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TAKEOVERS GET A MAKEOVER: A GUIDE TO THE NEW TAKEOVER BID REGIME IN CANADA

By Gesta Abols, Grant McGlaughlin and Michael Partridge

Gesta Abols, Grant McGlaughlin and Michael Partridge are partners at Goodmans LLP. The authors gratefully thank Jamie Habert, associate at Goodmans LLP, for his assistance in preparing this article. Contact: gabols@goodmans.ca or gmcglaughlin@goodmans.ca or mpartridge@goodmans.ca.

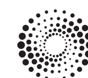
After a number of years of review and discussion, and after considering several different proposals, on February 25, 2016, the Canadian Securities Administrators (CSA) released the final version of new harmonized takeover bid rules. These new rules represent the most significant changes to the takeover bid landscape in Canada since the original adoption of the current takeover bid regime in 1966. This guide reviews the background to the amendments, outlines the fundamental changes reflected in the new rules and considers a number of implications and issues that we anticipate will result from their adoption.

Motivating Principles and Background to the New Rules

The takeover bid landscape in Canada is shaped by the principle espoused by securities regulators that shareholders should be the ultimate decision makers in determining whether to accept a takeover bid or not. That principle is, and continues to be, set out in National Policy *62-202 Take-Over Bids—Defensive Tactics* ("NP 62-202") the predecessor of which (National Policy 38—*Take-Over Bids—Defensive Tactics* ("NP 38")), was first adopted in 1986. The policies outlined in NP 62-202 form the basis for the well-established proposition that shareholder rights plans (poison pills) and other defensive tactics cannot be used to prevent shareholders from ultimately having the opportunity to tender to a takeover bid.

NP 38 represented an "attempt by the provincial securities commissions to regulate, but not to prohibit, target company defensive tactics. And it attempt[ed] to regulate in such a way that the interest of the target shareholders are maximized."[1] In other words, NP 38 was primarily focused on protecting the bona fide interests of target shareholders.[2] This was consistent with the conclusion of the Ontario Government-commissioned Kimber Report,[3] which held that "the primary objective of any recommendations for legislation with respect to the takeover bid transaction should be the protection of the bona fide interests of the shareholders of the offeree company."

This shareholder-centric perspective of NP 38 and NP 62-202 has informed numerous decisions of Canadian securities commissions over the past decades that have, with few exceptions, cease traded shareholder rights plans after a certain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time period (generally 45 to 70 days) to allow a hostile bid to proceed. The old regime, girded by this regulatory approach, clearly favored bidders and significantly limited a target's ability to defend against hostile bids. In most cases, once a hostile bid was launched, some form of change of control transaction would become almost inevitable.

After the destabilizing decisions of the securities commissions in *Pulse Data*[4] and *Neo Materials,*[5] which seemed to provide more power to the target board of directors and the seminal decision of the Supreme Court of Canada in *BCE*,[6] which confirmed that the fiduciary duty of directors of Canadian companies is to act in the best interest of the company (and not any one stakeholder group, including shareholders), a number of capital markets participants began to question whether the shareholder-centric approach to takeover bids unduly restricted the ability of boards to defend against hostile bids. These concerns were amplified by persistent concerns that the bidder-friendly nature of Canadian securities and corporate laws were contributing to the "hollowing out" out of corporate Canada. In response, the CSA embarked upon a detailed review of the takeover bid rules to determine if any changes were needed to rebalance the competing interests of targets, their directors and bidders.

Following this review, in March of 2013 the CSA and the Quebec Autorité des marchés financiers (AMF) published competing proposals to strengthen a target board's ability to respond effectively to a hostile bid.

The CSA proposal would have provided target boards with greater flexibility to use a poison pill as a defense tactic to "just say no" to a hostile bid. Under the CSA proposal, in order for a rights plan to remain effective in the face of a hostile bid, shareholders would have to approve it within 90 days of its adoption by the board (or, if implemented after a takeover bid had been launched, within 90 days of the date of the bid).

The AMF proposal focused on whether target directors had complied with their fiduciary duties in responding to a hostile takeover bid consistent with the reasoning in *BCE,* and only contemplated regulator intervention where required to protect the public interest. This essentially would have allowed target boards to implement a poison pill without shareholder approval for an unlimited period of time, as is permitted in the United States.

The competing proposals resulted in significant debate and, in September 2014, the CSA, including the AMF, announced that neither of the competing proposals would be adopted. Instead, the CSA outlined a proposed regime largely consistent with the final version of the new rules. The first version of the new rules was published for comment in March of 2015 and, following the receipt of comments, the new rules were adopted unchanged from the March 2015 proposal in any material respect other than shortening the minimum bid period from 120 days to 105 days. This change addressed concerns about whether a 120-day bid period would preclude bidders from using the compulsory acquisition provisions under corporate law.[7]

Overview of the New Rules

The stated intent of the new rules is to enhance the quality and integrity of the takeover bid regime and rebalance the dynamic between all bidders, target boards and target shareholders by

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(i) facilitating the ability of target shareholders to make voluntary, informed and coordinated tender decisions, and (ii) providing target boards with additional time and discretion when responding to a takeover bid. These two objectives are advanced by requiring all takeover bids to:

- receive tenders of more than 50% of the outstanding securities of the class that are subject to the bid, excluding securities beneficially owned, or over which control or direction is exercised, by the bidder or by any person acting jointly or in concert with the bidder (the "Minimum Tender Condition");
- be extended by the bidder for an additional 10 days after the Minimum Tender Condition has been achieved and all other terms and conditions of the bid have been complied with or waived (the "10 Day Extension Requirement"); and
- remain open for a minimum deposit period of 105 days unless (a) the target board states in a news release a shorter deposit period for the bid of not less than 35 days, in which case all contemporaneous takeover bids must remain open for at least the stated shorter deposit period or (b) the target issues a news release that it has agreed to enter into, or determined to effect, a specified alternative transaction (such as an arrangement), in which case all contemporaneous takeover bids must remain open for a deposit period of at least 35 days (the "105 Day Requirement").

The following table compares the key features of the new rules with the previous regime:

Provision	Previous Regime	New Rules
Minimum tender requirement	No minimum tender requirement. Any minimum tender requirement stated in the bid could be waived by the bidder prior to the expiration of the bid. "Any and all" bids permitted.	Bidders are prohibited from taking up securities under a bid unless the bid receives tenders of more than 50% of the securities of the class subject to the bid, excluding those beneficially owned by the bidder. "Any and all" bids prohibited.
Extension of successful bid following the expiration of the bid	No requirement to extend a successful bid, except to satisfy customary "permitted bid" requirements under a rights plan.	Following the initial deposit period, all successful bids must be extended for an additional 10 days to enable any shareholder that had previously not tendered to tender its securities.
Minimum deposit period	Minimum deposit period of 35 days, with extensions given where variations are made to the bid.	Minimum deposit period of 105 days, which may be reduced at the option of the target, or upon the acceptance by the target of a friendly transaction.

Although the new rules provide target boards and shareholders significantly more time to consider and respond to hostile bids, as well as more leverage when negotiating with hostile bidders, they continue to reflect the CSA's traditional shareholder-centric outlook. The new rules do not change the CSA's perspective that target shareholders should ultimately be free to decide to tender to a bid even if the target board does not think the transaction is in the best interest of the target, nor their view that regulators have a role to play in ensuring that decision can be made.

Implications and Issues

The CSA has clearly accomplished its goal of rebalancing the dynamics among bidders, target boards and target shareholders. The new rules have a number of important implications, some of which are clearly evident today. Others will no doubt only become apparent once the rules have been tested in practice.

Hostile Bids Are Now More Challenging

As intended, the new rules significantly shift leverage away from hostile bidders and to target directors and shareholders. This will make hostile bids more difficult to complete and could, as a result, reduce hostile bid activity in Canada.

Time is generally the enemy of a hostile bidder. The longer a hostile bid remains outstanding, the greater the chance that a competing buyer will emerge, the target company's circumstances will improve, market conditions will change or some other unexpected development will derail the transaction. The 105 Day Requirement should give target boards ample runway to respond to an unsolicited offer and, if appropriate, run a thorough sales process to locate potential "white knight" bidders or make a more compelling case that target shareholders should reject the hostile bid. A hostile bidder therefore now faces higher completion risk, which would be exacerbated in the context of a share exchange bid (because the value of the consideration—the bidder's shares—will also be subject to market risk over a longer period). In some cases, the longer bid period may by itself be enough to dissuade a potential hostile bidder from proceeding.[8]

In addition, a longer bid period means that third party financing could be harder to obtain, and at the very least may be more expensive, as the lender's commitment will need to be in place for longer than has traditionally been the case. Bidders may also find it more challenging to convince target shareholders to "lock up" to their offer in advance for a minimum of 105 days.

The Minimum Tender Condition and 10 Day Extension Requirement take away what has traditionally been one of the most effective tactics available to a hostile bidder—the ability to waive its minimum tender condition and acquire "any and all" shares that are tendered. That ability permitted a hostile bidder to acquire an effective control position in the target, allowing it to block a competing transaction even if it was unable to gain majority control. This, combined with the fact that target shareholders would not know prior to the tender deadline what the outcome of the bid would be, led to persistent concerns under the prior regime that shareholders could be coerced into tendering to a hostile bid due to concerns over being "left behind" in what (they feared) would become an illiquid investment with no prospect of another control transaction.

These concerns have been addressed in the new rules by requiring (i) a shareholder "vote" on a takeover bid through the Minimum Tender

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Condition, which precludes "any and all" bids and (ii) the 10 Day Extension Requirement, which alleviates the pressure on shareholders to tender before the initial expiry date, allowing those who are unsure about the bid to wait and see if it will be successful before deciding to sell. This may mean more shareholders prefer to wait for the 10 Day Extension Period before tendering, which could make it even harder for hostile bids to succeed.

None of these changes make hostile bids impossible. Even under the new rules, Canada will remain a "bidder friendly" place relative to other jurisdictions, including the United States. As Suncor's ultimately successful bid to acquire Canadian Oil Sands demonstrates, a hostile bidder that is prepared to wait out the 105 Day Requirement and accept the increased completion risk associated with the Minimum Tender Condition can still achieve its objectives - just not quite as easily as before.

Partial Bids Are Much More Challenging

If hostile bids will generally be harder to complete under the new landscape, partial bid—offers to acquire less than all of the target company's outstanding shares—will be much more difficult.

Because the Minimum Tender Condition applies to all bids, a bidder who launches a bid for even a relatively small percentage of the target's shares must still convince the holders of more than 50% of the outstanding shares not owned by it to endorse the offer by tendering to it. This could be a significant hurdle, particularly if the bidder already owns a significant amount of the outstanding shares or if there are one or more large shareholders who are not prepared to tender - either because they do not support the bid generally or they do not wish to sell their shares (the new rules do not provide any mechanism for shareholders to endorse a bid other than by tendering).[9]

Since partial bids are rare in Canada and, rightly or wrongly, have been heavily criticized as being particularly coercive, the impact of the new rules on partial bids is likely of little practical consequence. Still, there may be situations where the new rules will preclude a partial bid that is appropriate and not coercive—such as a partial bid used to facilitate the sale of a large block of shares at a price that exceeds 115% of market price. In certain circumstances, it may be possible to obtain discretionary relief from the CSA to avoid having the majority tender requirement apply to a partial bid in order to facilitate those kinds of transactions.

Hostile Bid Tactics Will Evolve

We believe that the new rules will force both bidders and targets to adjust their hostile bid tactics.

Since hostile bids will now truly be marathons, both sides will be forced to commit significant resources to waging a hostile bid campaign. Timing considerations will no longer be particularly important to bidders,[10] and the target board's ability to reduce the 105-day bid period to 35 days in the context of a friendly transaction should give it additional leverage in negotiating with a hostile bidder.

Since the success or failure of a bid will turn on collective, and not individual, decision making by the target shareholders, we also expect that bidders will devote more resources to aggressive

public relations and solicitation campaigns (social media, white papers, websites, etc.) to convince shareholders to tender. These will be opposed by equally vigorous campaigns against the bid by the target, and potentially by significant shareholders who oppose the transaction (although targets will have to be mindful that their public opposition doesn't make a subsequent endorsement of the bid difficult or awkward if a friendly transaction can be successfully negotiated).[11] Proxy solicitors, public relations consultants and social media experts will all be key members of the deal team on both sides of the transaction. Some parties may start to consider proxy contests for control of the target's board of directors as a prelude or even an alternative to launching a hostile bid.

The new rules will affect how hostile bidders approach lock-up agreements and building toehold positions prior launching a bid. The Minimum Tender Condition means lock-ups will be even more valuable than toe-holds because shares tendered under a lock-up will count towards reaching the Minimum Tender Condition while toe-hold shares will not. Since toeholds will no longer give hostile bidders an effective head start in acquiring a potential control position, they will likely have limited tactical value going forward. Although the impact of the new rules on the likelihood of a target company being sold once it is in play remains to be seen, there could be increased financial risk associated with acquiring a toehold if the new rules make it less likely that a target company will be sold (*i.e.*, a toe-hold position may not represent the same kind of downside protection for a hostile bidder as it did under the old regime).

Rights Plans Will Have Limited Utility

The new rules give all companies the benefit of what is effectively a statutory shareholders rights plan, but subject to the 105 Day Requirement instead of the 60-day bid period currently required for a "permitted bid" under most rights plans. There should therefore no longer be any need for targets to adopt "tactical" rights plans in the face of a hostile bid and the securities regulators will no longer be regularly called upon to determine if the time has come for "the pill to go."

Does this means that poison pills will disappear from the Canadian landscape altogether? Probably not. At the very least, rights plan will still be used to prevent "creeping" takeover bids[12] and could also potentially be used to prohibit partial bids. For these reasons alone, we expect that issuers will continue to adopt and maintain rights plans, although the "permitted bid" provisions of rights plans (both existing and new) will likely need to be updated to make them consistent with the new rules.

A more interesting question is whether, under the new rules, there is any room for a target to use a rights plan to extend the bid period beyond 105 days. For example, if after 105 days the target board believes it is close to securing an alternative transaction but needs more time to complete negotiations, could it adopt a rights plan to hold the hostile bidder off for a bit longer? The new rules do not provide any guidance on the continued use of rights plans, leaving that possibility open, but we expect that the regulators will have very little or no tolerance for the continued use of tactical rights plans except in highly unusual circumstances.[13]

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Other Defensive Tactics

Since tactical rights plans will be of limited use against hostile bids, we expect target boards to increasingly focus on deploying other defensive tactics against a hostile bid.

In particular, the Minimum Tender Condition makes the "tactical private placement" a very effective response to a hostile bid. By placing additional shares into the hands of a "friendly" shareholder, the target can make it more difficult for the hostile bid to succeed and the longer bid period will provide more opportunities for the target to structure and implement "defensive" financing transactions. We expect that considering these kinds of financings will become part of the standard defensive tactics playbook under the new rules.

The new rules do not include any changes on defensive tactics generally and confirm that the shareholder-centric principles of NP 62-202 continue to apply. This suggests that regulators would intervene if a private placement prevented shareholders from tendering to a bid. Historically, however, regulators have generally been reluctant to interfere with private placements as long as the target can establish a legitimate business purpose for the financing, which in practice has not been difficult to do.[14] It is possible that under the new rules the CSA may hold tactical private placements to a higher standard, though there are practical challenges to CSA intervention in that the "blunt instrument" of the cease trade order may not be effective against a private placement that has already closed. This may mean that bidders are forced to look elsewhere—such as the TSX or the courts—if they wish to challenge a private placement by the target.

Timing Issues

The new rules are not intended to address timing differences between competing transactions. For example, as is currently the case, if the target secures a white knight offer close to when a hostile bid is set to expire, the hostile bidder is permitted to maintain its timing advantage and target shareholders must choose between the bird in hand (the hostile bid) and the potential of two in the bush (the white knight).

There are, however, some circumstances where the new rules can potentially create timing differences between two competing offers. For example, if a target company announces an "alternative transaction" (such as an arrangement), the 105-day bid period for a competing takeover bid would be shortened to 35 days. If this were to occur in circumstances where, due to regulatory, financing or other reasons, a hostile bid could be completed faster than the white knight transaction, the hostile bidder may gain a timing advantage. In contrast, if the white knight transaction is structured as a bid, the hostile bid period could never be shorter than the white knight bid period (*e.g.*, if the white knight bid had a 90-day bid period, the hostile bid would have to be open for at least 90 days). Although we do not believe that timing considerations will drive transaction structures in most cases, there may be circumstances where a friendly transaction should be structured as a bid in order to reduce the chances that a subsequently announced competing bid gains a timing advantage.

New Rules, Same Jurisdictional Issues?

Although the new rules will be adopted across the country, they will—like all other securities laws—be applied and enforced at the provincial

level. There is no guarantee that each provincial securities commission will implement the rules in the same manner in the same circumstances. For instance, certain jurisdictions may be more open to extending the 105-day bid period through the use of a poison pill in unique circumstances and may take different views on the use of other defensive tactics such as private placements.[15] While we hope that this can be avoided, inconsistent decisions on issues arising under the new rules would create uncertainty for market participants much like the situation that evolved in the context of poison pill hearings.

Conclusion

The new rules will profoundly change the manner in which takeover bids are conducted in Canada and the securities regulators' role in those transactions. They rebalance the playing field, barring the most coercive elements of hostile bids under the current regime and providing target boards ample time to explore all potential alternatives to a hostile bid, without varying the principle that a target board cannot indefinitely "just say no" to a hostile bid. Although the new rules have, we believe, significantly improved the landscape in Canada, they leave open questions that may draw securities regulators into a contested takeover bid as market participants adapt to the new regime and deploy new defensive tactics.

Whether this affects the role of securities regulators in Canada in policing the conduct of target directors more broadly remains to be seen. There has been a longstanding debate as to whether securities regulators are best positioned to determine issues involving the fiduciary duties of target boards, partly based on their jurisdiction and partly on their expertise, but also because of the limited array and blunt nature of remedies available to them. The new rules represent, in some important ways, a step away from the regulators' traditional views on the appropriate roles of both boards and the regulators themselves in the context of corporate contests for control. The obvious next step—one that we believe is long overdue—would be a broader reexamination of NP 62-202 and consideration of whether courts or securities regulators should have primary responsibility for reviewing the conduct of target directors in the face of a hostile bid.

ENDNOTES:

[1]Stanley M. Beck and Rob Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics," MEREDITH Memorial Lectures, 1987, Faculty of Law, McGill University at p. 120.

[2]The regulatory philosophy embodied in NP 38 has been summarized in six maxims (Stanley M. Beck and Rob Wildeboer, "National Policy 38 as a Regulator of Defensive Tactics," MEREDITH Memorial Lectures, 1987, Faculty of Law, McGill University at p. 121): 1. Takeover bids have an important role in the economy, for both economic and legal reasons; 2. Target management is in a conflict of interest situation when facing a hostile bid.; 3. The primary objective of takeover bid legislation is the protection of the *bona fide* interests of target company shareholders. A secondary objective is to provide regulatory neutrality between the offeror and target management. 4. Target company shareholders have the right to make the takeover bid decision. As such, target management has no valid reason to (unilaterally) deny them that right. Target management motivation effectively becomes irrelevant. 5. The appropriate regulatory approach to takeover bids is to encourage unrestricted auctions. 6. It is inappropriate to design a specific set of rules regulating target director conduct, other than those imposed by corporate law fiduciary

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standards. However, even without specific rules, it is possible to develop presumptions as to what conduct may be proper or improper.

[3]In October 1963, the Ontario Government appointed a Committee on Securities Legislation with the following terms of reference: "To review and report upon, in the light of modern business conditions and practices, the provisions and working of securities legislation in Ontario and in particular to consider the problems of takeover bids and of 'insider' trading, the degree of disclosure of information to shareholders, the requirements as to proxy solicitation, procedures as to primary distribution of securities to the public and like matters, and generally to recommend what, if any, changes in the law are desirable-."(See 1.01, Kimber Report).

[4]*In the Matter of Pulse Data Inc.*, 2007 A.B.A.S.C. 895.

[5]In *Re Neo Material Technologies Inc.* 2009 LNONOSC 638 the Ontario Securities Commission declined to cease trade the rights plan and Neo Materials was able to keep it in place which effectively prohibited a partial bid from proceeding.

[6]*BCE Inc.,* [2008] 3 S.C.R. 560 (*BCE).*

[7]Compulsory acquisition provisions generally require that a bidder has a statutory right to acquire any shares that are not tendered to a takeover bid if the bidder acquires at least 90% of the shares not owned by it as of the date of the bid, but only if the shares are acquired within 120 days of the date of the bid.

[8]For example, in September 2015, Total Energy Services Inc. cancelled a proposed hostile bid for Strad Energy Services Ltd. after Strad adopted a rights plan that required a 120 day offer period for "permitted bids." In its press release announcing its decision to cancel the proposed offer, Total stated that "the 120 day period associated with the Poison Pill is inordinately long and exposes Total to an unacceptable level of risk in the context of challenging and uncertain industry and market conditions."

[9]Commenters raised this as a "practical issue" with partial bids under the new rules. The CSA have acknowledged that concern and advised that it will be monitoring partial bids to see if the new rules require further adjustments vis-a-vis partial bids.

[10]Target boards, their advisors and their families will be glad to know that, among other things, this likely means the end (or at least a sharp curtailment of) the "Christmas special"—a hostile bid that is launched immediately before the Christmas holidays in order to have the bid period start to run at a time where the target board will likely be unable to effectively respond.

[11]Suncor's recent hostile bid for Canadian Oil Sands likely represents a good preview of the way parties will approach soliciting shareholder support under the new rules.

[12]The new rules did not address the ability of a bidder to use exemptions from the formal bid requirements to build a 20%-plus ownership position in a target without making a formal bid to all shareholders.

[13]In particular, if a target adopts a tactical rights plan to extend the 105 day bid period and the bidder applies for a "cease trade" order in respect of the plan, we do not expect that, in that context, the regulators would apply the traditional "Royal Host" analysis (*i.e.*, has the time come for the pill to go?). Instead, we believe the target company would bear the burden of providing compelling evidence as to why the pill should be permitted notwithstanding the significant protections already provided by the new rules.

[14]See, for example, our December 1, 2015 Goodmans Update, *BCSC Permits Private Placement in Face of a Hostile Bid*.

[15]As discussed above, the AMF's original proposal would have given target boards much more freedom to resist hostile bids. This suggests that it may be somewhat more open to allowing the continued use of tactical pills than other regulators.

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