Corporate Commercial Law

RECENT DEVELOPMENTS OF IMPORTANCE

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Several important developments in Canadian corporate law and practice have occurred in the wake of the global economic downturn. Many of these developments impact change of control transactions and the approaches of buyers, sellers, targets and regulators to various aspects of M&A deals. This paper provides an overview of recent developments involving:

- shareholder rights plans;
- material adverse change clauses; and
- fairness opinions and shareholder approval issues.

Shareholder Rights Plans

A recent decision of the Ontario Securities Commission (the "OSC") in *Neo Materials Technologies Inc.* may signal a change in the regulatory approach to shareholder rights plans, particularly those implemented in the face of hostile take-over bids. This decision, together with two previous decisions of the Alberta Securities Commission *In re Pulse Data* and *Canadian Hydro Developers,* which dismissed challenges to rights plans, arguably constitutes a substantive departure for Canadian regulators on the question of when a poison pill rights plan has outlived its purpose and should be set aside. The three decisions suggest that regulators may now be showing more deference to the actions of target boards in adopting and continuing shareholder rights plans, particularly where the facts demonstrate that the board adhered to a proper process in implementing the plan and shareholders have approved the plan on an informed basis.

In *Neo*, the target ("Neo") was the subject of a hostile partial take-over by Pala Investment Holdings Limited ("Pala"). Pala, which already owned about 20 per cent of the outstanding Neo shares, made a bid to acquire a further 20 per cent of the Neo stock. The Pala bid was a "permitted bid" within the meaning of Neo's pre-existing shareholder rights plan since, among other things, the Pala bid was open for acceptance for 60 days rather than the statutory minimum of 35 days. Prior to the expiry of the Pala bid, the board of Neo adopted a "tactical" shareholder rights plan, which was approved by Neo's shareholders at an annual and special meeting. The new Neo rights plan did not include a partial bid within the ambit of the definition of a "permitted bid". Pala brought an application to the OSC to cease trade the Neo shareholders' rights plans in order to allow its unsolicited bid to proceed.

The OSC declined to grant the cease trade order requested by Pala. The bidder (Pala) took the position that the only legitimate purpose of a rights plan is to provide a target board with additional time to seek alternative transactions and suitors to enhance shareholder value as part of an auction process. In its reasons for decision, which were published on September 1, 2009, the OSC indicated that, in considering whether to exercise its public interest jurisdiction to intervene to cease trade a rights plan, it will carefully assess all of the events and circumstances surrounding implementation of the plan, including whether "informed shareholder approval" was given. In addition, the OSC indicated that it has broad discretion to determine whether to exercise its public interest jurisdiction to cease trade a rights plan. The OSC stated that, while it would not decline to exercise its jurisdiction to cease trade a rights plan in appropriate circumstances, a degree of administrative deference should be given to legitimate decisions of the board of directors of target companies. While "fully informed" shareholder approval of a tactical shareholders' rights plan is an important consideration for the regulators in determining whether to allow a plan to continue, the OSC noted that shareholder approval will not necessarily carry the day in circumstances where it can be shown that the target directors, in responding to a bid, failed to carry out their duties in the best interests of the corporation and the body of the target shareholders, or there is evidence of pressure applied to the target shareholders by management or the board to approve the plan. In *Neo*, the OSC concluded that the target shareholders were "informed" and that the board's decision to implement the plan was a product of its *bona fide* business judgment. Furthermore, the Commission found no evidence of undue pressure or coercion of target shareholders by the board or management.

The *Neo* reasons are interesting in terms of the apparent willingness of the OSC to defer to the target board's decision process and its tacit acknowledgment of the "business judgment rule" (which is largely a product of US jurisprudence). The OSC relied on the ruling of the Supreme Court of Canada in *Re: BCE Inc.*, and emphasized that directors' fiduciary duties are broad and must be considered in the context of the particular situation. The *Neo* decision suggests that the duty of directors in the context of a change of corporate control is not merely confined to short-term profits or share values and it is appropriate for directors to look to the long-term interests of the corporation in circumstances where the corporation is operating as a going concern. The decision is fairly clear that the purpose of a shareholder rights plan (including a tactical plan) is not limited to simply providing sufficient time to the target board to conduct an auction for the company or to seek alternative bidders. A rights plan (including a tactical plan) may be implemented by a target board to protect the long term interests of its shareholders. In other words, a board may legitimately determine, as a matter of business judgment that, in the face of an unsolicited bid, it is not necessarily in the best interests of the corporation to run an auction for the company at that precise point in time.

Historically, Canadian securities regulators have approached rights plans from the perspective of considering not if, but when, a rights plan be terminated by way of a cease trade order. In *Neo*, the OSC effectively rejected the traditional analysis with the proposition that as long as the rights plan continues to allow the board of a target to fulfil its fiduciary duty, then the plan has a demonstrable purpose and should be allowed to continue in effect. It should be borne in mind that *Neo* may be factually different than most typical rights plan cases which do not always involve shareholder approval of a tactical rights plan during the currency of the unsolicited bid.

The following important points can be drawn from the *Neo* decision:

- the OSC is prepared to adhere to the "business judgment rule" and defer to the decision of a target board to continue a rights plan in the face of a bid, provided that the board has demonstrably carried out an appropriate process;
- a tactical rights plan can be adopted for a broader purpose than simply conducting an auction run by the target board — *i.e.*, it can be utilized to protect the "long-term interests" of the target and its shareholders;
- it may now be more difficult to convince regulators to exercise their public interest jurisdiction to set aside a tactical plan in circumstances where there is a finding that the directors of the target have acted appropriately; and
- recent shareholder approval of a tactical plan that is "informed" and free of apparent coercion may be a critical factor.

Material Adverse Change Clauses

Material Adverse Change or "MAC" clauses are contained in the vast majority of acquisition agreements. A MAC clause typically allows a buyer to terminate an M&A transaction or renegotiate terms if an unforeseen material adverse business or economic event affecting the target occurs between signing and closing of the transaction. A MAC clause also provides a seller with a way to qualify representations and warranties in the acquisition agreement to prevent being found in breach for immaterial items. Material adverse change provisions are typically controversial and are heavily negotiated between buyer and seller. Buyers generally seek to enlarge the scope of a MAC clause in order to allow maximum flexibility to terminate a transaction. Sellers typically prefer to narrow the scope of the MAC clause to provide certainty of closing on the terms and conditions (including price) as initially agreed between the parties.

Recent global economic conditions have resulted in greater attention being paid to MAC clauses. Tightening of the credit markets has resulted in a significant decrease in global M&A activity, especially by private equity buyers who were previously able to dominate the M&A market, compared to strategic buyers, by virtue of their access to financing. Due to pressures applied by financial backers, many private equity buyers have either attempted to renegotiate transactions or to walk away from them by invoking a MAC clause. This has led to significant litigation in the United States, which should be of interest to Canadian market participants. Some of the cases are summarized below.

In re IBP, Inc. Shareholders' Litigation, a merger agreement contained a fairly broad MAC clause with no carve-outs. Tyson Foods asserted that IBP, the target, had incurred a material adverse effect due to its current quarterly earnings dropping significantly as compared to the comparable quarter in the previous year. The Delaware Court of Chancery ruled that this did not constitute a material adverse effect because it was not something that was significant in terms of its duration. Based on the *IBP* decision, parties seeking to invoke a MAC clause in order to terminate a transaction must meet a relatively high burden of proving that those events that are claimed to amount to material adverse change "substantially threaten the over-all earnings potential of the target in a durationally significant manner … the MAC should be material when viewed from the longer term perspective of a reasonable acquirer".

In *Frontier Oil Corp. v. Holly Corp.*, the court essentially adopted the *IBP* decision. However, the court focused on the specific wording of the MAC clause at issue and noted that the phrase "would have" or "would reasonably be expected to have" a material adverse change created an objective test with a higher threshold than wording such as "could" or "might". It was found that this standard requires a buyer to examine not only current conditions but also future evidence of a long-term downturn.

In *Genesco v. Finish Line*, Finish Line agreed to acquire Genesco for $1.5 billion in a highly leveraged transaction without a financing condition. Following execution of the agreement, Genesco announced quarterly earnings that were short of analyst projections. Finish Line then refused to proceed with the transaction and Genesco sued in order to compel specific performance. Finish Line took the position that the earnings shortfall constituted a material adverse change while Genesco argued that it was merely a short-term decline due to general economic conditions, and that those conditions fell within the specific carve-outs to the MAC clause in the agreement. In that case, the court accepted the view of the target that the decline in quarterly earnings was as a result of general economic conditions and found that the decline was not disproportionate to those incurred by other industry participants. The specific terms of the MAC provision contained a carve-out for general economic conditions and, as a result, Finish Line's claim was denied. However, the court went on to note that the language used in the merger agreement was an acknowledgment that a MAC could occur in only a three or four month period of time.

In view of the standard set by US courts for establishing *bona fide* reliance on a MAC clause, effective MAC clauses should be drafted to reflect carefully the allocation of risk between buyer and seller, as negotiated.

The general definition of a MAC is typically something as follows:

> "Material Adverse Change" means any event, occurrence, fact or circumstance which has or would reasonably expected to have a material adverse affect on the business, assets, condition (financial or otherwise), liabilities, results of operations or prospects of the target and its subsidiaries, taken as whole.

The term "material", which is the cornerstone of the definition of the MAC clause, is rarely defined. Some agreements attempt to define the term "material" by reference to a specific dollar amount; however, most do not. Typically, the concept of "materiality" is analyzed against transaction custom rather than by reference to precise legal definition. A negative economic impact of anywhere between 10 per cent to 20 per cent is generally required before an event or change can be considered to be sufficiently material to constitute a material adverse change. That said, there is no clear jurisprudence that adopts 10 per cent, 20 per cent or any other figure as the bright line test for every transaction.

In view of the US cases involving MAC clauses and recent market conditions, the following should be borne in mind when crafting a MAC clause:

Carve-Outs: In many transactions, sellers have successfully managed to negotiate specific items out of the MAC clause, with the result that the buyer's ability to rely on the MAC clause to terminate a deal is substantially narrowed. Some of these types of terms include carve-outs for changes:

- in financial market or general economic conditions;
- in law or the judicial interpretation of law;
- in general industry conditions in which the target operates that do not "disproportionally affect" the target (when compared to other industry participants);
- resulting from the announcement of the transaction;
- resulting from compliance with the terms of the agreement; and
- resulting from failure to meet financial projections or a stock price decline.

MAC Triggers: In drafting the MAC clause, there is usually a debate about whether the MAC clause is engaged only by the actual occurrence of the MAC (which favors the seller) or by events which "would", "could" or "might" reasonably be expected to result in a material adverse change (which clearly favors the buyer).

Pre-Existing Conditions/Events: If, as a result of the due diligence process surrounding a transaction, a specific condition or event of concern to the buyer is revealed, the issue is whether that event or condition should be specifically included or excluded from the MAC definition. In many cases, from the buyer's perspective, it would be preferable to deal with a known event/condition in the form of a specifically worded closing condition rather than relying on the general MAC.

To sum up, MAC clauses are important protective measures that protect a buyer from a genuinely significant event occurring between signing and closing. However, buyers should be careful in placing undue reliance on a MAC clause as a 'be all and end all' to capture all events of concern, even if specific carve-outs are negotiated out of the MAC clause.

The Hudbay Decision

In April 2009, the OSC released its reasons for decision in connection with a merger transaction involving Hudbay Minerals Inc. ("Hudbay") and Lundin Mining Corporation ("Lundin"). Although the decision focused primarily on the requirement to obtain shareholder approval in the context of a dilutive merger transaction, the OSC reasons include a number of interesting statements concerning fairness opinions, private placements in connection with M&A transactions and the ability to conclude a transaction in the face of a dissident shareholder challenge.

Hudbay had agreed to acquire Lundin by way of a plan of arrangement pursuant to which Hudbay shares would be issued to shareholders of Lundin. The arrangement would result in a dilution of just over 100 per cent to existing Hudbay shareholders. The TSX, in approving the listing of the Hudbay shares, did not require Hudbay shareholder approval, which is consistent with previous TSX decisions in cases such as Allstream/Manitoba Telecom and Glamis Gold/Goldcorp. Jaguar Financial Corporation, a Hudbay shareholder, requested the OSC to issue an order setting aside the TSX decision and requiring Hudbay to hold a shareholders' meeting to approve the deal. The OSC overturned the TSX decision on the basis that to permit the transaction to proceed without shareholder approval would be contrary to the public interest and would negatively impact "the quality of the marketplace". The OSC reasons include a number of very interesting comments on topics which the OSC acknowledged were not actually raised in argument.

In *Hudbay*, the OSC clearly indicated that it typically defers to the judgment of the TSX in areas that are within the TSX's sphere of expertise. However, in this case, the OSC determined that it did not have a basis upon which to conclude that the TSX decision was within a range of reasonableness. Accordingly, the OSC concluded that it could not defer to the TSX decision and it was required to determine whether the transaction would adversely affect the quality of the market place or be contrary to the public interest. The OSC determined that shareholder approval was required for the following reasons:

- the transformational nature of the transaction and its impact on the rights and interests of the shareholders of Hudbay;
- the 100 per cent level of dilution was determined to be "extreme" and at the outer end of the range of dilution in prior transactions in which shareholder approval was not required;
- a major change to the board of Hudbay as a result of the transaction with a majority of the directors of the merged entity being former Lundin directors; and
- scheduling of shareholder meetings in a fashion that seemed to be directed at foiling the exercise by Hudbay shareholders of rights to require a shareholders' meeting to consider replacement of the board.

In its decision, the OSC clearly indicated that "fair treatment" of shareholders is the paramount concern and overrides considerations of the parties related to deal certainty. The decision may signal that the OSC is increasingly willing to entertain complaints from shareholders founded on "fairness" considerations.

It is noteworthy that the TSX has very recently announced that it will now require a listed company to obtain shareholder approval in circumstances where it is issuing more than 25 per cent of its outstanding shares in connection with the acquisition of a public or private company. Before this announcement, the TSX Company Manual contained no specific bright line test and it was left to the discretion of the TSX to determine whether to impose shareholder approval if, for instance, the transaction would have a material affect on the control of the listed issuer.

Apart from the shareholder approval issue, the following comments were made by the OSC in *Hudbay* which are of particular interest to M&A practitioners:

- The OSC criticized the fairness opinion obtained by Hudbay. There is no legal requirement on a board to obtain a fairness opinion; however, boards typically do so in order to provide a defense to a potential claim of breach of fiduciary duty. Reliance in good faith on expert reports and opinions generally provides a basis for such a defense. The OSC specifically criticized the fact that the financial advisor, in this case, was to receive a success fee on completion of the transaction. The OSC stated:

  "While the Commission does not regulate the preparation or use of fairness opinions, in our view, a fairness opinion prepared by a financial advisor who is being paid a signing fee or a success fee does not assist directors comprising a special committee of independent directors in demonstrating the due care they have taken in complying with their fiduciary duties in approving a transaction."

  It is common practice to pay a success fee to financial advisors retained to provide a fairness opinion for a transaction. As a result of the decision, a practice may develop for an independent second opinion from a firm of financial advisors where their compensation does not include a success fee. Alternatively, boards and committees may be counselled to structure the financial advisory fee arrangements as flat fees or work fees that are not dependant on the outcome of the deal.

- In the *Hudbay* case, Hudbay acquired a 19.9 per cent shareholding in Lundin by way of a private placement negotiated at the same time as the arrangement. Issuance of the private placement shares was not conditional on the completion of the arrangement. The OSC indicated in its reasons that an acquiror should not be allowed to use the votes attached to shares issued in a private placement close in time to a merger transaction to influence the outcome of the vote on the transaction given the difference of interests between the acquiror and the target shareholders.
- The OSC focused on attempts made by the parties to schedule the Lundin shareholders meeting to approve the deal prior to a meeting of Hudbay shareholders that had been requisitioned by dissident Hudbay shareholders to replace the incumbent Hudbay board. The OSC stated that if shareholders wish to challenge a transaction by exercising their right to elect or remove directors in accordance with their rights under corporate law, a board should not act in a fashion to interfere with those rights. Interestingly, Hudbay's contractual ability to terminate the arrangement was quite limited and those termination rights would not have been affected by a change in its Board of Directors. ■

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