



FRASER MILNER CASGRAIN LLP

Takeover Battles: New Limits on Maximizing Shareholder Value?

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Directors of a company that is 'in play' have a fiduciary obligation to maximize shareholder value. One would have thought that this rule would always prevail. However, in *Ventas Inc v Sunrise Senior Living Real Estate Investment Trust*⁽¹⁾ the courts of Ontario preferred to subject the rule to an important exception: a 'superior proposal' that would otherwise maximize shareholder value will be prohibited from being considered by the target's directors and shareholders if it is made in contravention of the auction process established to sell the target company.

Facts

In September 2006 the board of trustees of Sunrise Senior Living Real Estate Investment Trust, a Canadian public real estate investment trust whose units are listed on the Toronto Stock Exchange, determined that it would conduct a sale of the units or assets of Sunrise through a confidential auction process. Purchasers that were approached by Sunrise's financial advisers and were interested in exploring a possible acquisition were required to enter into confidentiality agreements which also contained standstill provisions. Two of the parties which entered into confidentiality agreements with Sunrise and made initial bids included Ventas, Inc, a healthcare real estate investment trust with shares listed on the New York Stock Exchange, and Health Care Property Investors, Inc, a self-administered real estate investment trust. Ventas's agreement with Sunrise included a provision whereby the standstill clause would no longer apply if Sunrise entered into an agreement to sell more than 20% of its assets to a third party. Health Care Property Investors' agreement did not contain a similar provision.

Following the first round of bidding, Sunrise invited Ventas and Health Care Property Investors to conduct further negotiations and submit final binding bids, warning each that they should not assume that they would be given the opportunity to renegotiate or improve their offer. At this stage, Ventas submitted a second offer, while Health Care Property Investors withdrew from the auction. Thereafter, Sunrise and Ventas entered into an acquisition agreement pursuant to which Ventas would acquire all of Sunrise's assets for approximately C\$1.138 billion, representing a price of C\$15 per Sunrise unit, provided that Sunrise's unit holders voted in favour of the acquisition. Sunrise subsequently issued a press release to this effect, notified Health Care Property Investors of the agreement with Ventas, requested the return of Sunrise's confidential materials and reminded Health Care Property Investors of its obligations under the terms of its confidentiality and standstill agreement with Sunrise.

Health Care Property Investors then submitted a proposal to acquire all of Sunrise's assets at an amount representing C\$18 per Sunrise unit and issued its own press release

announcing that it had done so. Ventas and Sunrise each filed urgent applications in the Commercial List (a specialized section of the Ontario Superior Court of Justice with expertise in commercial matters) and Health Care Property Investors was joined as a necessary party.

First Instance Decision

In essence, the issue was whether (i) as argued by Ventas, Clause 4(4)(8)(v) of the purchase agreement required Sunrise to enforce the standstill provisions of its confidentiality agreement with Health Care Property Investors, or (ii) as argued by Health Care Property Investors and Sunrise, Clause 4(4)(3) of the purchase agreement provided for a 'fiduciary out' that allowed the trustees to consider Health Care Property Investors' proposal and thereby maximize unit holder value. The salient provisions of the purchase agreement were as follows:

"4.4(1) Following the date hereof, Sunrise shall not...

(i) solicit, initiate, encourage or otherwise facilitate... the initiation of any inquiries or proposals regarding, or other action that constitutes, or may reasonably be expected to lead to, an actual or potential acquisition proposal;

(ii) participate in any discussions or negotiations in furtherance of such inquiries or proposals or regarding an actual potential acquisition proposal or release any person from, or fail to enforce any confidentiality or standstill agreement or similar obligations to Sunrise or any of its subsidiaries...

(3) Notwithstanding anything contained in Section 4(4)(1), until the unit holder approval, nothing shall prevent the board from withdrawing or modifying, or proposing publicly to withdraw or modify its approval and recommendation of the transactions contemplated by this agreement, or accepting, approving or recommending or entering into any agreement, understanding or arrangement providing for a bona fide written, unsolicited acquisition proposal (that did not result from a breach of Section 4(4)) if and only to the extent that ...

(ii) the board, believes in good faith (after consultation with its financial adviser and legal counsel) that such acquisition proposal constitutes a superior proposal and has promptly notified the purchasers of such determination ...

(8) Sunrise shall ...

(v) not amend, modify, waive or fail to enforce any of the standstill terms or other conditions included in any of the confidentiality agreements between Sunrise and any third parties." [\(2\)](#)

The applications judge interpreted Section 4(4) of the purchase agreement to impose a clear and unambiguous obligation on Sunrise to enforce the standstill provisions of its confidentiality agreement with Health Care Property Investors and any other third parties. In doing so, the judge found, among other things, that the scheme of the purchase agreement was to enforce standstill agreements that had been signed as part of the auction process. The court found that it was a reasonable form of protection for Ventas, which also permitted Sunrise to consider proposals in good faith from third parties which were not subject to standstill provisions. The applications judge also referred to the fact that the parties to the purchase agreement were sophisticated and had been represented throughout by prominent law firms and financial advisers.

Ontario Court of Appeal Decision

In dismissing subsequent appeals by Sunrise and Health Care Property Investors, the Ontario Court of Appeal defined the central issue in the same narrow fashion as the court of first instance - namely, whether the provisions of Section 4(4) of the purchase agreement imposed an obligation on Sunrise to enforce the standstill provisions of its agreement with Health Care Property Investors. This can be contrasted with at least one potential alternative characterization of the issue before the court - that is, whether an apparent obligation to enforce standstill provisions could be sustained where the enforcement of the standstill would deprive unit holders of greater value for their units.

The court found that the applications judge had correctly applied the relevant principles of contractual interpretation and agreed that an important purpose of Section 4(4) was the enforcement of standstill agreements entered into by participants in the auction process. The court further rejected Sunrise's and Health Care Property Investors' arguments that the fiduciary out clause applied to any 'acquisition proposal', as that term was defined in the purchase agreement, finding instead that it applied only to proposals which were not in breach of Section 4(4) of the purchase agreement.

The court effectively held that a superior bid by a participant in the auction process which remained subject to a standstill was not in good faith and, therefore, was not permitted under the fiduciary out clause in Section 4(4)(3).⁽³⁾ Moreover, the court noted, like the applications judge, that the fiduciary out clause could have read as follows: "Notwithstanding anything contained in Section 4(4)(1) or Section 4(4)(8)." Further, the court declined to apply the US authorities relied upon by Sunrise and Health Care Property Investors, which suggested that a target vendor can place no limits on the directors' right to consider superior offers and that any provision to the contrary is invalid and unenforceable.⁽⁴⁾ In this regard, the court concluded as follows:

"The trustees did not contract away their fiduciary obligations. Rather, they complied with them by setting up an auction process, in consultation with their professional advisers, that was designed to maximize the unit price obtained for Sunrise's assets, in a fashion resembling a 'shotgun' clause, by requiring bidders to come up with their best price in the second round, subject to a fiduciary out clause that allowed them to consider superior

offers from anyone save only those which had bound themselves by a standstill agreement in the auction process not to make such a bid. In this case that turned out to be only Health Care Property Investors.

An auction process is well accepted as being one - although only one - appropriate mechanism to ensure that the board of a target company acts in a neutral manner to achieve the best value reasonably available to shareholders in the circumstances... I do not think the trustees can be said to have failed in the exercise of their fiduciary obligations to their unit holders in these circumstances simply by agreeing in the purchase agreement to preclude earlier bidders, which had bound themselves under standstill agreements not to do so, from coming in after the auction was concluded and the successful bidder had showed its cards and attempting to top up that bid."⁽⁵⁾

Implications

The applications judge and the court of appeal both commented that the Sunrise unit holders had the option of voting against the Ventas transaction (which would permit Sunrise to terminate the purchase agreement) if they were of the view that a better offer might be possible. Although both courts couched these statements in general terms, it is clear that they were referring to the possibility that Health Care Property Investors might resurface with its bid should Sunrise unit holders reject the transaction with Ventas. Curiously, the courts may thereby have inadvertently paved the way for entities such as Health Care Property Investors to interfere with transaction agreements between a target and a prospective purchaser. In the future other bidders which find themselves subject to standstill agreements might announce bids which they know are likely to be in contravention of their standstill obligations in order to disrupt acquisition agreements subject to shareholder votes, in the hope of persuading enough shareholders to reject the transaction on the basis that a more favourable offer might surface.⁽⁶⁾

Some might express surprise at the apparent lack of difficulty the courts had in overriding the principle of shareholder value maximization. However, others would likely insist that the decision simply enforces the importance of maintaining the integrity of the auction process. In any event, it is clear that contracts must be drafted clearly and unambiguously to ensure that the intended result is achieved.

For further information on this topic please contact [Michael Schafler](mailto:michael.schafler@fmc-law.com) or [Matthew Fleming](mailto:matthew.fleming@fmc-law.com) at Fraser Milner Casgrain LLP by telephone (+1 416 863 4511) or by fax 1 416 863 4592) or by email (michael.schafler@fmc-law.com or matthew.fleming@fmc-law.com).

Endnotes

- (1) 2007 CarswellOnt 1705 (CA), affirming 2007 CarswellOnt 1704 (SCJ - Comm List).
- (2) In addition to the no-shop and fiduciary out provisions of Section 4(4) reproduced herein, the purchase agreement contained a right-to-match provision and contemplated that Ventas would receive a break fee if it declined to match a superior proposal.
- (3) *Supra* note 1 at Paragraphs 59 to 61.
- (4) *Paramount Communications, Inc v QVC Network Inc*, 637 A 2d 34 (Del 1994), and *ACE Ltd v Capital Re Corp*, 747 A 2d 95 at 105 (Del Ch 1999).
- (5) *Supra* note 1 at Paragraphs 55 to 56.
- (6) This assumes that after shareholders reject a proposed transaction, the directors would waive the standstill in respect of the competing bidder in order to permit the superior proposal to be made to shareholders. This also assumes that the jilted bidder would not initiate proceedings against the competing bidder seeking damages in tort for interference with economic relations or inducing breach of contract or, alternatively, proceedings against the target on the basis that it failed to fulfil its contractual obligations to enforce the standstill of the competing bidder (provided grounds exist to do so). Notably, Ventas commenced an action against Sunrise on April 5 2007 for its alleged failure to enforce the terms of the standstill agreement with Health Care Property Investors, just days before the scheduled unit holder vote. Six days later, on April 11 2007 Ventas and Sunrise announced that the purchase agreement had been amended to increase Ventas's bid to C\$16.50 per unit. It was also announced that the action would be settled conditioned on the closing of the transaction. Ultimately, a majority of Sunrise shareholders approved Ventas's revised bid.

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