. Teck had not brought a mine into production in the province

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[78] In other words, the court will not examine whether the directors were in fact justified in their belief that the offeror's acquisition of control would be detrimental to the interests of the company. *Ibid.* at 268, [1966] 3 All E.R. at 428, *applying Piercy* v. *S. Mills & Co.* (1919), [1920] 1 Ch. 177 at 84, [1918-19] All E.R. Rep. 313 at 315-16; *Fraser* v. *Whalley, supra*, note 70 at 30, 71 E.R. at 369, 144 R.R. at 19.

[79] *Supra*, note 7. Commented on in F. Iacobucci, *The Exercise of Directors' Powers: The Battle of Afton Mines* (1973) 11 OSGOODE HALL L.J. 353; B.V. Slutsky, *Canadian Rejection of the Hogg v. Camphorn "Improper Purposes" Principle — A Step Forward?* (1974) 37 MOD. L. REV. 457.

[80] Such a contract is known in the mining industry as the "ultimate deal".

and could not match Placer's experience or personnel. Millar rejected Teck's higher offer because he wanted Placer involved in the property.

Teck, having failed to make a deal with Afton, began buying Afton's shares on the market. During this period, Millar and Placer negotiated for an ultimate deal. Millar and the other directors, realizing that Teck was coming close to having control and that they would not be in control of Afton much longer, negotiated an ultimate deal with Canex, Placer's wholly-owned subsidiary, which provided for the issuance of shares to Canex if it elected to put the property into production.[81]

Teck brought a derivative action as a shareholder of Afton against the directors alleging, *inter alia*, that the agreement with Canex was void because it was made for an improper purpose.

Berger J. found that the directors had reasonable grounds for believing that a takeover by Teck would cause substantial damage to the interests of Afton and its shareholders, and that the directors were acting in the best interest of the company.

In dismissing the plaintiff's action, Berger J. refused to follow *Hogg* v. *Cramphorn Ltd.*[82] After reviewing the American cases of *Bennett* v. *Propp*,[83] *Kors* v. *Carey*,[84] *Cheff* v. *Mathes*[85] and *Condec*,[86] he adopted the following test: Directors are entitled to resist a takeover bid if: (1) they act in good faith and (2) they decide, on reasonable grounds, that the takeover will cause substantial damage to the company's interests.[87] The burden of proof was placed on the plaintiff to show either that the directors' purpose was not to serve the best interests of the company, or that the directors did not have reasonable grounds for believing that the takeover would cause substantial damage to the interests of the company.

The *Teck* case was clearly a departure from the prevailing English view that the directorial power to issue shares is properly exercised

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[81] The shares when issued would have deprived Teck of control. However, since the share issuance was not to be immediate, it left the incumbent directors vulnerable for the interim period. They were in fact ousted by Teck since it acquired control before any shares were issued under the agreement. While it is arguable that the directors' willingness to act as they did in the face of the strong possibility of their ouster supports the presumption that they acted in good faith with a view to the best interests of the company (*see* Iacobucci, *supra*, note 79 at 372 n.64), it is more likely that it was a tactic to persuade Teck to halt its takeover attempt.

[82] *Supra*, note 75. It is interesting to note that the Judge did not have to refuse to follow *Hogg* v. *Cramphorn Ltd.* He could easily have distinguished it, as he did in any event, on the grounds that the primary purpose of the Afton directors was, unlike the Cramphorn directors, not the retention of control, but to make the best contract that they could for the company.

[83] *Supra*, note 58.

[84] 158 A.2d 136 (Del. Ch. 1960).

[85] 199 A.2d 548 (Del. 1964).

[86] *Supra*, note 25.

[87] *Supra*, note 7 at 315-17, [1973] 2 W.W.R. at 414-16.

only for the purposes for which it was conferred.[88] Berger J. expressed the view that the directors' exercise of a power was for an "improper" purpose if their purpose was not to serve the company's interests.

> The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose, it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers.[89]

Thus, the proper purpose doctrine was regarded merely as an element of the general principle that directors must act in the interests of the company.[90]

3. *The Law After Teck Corp. v. Millar*

It is difficult to determine the effects of the *Teck* case, since it has been the subject of thoughtful consideration in only two subsequent Canadian cases, *Re Olympia & York*[91] and *EXCO*.[92] Prior to that, however, it was considered by the Judicial Committee of the Privy Council in *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.*[93]

(a) *Howard Smith Ltd. v. Ampol Petroleum Ltd.*

In *Howard Smith*, Ampol Petroleum acquired thirty percent of the issued shares of R.W. Miller (Holdings) Ltd. ("Miller"). Shortly thereafter, it made a tender offer for all of Miller's issued shares. Its offer was rejected by Miller's directors as being too low. Howard Smith Ltd. then announced its intention to make a competing offer at a higher price. Ampol and another Miller shareholder, Bulkships (which collectively held fifty-five percent of the shares of Miller), declared their intention to act jointly in relation to the future operation of the company and to reject any offer for their shares. The effect of such a joint action would have been to frustrate Howard Smith's tender offer.

A plan was devised between Howard Smith and Miller's management whereby Miller would make an issue of its shares to Howard

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[88] *See, e.g.*, *Hogg* v. *Cramphorn Ltd.*, *supra*, note 75.

[89] *Teck*, *supra*, note 7 at 312, [1973] 2 W.W.R. at 410-11.

[90] *See* Slutsky, *supra*, note 79 at 459-60.

[91] *Supra*, note 12.

[92] *Supra*, note 11. *Teck* was also briefly referred to in *dictum* by the Ontario High Court. *See Re Royal Trustco Ltd. (No. 3)* (1981), 14 B.L.R. 307 at 314-15 (Ont. H.C.); *First City Fin. Corp.* v. *Genstar Corp.*, *supra*, note 44 at 646, 125 D.L.R. (3d) at 319. *Teck* was applied by the Manitoba Court of Appeal in *Olson* v. *Phoenix Indus. Supply Ltd.* (1984), 9 D.L.R. (4th) 451 at 454-55, [1984] 4 W.W.R. 498 at 502-03 (Man. C.A.).

[93] (1974), [1974] A.C. 821, [1974] 1 All E.R. 1126 (P.C.), *aff'g* a judgment of the New South Wales Supreme Court [hereinafter *Howard Smith*].

Smith of a size sufficient to dilute Ampol and Bulkships' collective holdings to a minority position, so that Howard Smith could proceed with its takeover bid. Ampol challenged the validity of the share issue. It was argued by Miller's directors that the share issue was made to satisfy the company's need for capital.

The Privy Council accepted the lower Court's findings of fact that the directors were not motivated by personal gain or by any desire to retain their positions and that the primary purpose of the directors was to reduce the combined shareholding of Ampol and Bulkships in order to induce Howard Smith to proceed with its tender offer. The share issue was set aside on the ground that the directors' power to issue shares was not exercised for a proper purpose.

Lord Wilberforce outlined the steps in the application of the proper purpose doctrine:

> [I]t is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as can best be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not.[94]

Lord Wilberforce was of the view that, although self-interest is the most common instance of improper motive, it does not follow from this that the absence of any element of self-interest is enough to validate an issue of shares.

As to the purpose for which the power to issue shares was conferred, Lord Wilberforce, quoting from *Harlowe's Nominees*, stated that it was too narrow an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company. "[T]here may be occasions when the directors may fairly and properly issue shares for other reasons, so long as those reasons relate to a purpose of benefiting the company as a whole, as distinguished from a purpose, for example, of maintaining control of the company."[95]

In ascertaining the primary purpose for which the power was exercised, the court will look objectively at the situation in order to determine how critical or substantial an alleged requirement of the company may have been.[96] The lower Court had examined the company's financial affairs and had found that there was not a pressing need to obtain capital by a share issue.

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[94] *Ibid.* at 835, [1974] 1 All E.R. at 1134.

[95] *Ibid.* at 836, [1974] 1 All E.R. at 1134, *approv'g Harlowe's Nominees*, *supra*, note 71 at 493.

[96] This examination is not to determine if the directors' decision was right or wrong, but rather to determine what was the primary purpose of the directors.

Lord Wilberforce distinguished *Teck* on the basis that the primary purpose of the directors in that case was to obtain the best ultimate deal for the corporation, whereas in *Howard Smith* the sole purpose of the directors was to dilute the majority voting power so as to enable a minority of shareholders to sell their shares more advantageously to an offeror. But while *Teck* was not disapproved, Privy Council affirmed the proper purpose doctrine.

Howard Smith appears to loosen the proper purpose doctrine when it recognized that there is no set purpose for the directorial power to issue shares. Notably, the authority of Miller's directors to issue shares was conferred by Miller's articles of association, which did not indicate any relevant restraints on the exercise of this power.[97] On the other hand, the Privy Council was of the view that it was not useful to attempt to limit the power by merely requiring that its exercise be in the interests of the company, since according to the Privy Council, that is just a restatement of the general principle applicable to fiduciary powers.[98] The Privy Council, however, appeared to revert to the traditional appoach of the proper purpose doctrine, exhibited in cases such as *Hogg* v. *Cramphorn Ltd.*,[99] by attempting to relate the purpose of the Miller directors in issuing the shares to some unstated purpose for which the power to issue shares was granted.[100]

The bottom line may simply be that there is something inviolate about a control bloc of stock that restricts even well-meaning directors from attempting to dilute it. It seems that any deliberate attempt by directors to dilute an existing majority or to shift control may be presumed to be primarily for the purpose of the self-interest of the directors unless the directors can prove that some significant corporate purpose, directly related to the issuance of the shares, is served. As the result in *Teck* shows, however, it is easier to attempt to dilute a shareholder on his way to acquiring a control bloc.

(b) *Re Olympia & York Enterprises Ltd.*

In *Re Olympia & York*,[101] Gulf Canada Corp., a subsidiary of Olympia & York Enterprises Ltd., made a takeover bid for Hiram Walker Resources Ltd. In response, the directors of Hiram Walker caused the company to enter into agreements with Allied-Lyons PLC

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[97] Lord Wilberforce paraphrased the relevant provision of the articles of association as follows: "the shares shall be under the control of the directors, who may allot or otherwise dispose of the same to such persons on such terms and conditions and either at a premium or otherwise and at such time as the directors may think fit". *Supra*, note 93 at 834, [1974] 1 All E.R. at 1132.

[98] *Ibid.* at 835, [1974] 1 All E.R. at 1133.

[99] *Supra*, note 75.

[100] Welling, *supra*, note 13 at 350.

[101] *Supra*, note 12. *See generally* R.L. Simmonds, *Case Comment* (1987) 66 CAN. BAR REV. 626, for a comment on *Re Olympia & York*.

whereby Allied would buy the distilled spirits business of Hiram Walker (representing about forty percent of Hiram Walker's total assets) and a new corporation, Fingas Investment Corp., would be formed, of which Hiram Walker would hold forty-nine percent of the voting shares. Fingas, capitalized by Hiram Walker and Allied, would then make a competing offer for Hiram Walker shares at a price higher than that offered by Gulf. Olympia & York and Interprovincial Pipe Line Ltd., another shareholder of Hiram Walker which was also trying to take over the company, sought injunctions arguing, *inter alia*, that the action of the Hiram Walker directors was for the purpose of entrenching themselves in the management of the company, and thus was a breach of their fiduciary duty.

Montgomery J., in holding that the directors did not breach their fiduciary duty, made several significant preliminary observations: (1) the similarity between the Canadian and the American regulatory scheme for takeovers made American case law more persuasive than English case law;[102] (2) twelve of the eighteen Hiram Walker directors were outside directors;[103] and (3) the directors acted upon the advice of their legal and financial advisers.[104]

Montgomery J. found that the sole purpose of the Hiram Walker directors was to ensure that as much as possible of the economic value of the company went to all shareholders rather than to the acquirer.[105] The inherent conflict of interest of the target directors was not expressly addressed by the Judge. This was, in all likelihood, because a majority of the Hiram Walker board consisted of outside directors whose independence was not in question. Moreover, according to Montgomery J., "[i]t matters not when the directors act in the best interests of the company and in good faith that they also benefit as a result".[106]

The Hiram Walker directors were under no obligation to acquiesce to the Gulf offer merely because a premium over market price was offered. Since the directors had reasonable grounds to believe that the "intrinsic value"[107] of the company's stock was higher than both the market price and the offered price, Montgomery J. stated that it would have been a breach of the directors' duty to the shareholders to acquiesce to the bid.[108]

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[102] *Re Olympia & York*, *ibid.* at 262, 37 D.L.R. (4th) at 210.

[103] *Ibid.* at 257, 37 D.L.R. (4th) at 196.

[104] *Ibid.* at 270, 37 D.L.R. (4th) at 209.

[105] *Ibid.* at 270-71, 37 D.L.R. (4th) at 209-10. It was on this basis that *Howard Smith*, *supra*, note 93, was distinguished.

[106] *Re Olympia & York*, *ibid.* at 271, 37 D.L.R. (4th) at 210.

[107] This, presumably, means the value that may not be reflected in the price at which the stock is traded.

[108] *Supra*, note 12 at 271, 37 D.L.R. (4th) at 210.

Montgomery J. accepted the reasoning in *Teck*[109] and stated that it reflects the law in Ontario.[110]

(c) *EXCO Corp. v. Nova Scotia Savings & Loan Co.*

In *EXCO*,[111] EXCO Corp. made an unsolicited takeover bid of Nova Scotia Savings & Loan Co. ("NSS&L"). Prior to its takeover bid, EXCO had amassed a 49.5 percent bloc of NSS&L common stock. In an attempt to defeat the EXCO takeover bid, the NSS&L management sought a suitor more to their liking. They found one in Halifax Developments Holdings Ltd. ("HDHL"). As a condition of becoming involved, however, HDHL required that, *inter alia*, NSS&L privately place 293,000 shares of its common stock in the hands of parties not unfriendly to HDHL and that stock options, which were to be granted to certain NSS&L officers to facilitate HDHL's competing bid, be exercised and the shares tendered in the HDHL takeover bid. The board of NSS&L agreed to, and complied with, the foregoing conditions, the effect of which was to reduce EXCO's position in NSS&L to approximately thirty-four percent and to increase HDHL's position to approximately twenty-five percent.[112]

Richard J., in holding that the NSS&L directors breached their fiduciary duty, approved and applied the proper purpose doctrine as articulated in *Howard Smith*.[113] The significance of this decision is its apparent disregard of the framework for analysis advanced by *Teck*, and its apparent reversion to the proper purpose doctrine as the basis

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[109] *Supra*, note 7. *See also*, *supra*, text accompanying notes 79-90.

[110] *Re Olympia & York*, *supra*, note 12 at 272, 37 D.L.R. (4th) at 211. Unfortunately, the excerpts from *Teck* quoted by Montgomery J. do little to clarify the law in Ontario. From the quoted *Teck* excerpts, it may be argued that the test in Ontario to determine if directors in resisting a takeover bid have breached their fiduciary duty is simply whether the primary purpose of the directors was to serve the best interest of the company. The second part of the *Teck* test, however, is missing, namely, that the directors decide, on reasonable grounds, that the takeover will cause substantial damage to the company's interest. Admittedly, this second element may well be part of the first element. That is, the absence of reasonable grounds may necessarily lead to the conclusion that the directors' primary purpose was not to serve the best interests of the company.

[111] *Supra*, note 11.

[112] This is an oversimplification of what is a fairly complicated fact situation, the exposition of which consumed over 70 pages of the judge's opinion.

[113] *Supra*, note 11 at 166-67, 35 B.L.R. at 263-64. It should be noted that, before reaching the issue of whether the directors breached their fiduciary duty, Richard J. held that the share allotments were in contravention of the *Nova Scotia Savings and Loan Act*, S.C. 1964-65, c. 72, and, consequently, the directors' actions were *ultra vires* and the share allotments were void. Thus, Richard J.'s opinion regarding the directors' breach of their fiduciary duty is *obiter dicta*. *Supra*, note 11 at 147, 35 B.L.R. at 233.

for determining the validity of directorial actions, at least in respect of the issuance of shares.[114]

Richard J. goes on to propose a refinement of the *Teck* test containing two significant features. First, the burden of proof in Richard J.'s test is placed on the target directors. Second, to discharge this burden, the target directors must show that the considerations upon which their decision was based are consistent *only* with the best interests of the company and inconsistent with any other interests.[115] Richard J. found that the purpose of the directors in issuing the shares was to dilute the equity position of EXCO. This, according to Richard J., was "a wrong purpose, i.e., a purpose which was not demonstrably in the best interests of the company".[116] The directors' use of their power to support one group in a takeover to the detriment of another was, in Richard J.'s view, more consistent with a finding that the directors were acting out of their own self-interest than with a finding that they were acting in the best interests of the company. In other words, "what the directors did was not inconsistent with self-interest. In so doing, they breached their fiduciary duty."[117]

Notably, Richard J. appears to restrict the application of his test to the directorial power to issue shares from the corporate treasury. There is, however, little reason for having a separate test for determining the validity of the exercise of different directorial powers. Directors, in the exercise of their powers, have the same fiduciary obligations regardless of the power being exercised.

(d) *The Proper Purpose Doctrine vs. The Teck Test*

The law in Canada is unsettled.[118] Prior to the *EXCO* case, it was relatively clear that *Teck* reflected the state of Canadian law, or, at

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[114] According to Richard J.,

> [s]ection 38 of the by-laws of NSS&L clearly give the directors power and authority to issue shares from treasury. However, it is clear at law that such power must be exercised in the best interests of the company and not for any collateral purpose. Although there may be reasons for issuing shares other than the raising of capital, that appears to be the principal reason. I find that the share issues of November 1980 and July 1983 from the treasury of NSS&L were not primarily for the purpose of raising capital. There was no demonstrable pressing need for capital on either occasion.

Ibid. at 163, 35 B.L.R. at 258. The opinion is also significant in that, contrary to the developing trend in takeover cases, not one American case was referred to.

[115] *Ibid.* at 165, 35 B.L.R. at 261.

[116] *Ibid.* at 166, 35 B.L.R. at 262.

[117] *Ibid.*

[118] *See, e.g., Re Royal Trustco Ltd. (No. 3), supra*, note 92 at 315: "A perusal of [the *Teck*] decision makes it clear that the law on this point, while developing, is still in a somewhat unsettled state."; *EXCO, ibid.* at 165, 35 B.L.R. at 262: "there is no clear line of authority in this country with respect to this area of the law".

least the direction in which the law was quickly moving. *EXCO*, however, has revived the spectre of the old proper purpose doctrine and appears to have thrust this area of Canadian corporate law deeper into what Richard J. himself described as "a morass of conflicts and inconsistencies".[119]

The proper purpose doctrine is an inappropriate analytical tool in that it proceeds from the false premise that directorial powers are conferred with a particular, restricted purpose in mind.[120] The effect of the doctrine is to direct a misleading and often futile inquiry into the proper purpose of a particular power. This was partially recognized by the Privy Council in *Howard Smith*.[121] There is, as one might suspect, no hidden list of proper purposes for directorial powers. In most Canadian jurisdictions, directors' powers are conferred directly by the corporations statute and not, as in the case of English companies statutes, by the shareholders.[122] Thus, to determine the purpose of a directorial power, one looks to the statutory grant. If the purpose of the power is specified in the statute, any exercise of the power must be primarily for the statutory purpose. As one might also suspect, however, the statutory grant is usually worded in broad terms that give little indication of the particular purpose or purposes for the power. "In such a situation . . . the only restraint on the power is the general equitable obligation to operate in the best interests of the corporation."[123] As Berger J. noted in *Teck*, "[t]he impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose."[124]

In addition, the proper purpose doctrine also fails because of the difficulty in implementing its subjective inquiry into the minds of directors to determine their primary purpose. How can one determine with any precision the primary purpose of target directors? As previously discussed, the difficulty of this task is enhanced by the fact that the primary purpose of the board of directors is itself a conglomeration of the various purposes of each director.[125] Clearly, a more objective test is needed. Recognizing this, Berger J. in *Teck* stated:

> [H]ow is the Court to determine [the directors'] purpose? In every case the directors will insist their whole purpose was to serve the company's interest. And no doubt in most cases it will not be difficult for the directors to persuade themselves that it is in the company's best interests that they should remain in office.[126]

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[119] *EXCO*, *ibid.* at 161, 35 B.L.R. at 256.

[120] *See* Slutsky, *supra*, note 79 at 460.

[121] *Supra*, note 93 at 835, [1974] 1 All E.R. at 1134: "To define in advance exact limits beyond which directors must not pass is . . . impossible."

[122] Welling, *supra*, note 13 at 48-52, 337.

[123] *Ibid.* at 340.

[124] *Supra*, note 7 at 312, [1973] 2 W.W.R. at 410-11.

[125] *See supra*, text accompanying notes 66-67.

[126] *Supra*, note 7 at 315, [1973] 2 W.W.R. at 414.

Berger J. then proposed a more objective test for evaluating directors' conduct: "[i]f [the directors] decide, on reasonable grounds, [that] a take-over will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company".[127]

The test proposed by Richard J. in *EXCO* fails in its application. Richard J. proposed that, in order to demonstrate the discharge of their fiduciary duty, the target directors must demonstrate that the considerations upon which their decision was based are consistent only with the best interest of the company and inconsistent with any other interests. The problem with this test is that a proper exercise of directorial powers may in some cases also benefit the directors. In fact, in contests for corporate control, it may be argued that, regardless of how adverse a takeover bid may be to the interests of the corporation and its shareholders, no defensive measure taken by the target directors can be inconsistent with self-interest, since successful defensive measures will preserve the target directors' control. Thus, target directors will rarely, if ever, be able to discharge the burden of proof placed on them under this test.

The approach adopted by the *Teck* case affords a more modern view of the role of the directors in the context of a takeover bid. However, as discussed below, Richard J. was on the right track when he placed the burden of proof on the target directors.

(e) *The Burden of Proof*

While *Teck* represents a signficant step in the modernization of Canadian corporate law, the decision is not without fault. Berger J. ignored the fact that a takeover bid thrusts the directors of the target company into a conflict of interest position and that the burden of proof should therefore be placed on the directors. This conflict was recognized earlier by the American courts[128] and the issue was recently addressed by the Delaware Supreme Court:

> When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment. . . . There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.
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> . . .

[127] *Ibid.* at 317, [1973] 2 W.W.R. at 416.

[128] *See Bennett* v. *Propp*, *supra*, note 58 at 409; *Cheff* v. *Mathes*, *supra*, note 85 at 554-55.

> In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership.[129]

For the purpose of this analysis, a distinction should be made between an "inside" director and an "outside" director. An inside director is a director who is also employed by the corporation. An outside director is a director who is not employed by the corporation and the term includes directors who may do business with the corporation in another capacity, for example as an investment banker, financial adviser or outside legal counsel.

The case of inside directors confronted with an unsolicited takeover bid clearly presents a conflict of interest problem. There is an obvious and substantial interest in preserving the independence of their company and thus securing their jobs, salaries, status and other not inconsequential perquisites. In addition, a takeover bid may be viewed as an affront to the target-management's ability to manage the corporation efficiently and effectively.[130] The protection of the business judgment rule is only available to directors who are disinterested with respect to the transaction under challenge.[131] Since inside directors have a palpable interest in any takeover attempt, the business judgment rule should not apply and such directors are not afforded the presumption that, in making their decision and in taking their actions to resist an unsolicited takeover bid, they acted on an informed basis, in good faith, and in the honest belief that their actions were in the best interests of the corporation and its shareholders. As fiduciaries in a conflict of interest situation, such directors should have the burden of proving that their actions were fair and reasonable to the corporation and its shareholders.[132] The fairness and reasonableness of the directors' defensive actions are measured by the effect or the objectively-anticipated effect of the defensive action, and not by the directors' intentions in adopting the defensive action.[133]

Notwithstanding this obvious conflict of interest, the weight of the American authorities suggests that, in responding to an unsolicited

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[129] *Unocal*, *supra*, note 57 at 954-55.

[130] *See generally* F.H. Easterbrook & D.R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer* (1981) 94 HARV. L. REV. 1161; F.H. Easterbrook & D.R. Fischel, *Corporate Control Transactions* (1982) 91 YALE L.J. 698.

[131] *See Aronson* v. *Lewis*, *supra*, note 28 at 812.

[132] An analogy can be made to the statutory treatment of the avoidance of material contracts with the corporation in which a director is interested. In order for such a contract to withstand attack, it must be proved that, *inter alia*, it was reasonable and fair to the corporation at the time that it was approved. *See, e.g.*, *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, s. 115(7); Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4, ss. 132(7), 132(8).

[133] *Compare Ivanhoe*, *supra*, note 57 at 97,236 (Del. Ch. 1987) and *AC Acquisitions* v. *Anderson, Clayton & Co.*, 519 A.2d 103, 115 (Del. Ch. 1986).

takeover bid, inside directors are not tainted by any inherent self-interest.[134] The American courts appear to have deliberately blinded themselves to what seems to be a matter of common sense. There should be no question that a serious and inescapable conflict of interest arises when inside directors are faced with a contest for corporate control. It would be "impossible to command the [inside] directors in this situation to avoid any conflict of interest, since it has been unavoidably thrust upon them".[135] The better view would seem to be that, in the context of an unsolicited takeover bid, inside directors should not be afforded the presumption of the business judgment rule and such directors should have to demonstrate that their defensive actions were fair and reasonable to the corporation and its shareholders.

It is in this regard that the test proposed by Richard J. in *EXCO* was a movement in the right direction: he placed the burden of proof on the directors. Unfortunately, he did not appear to distinguish between inside and outside directors. At the risk of reading too much into his opinion, it seems that Richard J. viewed the entire board, inside and outside directors alike, as tainted with self-interest in retaining their positions.[136] As previously discussed, this approach is sensible with respect to inside directors. However, as discussed below, this approach cannot be sustained with respect to outside directors.

In most modern, publicly-held corporations, a majority of the board of directors usually consists of outside directors.[137] Thus, in the context of an unsolicited takeover bid, we are seldom faced with a situation where a majority of either the target board or the committee of directors which evaluates the takeover bid has an obvious and substantial interest in preserving the independence of the company. Generally, we are faced with a decision by target directors, a majority of whom are outside directors.

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[134] *See, e.g., Johnson* v. *Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980) (Since "control is always arguably 'a' motive in any action taken by a director", it should not be presumed to interfere with the exercise of his business judgment.); *Panter, supra*, note 22 (7th Cir. 1981). *See also Unocal, supra*, note 57 at 955. *But compare* the dissenting opinion of Cudahy J. in *Panter* at 300-01 ("Directors of a New York Stock Exchange-listed company are, at the very least, 'interested' in their own positions of power, prestige and prominence . . . [a]nd they are 'interested' in maintaining the public reputation of their own leadership and stewardship against the claims of 'raiders' who say that they can do better."). *See generally* Block, Barton & Radin, *supra*, note 28 at 86-90.

[135] H. Marsh Jr., *Are Directors Trustees?* (1966) 22 BUS. LAW. 35 at 60.

[136] *See EXCO, supra*, note 11 at 137, 35 B.L.R. at 217 ("the members of the board came to regard NSS&L as their own 'private club' or preserve").

[137] A recent American survey indicates that outside directors constitute approximately 75% of the board membership of major corporations: 16 FED. SEC. & CORP. DEV. 167 (27 January 1984). In some jurisdictions, a public company is required to have a minimum number of outside directors on its board. *See, e.g., Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, s. 97(2); Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4, s. 115(3).

Defensive actions by such a board present a more difficult and subtle problem. Outside directors do not have the same direct interest in retaining their control. Their livelihood does not generally come from their positions as directors of the target company. Since they are not directly involved in the actual day-to-day management of the corporation, a takeover attempt is less likely to carry the implication that they have been ineffectual as directors. Therefore, the argument is that outside directors are untouched by the conflicts that may affect inside directors and thus the exercise of their business judgment in a contest for corporate control is not subject to impeachment.

This argument, however, ignores the realities of the modern corporation. In public corporations, outside directors are typically selected by the chief executive and not by the board of directors and, in making these selections, most chief executives will take into consideration the inclination of the candidate to support management.[138] It would be naive to ignore the fact that outside directors realize that they owe their directorship to the incumbent management, notably the chief executive.[139] Moreover, it would be unrealistic to believe that the relationship between the chief executive and the board, as well as the "psychological constraints of the board room", will not contribute to a structural bias against actions by outside directors that appear contrary to the interests of their inside colleagues.[140]

On the other hand, while outside directors are typically selected by the chief executive, the selection is generally made on the basis of the business acumen of the candidate and the unique perspective that he can bring to the company's board. Outside directors are well aware of their responsibility to the corporation and the shareholders, especially in these litigious times. Loyalty and friendship to the chief executive is one thing; but outside directors are professionals and no professional is willing to risk substantial liability or the trauma of a lawsuit merely to retain a directorship.[141] Moreover, it is not uncommon nowadays for the outside directors to retain their own legal counsel and financial experts to advise and assist them in the discharge of their

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[138] *See* W.L. Cary & M.A. Eisenberg, CASES AND MATERIALS ON CORPORATIONS, 5th ed. (Mineola, N.Y.: Foundation Press, 1980) at 926; M. Mace, DIRECTORS: MYTH AND REALITY (Boston: Graduate School of Business Administration, Harvard, 1972) at 77-85.

[139] The remuneration to be had as an outside director is also not insignificant. A recent survey reported that, in 1986, outside directors of large American industrial companies earned an average of $26,095. Their financial industry counterparts earned an average of $22,468 (the amounts are in U.S. funds). D. Simpson, "Board Fees and Benefits" 11:3 DIRECTORS & BOARDS (Spring, 1987) 33 at 33.

[140] W. Werner, *Corporation Law in Search of its Future* (1981) 81 COLUM. L. REV. 1611 at 1663. *See also Panter*, *supra*, note 22 at 300-01 (7th Cir. 1987).

[141] Directors' liability insurance and corporate indemnification are overrated as a panacea for the ills of directorships; neither offers much comfort against the personal trauma and disruption of life caused by a multi-million dollar lawsuit.

fiduciary duties.[142] The outside director who also renders professional services to the corporation, for example, legal or investment banking services, should be treated no differently from his other outside colleagues on the board. These directors, because of their professional training and experience, usually have a heightened awareness of their duties to the corporation and its shareholders. There is little reason to believe that lawyer-directors or investment banker-directors, regardless of the fees that they earn from the corporation, would be willing to jeopardize their reputations and their professional careers to retain a client, any more than there is reason to believe that a lawyer who defends an accused in a criminal case for a large fee would be willing to breach his duty to the court for the sake of an acquittal.[143]

A board of directors, comprised of a majority of outside directors, should not be subject to the same burden of proof as a board dominated by inside directors. A balance has to be reached between the protection of the interests of the corporation and its shareholders and the presumption of good faith and due inquiry that the law affords the business judgment of disinterested directors. This balance can be achieved by placing the initial burden on the directors to prove that: (1) they had reasonable grounds for believing that the takeover bid presented a danger to corporate policy and effectiveness or would result in substantial damage to the company's interests; (2) their decision to resist the takeover bid and their defensive measures were the result of an informed business judgment based on an evaluation of all material information; and (3) the defensive measures adopted were a reasonable response to the threat posed by the takeover bid.[144] Once the directors prove the foregoing, the burden should shift to the plaintiff, who has the ultimate burden of proof, to prove that the directors' actions were primarily for the purpose of perpetuating themselves in office, or some other breach of the directors' fiduciary duties.[145]

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[142] *See, e.g.*, *Pogostin* v. *Rice*, 480 A.2d 619, 623 (Del. 1984); *Hanson*, *supra*, note 22. *See also* the recent developments concerning Allegis Corp., *supra*, note 51.

[143] A business association or a commercial relationship with the corporation or incumbent management, however, may contribute to a finding that such directors are not disinterested. *See, e.g.*, *Packer* v. *Yampol*, C.A. No. 8432 (Del. Ch. April 18, 1986) (available Oct. 7, 1987, on LEXIS, States Library, Del. file) (finding directors who were allied with a dominant director "interested" with respect to defensive actions designed to thwart a challenge to corporate control where the outside directors variously (i) had consulting contracts with the company and served on the boards of other companies controlled by the chief executive; (ii) served as accountant for the company and acted as tax adviser to the chief executive; (iii) served as a personal accountant for the chief executive and his family; and (iv) served as the personal lawyer for the chief executive and his family). *See* Sparks, *supra*, note 28 at 43-44.

[144] This is in fact the American position. *See* *Unocal*, *supra*, note 57 at 955; *Revlon*, *supra*, note 61 at 180 (Del. 1986); *Moran* v. *Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985); *Buckhorn*, *supra*, note 22 at 227 (S.D. Ohio 1987).

[145] *See Moran* v. *Household Int'l, Inc.*, *ibid.*; *Buckhorn*, *ibid.*

By placing the initial burden of proof on the directors, we recognize the inherent conflict that confronts directors in a contest for corporate control. This is consistent with traditional fiduciary obligations when a conflict of interest is apparent.[146] The "reasonable grounds" showing required by the directors is merely the second prong of the *Teck* test with the onus reversed. Directors are in a much better position than a plaintiff-shareholder to substantiate the reasonableness of their belief that the takeover bid presented a danger to corporate policy and effectiveness or would result in substantial damage to the company's interests. The "informed decision" showing is necessary to ensure that the directors complied with the standard of care required of directors. Again, directors are in a superior position to a plaintiff-shareholder to demonstrate their due care and should be prepared to show the basis for their actions. This does not mean that the court is to determine whether, on the basis of available information, it would have made the same decision and taken the same action as the directors. The inquiry is to determine whether the directors informed themselves, "prior to making a business decision, of all material information available to them".[147] The "reasonable response" showing is necessary because directors, although charged with protecting the interests of the corporation and its shareholders, do not have "unbridled discretion to defeat any perceived threat by any Draconian means available".[148] The "reasonable response" showing is closely related to the "informed decision" showing since, in order for the defensive action to be reasonable in relation to the threat posed, the directors must analyze the nature of the proposed takeover and the anticipated effects on the corporation and its shareholders.[149]

If the directors cannot meet the initial burden of proof, the plaintiff may not necessarily succeed on a claim for breach of the directors'

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[146] *See, e.g.*, Shepherd, *supra*, note 17 at 36:

> [T]o determine whether a fiduciary duty . . . has been breached, it is necessary in many cases to use presumptions, reverse onus provisions [and] special burdens of proof . . . in order to assist claimants in proving their claim. These evidentiary or procedural rules are required where the scope of a power's misuse, and the extent to which a fiduciary has the capacity to hide a breach, put a beneficiary at a disadvantage in litigating the issue.

See also Brudney, *supra*, note 17 at 271.

[147] *Aronson* v. *Lewis*, *supra*, note 28 at 812. *See also Revlon*, *supra*, note 61 at 181 (Del. 1986); *Smith* v. *Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Buckhorn*, *supra*, note 22 at 227 (S.D. Ohio 1987).

[148] *Unocal*, *supra*, note 57 at 955. Neither the interests of the corporation nor the shareholders can be served if "the cure promises to be significantly worse than the ailment". *Moran* v. *Household Int'l, Inc.*, 490 A.2d 1059, 1075 (Del. Ch. 1985), *aff'd*, *supra*, note 144.

[149] *See Revlon*, *supra*, note 61 at 180 (Del. 1986).

fiduciary duty. The consequence of the directors' failure to meet the initial burden of proof is that the directors must prove that their actions were fair and reasonable to the corporation and its shareholders. This is appropriate since, by failing to meet the initial burden of proof, the target directors have, in effect, failed to show that their actions were not tainted by their personal interest in resisting their own ouster. Thus, they should be subject to the same "fair and reasonable" requirement as inside directors in order to sustain their defensive actions.[150] It would not be sufficient for the directors to prove, for example, that they made an informed decision and that their response was reasonable; they must also prove that they had reasonable grounds. The absence of reasonable grounds would call into question whether the directors' purpose in resisting the takeover bid was to serve the interests of the corporation and its shareholders, or to perpetuate their control. The fact that they considered all available material information and that their defensive response was reasonable does not legitimize directorial actions taken in the directors' own self-interest. In this situation, to sustain their actions, the directors would have to prove that their actions were fair and reasonable to the corporation and its shareholders.

(f) *Teck, Olympia & York and EXCO Revisited*

The application of the modified *Teck* test, as described above, to the *Teck*,[151] *Olympia & York*[152] and *EXCO*[153] cases would not, in all likelihood, have produced different results.

In *Teck*, it is unclear whether a majority of the three-person board of directors of Afton Mines consisted of outside directors.[154] Assuming that a majority of the Afton directors were outsiders, they would bear

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[150] *See supra*, notes 128-33 and accompanying text. *See also Ivanhoe*, *supra*, note 57 at 97,236 (Del. Ch. 1987); *AC Acquisitions* v. *Anderson, Clayton & Co.*, *supra*, note 133 at 115.

[151] *Supra*, note 7.

[152] *Supra*, note 12.

[153] *Supra*, note 11.

[154] While it is clear that Millar, who was the president of the target company, was an inside director, there is little discussion in the opinion of Berger J. as to the relationship of the remaining directors, Price and Haramboure, to the company. *See supra*, note 7 at 294, [1973] 2 W.W.R. at 390-91. Assuming that a majority of the directors of Afton Mines were insiders, the burden would have been on the target directors to show that their actions were fair and reasonable to the corporation and its shareholders. The directors of Afton Mines would probably still have been able to discharge this burden for the following reasons: (1) they favoured Placer to Teck long before the threat of a takeover attempt by Teck; (2) they had reasonable grounds for preferring Placer to Teck; (3) the directors honestly believed that they were acting in the best interests of the company and its shareholders; and (4) even in the midst of a takeover bid, the directors refused to accept what they thought was less than a fair contract from Placer, but instead held out for a better contract and got it.

the initial burden of proving that: (1) they had reasonable grounds for believing that the takeover presented a danger to corporate policy and effectiveness, or would result in substantial damage to the company's interests; (2) their decision to resist the takeover bid and their defensive actions were a result of an informed business judgment based on an evaluation of all available material information; and (3) the defensive measures adopted were a reasonable response to the threat posed by the takeover.

The Afton directors would have satisfied the "reasonable grounds" criterion since Berger J. found that the directors had "misgivings regarding Teck's financial capacity, its technical expertise, its managerial strength, and its marketing experience".[155] They would have satisfied the "informed business judgment" criterion since their decision to reject Teck's overtures was based on their knowledge of Teck's reputation and abilities.[156] They would have satisfied the "reasonable response" criterion since the defensive measure adopted (entering into the ultimate deal with Placer and granting Placer a stock option) was intended to avoid the ultimate deal going to Teck, which they believed lacked the qualifications to quickly and efficiently put the mine into production.

The outcome of *Olympia & York*[157] on the issue of the directors' breach of their fiduciary duty would likely have been the same under the application of the modified *Teck* test. A majority of the Hiram Walker board consisted of outside directors. The Hiram Walker directors discharged the initial burden of proof by showing the following: (1) they analyzed the anticipated effects of the takeover on the company and its shareholders, and concluded that the premium offered by the bidder was unreasonably low; (2) they acted on the advice of legal and financial experts; and (3) the defensive measure adopted was designed to provide the Hiram Walker shareholders with a value significantly in excess of the premium offered by the bidder.

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[155] *Ibid.* at 319, [1973] 2 W.W.R. at 417. "Teck did not have the experience or personnel to match Placer's. Dr. Keevil, Jr., himself went so far as to concede that Placer was 10 years ahead of Teck." *Ibid.* at 297, [1973] 2 W.W.R. at 393.

[156] Millar, a geological engineer, must be considered an expert regarding mining affairs. Moreover, he had personally negotiated with Teck and other majors, so he and the board had a reasonable basis on which to form a conclusion. Admittedly, it may be argued that the directors should have retained experts to assist them in evaluating the Teck takeover bid. While this would undoubtedly have assisted the Afton directors in discharging their fiduciary duties, it is by no means essential to the discharge of their duties, especially where the directors or management is intimately familiar with the business and the players, as was the case with the Afton directors. *See, e.g.*, *Smith* v. *Van Gorkom*, *supra*, note 147 at 876: "We do not imply that an outside valuation study is essential to support an informed business judgment. . . . Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information."

[157] *Supra*, note 12.

A different result may have been reached in *Olympia & York*, however, if the applicants had been able to show that Hiram Walker actually controlled Fingas since, after the completion of the Fingas offer, Fingas would have held forty-eight percent of the outstanding voting shares of Hiram Walker. The forty-eight percent bloc would have been sufficient to represent *de facto* control of Hiram Walker. In turn, Hiram Walker would have controlled Fingas. If this were the case, the effect of the Hiram Walker defensive measure would have been to insulate the Hiram Walker directors from ever being removed from office. Such a defensive measure would, in all likelihood, have been an unreasonable response because it would have deprived all Hiram Walker shareholders of their fundamental right to oust directors.

An example of a similar kind of entrenchment occurred in *Ivanhoe.*[158] In that case, the directors of Newmont Mining Corp., in an attempt to defend against an unsolicited tender offer of Ivanhoe Partners, assisted Newmont's largest shareholder, Gold Fields American Corp., in a "street sweep"[159] of Newmont stock. The street sweep by Gold Fields was financed in large part by the declaration of a substantial dividend by Newmont. As a condition of declaring the dividend and as a means of protecting against Gold Fields seeking to acquire control of Newmont in the near future,[160] the Newmont board of directors insisted that Gold Fields enter into a standstill agreement that required Gold Fields to vote its shares in any election for directors in favour of the Newmont board's director-nominees. The Delaware Chancery Court found this provision of the standstill agreement to be unreasonable in relation to the threat posed by Gold Fields. In the words of the Court:

> By thus "locking up" Gold Fields' 49.9% stock interest, the standstill agreement guaranteed the incumbency of the Newmont Board (or their designees) and, as a practical matter, assured the defeat of any hostile takeover attempt for possibly ten years. That agreement operated, then, to entrench the Newmont Board. The reasonable goals of limiting Gold Fields' ability to acquire majority stock control (and control of the Newmont Board) did not require, for their accomplishment, entrenching the Board and "locking up" the company.[161]

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[158] *Supra*, note 57.

[159] A "street sweep" refers to "a rapid accumulation of a large block of [a] target corporation's stock, through open market or privately negotiated purchases or a combination of both". *Ibid.* at 97,223 (Del. Ch. 1987).

[160] Several years earlier, Gold Fields had attempted to acquire up to 50% of the stock of Newmont. Newmont resisted this attempt. Newmont and Gold Fields subsequently resolved their differences by entering into a standstill agreement. This standstill agreement preceded the standstill agreement that was at issue in the case. *Ibid.* at 97,225 (Del. Ch. 1987).

[161] *Ibid.* at 97,238. This issue was resolved prior to the appeal to the Delaware Supreme Court by the amendment by Newmont and Gold Fields of the standstill agreement to eliminate this provision.

However, it could not be demonstrated in *Olympia & York* that Hiram Walker controlled Fingas[162] and, as a result, there would be no basis for finding that the defensive response was unreasonable.

Notably, the Hiram Walker defensive measure may also be challenged on the basis that the Hiram Walker directors breached their fiduciary duty to the shareholders since, in the structuring of Fingas, fifty-one percent of the voting shares of Fingas were given to Allied-Lyons and two other corporations, for what was in the case of the latter corporations nominal consideration.[163] The precise basis of such a challenge is the statutory standard of care imposed on directors by paragraph 134(1)(b) of the Ontario *Business Corporations Act, 1982* and the success of such a challenge would turn on whether the Hiram Walker directors exercised "the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances".[164] This issue was not addressed by Montgomery J. and was not resolved on appeal by the Divisional Court.[165]

The outcome in *EXCO*[166] on the issue of the directors' breach of their fiduciary duty would most likely have been the same under the application of the modified *Teck* test. A majority of the NSS&L board of directors appeared to consist of outside directors. Unlike the Hiram Walker directors, however, the NSS&L directors did not appear to conduct any analysis of the anticipated effects of the takeover on the company and its shareholders. In fact, the directors' basis for concluding that the takeover bid was not in the best interests of the company and its shareholders is unclear. The opinion of Richard J. does not indicate whether the directors feared that the takeover would result in substantial damage to the company and its interests. In addition, in the absence of any articulated basis for resisting the EXCO takeover bid, the target directors would not be able to show that their decision to resist the bid and their defensive actions were a result of an informed business judgment based on an evaluation of all available material information. We need not even reach the third part of the modified *Teck* test regarding the reasonableness of the response. Assuming for the moment that the NSS&L directors were able to satisfy the first two parts of the test, they still would not discharge their initial burden of proof because they could not demonstrate the reasonableness of their response. The reasonableness of the response is related to the directors' reasons for resisting the takeover bid. In the absence of stated reasons, the reasonableness of the response cannot be estab-

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[162] *See Re Olympia & York, supra*, note 12 at 261, 37 D.L.R. (4th) at 199-200.

[163] *See Re Olympia & York, ibid.* at 281, 37 D.L.R. (4th) at 220; Simmonds, *supra*, note 101 at 631.

[164] S.O. 1982, c. 4. *See also Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, s. 117(1)(b).

[165] *See supra*, note 12 at 281, 37 D.L.R. (4th) at 219-20, Reid J.

[166] *Supra*, note 11.

lished. Thus, to sustain their defensive measure, the NSS&L directors would have to prove that their actions were fair and reasonable to the corporation and its shareholders.

4. *Learning from the American Experience*

The fast pace of the development of American jurisprudence in this area affords a valuable opportunity for the Canadian law to develop by learning from the United States experience. The American courts have addressed several aspects of the fiduciary duty of directors in resisting an unsolicited tender offer. Their approach to and resolution of these issues are of particular interest.

(a) *Duty to Oppose a Takeover Bid*

Do the directors have a right or duty to oppose a takeover bid that they believe is not in the interests of the company or its shareholders? Since a successful takeover defence generally deprives the target shareholders of the opportunity to decide on the merits of the offer, the root of this question is really whether the shareholders should have a right to consider the offer. This has been the subject of great debate.[167]

There is already authority in Canada that directors have a right, as well as a duty, to oppose takeovers which they believe on reasonable grounds are not in the best interests of the corporation and its shareholders. In *Teck*, Berger J., in discussing the right of directors to resist a takeover, stated that "[i]f they believe that there will be substantial

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[167] *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, *supra*, note 130 (takeovers are an important market mechanism for policing managerial inefficiency, thus managers should do nothing to interfere with the offer); W.H. Steinbrink, *Management's Response to the Takeover Attempt* (1978) 28 CASE W. RES. L. REV. 882 (since management is more knowledgeable than the ordinary shareholder about the worth and prospects of the company, it is in the best position to determine whether the company should be sold to the offeror); L.A. Bebchuk, *The Case for Facilitating Competing Tender Offers* (1982) 95 HARV. L. REV. 1028 (target management should facilitate competing bids rather than remain passive or obstruct the tender offer).

For Canadian commentaries, *see* F. Iacobucci, *Planning and Implementing Defences to Take-Over Bids: The Directors' Role* 5 CAN. BUS. L.J. 131 at 165-66 (shareholders should have the right of disposing of their shares and deciding who should run the company); P. Anisman, TAKEOVER BID LEGISLATION IN CANADA: A COMPARATIVE ANALYSIS (Don Mills, Ont.: CCH Canadian, 1974) at 292-93 (directors should be prohibited from issuing shares to frustrate a bid without shareholder approval). *See also* Canadian Securities Administrators National Policy No. 38, *Take-over Bids: Defensive Tactics* in (1986) 9 O.S.C. Bull. 4255 at 4256, which purports to regulate certain defensive actions in takeover bids ("[t]he administrators consider that unrestricted auctions produce the most desirable results in take-over bids [and appropriate action will be taken in the event of] defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid").

damage to the company's interests if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorized as improper".[168] This view was later affirmed by Reid J., who indicated that "[t]he right and indeed the obligation of directors to take steps that they honestly and reasonably believe are in the interests of the company and its shareholders in a take-over contest . . . is perfectly clear and unchallenged".[169]

There is much authority in the United States which supports the Canadian position. In *Northwest Indus., Inc.* v. *B.F. Goodrich Co.*, it was stated that "management has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders".[170]

Both the Canadian and the American positions are consistent with the fundamental premise of corporate governance: it is the function of the directors to manage the corporation. Management of the corporation includes responding to takeover bids. As the guardians of the corporate enterprise and the protectors of the interests of the shareholders, the directors have the responsibility for the evaluation of takeover bids and for the formulation and execution of appropriate responses.

The shareholders are not an appropriate decision-making body. The sheer size of the shareholder constituency renders it an awkward forum for decision-making. Moreover, the diverse and often conflicting interests represented by the shareholders, and the lack of knowledge of the average shareholder of the value of the corporation and its prospects, suggest that the determination of the corporation's response to an unsolicited takeover bid should not lie with the shareholders.[171] The directors, on the other hand, should know the "intrinsic value"[172] of the corporation better than anyone else. They are familiar with the corporation's "non-investor constituencies"[173] and the value of these

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[168] *Supra*, note 7 at 315, [1973] 2 W.W.R. at 413.

[169] *First City Fin. Corp.* v. *Genstar Corp.*, *supra*, note 44 at 646, 125 D.L.R. (3d) 303 at 319. *See also Re Olympia & York*, *supra*, note 12 at 271, 37 D.L.R. (4th) at 210.

[170] *Supra*, note 65 at 712. *See also Berman* v. *Gerber Prods. Co.*, *supra*, note 25 at 1323; *Heit* v. *Baird*, *supra*, note 65 at 1161; *Treadway Cos.* v. *Care Corp.*, *supra*, note 23 at 381; *Panter*, *supra*, note 22 at 1194-95 (N.D. Ill. 1980); *Revlon*, *supra*, note 61 at 1247 (Del. Ch. 1985).

[171] This should come as no surprise since it would be impossible for any republic, including a corporate enterprise, to function efficiently if major decisions were required to be made by referendum.

[172] *See supra*, note 107.

[173] This term is used to refer to persons, organizations or other entities who may or may not be shareholders of the corporation, but whose function, service or support is of significant value to the success or the corporation. Each person within a constituency generally shares the same interests vis-a-vis the constituency. The interest of a non-investor constituency is the collective interest related to that specific constituency without regard to the interest that that constituency may have as an actual investor.

constituencies to the corporation's future success. The directors are also better suited to negotiate more favourable terms with the bidder or to seek a superior offer from other parties. Finally, as the elected representatives of the shareholders, the directors are a more appropriate forum for the reconciliation of the diverse interests of the shareholders.[174]

The Canadian Securities Administrators in National Policy No. 38[175] appear to take the position that the success of an unsolicited takeover bid should be determined by the target's shareholders, and that the role of the target directors is merely to seek the best available offer. This position, however, essentially relegates target directors to the role of auctioneers and places the target company permanently on the auction block. While such a role is appropriate for the target directors when a sale of the target is inevitable, it is not an appropriate role for target directors who believe, in good faith, that the best interests of the company and its shareholders are better served by the company remaining independent. The position adopted by the Canadian Securities Administrators is inconsistent with both the existing Canadian case law and the fundamental premise of corporate governance that the directors' role is to manage the company. It is too early to tell what effect National Policy No. 38 will have on the fiduciary duties of target directors. It would, however, be unwise for courts to blindly follow the policy without first critically evaluating the assumptions upon which it is based, in light of the existing framework for analysis articulated by such cases as *Teck*.

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[174] *See also GAF Corp.* v. *Union Carbide Corp.*, 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985) ("[t]he exercise of independent, honest business judgment of an enlightened and disinterested Board is the traditional and appropriate way to deal fairly and even-handedly with both the protection of investors, on the one hand, and the legitimate concerns and interests of employees and management of a corporation who service the interests of investors, on the other. Where such a Board, which has been voted into office, exists, their judgment on corporate management, obligations and policy — and any actions appropriate in that regard — are and should be controlling. Such a result is necessary in order to maintain balance and serenity in the marketplace and in corporate affairs, and to make sure that the existing shareholders are not lost someplace in the shuffle."). As previously discussed, as a safeguard against directorial abuse of this authority, target directors, in order to withstand a challenge to their actions in resisting a takeover bid, should be required to bear the initial burden of showing: (1) they had reasonable grounds for believing that the takeover presented a danger to corporate policy and effectiveness or would result in substantial damage to the corporation's interests; (2) their decision to resist the takeover and their defensive measures were as a result of an informed business judgment based on an evaluation of all material information; and (3) the defensive measures adopted were reasonable in relation to the threat posed by the takeover attempt.

[175] *Supra*, note 167.

(b) *Non-investor Interests*

Are the directors entitled to consider the interests of non-investors in deciding whether to resist an unsolicited takeover bid? There is established case law that indicates that the directors' concern should be focused on profit-maximization.[176] "Directors are arguably prohibited from taking into account the interests of employees, creditors, consumers, or society at large unless it can be established that payments for such non-business purposes will in fact create a business benefit."[177]

It has been said that the modern, publicly-held corporation has a broader set of responsibilities than just the maximization of its shareholders' investment.[178] This issue has been addressed in several recent American cases where the courts have expressly permitted directors, in evaluating a takeover bid, to also consider non-investor constituencies[179] provided that there are rationally-related benefits accruing to shareholders.[180] Examples of non-investor constituencies that may be considered by target directors include "creditors, customers, employees, and . . . the community generally".[181]

A balance must be achieved, however, between the interests of the shareholders and the interests of the non-investor constituencies. While the interests of the latter are not unimportant, it must be remembered that it is ultimately the financial investment of the shareholders that is at stake. Accordingly, target directors, in evaluating a takeover bid, cannot allow their concern for the impact of the takeover on non-investor constituencies to override the interests of the shareholders.[182] The directors must show that, by adopting measures intended to protect the interests of non-investor constituencies, the shareholders also derived a related benefit.

Concern for non-investor constituencies generally arises in "break-up" or "bust-up" takeovers in which the offeror seeks to finance the

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[176] *Parke* v. *Daily News Ltd.* (1962), [1962] Ch. 927, [1962] 2 All E.R. 929; *Re Lee, Behrens & Co.* (1932), [1932] 2 Ch. 46, [1932] All E.R. Rep. 889.

[177] F. Iacobucci, M.L. Pilkington & J.R.S. Prichard, CANADIAN BUSINESS CORPORATIONS: AN ANALYSIS OF RECENT LEGISLATIVE DEVELOPMENTS (Agincourt, Ont.: Canada Law Book, 1977) at 295.

[178] *See, e.g.*, E.M. Dodd Jr., *For Whom Are Corporate Managers Trustees?* (1932) 45 HARV. L. REV. 1145; D.L. Engel, *An Approach to Corporate Social Responsibility* (1979) 32 STAN. L. REV. 1.

[179] *See supra*, note 173.

[180] *See, e.g.*, *Ivanhoe*, *supra*, note 57 at 97,487 (Del. 1987); *Unocal*, *supra*, note 57 at 955; *Revlon*, *supra*, note 61 at 176 (Del. 1985); *Buckhorn*, *supra*, note 22 at 227 (S.D. Ohio 1987). *Compare Herald Co.* v. *Seawell*, 472 F.2d 1081 (10th Cir. 1972).

[181] *Unocal*, *ibid.*

[182] In *Teck*, *supra*, note 7 at 314, [1973] 2 W.W.R. at 413, Berger J. was quick to note that, although directors are entitled to consider the interests of non-investor constituencies, "it would be a breach of their duty for directors to disregard entirely the interests of [the] shareholders".

acquisition by selling assets of the acquired company. Such takeovers usually displace a substantial number of employees of the target company and, depending on the nature and size of the target company, may materially and adversely affect the community in which the target company is located. Where target directors resist a break-up takeover in part because of concerns regarding the impact of the takeover on non-investor interests, the shareholders of the target company will generally derive a related benefit by a successful defence since the target's workforce and support in the community (both of which generally are essential for the success of any going concern) will be preserved.

If the response of the directors in resisting a break-up takeover is to negotiate an acquisition of the target company by another party who also intends to break up the company, concern for non-investor interests is inappropriate since the object is no longer the protection or preservation of the corporate enterprise but to sell it to the highest bidder; no rationally-related benefit can accrue to the shareholders by seeking to protect the interests of non-investor constituencies. In *Revlon*,[183] the directors of Revlon, in an attempt to defeat a break-up takeover attempt by Pantry Pride, negotiated a buy-out by a third party who also intended to partially liquidate the company. The Delaware Supreme Court held that, once a break-up of the company became inevitable, the directors could no longer seek to protect the interests of non-investor constituencies. The reality of the break-up of the company changed the duty of the board from

> the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities. . . . It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[184]

It should be noted that, if a decision is made by the target directors to sell the target company in the face of a takeover bid, their duty may also be transformed into that of auctioneers. This is so regardless of whether the suitor who the target directors wish to acquire

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[183] *Supra*, note 61 (Del. 1986).
[184] *Ibid.* at 182.

the company intends to break up the company after its acquisition.[185] This is as one would expect because the effect of a sale of the target company on the interests of the shareholders is the same regardless of the intentions of the acquiror.[186]

Canadian corporate law appears to have already rejected the classical view that directors should only be concerned with profit-maximization to the exclusion of any consideration of the interests of non-investor constituencies. In *Teck*, Berger J. stated that this outdated approach "must yield to the facts of modern life", and the directors, while they cannot entirely disregard the interests of shareholders, are able to consider the interests of employees and the community.[187]

Admittedly, permitting directors to consider the effects of a take-over on non-investor interests is not without its own problems. It has been argued that "it is a near impossibility to determine whether target

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[185] *See Edelman* v. *Fruehauf Corp.*, 798 F.2d 882, 886-87 (6th Cir. 1986); *Ivanhoe*, *supra*, note 57 at 97,490 (Del. 1987); *CRTF Corp.* v. *Federated Department Stores*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,680 (S.D.N.Y. 1988). However, the fact that the target directors essentially become auctioneers when a sale of the company is inevitable does not mean that the directors are precluded from considering material factors other than price in those circumstances. The target directors are entitled to consider material factors directly related to the maximization of the shareholders' return on their investments. Such non-price factors may include the type of consideration offered by the bidder, the time necessary to consummate the transaction and the risk of nonconsummation of the transaction. *In re J.P. Stevens & Co. Shareholders Litigation*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,726 at 98,385 n. 6 (Del. Ch. 1988).

[186] It has recently been held that the sale of control of a target company is sufficient to invoke the so-called "Revlon principle" and to impose on the target directors the duty to facilitate an auction for the company. In *Black & Decker Corp.* v. *American Standard Inc.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,685 (D. Del. 1988), the target directors, in an attempt to defeat an unsolicited takeover bid, proposed a recapitalization plan under which the stock ownership of the public shareholders would decrease from 92.6% to 45.5%, while the stock ownership of encumbent management and an employee benefit plan would increase from 4.8% to 23.9% and from 2.6% to 30.6%, respectively. The Court found that the recapitalization plan amounted to a sale of control of the target company. The Court held that a sale of control was equivalent to a sale of the company and, under the Revlon principle, the duty of the target directors was transformed to the maximization of the shareholders' return.

It seems, however, to be inappropriate to equate a sale of control with the sale of the company. The distinction is that the former does not involve the complete divestment of the interests of the shareholders, as does the latter. Consequently, in a sale of control, the interests of the remaining shareholders still require the protection of the target directors. If the sale of control is but a step in the ultimate sale of the company, the sale of control should not be viewed in isolation and it may be appropriate to treat the sale of control as a sale of the company. In addition, it should be noted that there may be cases when a sale of control will, by itself, be tantamount to a sale of the company. This may be so when, after the sale of control, the shares remaining in public hands represent an insignificant part of the total outstanding shares. Whether a sale of control amounts to a sale of the company in these cases requires a case-by-case determination.

[187] *Supra*, note 7 at 314, [1973] 2 W.W.R. at 412.

management is correct in its assessment of [the impact on non-investors of the takeover] since these effects cannot be objectively measured. . . [T]here is no basis for expecting an offeror to be less socially responsible than a target."[188] There are at least two responses to this argument. First, it is not the function of the court to determine if it would have made the same decision as the target directors. The court's function is to determine if there was a reasonable basis for the directors' belief. The burden is on the directors to demonstrate that they had reasonable grounds for believing the takeover presented a danger to corporate policy and effectiveness or would result in substantial damage to the company's interests, and when non-investor interests are considered, that this consideration will result in some rationally-related benefit to the shareholders. Second, since the directors have the responsibility for the management of the corporation, they are entitled, in the exercise of their business judgment, to determine the impact of the takeover and to formulate a response, even though the response may not please all shareholders.

In sum, it is submitted that Canadian corporate law permits directors to consider the impact of a takeover on constituencies other than shareholders, provided that there are rationally-related benefits accruing to the shareholders.[189]

III. How do Directors Satisfy Their Fiduciary Obligations?

Having discussed to whom the directors owe their fiduciary duty and the nature of their fiduciary obligations when faced with an unsolicited takeover bid, the question then arises of what the law requires a director to do in order to discharge his fiduciary duty. What does a director have to do to avoid liability when confronted with an unsolicited takeover bid? As previously discussed, directors whose primary or sole purpose in resisting a takeover bid is to perpetuate their control are clearly in breach of their fiduciary duty to the corporation and its shareholders. Also, target directors, a majority of whom consists of inside directors, who cannot show that their actions in resisting a takeover bid were fair and reasonable to the corporation and its shareholder, may be in breach of their fiduciary duty. Where a majority of the target directors consists of outside directors, the directors will probably be in breach of their fiduciary duty unless they can discharge the initial burden of showing: (1) they had reasonable grounds for believing that the takeover presented a danger to corporate policy and effectiveness or would result in substantial damage to the

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[188] Gelfond & Sebastian, *supra*, note 52 at 459.

[189] *But see* Iacobucci, Pilkington & Prichard, *supra*, note 177 at 296 ("[T]he classical approach remains firmly established. In this state of the law, directors who depart from single-minded profit-seeking are at considerable risk.").

corporation's interests; (2) their decision to resist the takeover and their defensive measures were a result of an informed business judgment based on an evaluation of all material information; and (3) the defensive measures adopted were reasonable in relation to the threat posed by the takeover attempt.[190] It is this last case which raises the most difficulties. What constitutes reasonable grounds? How does one reach an informed business judgment? What is a reasonable response to the takeover attempt?

The root of the difficulty lies in the fact that the Canadian case law has not articulated the duties of a director in evaluating and responding to a takeover bid. Consequently, it is difficult to determine what target directors have to do in order to satisfy their fiduciary obligations. This Part will discuss how target directors can attempt to discharge their fiduciary duties.[191] The uncertainties will be raised where they exist. An effort will be made to resolve them by analogy to the available American jurisprudence.[192]

A. *Discharging the Fiduciary Duty*

1. *Impartiality*

Since directors are fiduciaries, they must act in what they believe to be in the best interests of the corporation and its shareholders. Accordingly, in arriving at a decision to resist a takeover bid, the directors must comply with the strict impartiality that is required by virtue of their position as fiduciaries. They must objectively evaluate the merits of the offer without regard to their personal interests. The first step in the objective evaluation of the takeover bid should be to ensure that, at a minimum, a majority of the target directors who are responsible for evaluating the bid are outside directors. This is intended to avoid the directors having to bear the burden of proving that their actions were fair and reasonable to the corporation and its shareholders in the event of a challenge to their actions.[193] If a majority of the board consists of inside directors, the board should appoint a committee of outside directors to evaluate the bid and to make a recommendation to the board. Even where a majority of the board consists of outside

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[190] As discussed, the failure to discharge this initial burden means that the directors must prove that their actions were fair and reasonable to the corporation and its shareholders in order to avoid liability, *see supra*, text at xxx.

[191] For a useful Canadian commentary, *see* Coleman, *supra*, note 1.

[192] Some reference will also be made to American commentaries in this area. The following are particularly useful: Sparks, Balotti & Abrams, *supra*, note 28; Block, Barton & Radin, *supra*, note 28; Committee on Corporate Laws, *Guidelines for Directors: Planning for and Responding to Unsolicited Tender Offers* (1985) 41 BUS. LAW. 209; Fleischer, *supra*, note 63 at 217-37; Lipton, *supra*, note 6 at 120-24.

[193] *See supra*, text accompanying notes 130-33.

directors, it is preferable, but not essential, for the board to appoint a committee of outside directors to evaluate the bid.[194] This will further insulate the actions of the board from a challenge based on the inherent conflict of interest of the inside directors. The outside directors must, of course, exercise independent judgment. They should not "rubber stamp" the view of management or the inside directors.[195]

This is not to suggest that inside directors should not play a part in the evaluation of the bid. As the day-to-day managers of the corporation, the inside directors have greater knowledge and insight into the business of the corporation, including the "intrinsic value"[196] of the corporation and its prospects. Inside directors are an invaluable resource for the outside directors in assessing the takeover bid. Outside directors should take advantage of the knowledge and insight of the inside directors by involving them in the evaluation of the takeover bid and the options open to the corporation. However, the decision to accept or reject the takeover bid must be made by or on the recommendation of the outside directors, or, in the event that inside directors also vote on the action to be taken by the board, at least a majority of those directors voting to resist the takeover bid (if that is the decision) should be outside directors. The reasonableness of the directors' belief is materially enhanced where a majority of the board favouring the action consisted of outside directors.[197]

Outside directors are therefore in a pivotal position in the face of an unsolicited takeover bid. It is they who will, or should, determine the corporation's response. While the outside directors may, in fact, owe their position to incumbent management, they owe their allegiance to the corporation and its shareholders. Their evaluation of the takeover bid must be made independently of the desires of, or their sympathy for, incumbent management.[198] Because outside directors play such a

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[194] *See, e.g.*, *Unocal*, *supra*, note 57 at 950 (8 of the 13 directors were outside directors). *See* S.V. Simpson, *The Emerging Role of the Special Committee — Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest* (1988) 43 BUS. LAW. 665 on the use of a special committee of directors in corporate transactions that involve the potential for a conflict of interests among the directors, the corporation and the shareholders.

[195] *See Edelman* v. *Fruehauf Corp.*, *supra*, note 185 at 886 ("The evidence compels the conclusion that the directors simply 'rubber stamped' the management buyout proposal. In so doing they breached their fiduciary duty.").

[196] *See supra*, note 107.

[197] *See Unocal*, *supra*, note 57 at 955; *Moran* v. *Household Int'l, Inc.*, *supra*, note 144 at 1356; *Aronson* v. *Lewis*, *supra*, note 28 at 815.

[198] It is not uncommon, and rarely unwise, for the outside directors to retain their own financial and legal advisers to assist them in evaluating the takeover bid. *See, e.g.*, *Pogostin* v. *Rice*, *supra*, note 142 at 623; *Ivanhoe*, *supra*, note 57 at 97,227 n.7 (Del. Ch. 1987). In such event, the advisers retained by the outside directors should not have any ties or any significant previous relationships with the corporation or incumbent management. *See, e.g.*, *Hanson*, *supra*, note 22 at 268 n.2, 277. *See also* Simpson, *supra*, note 194 at 678-80.

pivotal role in contests for corporate control, they should not vote with their feet when faced with a board action that they believe is contrary to the best interests of the corporation and its shareholders. While resigning may arguably be an implied dissent, it is equally consistent with a tacit agreement not to rock the boat in a stormy situation. Moreover, while the resignation may signal the existence of a problem, it does nothing to resolve it. Instead of resigning, outside directors should vigorously dissent and speak out.[199]

2. *Informed Business Judgment*

To demonstrate that their actions were the result of informed business judgment, the directors must show that they apprised themselves of material information reasonably available to them. Material information includes information concerning the bid and the bidder, a full evaluation of the bid (including strengths, weaknesses and legal issues raised), copies of the relevant documents (or at least accurate summaries thereof), reports concerning the value or the range of values of the target company and an assessment of its prospects, and reports of financial and legal experts.[200]

The directors should be able to demonstrate an understanding of the facts and issues involved. Accordingly, the directors should insist on a full presentation of the facts and a complete discussion of the issues prior to making a decision. Where management reports are used, the outside directors, in view of the apparent conflict of interest of management, should be especially critical of the report to ensure that they agree with the assumptions made in the report and that the report does not only address management's side of the issues. Proposals for defensive measures must be similarly approached by the directors.[201]

One of the best methods by which directors can demonstrate the exercise of their informed business judgment is to retain experts and to rely on their expert advice.[202] The *Canada Business Corporations*

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[199] *See* I. Barmash, "How Bendix Board was Split by Sharp Debate Over Allied" *The New York Times* (Sept. 24, 1982) D4 (resignation of some of the outside directors of Bendix Corp. during the attempt by Bendix to take over Martin Marrietta Corp. and the defensive tactic of Martin Marrietta to acquire Bendix). *See also EXCO, supra*, note 11 at 143-44, 35 B.L.R. at 227-28 (resignation of director after board approval of defensive measures).

[200] *See Buckhorn, supra*, note 22 at 230-31 (S.D. Ohio 1987); *Smith* v. *Van Gorkom, supra*, note 147 at 872-74; Sparks, Balotti & Abrams, *supra*, note 28 at 47.

[201] The directors are not expected to read every contract or legal document, or to know all of the particulars and intricacies of defensive tactics which they approve. The directors are expected, however, to demonstrate an understanding of all the relevant facts and issues. *See Moran* v. *Household Int'l, Inc.* 490 A.2d 1057, 1078 (Del. Ch. 1985), *aff'd supra*, note 144 at 1356; *Smith* v. *Van Gorkom, ibid.* at 883 n.25.

[202] *See* Lipton, *supra*, note 6 at 121-23 for a discussion concerning the use of experts.

Act expressly provides that directors are able to rely in good faith on the report of "a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him".[203] The use of independent experts by the directors to evaluate the takeover bid suggests two things. First, an objective assessment of the offer was conducted. This will lend support to demonstrate that the directors had reasonable grounds for their belief and their response was reasonable. Second, the directors exercised informed business judgment in deciding to resist the bid, if that is their decision. This will assist the directors in showing that their decision to resist and their defensive measures were based on an evaluation of all material information. It is important that the experts be independent, or else their effect may be neutralized by inferences of collusion. The directors should bring the experts into the picture as soon as there is any indication of a takeover bid.[204]

However, only good faith reliance upon experts is legitimate. Any attempt by the directors to utilize experts "to camouflage an improperly-motivated decision to oppose a takeover"[205] will likely do irreparable damage to the directors' defence against a shareholder suit.[206] Moreover, good faith reliance is not the equivalent of blind reliance. The directors have an obligation "to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it".[207] If reasonably possible, expert reports should be made available to the directors in advance of any decision to be made with sufficient time to digest the reports. The directors should inquire as to the basis of the reports, the underlying assumptions and the reasonableness of the assumptions. The directors should not be quick to accept a report just because it was prepared by an expert. The directors should be critical of the report in order to determine whether the report is complete, whether they agree with the underlying assumptions and whether they support the conclusions in the report.[208]

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[203] S.C. 1974-75-76, c. 33, s. 118(4). This is identical to Ontario's *Business Corporations Act, 1982*, S.O. 1982, c. 4, s. 135(4) and is substantially similar to the American Bar Association's MODEL BUSINESS CORP. ACT, *supra*, note 26, §8.30(b).

[204] This was exemplified in *Panter*, *supra*, note 22, when target directors immediately retained outside counsel to opine on the anti-trust aspects of the proposed takeover. The Court appeared to place much emphasis on the target directors' reliance on experts as evidence of the legitimacy of the decision to resist the bid. In *Treadway Cos.* v. *Care Corp.*, *supra*, note 23 at 384, the Court used the fact that the target directors had engaged an investment banking firm to assist in the negotiations and in the evaluation of proposed mergers as some evidence of the exercise by the directors of business judgment. *See also Unocal*, *supra*, note 57 at 951.

[205] Fleischer, *supra*, note 63 at 204.

[206] *See Royal Indus., Inc.* v. *Monogram Indus., Inc.*, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,863 (C.D. Cal. 1976).

[207] *Hanson*, *supra*, note 22 at 275.

[208] *See, e.g.*, *ibid.* (the Court found that the directors did not adequately inform themselves of the basis of the financial adviser's report and the underlying assumptions).

If experts are retained, they should be given sufficient time under the circumstances to formulate their opinions. Hastily prepared opinions under circumstances where more time was available create the suspicion that they were not carefully prepared and thus may receive less weight in court.[209] Therefore, the expert should be able to demonstrate the basis of his advice or opinion and the sufficiency of such basis for the advice or opinion rendered. Once the directors have requested the advice of experts, they should follow the advice, absent compelling reasons to the contrary. A decision by the directors not to accept the requested advice may naturally lead to an inference that the directors are not acting in good faith.[210]

Although it appears that an outside valuation report or a fairness opinion is not essential to support an informed business judgment,[211] conventional wisdom suggests that the prudent director should not act before obtaining such a report or opinion. The valuation process, however, is inherently manipulable due to the subjectivity of the art.[212] Thus, in order to enhance the weight of the valuation report or fairness opinion, the directors should retain a financial expert who has no interest in the corporation and no significant ties to incumbent management.[213] Ideally, the financial adviser should have no prior material involvement with the parties. However, given the relatively small number of major players in the investment banking industry and the broad range of different services marketed by these players, it is probably unrealistic to expect that the corporation or its management will not have had some prior dealings with the financial adviser sought to be engaged.

3. *Business Purpose*

To state the obvious, it is preferable for the directors to take defensive measures because of a belief that the offeror or its offer is undesirable and state that as a reason, rather than holding that belief and, for example, attempting to justify a share issuance to a friendly

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[209] *Royal Indus., Inc.* v. *Monogram Indus., Inc., supra*, note 206. *Compare Smith* v. *Van Gorkom, supra*, note 147 at 874; *Hanson, ibid.* at 275.

[210] *See Norlin Corp.* v. *Rooney Pace Inc., supra*, note 31; *Podesta* v. *Calumet Indus., Inc.*, [1978 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶96,433 (N.D. Ill. 1978).

[211] *Smith* v. *Van Gorkom, supra*, note 147 at 876 ("Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.").

[212] *See, e.g.*, R. Schmitt, "Suspect Opinions" *Wall Street Journal* (Mar. 10, 1988) 1.

[213] *See Edelman* v. *Fruehauf Corp., supra*, note 185 at 885 (the investment banker retained by the outside directors was also engaged in negotiating a buyout by the target management).

party on the fictitious basis that the corporation required capital. Once the alleged corporate purpose has been proved to be nonexistent, the motives of the directors will then be suspect.[214] If the directors do not believe on reasonable grounds that the offer is not in the interests of the corporation and its shareholders, and the proposed "defensive" measure has no legitimate corporate purpose, then they should question whether they want to interfere with the takeover bid. In other words, a court will likely be reluctant to find that target directors discharged their fiduciary duty if reasonable grounds do not exist to support the directors stated belief regarding the undesirability of the takeover bid.

4. *Scrutiny of the Offeror*

According to *Teck*, target directors are allowed to consider who is seeking control and why.[215] They are also entitled to consider the reputation, experience and policies of the offeror.[216] There is no clear guidance, however, on how these considerations should be weighed in arriving at a decision on a takeover bid. What happens if, for example, the offering price is extremely good but the business policies of the offeror are extremely bad? Which one takes precedence? How do the directors accommodate the interests of the tendering shareholders with the interests of the non-tendering shareholders? The tendering shareholders are not concerned with the identity of the offeror, its business practices or why it seeks control. They are divesting. Their only concern is price. On the other hand, the non-tendering shareholders are concerned about the identity of the offeror and its plans for the company. By opposing the bid, the directors will be impliedly favouring the non-tendering minority. By doing nothing, they disadvantage the non-tendering minority.

To resolve these issues, one must again look to the functional structure of the modern public corporation. As previously discussed, shareholders have consented to the conferral upon directors of the duty and power of management of the corporate enterprise. This includes the power to resolve the conflicting interests that often arise in the context of a takeover bid.[217]

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[214] *See Podesto* v. *Calumet Indus., Inc.*, *supra*, note 210. *Compare Howard Smith*, *supra*, note 93.

[215] *Teck*, *supra*, note 7 at 315, [1973] 2 W.W.R. at 413. *See also Unocal*, *supra*, note 57 at 956 (the board was entitled to consider the reputation of an offeror who was nationally known as a person who engages in the practice of initiating unsolicited takeover bids for the purpose not of acquiring the target company, but of inducing the target company to repurchase at a premium any target company stock acquired by him); *Ivanhoe*, *supra*, note 57 at 97,487 (Del. 1987).

[216] *Teck*, *ibid.* at 317, [1973] 2 W.W.R. at 415-16.

[217] To police against directorial abuse of this power, the directors bear the initial burden of proof. *See*, *supra*, note 174.

As a result, the directors have the power, and indeed the duty, to resolve the conflicting interests that surface in a contest for corporate control. The proper exercise of this power and the discharge of this duty are accomplished when the directors act in good faith and on the basis of all material information. It does not matter that a court would not have made the same decision as the directors. The courts will not second-guess the decisions of directors.[218] What matters is whether the directors made these difficult decisions in good faith and on the basis of all material information.

It should be noted that the case for the consideration of the credentials and the intentions of the offeror is even more compelling in the context of a partial bid[219] and in an exchange offer.[220] In a partial bid, many shareholders may be forced to retain their investment (unless they choose to sell in the market) under the control of the offeror if the takeover bid is successful. In an exchange offer, the shareholders of the target company are merely exchanging their investment in the target company for an investment in the offeror. In both a partial bid and an exchange offer, there will be a continuing investment by the shareholders which, if the takeover bid is successful, will be under the control of the offeror. Thus, the interests of even tendering shareholders may dictate that the target directors consider the reputation, experience and policies of the offeror.

5. *Non-investor Interests*

Teck rejected (or at least dealt a serious blow to) the theory that, in a contest for corporate control, the target directors could only be concerned with the objective of profit-maximization. The better view seems to be that target directors are entitled to consider the interests of non-investor constituencies in evaluating a takeover bid. As previously discussed, a balance must be achieved between the interests of the shareholders, on the one hand, and the interests of the non-investor constituencies, on the other.

Directors, in evaluating a takeover bid, should not allow their concern for the impact of the takeover on non-investor constituencies to override the interests of the shareholders. If the directors' decision to resist a takeover bid is based solely on their concern for non-investor interests, or if a defensive measure is intended to protect non-investor interests, the directors must be able to show that, by resisting

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[218] *See, e.g.*, *Crouse-Hinds Co.* v. *InterNorth, Inc.*, *supra*, note 34 at 702 ("the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility").

[219] A partial bid is a takeover bid for less than all of the outstanding shares of the target company.

[220] An exchange offer is generally a takeover bid where the consideration offered is securities of the offeror.

the takeover bid or adopting the defensive measure, the shareholders also derived a related benefit. Generally, this will not be too difficult if the directors' objective is for the company to continue intact and independently as a going concern since the future success of the company (and thus the welfare of its shareholders) is intertwined with such non-investor constituencies as the employees, the community, suppliers and customers.

If the directors' defensive tactic is to seek a suitor more to their liking than the unsolicited bidder, it is doubtful whether concern for non-investor interests is appropriate. In such a case, the object of the directors is not to protect or preserve the corporate enterprise but to sell it to the highest bidder. Under those circumstances, it will be difficult to demonstrate that a related benefit will accrue to the shareholders by seeking to protect the interests of non-investors.[221]

The prudent director will have some concern for non-investor interests but should make his paramount concern the interests of the shareholders.[222]

6. *Hasty Actions*

It is clear that target management is usually forced to act quickly in a takeover bid situation. A court, however, may infer that the primary purpose of the directors was to retain control if they cause the company to enter into an improvident transaction, as a defensive measure, without proper investigation.[223]

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[221] *See, e.g.*, *Revlon*, *supra*, note 61 at 182 (Del. 1986); *Edelman* v. *Fruehauf Corp.*, *supra*, note 185 at 886-87; *Ivanhoe*, *supra*, note 57 at 97,234 (Del. Ch. 1987), 97,489-90 (Del. 1987).

[222] An affirmative step to clarifying the extent to which non-investor interests may be considered may be taken by the directors by obtaining the adoption of a shareholders' resolution expressly enabling the directors to consider such interests in the event of a takeover bid. *See* Steinbrink, *supra*, note 167 at 906. Note an amendment to the certificate of incorporation of Control Data Corporation proposed by management: "The Board of Directors of the Corporation, when evaluating [certain takeover and related transactions], shall . . . give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation . . . and on the communities in which the Corporation . . . operate[s] or . . . [is] located." Proxy Statement, Management of Control Data Corp. (March 20, 1978) (for annual meeting of stockholders on May 3, 1978) in Steinbrink, *supra*, note 167 at 906 n.57.

[223] In *Royal Indus., Inc.* v. *Monogram Indus., Inc.*, *supra*, note 206, the target hastily and in an unprecedented manner acquired another company at an improvident price without a *bona fide* investigation. This conduct led the Court to conclude that the sole purpose of the directors was to perpetuate their control. *See also Condec*, *supra*, note 25; *Smith* v. *Van Gorkom*, *supra*, note 147 at 874.

A decision made in haste in the absence of any external time constraints may render the decision suspect.[224] The directors should take advantage of whatever time is allowed them to make a decision. The directors should also make as informed a decision as the circumstances permit. The use of accurate summaries of material contracts and strategies, and presentations by (and question and answer sessions with) experts are valuable in assisting directors in acting quickly and in an informed manner.[225]

7. *Reasonable Response*

To meet their initial burden of proof, the target directors must show that the defensive measures adopted were a reasonable response to the threat posed by the takeover attempt. This showing is closely related to the requirement that the directors demonstrate that their decision to resist the takeover attempt, and their defensive measures, were the result of an informed business judgment based on an evaluation of all material information. In order for the defensive measure to be a reasonable response in relation to the threat posed, the directors must have analyzed the proposed takeover bid and the anticipated effects on the corporation and its shareholders. A defensive measure is a reasonable response if its intended effect is to protect against the harm expected to be caused by the proposed takeover. In other words, the defensive measure must be directly related to the directors' reasons for rejecting the takeover bid.[226] It should be noted that a defensive measure is not a reasonable response merely because the target directors intended that the effect of the measure was to protect against the harm anticipated from the unsolicited takeover. The defensive measure adopted should be *reasonably* intended to protect against the anticipated harm in that there should be a reasonable basis for believing that the measure will have the anticipated effect. On the other hand, directors should not be required to be insurers of their actions. Thus, it would be inappropriate to require the target directors to show that the defensive measure would, in fact, have the anticipated effect.

The defensive measure is less likely to be a reasonable response if it will cause permanent damage to the company. Target directors

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[224] *See, e.g., Hanson, supra,* note 22 at 275 ("The directors manifestly declined to use 'time available for obtaining information' that might be critical given 'the importance of the business judgment to be made'. . . . [T]he SCM directors' paucity of information and their swiftness of decision-making strongly suggests a breach of the duty of care.").

[225] *See, e.g., Moran* v. *Household Int'l, Inc., supra,* note 144 at 1356 (effective use by target directors of summaries and presentations).

[226] *See, e.g., Re Olympia & York, supra,* note 12. The stated reason for the rejection by the Hiram Walker directors of the takeover bid was that the price was inadequate. The defensive measure adopted was a reasonable response since it was designed to realize more value for the shareholders.

cannot resist a takeover attempt at all costs. If the defensive measures inflict greater harm on the corporation and its shareholders than the anticipated harm of the proposed takeover, the natural inference to be made is that the actions of the directors were taken in order to preserve their positions. Consequently, to discharge their fiduciary obligations, target directors must, throughout the takeover attempt, evaluate continuously any proposed defensive actions in light of the current offer. It may be that the offer will be improved to address the stated concerns of the target directors. In such an event, unless the improved offer raises other concerns, further defensive actions will be inappropriate.

IV. CONCLUSION

One cannot make conclusive statements about the fiduciary obligations of directors in resisting an unsolicited takeover bid because Canadian courts have had little opportunity to address this issue and those that have addressed this issue have failed to produce a consistent and viable framework for analysis. The earlier cases used the proper purpose doctrine which restricted the exercise of directorial powers to the purposes for which the powers were conferred. This, however, resulted in a very difficult subjective inquiry to determine the primary purpose of the directors, and often resulted in a misdirected inquiry to ascertain the specific purpose of a directorial power, when none was stated by the source conferring the power.

Teck[227] represented a dramatic development in Canadian corporate law. Unfortunately, the advances that were made by *Teck* may have been diminished by the recent decision in *EXCO*,[228] which has cast more uncertainty upon the state of this area of the law. Not only did *EXCO* reintroduce the old proper purpose doctrine into the mainstream of Canadian corporate law, but it also appears to attempt to re-establish the relevancy of English company-law cases to Canadian corporate law. *EXCO* did offer one desirable development: it attempted to shift the burden of proof to the target directors. One would assume that this was in recognition of the inherent conflict of interest that confronts target directors in a takeover bid. The failure to recognize this was the primary failing of Berger J.'s opinion in *Teck*. Unfortunately, however, in *EXCO*, Richard J. failed to distinguish between inside and outside directors. The burden of proof required to be discharged by target directors should vary depending upon whether a majority of the board of directors consists of inside or outside directors.

Notwithstanding the shortcomings in the opinion of Berger J., the decision in *Teck* brought this area of Canadian corporate law into the

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[227] *Supra*, note 7.
[228] *Supra*, note 11.

modern era and, to some extent, tied the development of Canadian corporate law to American corporate law. That, in itself, was a significant step; it allowed us the benefit of the wealth of American jurisprudence in this area. Unfortunately, however, this area of Canadian law has not developed as rapidly or as steadily as one would have expected. Sixteen years after Berger J.'s seminal decision, we are still trying to determine the effect of *Teck* on Canadian corporate law.