Goodmans LLP Update

Corporate Securities Law

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Perpetual Energy Decision May Deter Issuers from Pursuing Dilutive Rights Offerings in Tandem with Convertible Debenture Share Repayments

The Alberta Securities Commission (ASC) recently released its reasons in an application between Perpetual Energy Inc. ("**Perpetual**") and a group of Perpetual's convertible debentureholders (the "**Applicants**").[1] The decision highlights the challenges presented by convertible debentures as they approach maturity for issuers experiencing a declining share price.

Perpetual, facing the pending maturity of its convertible debentures and a low market price for its shares, decided to manage its debt obligations by taking two steps: (i) it determined to repay its convertible debentures in kind (with shares in lieu of cash), and (ii) it initiated a rights offering which permitted its shareholders, but not the debentureholders, to purchase additional shares at a very significant discount to the share price used to repay the debentures. The purpose and effect of the rights offering was to allow Perpetual to settle its convertible debentures with shares (not cash) while limiting the debentureholders' post-repayment ownership of Perpetual to a fixed percentage not determined by the market but instead determined by the company and its advisors based on their own valuation of the company and the relative interests of shareholders and debenture-holders. That valuation significantly exceeded the market value of the company reflected by its share price.

Though Perpetual's rights offering was permitted to proceed despite the Applicants' challenges, the ASC decision highlights key points for consideration by issuers that have issued or may issue convertible debt and their investors, as well as for reporting issuers more generally:

- The debentureholder-protection provisions customarily included in trust indentures for convertible debentures do not address transactions such as those implemented by Perpetual. Underwriters and debentureholders should consider requiring that indentures for new issues of convertible debentures expressly address rights offerings (and similar transactions or capital reorganizations) conducted in tandem with repayment of the debentures in shares. The best solution may be to simply prohibit these transactions when clearly designed to mitigate the dilution that comes with a share repayment.
- Similarly structured transactions may not be permitted by securities regulators in the future, and may also create a risk of civil liability for oppression.
- The threshold of "abuse" that securities commissions in Canada require to exercise their public interest powers is high; "unfairness" to securityholders is not sufficient.

Background

Perpetual had approximately $35 million principal amount of convertible debentures outstanding that were maturing on December 31, 2015. As is typical in Canada, the trust indenture governing the debentures provided that instead of repaying the principal amount in cash, the debentures could be repaid in shares of Perpetual. The number of shares

[1] The Applicants were Polar Asset Management Partners Inc., K2 & Associates Investment Management Inc. and Cambridge Global Asset Management., a division of CI Investments Inc. Goodmans LLP acted as co-counsel to the Applicants.

the debentureholders would receive was based on a volume-weighted average price (VWAP) of Perpetual's shares: the lower the VWAP in the relevant period, the more shares would be issued on repayment of the convertible debentures.

On November 20, 2015, Perpetual announced a series of recapitalization transactions including the repayment of its outstanding convertible debentures in shares and a rights offering (the "**Rights Offering**") to raise $25 million from its existing shareholders (collectively, the "**Equity Transactions**"). The Rights Offering was backstopped by a corporation controlled by the Chairman of Perpetual's board (the "**Chairman**"), which controlled 22.9% of Perpetual's outstanding shares.

Only existing shareholders of Perpetual were permitted to participate in the Rights Offering; debentureholders, although they would soon be significant shareholders as a result of the repayment of the debentures in shares, were excluded. Under the terms of the Rights Offering, existing Perpetual shareholders would be able to buy new shares at a significant discount to the VWAP used to repay the convertible debentures.

The effect of the Equity Transactions was to disregard the pricing in the market for the securities, and instead to effectively fix the *pro forma* allocation of the outstanding shares of Perpetual at approximately 22% for the debentureholders and 78% for the existing shareholders and those parties who exercised rights. This allocation was the result of the determination by Perpetual's independent committee of directors, on the advice of its financial advisors, that Perpetual's shares had a value of 64¢ per share, despite Perpetual's shares closing at 44.5¢ per share on the last trading day before the recapitalization announcement (at the time of the ASC hearing, the Perpetual shares were trading at less than 10¢ per share).

This also meant that debentureholders would acquire 22% of the outstanding shares for their $35 million principal amount. In contrast, rights holders stood to receive in excess of 60% of the outstanding shares for only $25 million.

Perpetual argued that the backstop commitment would not have been forthcoming without certainty as to the proportionate post-investment equity interest of rights holders provided by the fixed allocations of equity.

The Applicants appealed the issuance of the receipt for the Rights Offering prospectus and in the alternative applied for a cease-trade order of the Rights Offering on the basis that the Equity Transactions were contrary to the public interest.

The Decision

While the ASC expressed doubt about the fairness and appropriateness of the Rights Offering in the circumstances of a convertible debenture share repayment, it declined to either issue a cease-trade order or intervene to stop the Rights Offering.

The ASC agreed with the Applicants that the "bargain" implicit in a convertible debenture investment was that debentureholders would receive, at maturity, something – either cash or shares, depending on how settlement were effected - of a realizable value equal or close to the principal amount of their debentures. Absent some better measure of realizable value, the ASC found that market trading prices were more relevant than a "notional" value determined by the issuer's board.

The ASC also found that the debentureholders were treated unfairly by Perpetual in the circumstances, describing the structuring of the offering as "troubling". However, the ASC concluded that "unfairness is not the same thing as abuse, and not alone a sufficient basis for exercising our public interest authority." Focusing on the financial challenges facing the company, the process followed by its board and the "internal logic" of the Equity Transactions once the 64¢ per share notional value was accepted (despite a lack of clarity surrounding whether the independent committee and its financial advisor "fully appreciated" the significance of the 64¢ notional share valuation), the ASC concluded that the Applicants did not establish abuse of debentureholders nor did they establish harm to the capital markets.

The ASC also noted the "blunt" nature of the remedies available to securities regulators, acknowledging that if unfairness amounting to oppression could be established by the Applicants in a commercial court, the arsenal of available remedies could more directly address the harm done, while allowing greater precision and differentiation among claims and claimants. However, considering the effect of this decision on future offerings of a similar nature, the ASC stated:

> *Moreover, we considered that a general deterrent effect might follow from this proceeding even were the Application to fail. The hearing aired important issues, and we expressed our concern about unfairness occasioned by the Offering. All of this could reasonably inform those involved in future transaction design and decision-making, and prompt questions that perhaps were not asked when the Offering was designed and approved. This proceeding could also prove informative to Staff or another ASC hearing panel asked in future to consider similar facts. We observed, therefore, that a (hypothetical) future arrangement designed, and likely, to thwart a negotiated bargain could well face an unwelcome regulatory response - irrespective of the outcome of this Application.*

Postscript

As a result of the Equity Transactions, the holders of convertible debentures were issued an aggregate of 232.1 million shares at 15.03¢ per share for approximately 22.2% of Perpetual's outstanding common shares post-Rights Offering. In contrast, the holders of rights (including the Chairman as a backstopper) were issued an aggregate of 665.4 million shares on the exercise of the rights at a price of approximately 3.76¢ per share (a 75% discount to the price at which shares were issued on repayment of the convertible debentures) for approximately 63.5% of Perpetual's outstanding common shares post-Rights Offering. The Chairman's ownership in Perpetual increased from 22.9% to 45% of its outstanding shares. Had the Rights Offering not occurred, the shares issued to the convertible debentureholders on maturity would have aggregated approximately 60% of Perpetual's outstanding shares (compared to the 22.2% they ended up with after the Rights Offering).

Please contact any member of our Corporate Securities Group if you wish to discuss this decision.