Goodmans LLP Update

Corporate Securities Law

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OSC Clarifies Basis for Intervening in Eco Oro Tactical Private Placement

On June 19, 2017, the Ontario Securities Commission (OSC) released its much anticipated reasons for its decision, *In the Matter of Eco Oro Minerals Corp.* (available here), in which the OSC overturned the decision of the Toronto Stock Exchange (TSX) to approve a private placement by Eco Oro Minerals Corp. (TSX: EOM) ("**Eco Oro**") – without requiring prior approval of Eco Oro's shareholders – in the midst of a proxy contest to replace the Eco Oro board. The OSC's decision provides important guidance about the regulation of so-called "tactical" private placements implemented during a proxy contest, while also leaving a number of important questions unanswered.

Background

The background and facts of this case are described in detail in our May 1, 2017 Update, *OSC Intervenes in Private Placement Implemented During Proxy Contest* (available here).

At a high level, the case involved a decision by the Eco Oro board of directors, to convert, just days before the record date for a special shareholders meeting requisitioned to replace Eco Oro's board, a portion of Eco Oro's outstanding convertible notes held by certain shareholders who were supportive of the incumbent board and management. The note exchange increased the voting interest of the supportive shareholders from approximately 41% to 46%.

The TSX did not require Eco Oro to obtain shareholder approval for the note exchange, primarily on the basis that the transaction did not "materially affect control" of Eco Oro because the transaction would not result in the creation of a new 20% shareholder (or group). As a result, Eco Oro was able to close the note exchange concurrently with the first public announcement of the transaction.

The requisitioning shareholders applied to the BC Supreme Court to set aside the note exchange using the corporate law oppression remedy. The dissident shareholders also applied to the OSC for an order setting aside the TSX's decision to approve the note exchange without requiring the prior approval of Eco Oro's disinterested shareholders (based on the OSC's authority to review decisions of the TSX) or, alternatively, an order (under the OSC's broad "public interest" jurisdiction) to, among other things, cease trade the shares issued under the note exchange on the basis that the transaction was contrary to the public interest.

BC Supreme Court Proceedings

The BC Supreme Court rejected the dissidents' oppression claim, following the longstanding practice of Canadian courts in deferring to the business judgement of the board of directors, particularly where the court determines that the board acted with a view to the best interests of the corporation and not in violation of any reasonable expectation held by the relevant stakeholders (in this case, the dissident Eco Oro shareholders). While the decision is being appealed, the Court's decision highlights the significant challenges faced by applicants when challenging corporate actions in court.

Key Findings of the OSC

While the OSC reiterated its general reluctance to substitute its own judgement for that of the TSX, in this case the OSC determined that it was not appropriate to defer to the TSX's decision, given the OSC's conclusions that, among other things:

- the TSX did not have (or did not absorb) all material information concerning the proposed note exchange (including the pending proxy

contest and the fact that the noteholders had signed letters of support for the incumbent board immediately before Eco Oro proceeded with the note exchange) in part due to the OSC's view that Eco Oro was "less than forthcoming" in its disclosure to the TSX; and

- the analysis of whether a private placement "materially affects control" of an issuer must take into account the particular circumstances of the transaction and the issuer, including the potential implications on any pending contest for control of the issuer (in this case, the OSC concluded the TSX decision did not fully account for the status of the pending proxy contest).

Accordingly, the OSC proceeded to conduct its own analysis of whether the note exchange materially affected control of Eco Oro. After considering the particular facts of this case, the OSC determined that the note exchange did indeed materially affect control of Eco Oro because it was reasonably expected to "tip the scales" in the proxy contest for control of Eco Oro in favour of the incumbent board. In doing so, the OSC concluded that a private placement that impacts the outcome of a pending proxy contest can materially affect control of the issuer even if the transaction does not result in the creation of a new control person (usually a 20% voting interest, absent unusual circumstances) or group.

Since the note exchange had already been completed without shareholder approval, the OSC imposed the following terms and conditions to give practical effect to its decision:

- an obligation on Eco Oro to allow shareholders to vote to either approve or reverse the note exchange (unless Eco Oro otherwise voluntarily unwound the note exchange), and to unwind the transaction if shareholders voted to reverse it;
- a cease-trade order in respect of the shares issued under the note exchange pending the outcome of the shareholder vote; and
- a requirement that Eco Oro not count any votes attached to the shares issued under the note exchange pending the outcome of the shareholder vote.

Since the OSC reached its decision and issued its orders (including the additional terms and conditions described above) solely on the basis of its authority to review decisions of the TSX, the OSC did not discuss whether it would intervene in the note exchange on the basis that it was contrary to the public interest.

Leave to appeal the OSC's decision to Ontario's Divisional Court has been granted, and the hearing is scheduled for August 1, 2017.

Key Takeaways

There has been increased use by issuers, and scrutiny by regulators, of tactical private placements in recent years, particularly in the context of take-over bids (see our paper, *The Role of Tactical Private Placements in Canada's New Take-Over Bid Regime*). Most notably, the OSC and the British Columbia Securities Commission (BCSC) – in their joint decision *In the Matter of Hecla Mining Company and Dolly Varden Silver Corporation* – recently developed a comprehensive framework for evaluating tactical private placements implemented in the context of a take-over bid (see our October 27, 2016 Update, *OSC and BCSC Establish New Framework for Regulating Tactical Private Placements*, available here).

The Eco Oro decision clearly signals to market participants that private placements implemented during proxy contests will also be scrutinized, and provides a number of important lessons for issuers, investors and other stakeholders:

- Enhanced Scrutiny of Private Placements. Before the Eco Oro decision, the TSX generally accepted representations from an issuer that a private placement did not "materially affect control" of the issuer (absent contrary information being brought to its attention). The OSC's decision clarifies that the TSX is now expected to conduct a reasonable degree of due diligence regarding the circumstances of the transaction and the issuer. Market participants should therefore expect that the TSX may scrutinize a private placement more carefully and require additional information. We expect that the scope and mechanics of this process will evolve as the TSX addresses this expectation going forward.
- More Frequent Shareholder Approval. The Eco Oro decision highlights the fact that the creation of a new 20% shareholder (or group) is not the only basis on which a private placement can

materially affect control of an issuer. In particular, the OSC has clarified that the concept of "materially affect control" can apply to private placements to groups of shareholders who are not necessarily "acting jointly or in concert" (within the meaning of applicable securities laws), if the transaction would nonetheless reasonably be expected to impact the outcome of a proxy contest. This may cause the TSX to more frequently require disinterested shareholder approval for private placements – even those that are relatively small or broadly distributed – if they are implemented during a proxy contest or might otherwise affect control.

• Potential Delays. Historically, as was the case in Eco Oro, it has been possible to obtain TSX conditional approval of, and potentially close, a private placement before publicly announcing the transaction. Going forward, we expect that the TSX may generally require issuers to publicly announce private placements before closing to give other market participants an opportunity to raise concerns about the transaction with the TSX or securities regulators before the transaction closes.

• Full Disclosure. The OSC may intervene in a decision of the TSX to approve a private placement if the TSX did not have all material information available to it. The OSC relied on this factor (and others) in intervening in Eco Oro, noting that Eco Oro was "less than forthcoming" in its disclosure to the TSX. Going forward, issuers and investors would be well advised to provide all material information to the TSX to protect the TSX's decision and the transaction from a subsequent challenge to the OSC on this basis.

• Establishing a Proper Record. In Eco Oro, the OSC concluded that the note exchange did not provide any meaningful benefit to Eco Oro or its shareholders generally and that its timing was suspect. While it is not entirely clear how these findings factored into the OSC's analysis (as discussed below), issuers would nonetheless be well advised to ensure that they create a proper record that demonstrates an immediate need for a private placement that is implemented during a proxy contest. Further, ensuring that private placements impact a proxy contest to the minimum extent necessary will likely assist issuers in establishing the *bona fides* of a private placement implemented during a proxy contest.

• Acting Promptly. In determining that unwinding the note exchange (if not ratified by shareholders) was an appropriate remedy, the OSC placed significant weight on the fact that the dissident shareholders had no knowledge of the transaction before closing and took immediate steps, upon learning of the transaction, to challenge the TSX decision. It will be important for other stakeholders seeking to challenge tactical private placements to do the same. In particular, if the TSX requires the public announcement of a proposed private placement before closing, it will be critical for aggrieved stakeholders to challenge the transaction before it closes.

Eco Oro and the OSC's reasons also leave a number of critical questions regarding the regulation of tactical private placements in the proxy contest context unanswered, including the following:

• Standard of Proof. The unique facts in Eco Oro – most notably the relatively equal levels of support for the dissidents and the incumbent board, the support letters executed by the noteholders just prior to the note exchange and the timing of the note exchange relative to the record date for the requisitioned shareholders meeting – made it easier for the OSC to conclude that this private placement would reasonably be expected to impact the outcome of the proxy contest (and therefore materially affect control of Eco Oro). While heightened scrutiny of private placements is expected, it is unclear what standard of proof the TSX will require in order to conclude that a transaction does or does not materially affect control of an issuer, or which party will bear that burden.

• Applicable Regulatory Framework. Securities regulators primarily regulate tactical private placements implemented in the take-over bid context under their public interest jurisdiction, guided by the principles set forth in National Policy 62-202 – *Defensive Tactics*. On the other hand, the OSC decided Eco Oro on the basis of the TSX rules, and declined to discuss whether it viewed the transaction as contrary to the public interest. Accordingly, the decision leaves open the question of whether tactical private placements during a proxy contest can be challenged under the OSC's public interest jurisdiction if they otherwise comply with the TSX's rules and, if so, whether the analytical framework would be the same as *Hecla* or whether different considerations would apply.

• Relevance of Business Purpose. At its core, the framework established in *Hecla* for regulating tactical private placements implemented in the context of take-over bids requires a balancing of the benefits of the private placement and its impact on the bid, in order to determine whether it is contrary to the public interest. In Eco Oro, the OSC's conclusion that the note exchange had minimal benefits to Eco Oro and its shareholders generally does not appear to have been a significant factor in the OSC's analysis, likely because it was focused on whether the transaction materially affected control of Eco Oro, as opposed to a public interest analysis. If private placements during proxy contests are regulated primarily on the basis of the TSX's rules (rather than public interest grounds), it is unclear how the potential benefits of the private placement – which are of critical importance in the *Hecla* framework – would factor into the analysis, if at all.

• Jurisdiction to Unwind Transactions. In this case, the OSC concluded that it has the authority to effectively unwind a completed private placement. Prior to Eco Oro, this question had attracted considerable debate among market participants. At the same time, the OSC clearly recognized that it must proceed cautiously in unwinding completed transactions. In this case, the OSC had concluded that unwinding the private placement (if not ratified by Eco Oro's disinterested shareholders) was appropriate, given its conclusion that the private placement provided minimal benefits to Eco Oro and its shareholders generally, as well as the fact that unwinding the note exchange presented no practical challenges (particularly since it was a non-cash transaction) or any adverse impact on the rights of third parties. It will be interesting to see how securities regulators, if called upon to do so, approach a situation where unwinding a private placement would potentially deprive the company and its shareholders of substantial benefits or materially adversely impact the rights of innocent third parties.

• Implications for the Take-Over Bid Context. In *Hecla*, the OSC and BCSC declined to intervene in Dolly Varden's substantial private placement on the basis that it was not, even in part, a defensive tactic. However, Dolly Varden's private placement was not challenged on the basis that it materially affected control of Dolly Varden (and therefore should have required shareholder approval), notwithstanding the profound impact the private placement had on Hecla's take-over bid for 100% of Dolly Varden. It remains to be seen whether the TSX or OSC will, in light of Eco Oro, determine that a private placement that would reasonably be expected to affect the outcome of a take-over bid materially affects control of the issuer and require shareholder approval as a condition to the private placement.

If the OSC's decision in Eco Oro is upheld on appeal, it could have a significant effect on the ability of issuers to implement private placements during a proxy contest. However, the ultimate impact of the decision will likely only be understood as the TSX – and potentially the OSC – apply the lessons of Eco Oro to other similar transactions.

The Saga Continues

The requisitioned meeting of Eco Oro's shareholders that was originally scheduled for April 25, 2017 was adjourned by the BC Supreme Court. Eco Oro has scheduled the special shareholders meeting to consider the note exchange for August 15, 2017, with its annual general and special meeting (at which directors will be elected) for later the same day. Eco Oro has said that the decision to convene the special meeting to approve the note exchange has been made without prejudice to its appeal of the OSC's decision to the Divisional Court, and that if the appeal is successful, the board of directors may determine to cancel the meeting. Meanwhile, the dissidents recently announced that they would apply to the BC Supreme Court for an order requiring that the requisitioned meeting to vote on (and potentially replace) the Eco Oro board be held immediately, before the meeting to approve the note exchange has been completed.

Please contact any member of our Corporate Securities Group to discuss these developments or their impact on any transaction.