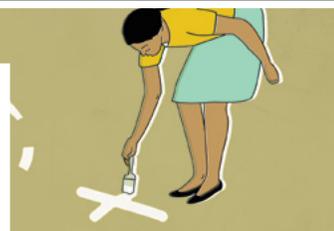


The Maturing Market for Shareholder Activism in Canada

by Andrew MacDougall & Noralee Bradley



Ongoing exposure to sophisticated shareholder activism in Canada is moving Canadian corporations to take a more proactive approach.

The Changed Landscape

Until recently, corporate Canada had little experience with proxy contests. Battles were few and principally resulted from a breakdown at the board level or between management and a substantial shareholder. This has changed. The emergence of tactical economic players, including well-financed players that can afford to take on some of Canada's largest companies, has led to increased activist activity and changes in company practice.

Corporate Canada now recognizes that shareholder activism has itself become a species of investment strategy in a diversified portfolio – and one that offers the hope of high short term performance to bolster portfolio returns during a period of economic uncertainty. And while large institutional investors in Canada may prefer to work behind the scenes to instigate change, they have demonstrated that in the right circumstances they will support someone else leading the charge.

The Rules They Are A-Changing

In response to pressure from both institutional shareholders and issuers, Canadian regulators are re-examining many of the rules and practices surrounding shareholder voting matters. The TSX now requires all listed issuers to provide shareholders with the ability to vote for individual directors rather than voting on a single slate, and to adopt a majority voting policy for the election of directors or explain why it has not done so. The Canadian Securities Administrators are

considering whether to (i) reduce the threshold for triggering share ownership reporting requirements (from 10% to 5%) and expand the content of the report, (ii) make changes to the proxy voting infrastructure, and (iii) introduce guidelines for companies providing proxy voting advice.



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The increased number of proxy contests has spawned increased litigation. Results have generally favoured the corporation and its management and board, but not always. Every situation is dependent on the specific facts and circumstances.

In favour of the corporation, courts have permitted:

- advance notice provisions for director elections;
- a company to disallow dissident votes where materially deficient disclosure was not corrected despite prompt notice of the deficiency; and
- a shareholder meeting to be held more than six months after receiving a shareholder requisition.

At the same time, in favour of dissident shareholders, courts have:

- declared a telephonic voting system used by a corporation to be deficient; and
- permitted a beneficial shareholder to requisition a shareholder meeting through an intermediary without providing the same information required from a registered shareholder.



Structural Responses to Activism

The initial reaction by Canadian corporations to the changed environment has been to consider the adoption of a range of structural defences to proxy contests, such as the following:

Advance Notice Provisions – A long-standing gap in structural defences in Canada compared to the U.S. has been the absence of company by-law provisions requiring advance notice to the corporation of any intention to propose nominees for director. Although a common U.S. practice, it was rare to find a Canadian company with such provisions. As a result, it has been possible for a dissident to propose director nominees with little or no notice to the corporation or other shareholders prior to the vote. This has changed. A large number of Canadian companies have now adopted such a provision and many more are in the process of doing so.

Enhanced Quorum Provisions – A smaller number of Canadian issuers have adopted an enhanced shareholder quorum provision that would increase the quorum requirement to a majority of the outstanding shares entitled to vote, in person or by proxy, for meetings at which shareholders

are being asked to vote on a contested matter, including but not limited to changes to board seats. Whether this will become a common practice in Canada is unclear, however, as ISS Canada has announced it will no longer explicitly recommend in favour of such provisions.

Prohibitions on Third Party Compensation Arrangements – Recent controversy over special compensation arrangements for director nominees of dissident shareholders has prompted issuers to adopt prohibitions against director compensation arrangements provided by third parties. While activist shareholders have justified such arrangements on the basis that it helps attract qualified director candidates and aligns their interests with the shareholders' interests, critics are concerned that such arrangements may adversely impact independence and lead both to fragmentation of the board and to excessive risk-taking. Even so, in the U.S., ISS has expressed concern about the broad scope of the wording of the prohibition and the possibility that it may result in the absence of highly qualified individuals and entrench the existing board and management.

Such measures will not, however, deter a serious shareholder activist. And there remain several features of Canadian law which provide structural advantages to activist shareholders including:

- the right to obtain the names and holdings of participants in the Canadian Depository for Securities and the names, addresses and holdings of beneficial owners in Canada who did not object to such information being provided without the consent or approval of the corporation;
- the ability to submit names of additional director nominees for shareholders to consider at the annual meeting, which the corporation must include in its proxy circular for the meeting;
- the ability to solicit proxies from up to 15 shareholders without complying with proxy solicitation rules;
- the ability to solicit proxies by public broadcast;
- the absence of a specific deadline prior to the meeting to commence a formal solicitation process; and
- the ability to requisition a special meeting of shareholders to replace directors.

Two further structural factors can work in favour of shareholder activists in Canada:

- share ownership reporting requirements are not triggered until a 10% threshold is reached (in the U.S. the threshold is 5%); and
- a shareholder rights plan that restricts the acquisition of a shareholding above a 20% limit can usually be successfully overturned after sufficient time has elapsed.

A Proactive Strategy

Strategic shareholder activists do their homework. They analyze the corporation's performance, strategy, capitalization, management and governance, assess alternatives and develop a plan they believe will increase returns to shareholders. They test their plan with larger investors and modify their approach accordingly. By the time the activist approaches management, they have a developed analysis, a sense of their support and a strategy for building further support through media relations and, if necessary, a proxy contest. Sophisticated companies are responding by taking a proactive approach.

A key starting point for management and boards is to seek advice from external legal and financial advisors on areas of potential vulnerability, and strive for an objective assessment of the corporation's strategy and plans, available alternatives and the reasons for not pursuing alternatives. Some corporations are actually conducting exercises with their management and boards and creating a game plan that can be implemented upon a first contact with an apparent activist shareholder – similar to planning exercises for unsolicited/hostile take-over bids.

Companies are also assessing their practices for communicating their strategy to investors, including, where appropriate, the reasons for not pursuing alternatives that an activist might propose. Clearly and consistently articulating the corporation's strategy and the rationale for pursuing that strategy can help build resiliency against criticism by an activist shareholder.

Shareholder engagement practices are also being re-examined, with companies gathering better information about the composition of their shareholder base and identifying more effective ways to engage with different classes of investors. Boards are considering ways to obtain more frequent feedback, and more independent sources of feedback, from investors on strategy and performance.

The activists' strategy of extensive advance planning, getting their message out front, reinforcing it frequently and modifying it as necessary has worked well. With a similar commitment to advance planning, a communications strategy, shareholder engagement and the right professional advice, corporations can reduce the likelihood of a proxy contest or increase the likelihood of success if a fight is unavoidable.

CONTRIBUTORS



Andrew MacDougall
Partner, Corporate
amacdougall@osler.com
416.862.4732



Noralee Bradley
Partner, Corporate
nbradley@osler.com
403.260.7002