



# Rewriting the Rules of the Takeover Game

Activist shareholders turned the Sears Canada deal upside down, confounding investors, boards and executives alike. But it was far from unique. How the new corporate warriors are bringing fundamental change to the way that the largest companies are bought and sold

---

By Julius Melnitzer

If M&A deals in Canada over the last year or so were a reality series, addicted watchers might want to look at re-runs of its most engaging episode, Companhia Vale do Rio Doce's (CVRD) luck at winning the hearts of Inco shareholders, even as Falconbridge succumbed to Xstrata's wooing. Lessons learned there are likely to be edifying when it comes to predicting what future installments might look like.

The entertaining multiparty drama featured friendly bids, hostile bids, international complications, hedge funds, arbitrageurs and legal powers like Davies Ward Phillips & Vineberg LLP for Xstrata; Heenan Blaikie LLP for Phelps Dodge; Lang Michener LLP for Teck Cominco; McCarthy Tétrault LLP for Falconbridge; Osler, Hoskin & Harcourt LLP for Inco; and Stikeman Elliott LLP for CVRD. But it also obscured the significance of a simple but important fact that is reshaping Canada's M&A and corporate governance environment: neither CVRD nor Xstrata negotiated with the boards of Inco or Falconbridge.

William Braithwaite of Stikeman Elliott, which represented Brazil's CVRD, puts it succinctly: "The winning bidders won by going directly to the shareholders."

Put another way, it turned out that the order of the corporate universe appears to have changed in fundamental ways that many counsel and their clients are still digesting: essentially, the shareholders were more important than the boards when it came to deciding the fate of either target.

"It used to be that a board of directors' recommendation to accept or reject an offer carried the day with shareholders," observes Donald Ross of Osler. "It was worthwhile to negotiate with the board because, for the most part, if you made a deal with them, you had a deal.

"Now boards can't carry shareholders to the same degree and bidders who negotiate with boards may be setting themselves up for further negotiations with minority shareholders in which the deal with the board becomes the floor. Unfortunately, this has made boards less relevant in some important ways."

The driving force behind this historic shift? Shareholder activism. And what fuels shareholder activism

is the growing heft and pervasiveness of hedge funds in North American capital markets. There are almost 10,000 hedge funds in the US and they control over \$1 trillion in assets. Some estimates suggest that hedge funds are responsible for 40 per cent of the volume on the New York Stock Exchange. "The intervention of hedge funds means that the shareholder profile can change significantly from the time of the first offer until the time you get to the end of a deal," Braithwaite notes.

With the change in profile comes a change of dynamics. "Whenever there's a deal announced at a premium to the market, anywhere from 10 to 30 per cent of the shareholder base bails out," says Garth Girvan of McCarthy Tétrault. "Hedge funds and arbitrageurs come in and displace a lot of the institutional shareholder base.

"So now what you have are important shareholders whose sole intent is to sell as quickly as they can at a higher price than they paid, which is a short-term approach. That conflicts with the duty of boards, which must take into account the value of the corporation as an operating enterprise in the longer term."

Hedge funds can even be the catalysts that put companies in play. That's partly because they often give less deference to special committees and their recommendations than the ordinary investor: the result is that they can dilute boards' influence over shareholder decision-making. Hedge funds have gone so far as to challenge independent directors' decisions to accept a premium price even where there is no competing proposal.

They are also proving that they are willing to employ broader and tougher tactics—especially litigation, the threat of litigation, risk-taking and brinksmanship—than arbitrageurs typically do. "These days some activist shareholders are prepared to throw a lot of money at trotting off to regulators and the courts even on a long shot," Braithwaite says.

Intensifying their clout, hedge funds are also adept at acting collectively: increasingly, they are gaining support from institutional investors who continue to hold onto their shares but are more willing

# Hedge Funds 101

The invasion of the hedge funds and their particular brand of shareholder activism is a recent phenomenon in Canada. So it's instructive to take a look at the American experience.

Andrew Brownstein, an M&A practitioner at Wachtell, Lipton, Rosen & Katz in New York, has a few tips for practitioners who encounter these funds in the M&A context. His advice includes the following:

- Hedge funds will scrutinize transactions to find an angle allowing them to extract a quick profit. They will resort to all sorts of tactics in pursuit of their goal, including "playing poker" with acquirers. In structuring and presenting transactions, acquirers need to manage these situations carefully and be willing to call any apparent bluffs;
- Many hedge funds move in loosely aligned packs, testing the limits of securities, reporting, and antitrust rules by taking advantage of the ambiguities in legislation and regulation. Companies should be prepared to hold them accountable if they cross the line;
- Proxy advisory firms should not be treated as neutral parties, but

*...continued on page 5*

to abandon their traditional support of management for aggressive or quiet support of shareholder activism.

"Even long-term institutional investors are on occasion becoming more outspoken than they have been in the past," says Andrew Brownstein, an M&A practitioner at Wachtell, Lipton, Rosen & Katz in New York. "The fusion of aggressive hedge fund activism and the power of large institutional shareholders is a potent formula that can energize an activist campaign."

Still, it's only recently that hedge funds have started throwing their weight around in Canada. And recently, they have been doing so with a vengeance. "Canadian markets have become so globalized that hedge funds have become important investors in this country," says Andrew Fleming of Ogilvy Renault LLP. "But hedge funds treat Canadian markets like they treat US markets. They're not asking whether they can do the same things in Canada that they can do in the US. They're asking why they can't."

More and more frequently, the funds get no satisfactory answer to the question, as Sears Holdings Corporation, the US parent of Sears Canada Inc., discovered to its dismay. In December 2005, Sears Holdings announced its intention to take its Canadian subsidiary private by buying the 46 per cent of outstanding shares the parent company did not already own. To do so, Sears Holdings required the approval of a majority of the minority shareholders of Sears Canada.

Sears Holdings got off to a good start, bringing on board Montreal's Natcan Investment Management and its 9.1 per cent stake. Sears Canada's special committee obtained a valuation at \$19-\$22.25 a share, even as hedge

funds were buying shares at \$18 on the open market. Unimpressed, Sears Holdings refused to raise its offer beyond \$17.97 a share.

Sears Canada's independent directors rejected the bid. Sears Holdings responded by threatening to eliminate Sears Canada's quarterly dividends and by entering into support agreements with the Bank of Nova Scotia, Scotia Capital and the Royal Bank of Canada. In return for the banks' support, Sears Holdings agreed to restructure the takeover so that the banks could preserve tax benefits that were not available to all shareholders.

Sears Holdings also entered into an agreement with US investment fund Vornado Realty LP. Vornado agreed to support the bid in return for a release from any claims relating to Vornado's dealings in Sears Canada shares. Sears Holdings did not disclose either the agreement with the banks or with Vornado in its bid filings.

In April, Sears Holdings announced it had sufficient support to do the takeover. But by this time the hedge funds—including a group made up of Pershing Square Capital Management L.P., Knott Partners Management, LLC, and Hawk-eye Capital Management, LLC—had accumulated a significant position in Sears Canada. Having purchased the shares at \$18, they weren't going down without a fight. "Even at the early stages, Pershing's press releases made it clear that they were prepared to litigate," says Mark Gelowitz of Osler, who represented Sears Holdings.

And prepared they were. The hedge funds filed a complaint with the Ontario Securities Commission alleging that Sears had violated securities law. Still, the Street regarded the complainants as decided underdogs, the general consensus being that "hedge fund" was still a dirty word in Canada and that the OSC and

Reprinted with permission from the February 2007 issue of the Lexpert Magazine. © Thomson Carswell.

the courts would see Pershing and its collaborators in that light.

But that's not how it played out and in fact, the OSC took the position that the funds had a good case. The commission ruled that Sears' disclosure was inadequate and that the US company had granted illegal collateral benefits to the banks and Vornado. It prohibited the banks and Vornado from voting their shares. The Divisional Court unanimously upheld the OSC and the Court of Appeal refused leave to appeal.

Without the banks' votes in support, Sears Holdings' bid failed. And the battle isn't over yet. William Ackman, who runs Pershing, recently purchased another 4.5 million Sears Canada shares, bringing the fund's stake to 13.2 per cent.

"There aren't many takeover bids that come along where the OSC feels compelled to stop a bid in its tracks because of the conduct of the bidder," says Kent Thomson of Davies, who represented the Pershing Group dissidents. "It's a clear signal from the OSC that it will not hesitate to intervene in transactions of this nature where it has reason to be concerned that minority shareholders are not being treated fairly and equally."

In other words, *Sears* raises the risk in takeover bids: it demonstrates that, at least so far as the OSC and Ontario's courts are concerned, hedge funds may be carnivorous, but they are entitled to be treated like real people too.

**M**ost real people, however, don't have as much money to risk as hedge funds do. And that's what makes these American interlopers particularly effective. "Let's face it, there's a lot of truth to the saying that all hedge funds have telephone numbers starting with area code 212

[Manhattan]," says McCarthy Tétrault's Girvan.

Which is to say that they have the wherewithal to pursue their goals. "It's not unusual for funds have a bigger legal budget than the company does," says James Hodgson of Hodgson Shields DesBrisay O'Donnell MacKillop Squire LLP.

The upshot is that real time M&A litigation is now here to stay in Canada. Take, for example, the \$400 million friendly offer made by Gold Fields Ltd., one of the world's biggest gold exploration and development companies, to buy Bolivar Gold Corp., a corporation incorporated in the Yukon and listed on the TSX. Friendly the offer may have been, but uncomplicated it was not. That was thanks to the intervention of Scion Capital LLC, an American hedge fund with assets of \$750 million and a major shareholder in Bolivar, whose principals felt that Gold Fields' offer wasn't rich enough.

The intensity and cost of the brawl that followed was indistinguishable from similar litigation in the US. Take the involvement of counsel from Bennett Jones LLP, Davies, Osler, and Stikeman Elliott, and the supporting roles played by Wildeboer Dellelce LLP, one of Canada's foremost securities law boutiques, and Blake, Cassels & Graydon LLP.

Bolivar was a junior gold mining company which had partnered with Gold Fields in financing the development of its Venezuelan properties. With the price of gold rising, even as the confrontational policies of Venezuelan President Hugo Chavez held down Bolivar's share price, Gold Fields approached Bolivar in November 2005 with an offer of \$3.00 per share.

By November 20, the parties had a letter agreement, backed by an opinion from GMP Securities Ltd., that \$3.00

*...continued from page 4*

rather as potential players who can make a difference. As these firms deal with high volumes of business in short time frames, lawyers must ensure that the proxy firms accurately understand the company's position;

- Both acquirer and target should analyze the likelihood that a hedge fund or group of hedge funds could accumulate a position that enables them to hold up a transaction. In this context the parties should be aware that, in larger transactions, the hedge funds may require the support of traditional institutional investors and proxy firms;
- Deals subject to "supermajority" or "majority of the minority" approval are particularly vulnerable to the machinations of hedge funds;
- Situations where boards have rejected nominally higher offers, perhaps because they were subject to regulatory risk, are also high profile targets for activists, and companies should take great care to maintain a proper record of a board's decision to reject any offer; and
- Some hedge funds use litigation to challenge specific aspects of transactions rather than blocking them entirely. Companies should be careful to structure and present their transaction in a way that will not give activists unnecessary leverage in this regard.

*J.M.*

## REWRITING THE RULES OF THE TAKEOVER GAME

per share was a fair price and in the interests of shareholders. Bolivar shares had never traded that high. Still, gold was at \$485 per oz., a significant rise from the \$415 the metal brought at the end of 2003.

Over the next 10 days, Bolivar and Gold Fields negotiated a definitive arrangement agreement. The agreement, announced on December 1 and supported by a further independent valuation, contemplated a plan of arrangement to be approved by the Supreme Court of the Yukon Territory, the jurisdiction of Bolivar's incorporation. Bolivar set a shareholders' meeting and vote for January 12.

The price of gold, however, had risen again, standing at \$493 on November 30. That left Scion, a US fund that was a major investor in Bolivar, very unhappy. But six weeks of press releases, circulars and proxy solicitations produced no movement from Gold Fields. All the while, Scion was raising its stake in Bolivar to 19 per cent.

The day before the shareholders meeting, Scion brought an application in the Ontario Superior Court of Justice that alleged breaches of the takeover bid and insider trading provisions of the province's *Securities Act*. Gold Fields responded by raising its offer to \$3.20 on the morning of the hearing. But 20 cents wasn't enough to satisfy Scion. The fund's lawyer, Luis Sarabia of Davies, unsuccessfully sought a delay of the meeting before Justice Geoffrey Morawetz of the Superior Court of Justice.

Undaunted, Sarabia and colleague Ed Babin brought another application in the Yukon (where Scion had filed for a "fairness hearing" to oppose the plan of arrangement) seeking to adjourn the meeting. After hearing the motion by conference call, Justice Ronald Veale, whose remarks during argument may have reflected a more generalized distaste for Scion's type of intervention, also ruled against the fund.

"At one point, Veale expressed his opinion that there was no need to adjourn the meeting simply because Scion was trying to get more money out of the deal," says Katherine Kay of Stikeman Elliott, who represented Gold Fields.

Scion fared no better at the shareholders' meeting the next day, where 76 per cent (10 per cent more than the two-thirds required), voted in favour of the deal. "The shareholders spoke and we believed that would be the end of it," Kay says.

But Gold Fields and Bolivar hadn't counted on Scion's tenacity, its willingness to take risks, and the extent of its resources. Within minutes of the vote, Sarabia made it clear that Scion would continue with both the Ontario and Yukon applications.

In early February, however, Morawetz dismissed the Ontario application. Soon afterwards, following a four-day hear-

ing, Veale approved the plan of arrangement and dismissed Scion's oppression action. Undeterred, Scion followed up with an expedited appeal to the BC Court of Appeal (which hears appeals from the Yukon), again to no avail.

The deal closed in Toronto within hours of the Court of Appeal's ruling. One would have thought that would be the end of it. But there are a lot of things about shareholder activism that don't go quite as expected. And *Re Bolivar* didn't disappoint.

The Yukon OBCA, like many corporate statutes, provides for a "dissent" hearing. While the "fairness" hearing determines whether a transaction will be approved, the dissent hearing allows shareholders who have voted against the deal to argue that they should be paid a better price for their shares. Scion brought such an application. In the spring of 2006, Gold Fields and Scion settled the matter on confidential terms.

On its face, Bolivar and Gold Fields won. But that wasn't the whole picture. The increase in the offer from \$3.00 to \$3.20 represented a \$5 million gain for Scion. The Street also has it that the dissent settlement allegedly put another \$3 million into the fund's pockets, more than covering the costs of litigation.

In other words, the hedge fund didn't win, but it didn't lose either, a fact that likely did not elude shareholder activists like the Pershing group behind the subsequent Sears litigation. It hasn't escaped the attention of boards and management either. "From what I can see, this type of litigation will ultimately be the face of M&A transactions going forward," says Craig Nelsen, executive vice-president of exploration for Gold Fields.

**B**ut it's not just M&A transactions in which shareholder activism has asserted itself. The dynamic of activism inspired by the hedge funds is allowing minority shareholders of all stripes to set agendas for many corporations.

"US hedge funds have taken their investment approach to Canada and they've had reasonable success with it," says Wes Hall, president of Kingsdale Shareholder Services Inc. "Their success has forced boards and management to take complaints from all kinds of majority shareholders—not just hedge funds—seriously."

Setting the agenda takes the form of pressuring boards to enhance share value by paying special dividends, buying back stock, or selling divisions. In the US, hedge funds have watered down hostile bid defenses by forcing boards to dismantle poison pills, promoted majority voting for directors, and successfully attacked classified boards.

A similar pattern is emerging in Canada. Most famously, Baker Brothers, a Wall Street investment firm, launched a successful proxy fight in early 2006 to replace the board of AnorMed, the Vancouver biotechnology firm behind the much-ballyhooed cancer drug Mozobil.

Baker Brothers became upset about the dilution of its interest when AnorMed's board announced its support of a bought share issue at a price the investment firm thought too low. AnorMed's board, perhaps motivated by the growing profile of activist shareholders, overreacted.

"The company resorted to defensive takeover tools when Baker Brothers had no intention of acquiring a controlling interest," says Berl Nadler of Davies, who represented Baker. Still, Nadler says that shareholder activism in a non-M&A context is the wave of the future. "More and more of these types of proxy bids—more aggressive, more proactive and more beneficial to the company than in the past—are emerging in Canada," he says. "That's a good thing because this type of action empowers groups who are interested in fixing companies."

However that may be, the new board did its job of fixing the company—and did it fast. Following a bidding war that began in August 2006 at US\$380 million, AnorMed's shareholders garnered US\$580 million when Genzyme, a major US biotech concern, bought the company. All's well that ends well, apparently.

Which is not to say that it's all roses for minority shareholders seeking to flex their activist muscles. In *McEwen v. Goldcorp Inc.*, Ontario's Divisional Court nixed a minority shareholder's attempt to force a shareholder vote, in the absence of a specific statutory requirement to do so.

The ruling involved Goldcorp Inc.'s \$8.6 billion acquisition of Glamis Gold Ltd., a BC corporation. The parties had structured the transaction as an arrangement of Glamis under BC's *Business Corporations Act* in which Goldcorp acquired all of Glamis' shares in exchange for Goldcorp shares and a nominal cash consideration. If two-thirds of Glamis' shareholders approved the deal, the BC legislation allowed Goldcorp to force the dissenting shareholders to exchange their shares. Goldcorp's board approved the transaction but did not put it to a shareholder vote.

Robert McEwen, Goldcorp's largest individual shareholder and former chairman and CEO, maintained that Ontario's *Business Corporations Act* required the approval of Goldcorp's shareholders for the Glamis transaction. His lawyer, Joseph Groia of Groia & Company, asked the Ontario Superior Court for a declaration embracing that requirement.

But both the Superior Court and the Divisional Court dismissed the application. They ruled that courts should not

interfere with the directors' choice of transactional structure where there was no statutory requirement for a vote and no oppression.

Despite the ruling, the future of shareholder activism in Canada is likely to be eventful. "Boards everywhere must realize that they can no longer take for granted the traditional deference afforded by shareholders to sophisticated, well-advised independent directors acting in good faith and with due care," says Brownstein. "Activist shareholders are increasingly skeptical of directors' will and ability to protect their interests. That's why it's more important than ever for companies to be proactive in explaining the reasons for and benefits of a transaction."

Sensitivity to the interests and views of significant shareholders is crucial, he adds, because early and open communication may save boards from being blindsided by investor dissent later.

It won't be long before this advice is tested. On the horizon is Royal Dutch Shell's anticipated \$7.7 billion bid to take Shell Canada private.

All indications are that it wouldn't hurt Royal Dutch to take a long, hard look at the new face of activist shareholders in Canada before launching its bid. ▀

---

*Julius Melnitzer is a freelance legal affairs writer.*

### Opening their own Pandora's Box?

From England comes news that two large hedge fund firms, Brevan Howard Asset Management LLP and Polygon Investment Partner LLP, plan to raise capital by listing on public markets. Not only does this open them up to a wider shareholder base that includes average investors, it also exposes these shareholder activists to the same activism that hedge funds—at least in North America—commonly impose on others.

Listing hedge funds or fund firms also makes them subject to greater regulatory scrutiny and limits their unique ability to short stock and use financial derivatives. But that doesn't appear to have deterred what appears to be an emerging trend in Europe.

The largest ever single fund listing occurred in December 2006, when Marshall Wace LLP raised almost US\$3 billion on Euronext Amsterdam. Two firms specializing in emerging markets, Ashmore Group PLC (London Stock Exchange) and Charlemagne Capital Ltd. (Alternative Investment Market) listed in London last October.

Finally, another UK hedge fund manager, Polar Capital Markets, announced that it would list the entire firm on the London Stock Exchange in February 2007.

*J.M.*