IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S. 5, as amended

AND

IN THE MATTER OF
NEO MATERIAL TECHNOLOGIES INC. AND PALA INVESTMENTS HOLDINGS LIMITED AND ITS WHOLLY-OWNED SUBSIDIARY 0833824 B.C. LTD.

REPLY
MEMORANDUM OF FACT AND LAW OF PALA INVESTMENTS HOLDINGS LIMITED AND 0833824 B.C. LTD.

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TABLE OF CONTENTS

A. OVERVIEW

1. In its continuing effort to use the Rights Plans[1] to stop shareholders from selling their shares to the Pala Offer (which, at $1.70 per share, offers a 54% premium to the closing price of Neo common shares on the last day of trading before Pala's announcement of its intention to make the Pala Offer and a 50% premium over the volume-weighted average trading price of Neo common shares on the TSX during the last 20 days prior to the announcement), Neo's board attempts to avoid the real issue by hiding behind the business judgment rule and raising the spectre of Pala of being a "bitter bidder" with questionable intentions and its eye on control. [2]

2. The focus of this application, however, should not be on the board's process or its conclusions in respect of whether shareholders should tender to the Pala Offer. While Pala disagrees with the substance of the board's conclusions concerning the benefits of the Pala Offer, Pala does not dispute that the board is entitled to reach conclusions and make recommendations to shareholders (which, in turn, can factor into an individual shareholder's decision whether to tender to the Pala Offer). Pala strongly disagrees, however, that Neo's board (even if supported by a majority of shareholders) should be able to use a rights plan – or two rights plans - to usurp the fundamental right of each of Neo's shareholders to sell their shares as they see fit, including by tendering to the Pala Offer. If the Commission accepts (contrary to Pala's position) that this power is theoretically available to Neo's board, then Pala submits it ought to be available only in very limited circumstances – which clearly do not apply to the Pala Offer.

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[1] All capitalized terms are as defined in Pala's Memorandum of Fact and Law.

[2] By Notice of Variation and Extension dated April 27, 2009, Pala increased its offer from $1.40 per Neo share to $1.70 per Neo share. In addition, as a means of further addressing Neo's stated concern about Pala's acquisition of effective control over Neo (and beyond Pala's offer to enter into a standstill agreement for one year), Pala decreased the maximum number of Neo shares to be acquired pursuant to the Pala Offer from 23 million (or 40%) to 10.6 million (or 29.9%). As described below, Pala now also undertakes to seek to elect only one seat on Neo's board until the next annual general meeting of shareholders, provided that either Neo waives the application of the Rights Plans or they are cease traded by the Commission.

B. THE FUNDAMENTAL RIGHT OF SHARE OWNERSHIP INCLUDES THE RIGHT TO SELL – THERE IS NO ABILITY TO 'JUST SAY NO'

Rights plans cannot be used to restrict indefinitely a fundamental right of ownership

3. There can be no doubt that a fundamental right of share ownership includes the right to freely alienate shares of a publicly traded corporation, subject only to very limited statutory exceptions. The *Canadian Business Corporations Act* explicitly makes transferability a fundamental characteristic of a share:

> 49(9) A distributing corporation, any of the issued shares of which remain outstanding and are held by more than one person, *shall not have a restriction on the transfer of ownership of its shares* of any class or series except by way of a constraint permitted under section 174. [emphasis added] [3]

4. Pursuant to the decision of the Supreme Court of Canada in *Edmonton Country Club,* the "right of a shareholder to transfer his shares is undoubtedly one of the incidents of share ownership."[4] Similarly, the Ontario Court of Appeal, in *Royal Bank of Canada v. Central Capital Corporation,* describes one of the basic rights of a shareholder to be "the right to transfer ownership of the share."[5] In *Edmonton Country Club*, the Supreme Court of Canada held that private corporations may impose "reasonable" restrictions on the transferability of shares. Section 49(9) of the CBCA goes further to confirm that the right of transferability is *not* subject to the "reasonableness" restriction that applies in the case of private corporations.

5. Neo asserts that "[i]f a majority of shareholders determine that they do not want the Pala Partial Offer to be accepted by <u>any</u> shareholder, the Rights Plans provides them with that protective right." In essence, the Rights Plans provide Neo's shareholders with this "protection" in two different ways. First, the Second Shareholder Rights Plan, which bans partial bids and therefore the Pala Offer outright, received the approval of the majority of independent shareholders at the Neo Special Meeting. Second, the definition of Permitted Bid contained in both Rights Plans provides for a Minimum Tender Condition such that the majority of

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[3] *Canadian Business Corporations Act,* R.S.C. 1985, c. C-44 ("CBCA"), section 49(9). The permitted constraints under section 174 generally relate to meeting and maintaining Canadian ownership requirements.

[4] *Edmonton Country Club v. Case*, [1975] 1 S.C.R. 534 at 549

[5] *Royal Bank of Canada v. Central Capital Corp.* [1996] O.J. No 359 at para. 40

independent shareholders must tender to an offer if it is going to proceed as a Permitted Bid. Either way, Neo asserts that the notion of "shareholder democracy", or the collective view of the majority of shareholders, should trump individual shareholder rights.[6]

6. This assertion does not withstand scrutiny given the provisions of the CBCA and the holdings of the Supreme Court of Canada and the Ontario Court of Appeal. It is simply impermissible under the CBCA for directors to create any restriction on transferability (other than as permitted under section 49(9) of the CBCA). In creating a poison pill that subjects the individual right of alienation to the will of the majority, such as in the case of a minimum tender condition, directors create a restriction on transferability. In its effort to balance the directors' fiduciary duty to seek out value enhancing alternatives in connection with take-over bids against the individual shareholder's right to chose, National Policy 62-202 permits, at least in practice and from the perspective of securities regulators with a view to the public interest, the use of a rights plan to place a *conditional* restriction on the transferability of a target's shares – but, and most important, only for legitimate purposes (being those that are congruent with the purposes of take-over bid legislation and the fiduciary duties of the directors) and only for a limited period of time.

7. Neo suggests that the terms of the Rights Plans effectively form part of the securities that were purchased, and that removing the Minimum Tender Condition would be akin to amending the articles or terms of Neo's shares against the will of shareholders.[7] With respect, against the backdrop that partial bids are permitted in Canada, provide clear benefits to shareholders and are in the public interest, and given that the Minimum Tender Condition contained in the Rights Plans creates a perverse negative coercive effect on Neo's shareholders,[8] it is difficult to see how

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[6] If Neo's board was truly comfortable with letting the majority decide pursuant to the Minimum Tender Condition contained in the First Shareholder Rights Plan (which Pala does not agree is the proper use of a rights plan), then it is difficult to understand why Neo's board decided to put the Second Shareholder Rights Plan, which bans partial bids outright, in place at all. In any event, the combined fact that Neo then reduced the term of that ban to one year by amending the Second Shareholder Rights Plan and then waived the 48 hour proxy cut-off (so as to enable itself to continue to solicit proxies in its favour and with knowledge of the identity of the shareholders who had already voted against the Second Shareholder Rights Plan that point) is highly suggestive of entrenchment.

[7] See Neo's Supplemental Memorandum of Fact and Law at para. 16.

[8] Pala's submissions in respect of the benefits of partial bids are found in paragraphs 68 - 74 and 91 - 93 of its Memorandum of Fact and Law (including Schedule "A" thereto).

preventing shareholders from being individually able to sell their shares in these circumstances constitutes a "protective right" or could reasonably form part of the understood terms of Neo's shares. Quite the contrary, Neo's shareholders would have reasonably expected no restrictions on their fundamental right of alienation, other than perhaps the legitimate use of a time-limited shareholder rights plan. This expectation would be consistent with Neo's public disclosure as to the purpose of the First Shareholder Rights Plan (long before Pala had acquired any interest in Neo).

8. Moreover, other than the questionable (and, in any event, fact-specific) decision of the Alberta Securities Commission in *Pulse Data,*[9] the only conceivable legitimate purposes of rights plans, and, therefore, the only legitimate basis for a temporary or conditional restriction of this nature on a shareholder's inherent right to free alienation, are limited to: (i) giving the board more time to find an alternative value enhancing transaction; and (ii) ensuring the equal treatment of all shareholders. Once these purposes are no longer being met, the provincial securities regulators act in the public interest to set the poison pills aside and let each individual shareholder decide whether to tender. The reasonable expectation of Neo's shareholders, therefore, must be that both Rights Plans are subject to expiration once the board's duties and the stated purposes of the Rights Plans are fulfilled in respect of a particular offer or any follow-on value enhancing transaction.

Canadian law does not permit Neo's board to 'just say no'

9. It is important to remember that the explicit stated purpose of the First Shareholder Rights Plan is to "give adequate time for shareholders of the Corporation to properly assess the merits of a bid without undue pressure and to allow competing bids to emerge." The stated purpose of the Second Shareholder Rights Plan is to "prevent the acquisition of control of, or a creeping takeover bid, for the Company by means of a partial bid."[10] There is no discussion in

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and in the Halpern affidavit.

[9] *Re Pulse Data Inc.* (2007), A.B.A.S. 895

[10] In a further effort to allay Neo's concern that Pala is undertaking a "creeping" take-over of Neo, Pala has indicated a willingness to enter into a standstill agreement whereby it will not take steps to increase its ownership position in Neo for the next 12 months on certain terms. As stated by Jan Castro in paragraph 53 of his affidavit dated April 22, 2009 (the "First Castro Affidavit"), Pala's goal has never been to achieve a position of legal or

Neo's public statements of the board's now apparent true purpose: to use the Rights Plan as a means of preventing minority shareholders from being able to sell their shares to Pala, or to any other partial bidder. Or, further, perhaps Neo's objective is to prevent anyone from acquiring a large block of shares in Neo.

10. While Pala accepts that Neo's board is entitled to chose not to proceed with a public auction as a response to the Pala Offer, Pala fails to understand how the board, having made that choice, can justify the continuation of these poison pills. The failure of Neo's board to act in accordance with the stated purpose of the Rights Plans is a potent reason for questioning the motives of the board. Neo's board has utterly failed to do what National Policy 62-202 states is the fundamental purpose of, and the only justification for, defensive tactics – to seek a better deal for shareholders. Paying lip service to this fundamental purpose by establishing a special committee and retaining independent legal and financial advisors that considered "alternatives to maximizing shareholder value, including maintaining the *status quo* and pursuing the company's current business plan"[11] (and were able to issue a Directors' Circular recommending that shareholders reject the Pala Offer in only eight business days after the offer was made) cannot rescue Neo's board from its failure to *actually* use the Rights Plans to seek better value for its shareholders.[12]

11. Contrary to Neo's interpretation of *Schneider*, Canadian law does not permit Neo's board to permanently 'just say no' to the Pala Offer. In *Schneider*, a case involving a majority shareholder that elected to support one bidder and refused to consider any other bid, the Ontario

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effective control over Neo. In addition, Mr. Castro confirms, in the Second Castro Affidavit, that Pala will undertake not to seek more than one seat on Neo's board until Neo's next annual general meeting, provided the Neo either waives the application of the Rights Plans to the Pala Offer, or the Rights Plans are cease-traded by the Commission.

[11] See paragraph 68 of Neo's Memorandum of Fact and Law.

[12] Similarly, Neo is wrong to assert that it has sagely "used the New Rights Plan to the advantage of shareholders; the defensive pill has already resulted in an increased offer price by Pala." The increased offer price by Pala merely reflects that "rising water floats all boats" - that stock prices have generally gone up across all markets and Pala's increased bid merely reflects that widespread increase. Further, and more important, it is difficult to see how the increase in the Pala bid from $1.40 to $1.70 per Neo share can be touted as a "benefit" to shareholders when Neo's board will not allow the bid to be put to Neo's shareholders due to the restrictions in the Rights Plans. A higher bid is only a benefit to Neo's shareholders if they actually have an opportunity to tender their shares to the Pala Offer!

Court of Appeal held that "an auction need not be held every time there is a change in control of a company." The Court went on to say, however, that:

> "An auction is merely one way to prevent the conflicts of interest that may arise when there is a change of control by requiring that directors act in a neutral manner toward a number of bidders: *Barkan v. Amsted Industries Inc.*, 567 A.2d 1279 (U.S. Del. Super. 1989) at 1286. The more recent *Paramount* decision in the United States ... has recast the obligation of directors when there is a bid for change of control as an obligation to seek *the best value reasonably available to shareholders in the circumstances* ... [emphasis added]
>
> When it becomes clear that a company is for sale and there are several bidders, an auction is an 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. When the board has received a single offer and has no reliable grounds upon which to judge its adequacy, *a canvass of the market to determine if higher bids may be elicited is appropriate, and may be necessary* ... [emphasis added]

12. Accordingly, the Court embraced the view that when there is a take-over bid, the duty of directors is to "achieve the best value available to shareholders in the circumstances." This holding cannot be interpreted to mean that directors are permitted to use a rights plan to prevent a bid from going to shareholders.

National Policy 62-202 cannot be ignored

13. In essence, to prevent individual minority shareholders from selling their shares to Pala now, Neo would like the Commission to follow the lead of the ASC in *Pulse Data*[13] and to ignore the wealth of prior authority and the direction provided by National Policy 62-202. As the Commission stated in *Re Chapters*,[14] "National Policy 62-202 is the starting point with which the Commission should begin its analysis of a Rights Plan." This policy confirms that Canadian securities regulatory authorities appreciate that defensive tactics " ... may be taken by a board of directors of a target company in a *genuine attempt to obtain a better bid* ..." [emphasis added]. A

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[13] As noted in paragraph 80 of Pala's Memorandum of Fact and Law, the decision in *Pulse Data* can be distinguished from this case on its fact (even more so now that Pala is offering an even greater premium and has decreased the maximum number of shares to be acquired.) Additionally, the decision of the ASC does not represent securities law in Ontario and, in Pala's opinion, was incorrectly decided. Contrary to Neo's submissions, therefore, the decision in *Pulse Data* is not determinative of the issues in this lawsuit.

[14] *Re Chapters Inc.* (2001), 24 O.S.C.B. 1657 (O.S.C.)

genuine attempt to obtain a better bid cannot, by definition, include a 'just say no' defence intended to completely frustrate the Pala Offer.

14. As stated in National Policy 62-202(5), Canadian securities regulatory authorities, out of a recognition that there is a possibility that the interests of management and the board of a target company will differ from those of its shareholders in connection with take-over bids, "will take appropriate action if they become aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid." The concern expressed in the opening words of National Policy 62-202 that "the interests of management of the target company will differ from those of its shareholders" is the policy that underlies the determination that the shareholders must decide.[15]

15. The content of National Policy 62-202, and indeed its direction to securities regulators to intervene when defensive tactics are being used to prevent shareholders from deciding for themselves, is itself a compromise between letting the directors fulfill their fiduciary function in connection with the offer by pursuing value-enhancing transactions for a period of time, and allowing the individual shareholders the ultimate determination of whether the bid succeeds or fails.[16] Thus, an implicit but vitally important premise to allowing a rights plan to continue is a determination that the board is, in fact, fulfilling its fiduciary duty by pursuing alternative value-enhancing transactions. If it is not, then the rights plan ought to be cease traded. In this case, Neo's board is no longer performing that duty (if it ever did). In keeping with National Policy 62-202, therefore, the time has come for the Rights Plans to go.

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[15] Neo states that it is "completely illogical" for Pala to praise Neo management and yet "raise the spectre of management entrenchment, after its advances were refused, to invoke the public interest of the jurisdiction of the Commission." With respect, Neo has missed the point. Pala can praise executive management for a job well done to date and yet, for the reasons acknowledged by National Policy 62-202, be reasonably concerned that the response of Neo's board to the Pala Offer is inappropriate and has been tainted by a desire to remain on board.

[16] See *BGC Acquisitions Inc. and Argentina Gold Corp.* (1999) L.N.B.C.S.C. 55 (B.S.C.) as endorsed in *Re Chapters Inc.* (2001), 24 O.S.C.B. 1657 (O.S.C.)

The affirmation of the Second Shareholder Rights Plan is merely a factor and does not entitle the board to 'just say no' to the Pala Offer

16. Much as was done in the submissions of the target in *Pulse Data*, Neo baldly asserts that it is "trite" that corporations are governed by a majority of their shareholders and that the Commission, therefore, ought not "second guess" the ratification of the Second Shareholder Rights Plan by a majority of Neo's shareholders. This analysis overemphasizes the power of shareholders under Canadian corporate and securities law and oversimplifies the role of the Commission in the context of cease trade applications.

17. Rather than being "governed by a majority of its shareholders," the business and affairs of a corporation are managed or supervised by its directors which, in turn, are subject to fiduciary duties owed by the directors to the corporation.[17] The role of a shareholder in governing a corporation is limited to its ability to elect directors. Beyond that, shareholders have only limited rights to approve or reject, by ordinary or special resolution, certain transactions recommended by a Board, such as amalgamations, plans of arrangements or a sale of all or substantially all of a company's assets. Shareholders as a collective do not have any right to effectively approve a restriction on the fundamental right of individual shareholders to sell their shares as they see fit.

18. In addition, in considering whether or not to cease trade a rights plan, the case law is clear that while shareholder approval is a relevant consideration for the Commission, shareholder approval of itself will *not* establish that a plan is in the best interest of the shareholders.[18] The Commission has articulated shareholder approval as one among many of the *indicia* of whether a poison pill should to allowed to continue.[19] Securities commissions should and do exercise their

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[17] See CBCA, sections 102 and 122.

[18] Citing the 1969 decision of the English Court of Appeal in *Bamford v. Bamford*, [1969] 2 W.L.R. 1107, Neo takes the position that even if its board was wrong to have implemented the Second Shareholder Rights Plan, the affirmative vote served to ratify this directorial wrongdoing. Aside from the fact that a 1969 decision of the English Court of Appeal is not "Canadian corporate law," certain provisions in the *CBCA* and other similar statutes in Canada have expressly abrogated the English common rule that ratification of directorial wrongdoing relieves directors of their duties. (See, for example, sections 122(3) and 242(1) of the *CBCA*.)

[19] See the "shopping list" of considerations referred to by the Commission consistently since it was established in *Re Royal Host Real Estate Investment Trust* (1999), 22 O.S.C.B. 7819

discretion to set aside rights plans that have been approved by shareholders. When they have not done so, it is because they see a continued legitimate purpose to the operation of the pill at least for a further limited period of time.[20]

19. To the extent the Commission is influenced by the shareholder vote approving the Second Shareholder Rights Plan, the results of that vote should not be taken at face value as providing a clear endorsement of the board's determination to 'just say no" or as a basis for somehow allowing the collective to trump an individual shareholder's right made under the guise of "shareholder democracy".[21] Since shareholders would be expected to vote against the backdrop of existing law, the best interpretation of the vote may be that shareholders, in voting in favour of the Second Shareholder Rights Plan, simply voted to give management more time to pursue value-enhancing transactions. To suggest that a vote in favour of the Second Shareholder Rights Plan is tantamount to a plebiscite on the Pala Offer goes far too far and, even if true, far beyond a legitimate basis for permanently denying an individual shareholder who did not vote in favour of that plan to tender to the Pala Offer.

20. Affirmation of the Second Shareholder Rights Plan is but one consideration for the Commission in determining whether to restrict the ability of an individual shareholder to sell its shares, and, in assessing that consideration, the Commission ought to be cautious in interpreting the results of that vote. Here, given the consequences of such a restriction, caution is particularly warranted and Pala submits that the Commission should give little or no weight to the shareholder vote. Equally, the Minimum Tender Condition contained in both Rights Plans, which accomplishes the same goal of majority views trumping individual minority shareholder rights to tender, should also be rejected by the Commission.

21. At this point, almost 1.9 million shares have been tendered to the Pala Offer.[22] These shareholders want to sell their Neo shares to Pala now. Since 12,976,593 shares (not including

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[20] *Re Cara Operations Ltd.* (2002), 25 O.S.C.B. 7997 (O.S.C.); *Re Royal Host Real Estate Investment Trust* (1999), 22 O.S.C.B. 7819; *Re Lac Minerals Ltd. and Royal Oak Mines Inc.* (1994), 17 O.S.C.B. 4963; *Re MDC Corporation and Regal Greetings & Gifts Inc.* (1994), 17 O.S.C.B. 4971

[21] See, for example, Neo's Memorandum of Fact and Law at paras. 4, 81 and 63, and the Karayannapoulos affidavit at para. 66

[22] Second Castro Affidavit at para. 22

those held by Pala) were voted against the Second Shareholder Rights Plan (representing 18.76% of the total shares voted or 11.29% of Neo's total float) then it is reasonable to assume that many of these shares will be tendered to the Pala Offer depending on each individual shareholder's assessment of the strength of the Pala Offer as the expiration date of that offer approaches.[23] This does not take into account the potential that some of the shareholders who did not vote in respect of the Second Shareholder Rights Plan at all (representing another 22,088,980 shares or an additional 19.22% of Neo's total float) may also be inclined to tender their shares to the Pala Offer.[24] Further, a number of shares have been tendered since the Neo Special Meeting, which indicates that shareholders are interested in the price that is being offered. In Pala's submission, therefore, it would be contrary to shareholders' expectations and the current landscape of corporate and securities laws, including National Policy 62-202, to permit Neo's board or Neo's majority shareholders to collectively 'just say no' to the Pala Offer and to prevent completely these interested shareholders from selling their shares now to a premium offer.

C. THE PALA OFFER POSES NO DANGER TO NEO OR ITS SHAREHOLDERS

22. Pala submits that all shareholders in public companies have a fundamental right to sell their shares as they wish, subject only to specific regulations and the time-limited use of shareholder rights plans for legitimate purposes. If the Commission nevertheless accepts that it is theoretically possible for a board, supported by a majority of shareholders, to use a rights plan to restrict a minority shareholder's right to sell in the context of a take-over bid for more than a narrow time-limited period, then the right to impose such a restriction on the minority individual shareholders certainly cannot be considered absolute. Restrictions of this nature must be examined by the Commission on a case-by-case and should only be permitted if the resulting danger to the corporation and its remaining shareholders is patently obvious. In other words, the Commission should be very reluctant to ever allow a rights plan to stand beyond the period

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[23] Pala recognizes that some shareholders who voted against the Second Shareholder Rights Plan may have no intention of tendering to the Pala Offer and some of the shareholders that voted in favour of the Second Shareholder Rights Plan may already have tendered to the Pala Offer.

[24] Further, it also does not take into account the fact that those shareholders who may have voted in favour of the Second Shareholder Rights Plan as means of giving management the continued opportunity to secure a better offer will ultimately want to tender to the Pala Offer at some point. The Pala Offer will no doubt become more and more desirable to these shareholders (and indeed to all shareholders) if the trading price of Neo's shares declines as the bid expiry date approaches.

necessary to permit the target's board to find another value-enhancing transaction. Pala simply does not accept that its offer poses any such "danger" to Neo or its shareholders.

Neo's concerns about "control" are entirely overstated

23. According to Neo, many of the "dangers" inherent in the Pala Offer arise from the fact that as a 29.9% shareholder Pala will gain "effective control" and "can act in a self-interested manner to the detriment of other shareholders." Not only does this argument apply equally to any large block shareholder, it also ignores the fact that there are many benefits inherent in having a large block or cornerstone shareholder.[25] By logical extension, and seemingly to avoid having an "activist" shareholder that may seek representation on the board or the ear of management on certain issues (which should be applauded not disparaged), Neo's board will apparently resist any attempt by any party to acquire a block in Neo. The board's preference to avoid a large block shareholder cannot constitute the type of "danger" that would cause the Commission to exercise any discretion that it may have to leave a rights plan in place indefinitely.

24. Moreover, on the particular facts of this case, Neo's concern about the "dangers" that would arise from Pala owing 29.9% of Neo (which assumes that the Pala Offer will be entirely successful) are unfounded for the following reasons:

(a) At 29.9%, Pala will not have legal control over Neo. In addition, Pala has offered to enter into a standstill agreement in respect of future acquisitions of Neo shares.

(b) Further, at 29.9%, it is unlikely that Pala will be able to exercise *de facto* control over Neo. Based on the voting levels of shares represented in person and by proxy at shareholder meetings in the last six years, Pala would have had *de facto* control on only one occasion in 2008 when only 56% of the shareholders voted.

(c) Even if Pala did have *de facto* control, there is nothing sinister about being able to elect a board of directors (who are under a fiduciary duty to the corporation). Indeed, although not so here, takeover bids are frequently motivated by a desire to

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[25] See the "agency problem" as explained in the Halpern affidavit at paras. 15 – 17.

replace inefficiencies in management and direction. To scourge an acquirer because it will be in a position to elect the board is to scourge all take-over bids.[26] In addition, Pala has now undertaken not to seek more than one seat on Neo's board until the next annual general meeting, provided that either Neo waives the application of the Rights Plans to the Pala Offer, or the Rights Plans are cease-traded by the Commission.

(d) In addition, while at 29.9% Pala could theoretically have "blocking control" on special resolutions for fundamental changes, transactions of this nature are very limited. The mere potential for Pala to have "blocking control" in a limited set of circumstances (and which would apply equally to any large block shareholder) cannot reasonably ground Neo's claim that this level of ownership "will significantly impair management's ability to effectively execute growth opportunities" or "compromise Neo's future organic and acquisitive growth initiatives."[27]

(e) Neo also argues that Pala would be inclined and able to block a subsequent take-over bid.[28] This argument is unsound at a theoretical level since a shareholder in a blocking position is in a perfect position to negotiate a higher price from an acquirer to the benefit of all shareholders and, as a financial investor as opposed to strategic investor, it follows that this is what Pala would be inclined to do. In essence, a shareholder with a blocking position can perform essentially the same function as the directors are expected to perform when there is a time-limited poison pill, but likely more effectively. There is simply no foundation to suggest

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[26] Notably, as pointed out in the Second Castro Affidavit, Pala does not currently control any board of the companies that it has invested in. On average, Pala holds 17.7% of board seats in companies, with an average holding of 25%.

[27] See paragraphs 40 – 43 of Neo's Memorandum of Fact and Law.

[28] Neo relies on *Re Falconbridge* as recognizing the creeping bids can have harmful effects on the shareholders of the target company. In that case, however, the Commission held that a partial bid would be regarded as coercive if the end result of the bid was to leave minority shareholders in a highly illiquid market. It is the illiquidity that substantially subtracts from value. There can be no question in this case, however, that with 85 million shares outstanding, if Pala were to obtain 29.9%, the market for Neo's shares would remain highly liquid.

> that Pala, as a financial investor who, unlike a strategic investor, is not seeking to increase its investment in Neo as a means of improving its market share, eliminating competition or creating synergies, would ever be motivated to hold out indefinitely and not tender to a subsequent take-over bid. Unlike a comparison between the managers and directors of a corporation on the one hand and shareholders on the other, there is actually an alignment of interests between a block financial shareholder and the balance of shareholders in connection with a take-over bid; they both wish to sell at the highest price possible.

The benefits to Pala's increased ownership

25. For the reasons expressed in Pala's public disclosure and the First and Second Castro Affidavits, Pala believes that its increased ownership will be beneficial to Neo and to Neo's shareholders. Pala appreciates that Neo disagrees; however, the expression of Neo's views on the advantages or disadvantages of the Pala Offer should be limited to its recommendation that shareholders not tender to the Pala Offer and should not prevent entirely the Pala Offer from being made to Neo's shareholders thereby preventing the individual shareholders from having their inherent right to freely choose whether to tender to the bid.

The loss of key management is within Neo's control

26. Another "danger" alleged to arise from Pala's increased ownership is the "substantial risk to Neo that there will be significant departures of senior management to the detriment of Neo."[29] As Pala has made clear, it currently supports management and has no desire to see management go as a result of Pala increasing its ownership in Neo. According to Neo's public disclosure, the change of control provisions permit key management to elect to leave (and be paid handsomely) in the event that one shareholder were to obtain 30% (which is not the case here).[30] The ability for Neo's management to trigger these payments when they *leave voluntarily* undermines the rationale behind golden parachutes – to prevent an acquirer from electing to terminate key

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[29] See paragraph 44 of Neo's Memorandum of Fact and Law.

[30] Neo admits in its paragraph 45 of its Memorandum of Fact and Law that it did not previously disclose the 30% threshold in connection with its discussion of the change of control provisions in the key employment agreements.

management following a change in control causing a loss of invaluable human capital to the detriment of the target's shareholders. The loss of key personnel is within Neo's control (as is the ability to amend these provisions in the event of a Normal Course Issuer Bid). The threatened imminent departure of Neo's senior management team following a change of control must be aimed at reducing Neo's desirability as a target corporation.

D. PALA TOOK A PRAGMATIC APPROACH IN STRUCTURING THE PALA OFFER AS A PERMITTED BID

27. When launching the Pala Offer, Pala took a pragmatic approach. Pala structured its offer as a Permitted Bid as it would be beneficial to all Neo shareholders if the Pala Offer could be completed as a Permitted Bid should it become apparent that the Minimum Tender Condition would be met or that the application of the Rights Plans would be waived by Neo's board. Since neither of these events has happened, or was at all likely to happen, Pala commenced its cease trade application to the Commission.

28. The disclosure in the Pala Offer is clear as to the intentions of Pala and Pala's ability to apply to have the Rights Plans cease traded.[31] For so long as the Minimum Tender Condition continues to apply, Pala must satisfy it in order for the Pala Offer to proceed as a Permitted Bid under the Rights Plans. However, the Minimum Tender Condition will no longer apply if the Rights Plans are either waived by Neo's board or if the Rights Plans are subject to a cease trade order of the Commission. In the Pala Offer, Pala clearly and expressly reserved its right to challenge the application of the Rights Plans by seeking such a waiver (as it did unsuccessfully) or such an order (as it is now doing). If the Minimum Tender Condition requirement in the Rights Plans no longer applies as a result of a waiver on the part of Neo's board or a cease trade order made by the Commission, then Pala can take-up any shares tendered to its offer subject to the stated maximum. Accordingly, the Pala Offer meets all of the requirements of a Permitted Bid.

29. In event that the Second Shareholder Rights Plan is cease traded, then, contrary to Neo's assertions, the Commission does have jurisdiction, and the Commission should exercise this

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[31] See the cover page, page 5 under "Summary", page 18 under "Conditions to the Offer" and page 21 "Subsequent Offering Period" in the Pala Offer documents at Exhibit "M" to the First Castro Affidavit.

jurisdiction, to also cease trade the First Shareholder Rights Plan. This is not a case of Pala "audaciously" asking the Commission to "amend the terms of its offer" to change a Permitted Bid to a not Permitted Bid.[32] Rather, Pala is pragmatically asking the Commission, now that it is all but clear that the Minimum Tender Condition cannot be met and since a determination as to the validity of the Second Shareholder Rights Plan effectively determines the validity of the First Shareholder Rights Plan (since they overlap, particularly on the central issues relating to the Minimum Tender Conditions), to exercise its jurisdiction to cease trade the First Shareholder Rights Plan because it too has outlived (if indeed it ever served) its stated and legitimate purpose.[33]

E. CONCLUSION – THE TIME HAS COME FOR THE RIGHTS PLANS TO GO

30. Pala does not accept that corporate and securities laws in Ontario allow Neo's board to use the Rights Plans to prevent Neo's shareholders from ever having the opportunity to tender to the Pala Offer. Further, Pala does not accept that the majority of Neo's shareholders have the right, whether exercised through a vote in favour of the Second Shareholder Rights Plan or as a result of the Minimum Tender Condition in the Rights Plans, to restrict indefinitely the individual right of minority shareholder to sell their shares to the Pala Offer. Under the applicable corporate and securities laws, Neo's board has the right to criticize Pala and the Pala Offer, but it does not have the right to make illegitimate use of the Rights Plans – a use completely counter to the board's own stated purpose for these plans – in order to "cram down" the rights of the minority to tender their shares to the Pala Offer, or indeed to any offer.

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[32] If the Pala Offer does not constitute a Permitted Bid (which Pala does not believe to be the case), then the Commission clearly has jurisdiction to consider both Rights Plans at the May 7 hearing. In any event, section 127 of the *Securities Act* is broad enough to grant jurisdiction to the Commission to cease trade both Rights Plans since it allows the Commission to act in what, in its opinion, is in the public interest.

[33] Pala is not the only bidder to have taken a pragmatic approach to permitted bids. See for example the Offer to Purchase of Manulife Financial Corporation in Canada Life Financial Corporation, the Offer to Purchase of Alcan Inc. in Alcoa Inc., the Offer to Purchase of Northgate Minerals Corporation in Aurizon Mines Ltd. and the Offer to Purchase of Invecture Group in Frontera Copper Corporation. In addition, Pala itself, then represented by Neo's counsel, Stikeman Elliot LLP, previously took a similar pragmatic approach in the Offer to Purchase in Rockwell Diamonds Inc.

31. Accordingly, at both a high level (rights plans cannot, at law, be the source of an indefinite restriction on the alienability of shares) and specific to the Pala Offer (the Rights Plans cannot be used to prevent the Pala Offer from being put to Neo's shareholders, particularly as there is no "danger" that would result to Neo or Neo's shareholders), Pala requests that the Commission exercise its jurisdiction to issue a cease trade order in the public interest in respect of the Rights Plans.

IN THE MATTER OF NEO MATERIAL TECHNOLOGIES INC. AND PALA INVESTMENTS HOLDINGS LIMITED AND ITS WHOLLY-OWNED SUBSIDIARY 0833824 B.C. LTD.

IN THE MATTER OF THE *SECURITIES ACT*, R.S.O. 1990, c. S. 5, AS AMENDED

AND

IN THE MATTER OF NEO MATERIAL TECHNOLOGIES INC. AND PALA INVESTMENTS HOLDINGS LIMITED AND ITS WHOLLY-OWNED SUBSIDIARY 0833824 B.C. LTD.

REPLY MEMORANDUM OF FACT AND LAW OF PALA INVESTMENTS HOLDINGS LIMITED AND 0833824 B.C. LTD.

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