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SERIAL-INVERTER RULE HITS TARGET, AND NEW PROPOSED EARNINGS-STRIPPING REGULATIONS ISSUED UNDER SECTION 385 LEAVE COMPANIES AND TAX PRACTITIONERS WONDERING, "IS NEVER BETTER THAN LATE?"

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On April 4, 2016, the U.S. Treasury Department released two significant packages of U.S. federal tax regulations. T.D. 9761 contains temporary regulations primarily addressing the anti-inversion rules under section 7874 of the Internal Revenue Code, and REG-108060-15 contains proposed earnings-stripping regulations that apply generally to related-party debt.

Within 30 hours of the release of these rules, Pfizer and Allergan[1] announced that their planned merger was off—apparently, a victim of the "serial inverter" rule contained in the new temporary section 7874 regulations and possibly the proposed anti-earnings-stripping rules. Treasury regulations are not supposed to target specific taxpayers, and while the new anti-inversion regulations are broad in effect, they seem uniquely tailored to target the Pfizer-Allergan transaction.

Temporary Anti-Inversion Regulations

While the temporary anti-inversion regulations implement those rules described in Treasury Notices 2014-52 and 2015-79 (the "Notices"), they also introduce new rules and modifications to existing rules without prior (or proper) notice. Chief among these new rules is the so-called serial-inverter rule. The market was understandably surprised by these new rules. There is precedent for restraint in these matters. For instance, Treasury historically has made newly-introduced rules, such as these, effective only for transactions signed after the introduction date, thereby excluding from their applicability transactions already under a binding contract or publicly announced. These new rules provide for no such restraint. Thus, these new rules have an unsettling impact on the U.S. marketplace because, for obvious reasons, they destabilize its reliability—reliability that makes it the

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most favored marketplace in the world in which to do business. The U.S. capital markets need a predictable platform to remain the world's finest, which includes certainty in the tax law when structuring business deals. Business activity cannot be conducted in an efficient manner if there is a risk that the government will change the playing field midway through the game. These new rules and modifications to the Notices are effective for transactions completed on or after April 4, 2016 (regardless of when signed).

Under section 7874 generally, a foreign acquiring corporation is treated as a U.S. corporation for U.S. tax purposes if it acquires substantially all of the stock (or property) of a U.S. target corporation and the shareholders of the U.S. target corporation own at least 80 percent of the foreign acquiror stock after the exchange. Although a foreign acquiring corporation remains a foreign corporation for U.S. tax purposes when the U.S. target corporation's shareholders receive less than 80 percent of the foreign acquiring corporation stock in the exchange, section 7874 denies the U.S. corporation use of certain tax attributes when the shareholders of the U.S. target corporation own at least 60 percent, but less than 80 percent, of the foreign acquiror stock after the exchange.

For purposes of calculating the inversion ownership fraction with respect to a new acquisition, the serial-inverter rule disregards foreign acquiring corporation stock issued (or deemed issued) in prior acquisitions of U.S. corporations by that foreign acquiring corporation occurring within the 36-month period ending on the date a new acquisition becomes subject to a binding contract. This rule is designed to prevent foreign corporations from obtaining the benefits of an increased denominator of the ownership fraction for the foreign acquiring corporation stock issued in prior acquisitions.

When it applies, the serial-inverter rule has the effect of increasing the likelihood (by reason of a lower denominator) that the foreign company shares issued in the new acquisition to the U.S. corporation shareholders will represent 60 percent (and maybe 80 percent) of the adjusted number of outstanding shares of foreign acquiring corporation stock, thus increasing the likelihood that the new acquisition will be subject to the punitive rules of section 7874.

For example, assume that a foreign acquiring company ("FA") is worth $100 in Year 0. In Year 1, FA acquires a U.S. company ("DT 1") in exchange for $50 of FA stock. In Year 2, FA acquires a U.S.

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company ("DT 2") in exchange for $50 of FA stock. Finally, in Year 3, FA acquires a U.S. company ("DT 3") in exchange for $150 of FA stock. Absent the serial-inverter rule, DT 3 shareholders would own $150/$350, or 43 percent of the FA stock post-inversion. Under the serial-inverter rule, the stock of FA issued in the acquisitions of DT 1 and DT 2 is disregarded when determining whether the DT 3 acquisition is a 60-percent or 80-percent inversion. As a result, FA is treated as if it were worth $100 before the acquisition of DT 3, and DT 3's shareholders are deemed to own $150/$250 or 60 percent of FA after the transaction, resulting in a 60-percent inversion.

The 36-month look-back period begins on the signing date of a new transaction, but the regulations are effective for transactions closing on or after April 4, 2016. Effectively, for pending transactions, the 36 months can reach back to 2013 or earlier. The Pfizer-Allergan merger signed on November 23, 2015. During the 36 months prior to the signing date, Allergan acquired, in exchange for its stock, two U.S. companies. The additional Allergan market capitalization created by these acquisitions, and thus the denominator of its ownership fraction, allowed for Allergan's acquisition of Pfizer without resulting in a 60-plus percent inversion, at least until the serial inversion rule was introduced. Immediately after the Pfizer-Allergan merger was called off, some speculated that the companies could merely wait for the 36-month look-back period to lapse and then resign the deal. However, a closer look at these new rules, specifically an anti-avoidance rule related to the serial-inverter rule, leads one to conclude that the companies cannot merely enter into the same, or substantially similar, contract outside the 36-month period (note, however, that "substantially similar" is not defined).

Implementation of Rules Introduced in Notices 2014-52 and 2015-79

The regulations also implement rules previously introduced in the Notices, which (1) target situations where a U.S. Company attempts to "skinny down" its value or the foreign company tries to "pump up" its value just prior to an inversion to stay under the 60-percent or 80-percent thresholds, and (2) make 60-percent inversions less attractive by decreasing the tax benefits that can be achieved after an inversion. Specifically, the regulations include the following:

Rules from Notice 2014-52: For purposes of determining whether the 60-percent and 80-percent tests are satisfied, the regulations—

- decrease the relative size of a foreign acquiring corporation for purposes of calculating the ownership fraction if such foreign acquiring corporation holds a significant amount of passive assets;
- ignore certain distributions made by the U.S. corporation during the 36 months preceding an inversion; and
- subject certain types of multi-step spin-offs (so-called "spinversions") to section 7874.

For purposes of preventing the U.S. corporation from using the tax benefits resulting from entering into an inversion structure, the regulations—

- treat related-party foreign-to-foreign "hopscotch" loans as investments in U.S. property subject to current U.S. tax as a dividend;
- prevent the tax-free de-controlling of a controlled foreign corporation; and
- prohibit certain related-party stock sales from being used to strip the earnings of a controlled foreign corporation.

Rules first introduced in Notice 2014-52 that were implemented by the temporary regulations without substantive change are effective for transactions completed on or after September 22, 2014.

Rules from Notice 2015-79: The regulations—

- deny the exception to section 7874 for "substantial business activities," unless the foreign acquiring corporation's group has substantial business activities in the country where its parent is tax resident;
- treat what would otherwise be a 60-percent inversion as a *per se* 80-percent inversion if a foreign corporation and U.S. corporation are each acquired by a new foreign acquiring corporation organized in a third country; and
- treat "indirect" transfers of property by a U.S. corporation after a 60-percent inversion as if directly made by the U.S. corporation for U.S. tax purposes.

Rules first introduced in Notice 2015-79 that were implemented by the temporary regulations without substantive change are effective for transactions completed on or after November 19, 2015.

These regulations are temporary and will sunset on April 4, 2019, although it is generally the case that final regulations are issued before a temporary regulation sunsets.

Proposed Earnings-Stripping Regulations

In the Notices, Treasury also put taxpayers on notice that it was considering the issuance of anti-earnings-stripping rules to address base erosion. One of the purposes of an anti-earnings-stripping rule is to prevent U.S. companies from shifting income from high-tax to low-tax jurisdictions through the issuance of debt between related companies (*i.e.*, where the interest on the debt would generate a tax deduction offsetting income taxed at a high rate, but would be taxed in a different jurisdiction with a lower rate). Base erosion is a strategy employed by taxpayers ever since interest became deductible, and has historically been used to reduce double taxation imposed on U.S. corporations owned by individual and corporate shareholders alike. It is a mainstay of tax planning that taxpayers are allowed to capitalize their corporations with debt, as opposed to equity, to the extent such debt is supportable as true indebtedness under the case law. The proposed section 385 regulations contain rules targeted at eliminating this electivity and thus heretofore acceptable base erosion. But, as drafted, the proposed regulations are not limited to merely base-erosion arrangements. The regulations apply to a much broader set of related-party arrangements, for example, they apply to debt instruments between both U.S.-to-U.S. related parties (except members of a U.S. consolidated group) as well as U.S.-to-foreign related parties. Furthermore, these rules affect not only inverted companies that use intercompany debt to erode the U.S. tax base, but they apply with equal force to everyday intra-group financing transactions.

Specifically, the proposed regulations (i) require certain related-party debt to be treated as stock of the issuer, (ii) enable the IRS to treat certain related-party debt as part debt and part equity, and (iii) specify due diligence and documentation that must be undertaken and maintained in order for certain related-party debt to be respected as debt for U.S. tax purposes. In each of these cases, the proposed regulations treat debt as stock despite the intent of the parties to create a garden variety debtor-creditor relationship. The effect of the application of these rules would be the denial of any interest deduction taken with respect to recharacterized debt and the recharacterization of payments made on the debt as distributions on stock (potentially treated as dividends for U.S. tax purposes).

The application of the proposed regulations is limited to debts between members of a group (referred to in the regulations as an "expanded group"), which generally includes all corporations (foreign and domestic) related through direct, or indirect, common stock ownership of 80 percent or more (measured either by voting power or by value). Expansive attribution rules also apply for purposes of determining stock ownership. The proposed regulations do not apply,

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however, to debts directly between members of a U.S. consolidated group, until such debt instruments cease being consolidated-group debts, for example when the debtor or creditor cease to be consolidated group members (but remain members of the expanded group), or the debt is no longer held by consolidated group members.

Recharacterization of Debt Rules

Under the proposed regulations, intercompany debt can be recharacterized as stock if it is issued (i) as a distribution from one expanded group member to another, (ii) as consideration by one expanded group member for the stock of another, or (iii) as boot in certain intergroup reorganizations. Additionally, intercompany debt may be recharacterized as stock when issued with a principal purpose of funding a distribution or acquisition by the funded member, regardless of whether the lending member is a party to such distribution or acquisition. A principal purpose of funding the distribution or acquisition is generally presumed, on a non-rebuttable basis, if the debt instrument in question was issued within the 36 months before or after the distribution or acquisition, subject to a limited exception for debt issued in the ordinary course of certain trade or business activities. This 36-month look-back and 36-month look-forward period is both arbitrary (because the 72-month period is without any obvious justification) and inappropriate (because it will make it extremely difficult for U.S.-based multinational companies to routinely finance their business activities on a day-to-day basis).

Not all intercompany debt is subject to recharacterization. As mentioned above, debt directly between U.S. consolidated group members is exempt from these rules. Debt distributed by a member is not recharacterized as stock to the extent of the issuer's current-year earnings and profits. For reasons that have not yet been adequately explained by the government, this exception does not apply to accumulated earnings and profits, so a corporation that wishes to utilize the exception on an ongoing basis must make annual dividend distributions. Limiting the exception to current-year earnings and profits fails to take into account the practical difficulties of paying dividends annually in many foreign jurisdictions. Additionally, these rules do not apply to expanded groups if the aggregate issue price of all the expanded group's debt subject to these rules does not exceed $50 million. However, because expansive attribution rules apply in determining the members of the expanded group, many taxpayers who hope to take advantage of this exception may be surprised, particularly where an acquisition vehicle or joint venture treated as a partnership for U.S. federal tax purposes has corporate investors who themselves utilize intercompany debt. Under these proposed regulations, debt issued by a borrower who has the ability to pay interest and principal when due can be treated as equity if the borrower has made or makes a dividend distribution (other than out of current earnings) during the 36 months before or after the borrowing.

These recharacterization rules are generally applicable to debt instruments issued on or after April 4, 2016. However, such instruments will continue to be treated as debt until 90 days after the finalization of the proposed regulations, at which time such debt instruments, if outstanding and subject to the recharacterization rule, will be treated as exchanged for stock for U.S. tax purposes. The regulations attempt to prevent some of the negative tax consequences of the deemed exchange, such as preventing cancellation-of-indebtedness income for the debtor and recognition of gain or loss by the creditor.

Bifurcation Rules

The proposed regulations convey almost unlimited authority to the IRS (with no ability on the part of the taxpayer) to bifurcate a related-party debt instrument, thereby treating it as partially debt and partially stock where there is a mere reasonable expectation that only a portion of the principal amount of the debt will be

satisfied. These bifurcation rules, however, apply to "modified expanded groups" by lowering the ownership threshold from 80 percent to 50 percent. These bifurcation rules are generally applicable to debt instruments issued on or after the date that these rules become final.

Documentation Requirements

The proposed regulations also prescribe rules requiring certain documentation and information to be prepared and maintained in connection with the issuance of related-party debt between members of expanded groups in order for such debt to be respected as debt for U.S. tax purposes. With regard to these intragroup arrangements, this requirement is the sole gateway into debt treatment, regardless of the creditworthiness of the borrower, or the intent of the parties to enter a creditor-debtor relationship. Generally, the proposed regulations require that such documentation must evidence (i) the legally binding obligation to pay, (ii) the creditor's right to enforce, (iii) the reasonable expectation of repayment, and (iv) an ongoing arm's-length debtor-creditor relationship during the life of the debt. The proposed regulations require that the documentation be prepared no later than 30 days after the date the debt is issued, except for documentation of the debtor-creditor relationship, which must be prepared within 120 days after the date the debt is issued. The rules also provide relief for taxpayers that fail to comply, if such failure is due to reasonable cause.

These documentation rules apply to expanded groups that (i) include a member that is publicly traded, (ii) have assets in excess of $100 million, or (iii) have annual revenue in excess of $50 million. These documentation rules are generally applicable to debt instruments issued on or after the date that these rules become final.

The Validity of the Regulations

Generally, Congress must authorize a federal governmental agency (typically, by statute) to issue regulations that have the force of law. Tax-related regulations issued by the Treasury Department are no different. In the case of the proposed earnings-stripping regulations, the Treasury Department claims its authority can be found in section 385 of the Internal Revenue Code, which Congress originally enacted as part of the Tax Reform Act of 1969. Section 385 authorizes Treasury to "prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness." However, section 385 does not appear to authorize Treasury to prescribe simply any debt-related regulations it deems appropriate for its policy goals. As is clear from the face of the statute, Congress granted Treasury much more limited authority. Section 385 requires that any regulations issued thereunder must "set forth factors which are to be taken into account in determining . . . whether a debtor-creditor relationship exists." In other words, Congress authorized Treasury to do little more than enumerate specific factors to provide taxpayers with guidelines for resolving ambiguities between debt and equity—and not rewrite settled principles of tax law.

The legislative history behind the Tax Reform Act confirms what the plain language of section 385 says. A report by the Senate Committee on Finance in 1969 states that in response to many prior court cases, and "[i]n view of the uncertainties and difficulties which the distinction between debt and equity has produced in numerous situations other than those involving corporate acquisitions . . . [,] it would be desirable to provide rules for distinguishing debt from equity in the variety of contexts in which this problem can arise. The differing circumstances which characterize these situations, however, would make it difficult for the committee to provide comprehensive and specific statutory rules of universal and equal applicability. In view of this, the committee believes it is appropriate to specifically authorize . . . Treasury to prescribe the appropriate rules for distinguishing debt from equity in these different situations." Therefore, the report

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explains that section 385 gives Treasury "specific statutory authority to promulgate regulatory guidelines, to the extent necessary or appropriate, for determining whether a corporate obligation constitutes stock or indebtedness. The provision specifies that these guidelines are to set forth factors to be taken into account in determining, with respect to a particular factual situation, whether a debtor-creditor relationship exists or whether a corporation-shareholder relationship exists."

Thus, viewed in this context, it is plain that section 385 requires Treasury to establish a factor-based approach, providing guidelines for purposes of determining whether a particular arrangement, or relationship between a purported debtor and creditor was in substance a debt, or alternatively risk capital and thus stock. The proposed regulations, however, do not take that approach. By prescribing rules that treat particular debt instruments as stock based merely upon the relationship of the purported debtor and creditor and the transaction in which the instrument is created, and specifically by doing so with a view to eliminating certain perceived abuses that have nothing to do with the substance of whether a debtor-creditor relationship has been created, Treasury is legislating outside the bounds of the authority it was granted under section 385. Certainly, nothing in section 385 suggests that Congress intended for Treasury to overturn settled tax principles on how to distinguish between debt and equity, and, indeed, no one in the decades since section 385 was enacted has thought section 385 authorized the sea change in tax law that Treasury now seems to think the statute did.

The preamble to the proposed regulations is particularly revealing, because it proves that Treasury is targeting earnings stripping and the deductibility of interest on related-party debt. The preamble states that "inverted groups and other foreign-parented groups use [the types of transactions covered by the proposed regulations] to create interest deductions that reduce U.S. source income without investing any new capital in the U.S. operations. In addition, U.S.-parented groups obtain distortive results by, for example, using these types of transactions to create interest deductions that reduce the earnings and profits of controlled foreign corporations (CFCs) and to facilitate the repatriation of untaxed earnings without recognizing dividend income." In its authority granted under section 385, Congress did not intend for Treasury to use its section 385 authority as an anti-abuse measure limiting interest deductions—to the contrary, other provisions of the Internal Revenue Code explicitly govern that topic, including sections 163(j) and 279. It is widely believed that Treasury's inability to find a way to use its authority under section 163(j) to address its base erosion concerns led it to the all-or-nothing approach of the proposed regulations.

By addressing earnings stripping under the auspices of section 385, Treasury has gone farther than the Organization for Economic Cooperation and Development's Base Erosion and Profit Shifting project, a multi-jurisdictional effort on behalf of 34 countries. The OECD has recommended a far more modest approach for limiting earnings stripping by setting a 10- to 30-percent-of-EBITDA interest deduction threshold. Furthermore, the European Commission's Anti-Tax Avoidance Package includes a 30-percent-of-EBITDA interest-deduction limit.

In the face of these recommendations, Treasury's proposed rules are unprecedented, overreaching and unnecessary. We have heard that Treasury and the Internal Revenue Service are seeking to finalize these regulations by August 2016. We can only hope that Treasury will reevaluate its decision to police earnings stripping and the deduction of interest with a more appropriate tool. The authority granted to Treasury under section 385 was limited to providing factors for determining the substance, as debt or equity, of a purported debt instrument based on the relationship created under the instrument in question, not to determine debt or equity treatment based on the mere

relationship between the debtor and creditor. This distinction is one apparently lost on the Treasury.

ENDNOTES:

[1]Jones Day did not advise Pfizer or Allergan with respect to this proposed transaction.

THE ROLE OF PRIVATE PLACEMENTS IN CANADA'S NEW TAKEOVER BID REGIME

By Jonathan Feldman, Christopher Sunstrum and Matthew Prager

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Meaningful changes to Canada's takeover bid regime that took effect on May 9, 2016 are expected to significantly impact the way target boards respond to unsolicited or "hostile" takeover bids.[1] Among other things, the new rules allow a majority of shareholders to determine (through their tender decisions) whether or not a hostile bid can proceed and provide target boards with substantially more time to persuade shareholders to reject a bid or implement alternatives to the bid. The amendments also render the primary tool historically used by target boards—the shareholder rights plan or "poison pill"—effectively irrelevant as a tactical response to a hostile bid.[2]

Given these developments, there has been renewed discussion about the appropriate role of, and the tools available to, target boards in responding to hostile bids under the new regime. In particular, there has been an increased focus on the potential use of private placements[3] as part of target boards' responses to hostile bids. While a long line of decisions regarding shareholder rights plans provided a reasonable level of certainty regarding the regulatory approach to rights plans, the framework for these "tactical" private placements is less clear.[4] This article seeks to clarify the relatively limited jurisprudence surrounding tactical private placements to date, and highlights considerations relevant to target boards considering this option as well as to bidders seeking to minimize execution risk.

The Canadian Takeover Bid Landscape

Bidders seeking to acquire control of a Canadian public company can make an offer directly to the target's shareholders without seeking the approval of the target's board or management. The offer must comply with the formal takeover bid rules under applicable Canadian securities laws, which are primarily intended to protect the interests of the target's shareholders.

Directors of Canadian corporations owe a fiduciary duty to act in the best interests of the corporation. In *BCE Inc. v. 1976 Debentureholders*,[5] the Supreme Court of Canada confirmed that the interests of the corporation are not confined to short-term profit or share value, and that, even in a potential change-of-control situation, there is no obligation to prioritize shareholder interests over the long-term interests of the corporation and its multiple stakeholders.[6] It follows that when faced with a hostile takeover bid, the target's board is not obligated to pursue a sale of the corporation and may, depending on its assessment of the corporation's best interests, pursue alternatives or take other steps (so-called "defensive tactics") that may have the purpose or effect of impacting the bid.

Canadian courts, applying the "business judgment rule," generally defer to a target board's decision to implement defensive tactics if the decision was impartial, informed and within a range of reasonable alternatives. In contrast, Canadian securities regula-

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tors evaluate defensive tactics as part of their broad public interest jurisdiction, which seeks to alleviate conduct that is abusive of shareholders or the capital markets.[7] Application of their public interest jurisdiction to defensive tactics is guided by the principles embodied in National Policy 62-202—*Take-Over Bids—Defensive Tactics* (NP 62-202), which seeks to prevent shareholders from being deprived of the ability to respond to a takeover bid (or a competing bid).

Prior to the amendments to the bid regime, target boards faced with a hostile bid would typically implement (or maintain, if one had already been adopted) a shareholder rights plan. A rights plan prevents a takeover bid from proceeding unless it is supported by the target's board (or, in some cases, complies with certain "permitted bid" conditions set out in the plan). As a result of their predisposition toward shareholder interests, challenges to rights plans have almost exclusively been made to securities regulators, rather than the courts. Securities regulators, applying NP 62-202, have generally struck down rights plans once they no longer serve to maximize shareholder choice and value. With rights plans, the question is not if, but when the pill should go (typically within 45 to 70 days).

As a result of this regulatory approach, it has generally been accepted that Canadian boards cannot "just say no" to a hostile bid.[8] At the same time, before the recent amendments to the takeover bid regime, the inability of a majority of target shareholders to collectively block a bid created significant pressure on individual shareholders to tender—even if they believed the bid was inadequate—to avoid being left with an illiquid minority interest and no prospect of a further premium control transaction. The inability of both target boards and shareholders to effectively respond to hostile bids led to persistent allegations that the Canadian takeover bid regime too heavily favored bidders and inevitably led to the sale of control of the corporation, often at an inadequate premium.

In response to these concerns, the Canadian Securities Administrators (CSA) embarked on a detailed review of the takeover bid rules and the regulation of defensive tactics generally. After initially proposing alternatives to strengthen a target board's ability to effectively respond to a hostile bid,[9] the CSA instead opted to pursue structural amendments to the takeover bid rules. The final amendments, which became effective on May 9, 2016, seek to rebalance the dynamic between bidders, target boards and target shareholders by requiring all takeover bids to:

- remain open for a minimum bid period of 105 days unless the target board reduces the bid period (to a minimum of 35 days) or agrees to certain competing transactions (in which case the minimum bid period will automatically be 35 days);
- receive tenders of more than 50% of the outstanding shares of the class that are subject to the bid (excluding shares owned by the bidder group); and
- be extended for at least 10 days after the 50% tender condition has been achieved.

The amendments raise questions about the appropriate role of the board and the use of defensive tactics in the new bid regime, particularly given that a majority of shareholders can now effectively block a bid. In this new framework, a target board's first line of defense against a bid it believes is not in the target's best interests will generally be a robust campaign to persuade shareholders to reject the bid. However, target board action beyond making a recommendation may still be necessary in the new regime, given that:

- the amendments are expected to mitigate, but may not eliminate, the pressure on target shareholders to tender to an inadequate bid (particularly given the potential impact on the target's share price following an unsuccessful bid);
- *BCE* mandates that directors pursue the long-

term best interests of the corporation, even if those interests diverge from the short-term interests of its shareholders; and

- the extended timeline and increased uncertainty in the outcome of a bid (given the mandatory minimum tender condition) heighten the risk to the target and its shareholders of foregoing value-enhancing transactions simply because a bid has been launched.

Given the continued application of NP 62-202 in the new regime and the fact that the amendments effectively provide target boards with a statutory shareholder rights plan, we expect that, absent unusual circumstances, any attempt by a target board to use a rights plan to further extend or block a bid would be met with swift regulatory intervention. An important question, therefore, is what tools can target boards now use to discharge their fiduciary duties in the face of a hostile bid? For reasons we discuss in greater detail below, there has been increased attention on whether private placements can potentially fill this role.

Regulation of Tactical Private Placements in Canada to Date

Before the advent of rights plans in Canada, private placements were a common tactical tool used by target boards in responding to hostile bids. Securities regulators declined early opportunities to intervene in these transactions on the basis that courts were the more appropriate forum,[10] while judges generally deferred to the business judgement of directors unless it could be demonstrated that they were not acting in the corporation's best interests.[11] National Policy 38 (NP 38) (the predecessor to NP 62-202)—which explicitly refers to an issuance of securities representing a "significant percentage" of the target's outstanding securities as a potential defensive tactic that will be scrutinized—was implemented in part to address concerns that private placements were being used as defensive tactics. However, the proliferation of rights plans that occurred shortly after NP 38's adoption largely supplanted private placements as the predominant tactical takeover defense and quickly became the focus of NP 38's (and subsequently NP 62-202's) application.

More recently, private placements have begun to re-emerge in Canada as a tactical tool in a number of situations. Bidders (and dissident shareholders), emboldened by the regulatory approach to rights plans and deterred by the deference afforded by the business judgement rule, have sought to challenge these transactions before securities regulators rather than the courts. These decisions, the most important of which are described below, illustrate some of the challenges securities regulators face in evaluating tactical private placements compared to rights plans. It is helpful to understand these cases before attempting to delineate the analytical framework for determining when and how securities regulators will intervene in tactical private placements.

Icahn Partners LP v. Lions Gate Entertainment

Lions Gate[12] involved a battle for control of Lions Gate Entertainment Corp. during which Carl Icahn launched multiple hostile takeover bids and a proxy contest aimed at replacing Lions Gate's board. In the midst of these initiatives, Lions Gate executed a series of "de-leveraging" transactions whereby outstanding convertible notes were transferred to a director of Lions Gate (who was also its second-largest shareholder) and converted into common shares, resulting in dilution of Icahn's holdings from 37.9% to 33.5%. In response, Icahn announced his second takeover bid and applied to the British Columbia Securities Commission (BCSC) to unwind the transactions on the basis that they were an improper defensive tactic. The BCSC dismissed the application (without formal reasons),indicating that the courts were the appropriate forum. Icahn subsequently brought an oppression claim before the Supreme Court of British Columbia.[13]

Following the framework set out in *BCE*, the Court ultimately rejected Icahn's claim. Having determined

that the only reasonable expectation Icahn could have held in the circumstances was that Lions Gate's board would comply with its fiduciary duties, the Court went on to consider whether the board acted with a view to the best interests of the corporation. The Court determined that while a secondary purpose of the impugned transactions was to dilute Icahn's holdings, their primary purpose was to reduce Lions Gate's substantial debt. Further, Lions Gate's board had reasonably concluded that *both* purposes were in Lions Gate's best interests. In reaching these conclusions, the Court reaffirmed the vitality of the general principle set forth in *Teck* that directors of Canadian corporations are authorized to use their powers to adopt defensive tactics where they have carried out reasonable enquiries to inform themselves as to where the corporation's best interests lie, and are *bona fide* of the belief, based on reasonable grounds, that a proposed takeover will run contrary to those interests. This proposition perhaps most starkly illustrates the different philosophical approaches of courts and securities regulators regarding defensive tactics.

ARC Equity Management (Fund 4) Ltd., Re

In late 2008, facing mounting financial challenges, Profound Energy Inc., a junior oil and gas company listed on the Toronto Stock Exchange (TSX), commenced a review of strategic alternatives. That process culminated in a proposed transaction whereby Paramount Energy Trust agreed to make a premium bid for all of Profound's shares. Profound's largest shareholder (ARC), which held approximately 31% of its outstanding shares, opposed the transaction and refused to sign a lock-up agreement with Paramount. As part of the transaction, Profound agreed to issue to Paramount special warrants that were convertible into 19.9% of Profound's outstanding shares (post-conversion). Conversion of the special warrants was not conditional on the bid's completion and would occur automatically if Paramount failed to acquire a majority of Profound's outstanding shares. Profound also implemented a shareholder rights plan that effectively prevented ARC from increasing its stake other than through a formal takeover bid. Notwithstanding ARC's objections, the TSX ultimately approved the private placement. Notably, ARC chose not to appeal the TSX's decision.[14]

Paramount eventually acquired (under the bid and through open market purchases) just over 59% of Profound's outstanding shares. Paramount then converted its special warrants, increasing its ownership interest to just over 67%, and announced its intention to implement a second-step amalgamation to acquire the remaining Profound shares (including the shares owned by ARC). Without the ability to vote the private placement shares, it would have been virtually impossible for Paramount to acquire 100% of Profound without ARC's cooperation.

ARC applied to the Alberta Securities Commission (ASC) for an order effectively preventing Paramount from voting the private placement shares in favour of the amalgamation. The ASC concluded that the private placement was a "hybrid" transaction that was in part a *bona fide* financing and also a tactical tool designed to assist Paramount (if necessary) in acquiring 100% of Profound. In doing so, the ASC focused in particular on Profound's significant financial challenges and the attractiveness (to Profound) of the terms of the private placement. While the ASC conceded that the private placement may have been unfair to ARC, it ultimately concluded that the transaction did not amount to the type of "abuse" that securities regulators' public interest jurisdiction seeks to alleviate.

Notably, the ASC considered that a prior statement (in obiter) of the Ontario Securities Commission (OSC) in *HudBay Minerals Inc., Re*[15] that "an acquirer should not generally be entitled, through a subscription for shares carried out in anticipation of a merger transaction, to significantly influence or affect the outcome of the vote on that transaction"[16] did not amount to a binding rule that applied in all circumstances. Nevertheless, the ASC noted that,

depending on the circumstances, a future effort to follow Paramount's approach may lead to a different outcome. It also suggested that a thorough policy review of the role of private placements in connection with proposed acquisitions may be appropriate and could prompt refined policies or law.

Fibrek Inc. v. AbitibiBowater Inc.

In December 2011, Resolute Forest Products Inc. (formerly AbitibiBowater Inc.) commenced a takeover bid for Fibrek Inc. at C$1.00 per share. Resolute signed irrevocable lock-up agreements with three of Fibrek's shareholders who, along with another shareholder who publicly supported the offer, held approximately 51% of Fibrek's shares. Two of the supporting shareholders were also insiders of Resolute.[17]

Fibrek's board recommended against Resolute's offer and eventually negotiated a superior proposal with Mercer International Inc. that represented (after a subsequent price increase) a 40% premium over the Resolute offer. As part of the transaction, Fibrek agreed to issue to Mercer special warrants to acquire 19.9% of Fibrek's shares (post-conversion) at a price of C$1.00 per special warrant. The warrants were necessary for Mercer's bid to have a chance to succeed, given that a majority of Fibrek's shares were already committed to the Resolute offer. Resolute sought an order from the *Bureau de décision et de révision* ("The Bureau"), Québec's independent securities regulatory tribunal, to cease-trade the private placement and Mercer's bid on the basis that the private placement, along with a 5% break fee payable to Mercer in the event of a superior proposal, were improper defensive tactics.

The Bureau cease-traded the private placement (but not the bid), concluding that the private placement and break fee were defensive tactics that were abusive of Fibrek's shareholders and the capital markets. In doing so, the Bureau expressed the view that dilutive private placements in a takeover bid should not be permitted unless the target has a genuine and immediate need for the funds. The Bureau held that using a private placement for the sole purpose of undermining the lock-up agreements compromised the auction process and prevented a majority of Fibrek's shareholders from deciding for themselves whether to accept the Resolute offer, contrary to the principles underlying NP 62-202. The Bureau distinguished *ARC* primarily on the basis that the private placement to Paramount was not made in response to a takeover bid, Profound was in serious financial difficulty, and the private placement's terms were highly favorable to Profound.

The Court of Québec overturned the Bureau's decision, holding that the private placement in fact facilitated shareholder choice and was therefore entirely consistent with NP 62-202. However, the Bureau's decision was restored on administrative law grounds by the Québec Court of Appeal, which afforded the highest degree of deference to the Bureau in determining that its decision was defensible on the facts and the law. Mercer eventually withdrew its offer and Resolute ultimately acquired 100% of Fibrek for C$1.00 per share.

Inmet Mining Corporation et al., Re

In July 2012, Petaquilla Minerals Ltd. announced an intention to conduct a C$210 million note offering (which would potentially include warrants) to, among other things, finance capital expenditures. Nearly two months later, Inmet Mining Corporation formally commenced a hostile bid for all of Petaquilla's shares. It was a condition of the bid that the note offering not occur. Inmet applied to the BCSC to cease-trade the note offering and Petaquilla's pre-existing rights plan. At the time of the hearing, the details of the proposed note offering (including whether warrants would be offered) had not been determined.[18]

The BCSC accepted that the note offering was proposed in the ordinary course of business and not as a defensive tactic. Nevertheless, the BCSC cease-traded the note offering because it could deny Petaquil-

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la's shareholders the opportunity to tender to the Inmet bid (given Inmet's bid conditions). In doing so, the BCSC determined that Petaquilla had no immediate need for financing and that there would be no adverse impact on Petaquilla during the short period between the hearing and the expiry of Inmet's offer. The BCSC also explicitly referred to evidence that Petaquilla's board had not ruled out using the note offering as a defensive tactic. Curiously, in its reasons, the BCSC did not provide any legal analysis of the application of its public interest jurisdiction (including NP 62-202) to a private placement, nor did it refer to *ARC* or *Fibrek*. Inmet ultimately did not achieve its minimum tender condition and abandoned its bid.

Red Eagle, Re

In June 2015, after a series of unsuccessful merger discussions, Red Eagle Mining Corporation announced a hostile bid for CB Gold Inc., a mineral exploration company listed on the TSX Venture Exchange (TSX-V). At that time, CB Gold was in need of financing to remain a going concern (and at one point had requested financing from Red Eagle).[19]

In July 2015,CB Gold announced that it was supporting a competing offer by Batero Gold Corp., a related party, that, after a subsequent price increase, was financially superior to the Red Eagle offer. The same day, CB Gold completed a C$575,000 private placement to Batero. Before approving the private placement, the TSX-V considered whether it was a defensive tactic, but was ultimately satisfied that CB Gold needed the funds to continue to operate.

Red Eagle applied to the BCSC to, among other things, cease-trade the private placement on the basis that it was an improper defensive tactic. As of the date of the hearing, 48% of the CB Gold shares (52% before giving effect to the private placement) had been tendered to the Red Eagle offer and, importantly, Red Eagle had waived its 50% minimum tender condition.

The BCSC declined to cease-trade the private placement, primarily because it was not clearly a defensive tactic (given the evidence that CB Gold required financing to remain a going concern) and did not prevent CB Gold's shareholders from tendering to the Red Eagle offer (given that Red Eagle had waived its 50% minimum tender condition). The BCSC also considered the fact that, without the private placement, Batero may not have made its offer and CB Gold's shareholders would have only had one bid to consider.

Delineating the Regulatory Framework for Tactical Private Placements

In contrast to the framework for rights plans described above, application of securities regulators' public interest jurisdiction to private placements is more challenging and the outcome in any particular case is less predictable. Chief among these challenges is the fact that, unlike rights plans, private placements serve purposes beyond simply blocking a bid that may benefit the target and its shareholders. For this and other reasons described below, securities regulators have expressed the need for caution when intervening in private placements on public interest grounds. As the BCSC put it in *Red Eagle*:

> Unlike a rights plan, where a board's only purpose for introducing the rights plan is to impact the manner in which takeover bids are conducted, private placements may have other business objectives. As a consequence, any review of a private placement by a securities regulator risks straying even further into areas of corporate law than in the rights plan context.[20]

This heightened caution partly manifests itself in an analytical framework that requires regulators to balance a broad range of competing considerations before concluding that intervention is in the public interest. To borrow a phrase from *Fibrek* (citing the OSC's decision in *Sterling Centrecorp Inc. (Re)*):[21] "the [regulator] must examine all the facts, all the circumstances and all the interests at play and the impact of the remedy sought on those interests."[22] While this approach lacks the predictability of the "when, not if"

rights plans mantra, it provides flexibility to deal with the unique challenges inherent in regulating tactical private placements. Some insight into the various facts, circumstances, interests and impacts that securities regulators may consider can be discerned from the cases discussed above.

Effect on Shareholder Choice

Given the predominant focus of securities regulators' public interest jurisdiction on shareholders' interests, the starting point for this analysis will generally be the effect of the impugned private placement on shareholder choice. If the private placement is likely to deprive shareholders of the ability to respond to a bid (or a competing bid), the policy concerns underlying NP 62-202 will be engaged and the target will usually bear a heavy onus in persuading regulators that intervention is not in the public interest. Notably, NP 62-202 was found to be engaged in both of the decisions where securities regulators intervened (*Fibrek* and *Inmet*), but was not engaged in two of the cases in which regulators did not intervene (*ARC* and *Red Eagle*). The one potential exception to this pattern is *Lions Gate*, where NP 62-202 may have been engaged due to the possibility that shareholders would be prevented from tendering to Icahn's second takeover bid (in view of his bid conditions), but the BCSC determined to not intervene. Without the benefit of substantive reasons, it is unclear whether the BCSC's decision was based on its determination that the policy objectives of NP 62-202 were outweighed by other factors, including the benefit of Lions Gate's debt reduction and the fact that the transaction had already been completed at the time of the application (unlike the private placements in *Fibrek* and *Inmet*).

Unfortunately, determining when a private placement is truly likely to prevent shareholders from tendering to a bid can itself be a difficult task. For example, in *Red Eagle*, even though the private placement was implemented in response to a hostile bid, the BCSC determined that NP 62-202 was not engaged because Red Eagle had waived its minimum tender condition. That conclusion seems relatively uncontroversial. However, if Red Eagle had maintained its 50% minimum tender condition, would the fact that the private placement reduced the shares tendered to Red Eagle's offer from 52% to 48% have led the BCSC to conclude that NP 62-202 was directly engaged? As the BCSC pointed out, it is not clear that holders of a majority of CB Gold's shares (even excluding the private placement shares) would ultimately have supported the Red Eagle bid, given that Batero had increased its bid price above Red Eagle's only six days prior to the hearing. Had the BCSC been confronted with this scenario, it would have been placed in the difficult position of having to speculate about the future tender decisions of CB Gold's shareholders. This hypothetical example illustrates the challenges in determining (or predicting) the effect of private placements on a bid.

Even if a private placement engages NP 62-202, regulators generally do not automatically intervene. For example, in *Inmet*, the BCSC appears to have placed at least as much weight on the fact that its order would have no adverse impact on Petaquilla as it did on the need to protect the right of shareholders to decide whether to accept the Inmet bid. The BCSC did not foreclose the possibility that adverse effects on shareholder choice might be outweighed by other factors in certain circumstances.

One such circumstance may be where the tactical private placements actually enhances, rather than inhibits, shareholder choice. This issue arises to some degree in each of *ARC*, *Fibrek* and *Red Eagle*. In *Red Eagle*, the BCSC recognized that the impugned private placement enhanced shareholder choice because Batero may not have made its offer had CB Gold not also obtained interim financing. As the BCSC put it, "without the private placement, the auction would not have taken place."[23] While the Bureau in *Fibrek* took an extremely narrow view of the appropriate role of private placements during the course of a hostile bid,

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many market participants have supported the view of the Court of Québec, which strongly endorses the tactical use of private placements to facilitate shareholder choice. We expect that other regulators (and possibly the Bureau) may either decline to follow the Bureau's decision or distinguish it based on its relatively unique facts.[24]

Effect on Capital Markets

In *Fibrek*, the Bureau intervened partly due to its view that the private placement's effect on the lock-up agreements was abusive of the capital markets given the *bona fide* role lock-up agreements play in encouraging bids (which securities regulators have generally found outweighs any auction-inhibiting effect they may have). While the result in *Fibrek* has been questioned, it serves as a reminder that a private placement's broader effects on the capital markets (which may be highly fact-specific) must also be considered as part of the regulatory risk assessment.

Effects on the Target

In each of *ARC*, *Fibrek*, *Inmet* and *Red Eagle*, the regulator considered the target's need for the financing. In the two cases where an immediate need for financing was found to exist (*ARC* and *Red Eagle*), the regulator did not intervene, while in the two cases where the financing was not immediately needed (*Fibrek* and *Inmet*) a cease-trade order was issued. This pattern suggests that securities regulators will give some weight to the benefits (or lack thereof) achieved by a private placement. However, since the private placements in *ARC* and *Red Eagle* did not engage NP 62-202, these results must be considered in that context.

There has not yet been a case in Canada where a securities regulator has had to directly weigh an immediate financing need (or other sufficiently compelling business purpose)against the policy considerations of NP 62-202. This situation may have arisen in *Red Eagle* if the minimum tender condition had not been waived (which of course would be the case in the new bid regime). The BCSC explicitly considered this possibility but declined to provide any definitive guidance, simply noting that the application would have been "considerably more difficult" in those circumstances because NP 62-202 would have become "more directly engaged."

It is worth highlighting at this point the important distinction between a valid business purpose (or effect)of a private placement and the business judgment rule applied by the courts. While regulators will consider the actual benefits achieved by a private placement, they do not appear to have deviated from their longstanding practice of subordinating the business judgment (or "good intentions") of boards to the principles of NP 62-202. It will be interesting to see whether this approach evolves in the regulation of tactical private placements, given the need for securities regulators to assess the effects (both positive and negative) of a private placement on a target and its shareholders at a time when its various impacts may be highly uncertain. In light of these challenges, it may be helpful for securities regulators, in forming their own opinion (and not for the purpose of affording deference), to give greater weight to the views of those responsible for managing the corporation's business and affairs.

Impact of Potential Remedies

Even where the foregoing factors suggest that there may be an abuse of shareholders or the capital markets, regulators must have an appropriate remedy available to alleviate the impugned conduct. This issue arises when a private placement has already been completed. There is some uncertainty about whether a cease-trade order can be used to "unwind" a private placement (particularly where the proceeds have been spent). The BCSC in *Red Eagle* explicitly contemplated that its public interest jurisdiction includes an ability to unwind a completed private placement (though that conclusion was at odds with the position of its Staff).

On the other hand, the OSC's decision in *Tuckamore Capital Management Inc., Re*[25] suggests that, at a minimum, the OSC has concerns about its ability to practically—if not legally—unwind a completed private placement.[26] Without the benefit of formal reasons in *Lions Gate*, it is unclear whether the BCSC's decision to not intervene in that case was based, at least in part, on concerns about its ability to unwind the completed de-leveraging transactions. Notably, the private placements in *Inmet* and *Fibrek* had not been completed at the time of the hearing whereas in each of *Lions Gate*, *ARC* and *Red Eagle*, the private placement had been completed and the regulator, for one reason or another, declined to intervene.

There are also questions about whether a cease-trade order, even if legally available, is an *appropriate* remedy for a tactical private placement, given its collateral effect of denying the target and its shareholders the entire benefit of the transaction. This problem was illustrated in *Re Perpetual Energy Inc*.[27] which involved a proposed rights offering by Perpetual Energy Inc. that, if completed, would significantly decrease the percentage (and value) of Perpetual's equity that the convertible debenture holders would receive upon repayment of their debentures in kind. While the ASC determined that the transaction was unfair to the debenture holders, it declined to intervene in part because the "blunt" nature of a cease-trade order would have precluded Perpetual from obtaining the necessary financing provided by the rights offering. The ASC noted that if the debenture holders could establish unfairness amounting to oppression, the court would have a broader arsenal of remedies that may be more appropriate. Similar challenges arise with tactical private placements, as demonstrated in *Fibrek* where the cease-trade order resulted in shareholders losing a 40% premium for their shares.

Given that private placements generally do not block a bid in the same way as rights plans, there may be opportunities for securities regulators to fashion more suitable remedies that can address the policy concerns of NP 62-202 without denying the target and its shareholders the benefits of the transaction. For example, securities regulators could permit a bidder to exclude the privately placed securities in determining whether the mandatory 50% tender condition has been satisfied, or to waive the minimum tender condition entirely.[28] However, this alternative remedy may not adequately address a situation where the bidder is not willing or able to proceed with less than legal control (*i.e.*, more than 50% of *all* outstanding shares). In those circumstances, the regulator may be put in the unenviable position of having to make a binary decision between denying shareholders the ability to consider a bid or denying the target (and its shareholders) the benefits of the private placement.

Timing Considerations

Timing considerations exacerbate the challenges faced by securities regulators when considering whether and how to intervene in tactical private placements. Rights plans—which simply "sit on the shelf" unless and until triggered—permitted regulators to defer hearings until they had reasonable visibility about whether a cease-trade order would inhibit an ongoing auction. In contrast, the accelerated timeline and commercial nature of private placements, combined with the significantly extended bid period under the new regime, may require regulators to make decisions at a time when the likely outcome of the bid and the various effects of the private placement are highly uncertain. Needless to say, targets' circumstances and financial markets can change dramatically over the course of 105 days. While it may have been reasonable to require Petaquilla to very briefly defer a non-urgent financing in *Inmet*, requiring a target to defer (or abandon) a beneficial transaction—potentially for several months—when it is unclear whether a hostile bid will ultimately succeed is a far riskier proposition for the target and its shareholders.

Shareholder Approval

NP 62-202 explicitly provides that prior share-

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holder approval of corporate action would, in appropriate cases, mitigate concerns regarding the propriety of alleged defensive tactics. Nonetheless, with some notable exceptions,[29] shareholder approval of rights plans was usually insufficient on its own to justify maintaining a rights plan once it was no longer facilitating an auction. Given the fundamental principle of collective shareholder choice underlying the new bid regime, shareholder approval of tactical private placements may carry more weight than it did for rights plans. Shareholder approval may allow a target to implement a private placement that could be more likely to prevent a hostile bid from proceeding, and that therefore might otherwise not be expected to survive regulatory scrutiny. If so, it will be interesting to see if, in appropriate circumstances, targets use shareholder approval (even if not legally required) to implement private placements that effectively give shareholders an alternative choice of remaining "independent." The ability to convene a shareholders' meeting much more quickly than a hostile bid can be completed would provide the target with a significant timing advantage that was not available under the old regime,[30] and approval of the private placement would require only a majority of the votes cast (as opposed to the outstanding shares), other than those excluded as required by the applicable stock exchange.

Stock Exchange Approval and Jurisdictional Issues

Stock exchange approval,[31] which is required for private placements involving the issuance of listed securities (or securities convertible into listed securities), potentially adds another layer of complexity and uncertainty that was not present in the rights plan context.[32] This additional approval requirement raises substantive questions about the decision-making framework of the exchange and the appropriate standard of review on appeal, as well as jurisdictional issues where both an appeal of the exchange's decision and a public interest application are pursued.

The rules of both the TSX and TSX-V specify a number of circumstances in which shareholder approval of a private placement will automatically be required.[33] Both exchanges also have broad discretionary authority to not approve, or impose conditions (including shareholder approval) on, private placements. For example, the TSX considers the impact of the transaction on "the quality of the marketplace provided by the TSX." In addition to a number of enumerated factors,[34] this assessment includes a general evaluation of the impact of a transaction on the public interest and shareholder interests, matters that may overlap with securities regulators' defensive tactics analysis. The TSX-V, on the other hand, is expressly mandated to consider whether a private placement is a defensive tactic as contemplated by NP 62-202.Historically, absent unusual circumstances, the exchanges' discretionary powers have only infrequently been used to block transactions or require shareholder approval where it would not otherwise be required under the rules of the exchange. If tactical private placements become more common, it will be interesting to see whether exchanges engage in a more robust analysis of the relevant public interest considerations, or whether they defer such matters to securities regulators (at least in cases where a public interest application has been made). In *Fibrek*, the TSX followed the latter approach and did not engage in any defensive tactic analysis regarding the Mercer private placement.

It will also be interesting to see whether exchange decisions regarding public interest matters will be afforded deference by securities regulators if appealed.[35] In *Red Eagle*, the TSX-V had already determined that the private placement was a *bona fide* financing and not a defensive tactic. While the application to the BCSC was not pursued as an appeal of the TSX-V's decision, the BCSC considered that it was effectively being asked to second-guess the TSX-V's decision. Since the OSC has not yet engaged in a substantive review of a TSX decision approving a tactical private placement, it remains to be seen how the OSC will balance deference to the TSX's decision against its

own public interest mandate. The OSC has held in other contexts that it will intervene where its perception of the "public interest" differs from the TSX's assessment of the "quality of the marketplace."[36]

Finally, the ability to pursue both an exchange appeal and a public interest application raises questions about the potential for inconsistent rulings where the regulator responsible for the appeal differs from the target's principal regulator. In *Fibrek*, after the Bureau's decision was initially overturned, OSC Staff filed submissions advocating that the OSC not, as part of its review of the TSX's decision to approve the Mercer private placement, assess whether the transaction was a defensive tactic (given that the Bureau had already considered that issue). In addition, following the Court of Appeal's decision in *Fibrek*, Mercer requested that the OSC (in view of the significant connecting factors to Ontario) hold a simultaneous hearing with the Bureau regarding Mercer's application to cease-trade the Resolute bid. In its decision,[37] the OSC held that while it had jurisdiction to hear Mercer's application, it should not do so because the application was substantially similar to Mercer's application to the Bureau and the Bureau was already engaged in considering issues raised by the Resolute and Mercer bids.

The OSC's approach in *Fibrek* strongly suggest that it will not permit a framework that could result in inconsistent decisions among securities regulators regarding defensive tactics. It will be interesting to see if the BCSC follows a similar approach. The answer may be complicated by the fact that the TSX-V (unlike the TSX) is specifically mandated to apply NP 62-202 to private placements.

Tactical Private Placements in Practice

Private placements have proven to be effective tactical tools in certain situations. They may become more common under the new bid regime because, among other things:

- the 105-day minimum deposit period provides significantly more time to negotiate, structure and execute a tactical private placement before a bid's expiry,
- the inability of bidders to waive the 50% minimum tender condition may enhance the tactical effectiveness of private placements that withstand regulatory scrutiny, and
- the extended timeline and increased uncertainty in the outcome of a bid may make boards more reluctant to risk deferring or foregoing currently available opportunities (which may involve private placements) that they believe are in the corporation's best interests.

While the decisions described above demonstrate that the analysis will be highly fact-specific, they also provide some general insights into practical steps that targets and bidders can take to protect their respective interests.

Considerations for Targets

Tactical private placements will not be appropriate in many circumstances, either because they are unlikely to be effective in achieving the target's objectives, have little chance of surviving regulatory scrutiny if challenged or are simply not a viable option (because, for example, there is insufficient investor demand). Some of the circumstances where tactical private placements may be appropriate include those where:

- the private placement provides compelling benefits to the target and/or its shareholders,
- the target has (preferably arm's length)investors willing to subscribe on favourable commercial terms,
- a relatively small number of shares (ideally less than 20%) is required to achieve the target's objectives,
- the bidder requires legal control to proceed with

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its bid (thereby potentially limiting the effectiveness of remedies such as a waiver of the minimum tender condition), and

- the private placement can be completed relatively early in the course of the bid (thereby potentially limiting regulators' visibility of the impact of intervention).

Of course, not all tactical private placements are challenged. Indeed, the mere implementation of a tactical private placement (or other defensive tactic) tests a bidder's resolve, and tactical private placements have been used in Canada without being challenged. Accordingly, the risk of regulatory intervention is only one (albeit a very important) factor to consider as part of a broader strategic analysis. At the same time, there are steps that targets can take to help minimize the risk of intervention if a tactical private placement is ultimately challenged.

1. Minimum Effective Dose

Structuring a tactical private placement will typically require trade-offs between features that provide tactical effectiveness and those that will help withstand regulatory scrutiny. Given securities regulators' focus on the effects of a tactical private placement on shareholder choice, targets should seek to ensure that shareholders' ability to tender to a bid is adversely impacted to the minimum extent necessary. In *ARC* and *Fibrek*, the ASC and the Bureau each considered—and reached opposite conclusions regarding—the extent to which the private placement was preclusive of competing offers. Covenants that the investor will not tender to a bid may similarly attract regulatory attention (for example, in both *ARC* and *Fibrek*, the regulator considered whether the investor was required to support superior proposals).

2. Establishing a Proper Record

Securities regulators will not defer to the target board's judgment regarding the benefits of a private placement. Rather, they will carefully scrutinize the evidence to determine if the board's primary motivation was to frustrate the bid. Accordingly, targets should be mindful of the record they establish, even before a private placement becomes a likely scenario.

For example, prior disclosure that does not support the need for a private placement may significantly undermine a target's claim that the transaction serves a *bona fide* business objective. In *Fibrek*, the Bureau noted that Fibrek's public disclosure did not indicate any immediate need for financing.

Similarly, the target's conduct can be an important factor that regulators will consider in determining whether a private placement is primarily a defensive tactic. CB Gold's prior request for similar financing from Red Eagle appears to have been relevant to the BCSC's determination in *Red Eagle* that the private placement was at least in part a *bona fide* financing. Similarly, in *ARC*, the ASC considered that Profound ultimately used the proceeds for its stated purpose of retiring debt. On the other hand, conduct that is inconsistent with the alleged rationale for the transaction (such as the fact that Fibrek had not sought any alternative sources of financing) is likely to be a significant factor that weighs in favour of intervention.

Finally, while an independent and informed board process is unlikely to attract any meaningful deference (particularly where NP 62-202 is engaged), an inadequate process is likely to reinforce the policy concerns underlying NP 62-202. Of course, a robust process is also of critical importance if the target ends up before the courts, either because a securities regulator declines to intervene or the bidder otherwise pursues a corporate law remedy (such as oppression or breach of fiduciary duty).

3. Commercial Terms

Unlike rights plans, there is no "one-size-fits-all" approach to tactical private placements. Their structure and terms in any particular situation may depend on, among other things, the purpose of the tactical

private placement, the terms of the hostile bid, the target's capital structure, the stock exchange on which the target is listed, any pre-existing relationship between the target and the investor, and the relative bargaining power of the target and the investor.

Targets and investors should carefully consider whether the commercial terms of a tactical private placement (including provisions such as board nominee rights, pre-emptive or registration rights, standstills, voting covenants and transfer restrictions) are consistent with market practice. Terms that are favourable to the target will result in more weight being attributed to the business purpose of the private placement. In *ARC*, the ASC placed significant weight on the premium subscription price and the level of certainty that Profound would receive the proceeds even (or especially) if Paramount's bid was unsuccessful. On the other hand, in *Fibrek*, the Bureau focused on the facts that the subscription price was significantly lower than Mercer's bid price and that Mercer could back out of the financing in a number of circumstances. Investors in a tactical private placement may find themselves with relatively greater leverage, so the temptation to extract more favourable terms must be balanced against deal certainty.

4. Insider Involvement

While not expressly addressed in any of the reported decisions, it seems reasonable to assume that securities regulators will consider the extent of insider or related party involvement in evaluating whether a private placement is primarily a defensive tactic (though *Red Eagle* implicitly suggests that this is not a determinative factor).[38] Less clear is how securities regulators and the stock exchanges will view "friendly" parties who are alleged to support management, but are not technically insiders (as was alleged regarding Tuckamore's tactical private placement).

5. Timing Considerations

As noted above, securities regulators may be more reluctant to intervene in tactical private placements that are completed well before a bid expires compared to those completed on the "eve of expiry." However, tactical private placements require time to properly structure, negotiate and implement. While there may be some advantage to proceeding quickly, haste should not prevail over diligence and thoughtfulness.

Considerations for Bidders

While tactical private placements do not block bids in the same way as rights plans, they may nevertheless make a bid (or second-step transaction) more difficult or expensive. Since directors generally have the power to issue shares without shareholder approval (subject to stock exchange requirements), bidders confronted with a tactical private placement that threatens the bid will need to take immediate steps to challenge the transaction. While securities regulators' predisposition toward shareholder interests will generally shift the burden to a target where the private placement is likely to impact shareholders' ability to tender to the bid, there are proactive steps bidders can take to increase their chances of success.

1. Move Quickly

The single most important thing a bidder can do is move quickly. Private placements are often completed very soon after, or even before, they are publicly announced. Bidders should take steps to ensure they will have an opportunity to challenge a private placement before it is completed. Once a private placement closes, the remedies available to a securities regulator may be more limited. In that case, it is more likely the bidder's sole recourse maybe to the courts, where a high degree of deference will generally be afforded to the target board's decision. Bidders should preemptively request that the target's stock exchange notify the bidder of any listing applications and permit the bidder to make submissions to the listing committee before any transaction is conditionally approved. Bidders should be prepared to make submissions to the applicable stock exchange and securities regulator

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within days of the announcement of the private placement.

2. Pursue All Available Avenues of Recourse

Given the lack of predictability in how the various regulators will approach tactical private placements, bidders should attack on multiple fronts simultaneously. An objection to the target's stock exchange would typically be the first step (unless the transaction has already been completed). At the same time, securities commissions have the power to grant temporary cease-trade orders for up to 15 days (subject to extension) on an *ex parte* basis, which may be sought before stock exchange approval has been obtained.[39] Failure to pursue all available remedies may be a factor regulators weigh in determining whether a transaction is "abusive," as was demonstrated by the weight the ASC placed on ARC's decision to not appeal the TSX's decision to approve Profound's private placement.

3. Bid Conditions

Bidders should carefully consider the conditions they include in a bid. For example, in *Inmet*, NP 62-202 was directly engaged because of Inmet's condition that the note offering not occur. While bidders should not assume that securities commissions will automatically intervene in any transaction that might cause a condition not to be satisfied, *Inmet* demonstrates that a bidder's conditions may be an important factor. As is customary, a condition that the target not issue (or commit to issue) any securities should be a condition of most bids.

Bidders should also be cautious about waiving their conditions. In *Red Eagle*, the BCSC held that NP 62-202 was not directly engaged because Red Eagle had waived its 50% minimum tender condition. While it is not clear whether the result would have been different if the condition had been maintained (particularly given the compelling evidence that CB Gold was in serious financial difficulty), it is clear that Red Eagle would have been in a stronger position if it had not waived its minimum tender condition (or waited until after the hearing to do so). While a 50% minimum tender condition is mandatory under the new bid regime, *Red Eagle* nevertheless underscores the importance of strategic considerations when waiving bid conditions or otherwise amending a bid.

A Brief Note About Tactical Private Placements in Other Situations

NP 62-202 currently only applies to tactical private placements that impact a takeover bid. However, *ARC*, *HudBay*, and *Tuckamore* extend the use of tactical private placements beyond the takeover bid context and into the realm of proxy contests and voting transactions. Given the potential effectiveness of private placements as a tactical tool, and recent trends in shareholder activism in Canada, there is reason to believe that tactical private placements may continue to gain popularity in these situations. While securities regulators are purporting to apply the same fundamental standards for intervention on public interest grounds in all cases (namely, abuse of investors or the capital markets), they appear to ascribe far more weight to shareholders' interests in a takeover bid. However, it is not intuitive why effectively denying shareholders the right to vote should be considered any less abusive (or otherwise contrary to the public interest) than denying shareholders the ability to tender. Given the OSC's statements in *HudBay* and the policy concerns expressed by the ASC in *ARC*, it will be interesting to see whether securities regulators or the TSX engage in proactive policy-making or otherwise demonstrate a willingness (when the appropriate case presents itself) to extend principles similar to those underlying NP 62-202 to non-bid situations.

Conclusion

The role of rights plans in the Canadian takeover bid regime was very clear. Their only legitimate

purpose was to provide target boards more time to facilitate shareholder choice, but the ultimate question was "when," not if, the pill should go. At this point, however, the role of private placements in the new bid regime is less clear. On one hand, the recent bid amendments suggest a potentially greater role for private placements, both as a tactical tool for enhancing shareholder choice and one that can achieve *bona fide* business objectives that may arise during the course of a hostile takeover bid. On the other hand, inertia of the regulatory approach that was cultivated during the rights plan era has the potential to significantly limit the circumstances in which private placements can be used while a bid is in progress. One thing that is clear is the stakes are a lot higher than they were in the rights plan context, given the potentially adverse consequences of intervention to a target and its shareholders. While some regulators already appear to be proceeding more cautiously, establishing a new paradigm for the regulation of tactical private placements may require a case where a regulator is compelled to decide whether it is prepared to potentially deny a target (and its shareholders) substantial benefits for the sake of preserving an uncertain possibility that shareholders might be able to tender to a takeover bid at some point in the future. In that case, regulators may be forced to finally consider not just when, but "if" they will intervene.

ENDNOTES:

[1]For more information regarding the new takeover bid regime, please refer to Gesta Abols, Grant McGlaughlin and Michael Partridge, "Takeovers Get a Makeover: A Guide to the New Takeover Bid Regime in Canada," *The M&A Lawyer*, March 2016, Vol. 20, Issue 3.

[2]Rights plans are expected to continue to prevent "creeping" acquisitions of control through transactions that are exempt from the formal bid requirements (such as open market purchases and privately negotiated acquisitions)as well as irrevocable lock-ups for more than 19.9% of the target's shares (including the bidder group's shares).

[3]A private placement is an issuance of securities from treasury that is exempt from the prospectus requirements under Canadian securities laws.

[4]For the purposes of this article, we consider a private placement to be "tactical" if it may affect a bid, even if that is not its primary purpose.

[5]2008 SCC 69 [*BCE*].

[6]The Supreme Court of Canada explicitly refused to endorse the application of so-called *Revlon* duties, which require directors of Delaware corporations to maximize value for shareholders once it becomes clear that a sale of control of the corporation will occur. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

[7]*See Canadian Tire Corp. v. C.T.C. Dealer Holdings Ltd.* (1987), 10 O.S.C.B. 857 and *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132.

[8]This is in contrast to target boards of Delaware corporations who can, in appropriate circumstances, "just say no" to a hostile bid by maintaining a rights plan in place indefinitely without obtaining shareholder approval. *See Air Products & Chemical v. Airgas* 16 A.3d 48 (Del. Ch. 2011).

[9]In March 2013, the CSA and the Québec Autorité des marchés financiers (AMF) published competing proposals. The CSA proposal would have allowed a rights plan to remain effective in the face of a hostile bid if approved by shareholders. The AMF proposal would have replaced NP 62-202 with a new policy that would have provided greater deference to defensive tactics adopted by a target board through an impartial and informed process.

[10]*See*, for example, *Canada Malting Co., Re,* (1986) 9 O.S.C.B 3566 and *Torstar Corp. Re*, 9 O.S.C.B. 3087.

[11]*See*, for example, *Teck Corp. Ltd. v. Millar* (1972), 33 D.L.R. (3d) 288 [*Teck*].

[12]2010 BCSC 1547, aff'd 2011 BCCA 228 [*Lions Gate*].

[13]Canadian corporate statutes generally provide courts with broad remedies to rectify corporate conduct that is oppressive or unfairly prejudicial to, or unfairly disregards, the "reasonable expectations" of shareholders and other corporate stakeholders. *See BCE*, supra note 6.

[14]2009 ABASC 390 [*ARC*].

[15]32 O.S.C.B 3733 [*HudBay*]. *HudBay* involved

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an appeal to the OSC of the TSX's decision to conditionally approve (without requiring shareholder approval) the listing of common shares of HudBay Minerals Inc. to be issued as consideration for the acquisition of Lundin Mining Corporation. The OSC's comments referred to HudBay's intention to vote shares of Lundin that it had recently acquired through a private placement in favour of the acquisition. However, this question was not directly relevant to the issues before the OSC in this case.

[16]*Ibid* at para 266.

[17]2012 QCBDR 17 [*Fibrek*].

[18]2012 BCSECCOM 442 [*Inmet*].

[19]2015 BCSECCOM 401 [*Red Eagle*].

[20] *Red Eagle*, *supra* note 20 at para 71.

[21]30 O.S.C.B 6683.

[22]*Fibrek*, supra note 18 at para. 101.

[23]*Red Eagle*, supra note 20 at para 96.

[24]In addition to the irrevocable lock-up agreements, the Bureau considered that Fibrek's ability to redeem the special warrants following a superior proposal was preclusive of competing offers because made it impossible for a competing bidder to know how much it would have to pay to acquire100% of Fibrek's outstanding shares.

[25]37 O.S.C.B 7584 [*Tuckamore*].

[26]In that case, a dissident shareholder of Tuckamore Capital Management Inc. sought a temporary cease-trade order preventing a private placement of approximately 17% of Tuckamore's shares during a proxy contest. As a condition to its order dismissing the application, the OSC required undertakings that, among other things, Tuckamore and the investor would unwind the private placement if the application for a permanent cease-trade order was successful.

[27]2016 ABASC 2.

[28]Securities regulators could achieve these results through their power to grant exemptive relief from the formal bid requirements, which requires that the application not be prejudicial to the public interest.

[29]*See*, for example, *Re Pulse Data Inc.*, (2007) ABASC 895 and *Re Neo Material Technologies Inc. and Pala Investments Holdings Limited, et al,* (2009) 32 O.S.C.B. 6941.

[30]A private placement generally would not be a type of competing transaction that would cause the acceleration of the minimum bid period under the new rules.

[31]This article only considers the policies of the TSX and TSX-V. However, the policies of any foreign stock exchange on which the target's shares are listed would also need to be considered.

[32]In accordance with section 634(b) of the TSX Company Manual, the TSX defers its review of a rights plan until after the appropriate securities commission has determined whether it will intervene pursuant to NP 62-202.

[33]For example, shareholder approval would generally be required if a private placement would result in a new holder of more than 19.9% of the target's shares.

[34]These include, among others, the existence of an order issued by a court or administrative regulatory body that has considered shareholders' interests.

[35]Appeals of TSX decisions are heard by the OSC while appeals of TSX-V decisions are heard by the BCSC.

[36]*HudBay*, *supra* note 16.

[37]35 O.S.C.B. 3645

[38]The TSX will generally require shareholder approval where a private placement results in insiders acquiring shares equal to 10% or more of the issuer's market capitalization in any six-month period. The TSX will also consider the involvement of insiders in its analysis of the "quality of the marketplace."

[39]The potential utility of this strategy was demonstrated in *Tuckamore*. *See* footnote 26 above.

M&A IMPLICATIONS OF CORPORATE GOVERNANCE AND SUCCESSION PLANNING FOR FAMILY-CONTROLLED BUSINESSES

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Family-controlled businesses face unique corporate governance and planning issues with the passage of time as ownership and control is handed down from founders to their successors and heirs. These obstacles are best illustrated by way of example:

> Imagine a successful company founded in 1982 by a charismatic inventor, Margaret. Suppose that Margaret is now in her early seventies but has continued to serve as a very hands-on chief executive officer. Margaret has three children, Sally (an officer and director of the company positioned to succeed Margaret), Sam (a successful investment banker) and Michael (a respected but financially constrained artist), and nearly a dozen grandchildren. Margaret has a very loving relationship with all of her children and grandchildren and, for purposes of estate planning, wants them all to be treated equally as an economic matter.
>
> Suppose that Margaret has decided that upon her death a trust will receive all of her shares in the company, and such shares constitute 70% of the company's outstanding equity with 30% held by various third party investors. The beneficiaries of the trust are to be all of Margaret's lineal descendants, and the trust will have three trustees: Sally and two other persons who are officers and directors of the corporation but who are not Margaret's lineal descendants.

There are many important questions that Margaret must face in deciding how to set up a flexible and effective corporate governance structure for her company while simultaneously achieving her estate planning objectives. For instance, given that the company's shares will be held by a trust, how should the governing documents address the duties and obligations of the trustees? How will power in the company be allocated among heirs such as Sally who are actively involved in the business and others who are not but whose inheritance is tied to the company's value? Will the company remain family-controlled even if it needs outside capital? What will happen if Margaret's children or grandchildren have a dispute about the company or finances? What if some of her heirs want to monetize their investment by selling the company or taking it public, but others do not?

Legal advisors must be ready to help navigate such questions. This article sets forth five topics to consider when advising business owners on such planning matters.

Fiduciary Duties of Trustees, Controlling Shareholders and Directors

Frequently, family-controlled businesses are held in trust. The use of trusts has many benefits, including tax benefits, creditor protection, centralization of control, and succession planning. When a trust holds a controlling interest in a business, however, the fiduciary duties the trustee owes to the trust beneficiaries at times may conflict with the duties the trustee as shareholder owes to the company and other shareholders. Frequently, these issues can be managed effectively by careful advance planning.

Fiduciary Duties and Standard of Conduct of Trustee

The primary duty of a trustee is to administer the trust and its assets for the benefit of the trust beneficiaries. A trustee owes fiduciary duties to the trust beneficiaries, and must administer the trust in good faith, in accordance with the terms of the trust's governing instrument and in the interests of the beneficiaries. Notable fiduciary duties include:

- *Duty of Loyalty*: The law imposes on a trustee a duty of undivided loyalty to the beneficiaries for whom the trustee acts. This duty at times may conflict with duties that the directors of a trust-controlled business owe to outside shareholders. In addition, a trustee generally may not deal with the trust assets for the trustee's own benefit.

- *Duty of Impartiality*: A trustee has a duty to administer a trust with due regard to the respective interests of both income beneficiaries and remaindermen. A trustee considering a transac-

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tion for a family-controlled business held in the trust must favor neither the interests of current family beneficiaries nor the interests of future (*e.g.*, even unborn) family beneficiaries.

Under state trust law generally, a trustee's standard of care is the "prudent investor" standard. A trustee generally is charged with the exercise of such care and skill in the performance of the trustee's duties as would be exercised by a prudent person of commensurate skill in handling similar matters. The creator of a trust may alter the trustee's standard of care in the trust instrument so long as the standard is not contrary to public policy in the relevant state. The acceptable standard of care varies among the states. Many states allow a trustee generally to be excused from liability except in cases of "willful misconduct" but others have developed a different minimum standard of care and will not excuse liability for "gross negligence." Where a settlor such as Margaret intends to relieve a trustee from liability for particular acts or conduct, the exculpation provision ideally should be as specific as possible.

Addressing Potential Conflict Situations in Advance

When a trust, such as Margaret's, will own voting control of a family business that has non-family member minority owners, there are various potential conflicts of interest that may arise. This is particularly the case where a corporate transaction may disproportionately benefit the trust. Margaret's trust would have trustees who are also company directors and, as such, may owe a corporate law duty to act in the best interests of all shareholders. Further, in some states, the trust itself (as a controlling shareholder of the company) may owe duties to the minority shareholders. Under trust law, however, the trustee's duty is to act in the best interests of the trust beneficiaries.

Margaret and her advisors should consider what would happen if a large competitor proposed to acquire the company after ownership of her shares pass to the trust. In exercising a trustee's duty of care in accordance with the prudent investor rule, a trustee generally has a duty to diversify the trust's assets. A trustee may incur liability to the beneficiaries for failing to diversify the trust's investments if the failure to diversify is shown to cause a loss to the trust. A trustee's presumptive duty to diversify may require the trustee to consider this proposed sale of Margaret's company if the business constitutes a significant holding of the trust, even if a sale of the business at that time may not be in the best interests of the other shareholders.

To minimize the potential conflict, the governing instrument of Margaret's trust may contain terms authorizing or directing the trustee to hold a particular business interest even though holding such interest otherwise would violate the prudent investor rule, thereby relieving the trustee from the duty to diversify with respect to a particular holding of the trust.

Similarly, a provision in a trust instrument prohibiting a sale or limiting the authority of a trustee to sell a business holding may create a conflict with the other shareholders. Such a provision could require a trustee to reject a purchase offer even if it is in the best economic interests of the shareholders, including the trust. As a general matter, such provisions should be avoided.

Other potential conflicts should be considered and addressed in advance. For example, under applicable trust law, an individual's potential conflict as a result of acting as an officer or director of a trust-controlled business may *per se* disqualify the individual from acting as trustee. A trustee's duty of loyalty also could prohibit an individual acting as trustee from receiving a personal benefit from a trust-controlled business, which would include compensation as an officer or director of the company.

To avoid such problems, the governing instrument of Margaret's trust may authorize each of the trustees

(i) to act as trustee even if the trustee also is an officer or director of the company and (ii) to receive compensation and other benefits from the business in the trustee's capacity as an officer or director. An alternative approach to managing potential conflict situations is to provide a mechanism in the trust's governing instrument for the appointment of an independent special trustee to act when the trustee has a conflict.

Finally, conflicting fiduciary duties can be mitigated by a thoughtful choice of entity. The state laws governing limited liability companies may be more flexible than those governing corporations with respect to fiduciary duties. In Delaware, corporate directors and officers are subject to non-waivable fiduciary duties, while a limited liability company agreement can limit or eliminate most duties of a member or manager of the limited liability company. Accordingly, in a trust-controlled entity formed as a limited liability company, the issue of potential conflicting fiduciary duties can be addressed up front as a contractual matter.

Potential Conflict Situations That Cannot Be Managed Effectively in Advance

Although a trust's governing instrument may contain general waivers of conflicts, some conflicts are not waivable. This is particularly the case where a trustee is an "insider" of a company in which the trust holds a controlling interest and a transaction the trustee must approve or permit could be construed as unduly benefiting the trustee in a personal capacity.

Imagine that the proposed sale of Margaret's company would also result in Sally receiving a significant change in control payment from the company as a result of early vesting of equity awards she holds. Sally could be liable to the trust beneficiaries if she approves or permits this transaction. Exculpatory clauses and conflict waivers in the trust's governing instrument and reliance on an independent advisor's fairness opinion alone may not provide sufficient protection for such conflicts. In this sort of situation, a trustee may wish to obtain the trust beneficiaries' consent to the proposed transaction.

A trustee will be protected from liability for the trustee's actions if such actions are consented to by the beneficiaries, so long as such consent is fully informed and not improperly induced by the trustee and the consenting beneficiaries are of age and otherwise have capacity to provide consent. Adult beneficiaries who have capacity generally may provide effective consent. In addition, under "virtual representation" statutes and similar provisions in a trust's governing instrument, the adult beneficiaries may represent and bind other trust beneficiaries, including charities and those who are minors, unborn or under a disability, with respect to trust matters.

For large trusts with many beneficiaries, however, obtaining effective consents from the beneficiaries may present practical difficulties. In order for the beneficiaries' consents to be fully informed, the beneficiaries generally should be independently represented by advisors who can assist them in evaluating a proposed transaction. In addition, the beneficiaries and their advisors would need access to confidential information at the company level, which likely would necessitate entering into nondisclosure agreements.

In the M&A context, consideration would need to be given as to whether the trustees would receive a disclosure document that is separate from what is provided to other shareholders, and, if so, what the company's role (if any) would be in preparing and filing such a document. In addition, the parties to the M&A transaction would need to agree as to whether the transaction would be conditioned on the consent of the beneficiaries or whether that consent could be obtained pre-signing.

Liquidity and Third-Party Investments

When relatives co-own a business they often face some of the same challenges and obstacles that present themselves to parties pursuing a joint venture.

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Over time, just as with a joint venture, the circumstances of the co-owners or the underlying business might change, creating additional challenges. For instance, Michael, the artist, may have a growing need for liquidity to fund his children's education, or the company might reach a stage in its life cycle where it needs to grow by acquisition but requires external investment to do so.

There is an inherent tension between granting heirs liquidity or allowing outside investment and ensuring that a family continues to control the company. The right balance depends on personal preferences and the needs of the parties in question. But estate planning that assumes that the needs of the company and heirs will remain static could lead to conflict among heirs or underinvestment in the company. Accordingly, a flexible framework is best.

Some of the devices that traditionally are used in joint ventures can be used to give family businesses and their owners the flexibility they need to navigate unforeseen developments. The following devices can be calibrated to strike the right balance:

- *Options*: Call options can give a company or its shareholders the ability to purchase the interest of other shareholders while put options can give a shareholder the right to force a company or other shareholders to purchase their shares, in each case, pursuant to specified formulas and processes. Options can satisfy the needs of those who desire liquidity while ensuring that ownership stays with the existing shareholders. Options also can facilitate a clean exit if a dispute is festering between co-owners.

- *Transfer Restrictions Coupled with Rights of First Refusal or Rights of First Offer*: Transfer restrictions limit the universe of transferees to a specific set of persons, unless the person who desires to sell their shares complied with the requirements of a ROFR or ROFO. This allows a sale to or an investment by third parties while giving other heirs the opportunity to preserve family control.

- *Preemptive Rights*: Before a company can issue new equity, existing owners are given the opportunity to subscribe to the new shares in order to maintain their proportionate ownership. This creates a framework for private placements to third parties subject to existing family members having the opportunity to invest the capital the company needs.

- *Tag- and Drag-Along Rights*: Such rights help facilitate the sale of a whole company while ensuring that all shareholders are treated fairly and that no shareholder can extract hold-up value.

The facts and circumstances will determine which, if any, of these tools are appropriate, and how to fine-tune the mechanical details. Particular pressure points for consideration include timing of potential exits, the valuation of shares and the liquidity of the parties. Some of the devices (for example, options and transfer restrictions) can have an impact on the valuation of the affected interest in the company for estate and gift tax purposes, and accordingly the design and crafting of such provisions by the M&A lawyer should be coordinated with the client's estate planning attorney.

Balancing the Needs of Active and Passive Owners

It is common in family-controlled business that over time some family members will be actively involved in the business while others will be passive owners. This can create a host of problems or incite conflict as the interests of active and passive owners diverge.

With respect to Margaret's company, it is easy to see how her children might have different views regarding what is best for the company. Sally, as a company insider, may prefer that more returns are reinvested in the company rather than distributed.

There is also a risk that she might engage in transactions that are self-enriching—whether it be setting a favorable salary for herself or giving other insiders equity compensation to increase the power or benefits of management. At the other end of the spectrum, Michael, given his financial constraints, might be more likely to prefer that the company sell itself, or that dividends be maximized at the expense of reinvestment. Alternatively, Sam's independent banking experience might lead him to second-guess Sally's leadership or have strong preferences regarding the company's capital allocation strategy.

Ultimately, corporate and estate planners need to create a framework under which passive shareholders are treated fairly and not abused, but do not have undue rights to impact the management of the company. The exact solution can vary. One approach is to give passive shareholders who own a specified threshold proportion of the company's equity veto rights over certain significant transactions including initial public offerings, amendments to the company's organizational documents and a sale of the whole company, as well as any transaction that could impair their economic or governance rights in a manner disproportionate to other shareholders. Sometimes combining veto rights with a put right, a call right or another exit mechanism for minority shareholders who feel disenfranchised can prevent discord from bringing the enterprise to a standstill.

The rules governing the appointment of directors or the ability of shareholders to directly influence company policy can be another means for calibrating the balance of power. In families where there are well-defined factions and groups of family members, each faction can be given the ability to appoint directors. For instance, each faction of Sally, Sam and Michael could have the right to appoint a portion of the board. In large, multi-generational families where there can be dozens of stakeholders, a more democratic, inclusive model can be used whereby decisions about material company policies are made at family meetings.

Family-Controlled Companies with Publicly-Traded Equity

It is possible for a company to have public shareholders while still remaining firmly controlled by a founder and her heirs. Public equity ownership under the stewardship of family control raises a host of issues ranging from how to achieve such a structure to considering the public disclosure requirements imposed by federal securities laws. While a family-controlled public company may be able to take advantage of controlled-company exceptions to stock exchange listing rules, the company likely still will be subject to other restrictions and requirements that should be considered in connection with the decision to take the company public.

Dual-Class Equity Structure

A common method for tapping public equity markets without relinquishing control is to employ dual-class common stock featuring one class with special voting and governance rights that is held by a select group of shareholders (*e.g.*, founding shareholders and their heirs) and another class that is sold to the public but has limited voting and governance rights. Dual-class structures are not new but they have continued to proliferate with the IPOs of companies such as Facebook, Google, Shake Shack and Fitbit.

The apparent convenience of a dual-class structure comes with long-term costs. It might make sense for uniquely gifted founders such as Margaret to maintain special control over an enterprise even if it has public shareholders. But such arrangements could be subject to long-term problems as control is retained over multiple generations. Even if second-generation leaders such as Sally are well suited to lead, someone in Margaret's position may not know whether third- or fourth-generation heirs will continue to have the desire or ability to lead the company. Management of the company's affairs might suffer and the risk of scrutiny for such failures is greater in a public company. And, of course, if the family's fortunes are

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tied to the company, third- and fourth-generation heirs might be worse off than if the family's wealth were originally invested in a diversified portfolio of assets.

The liquidity concerns that plague privately held family businesses can still apply in dual-class companies. This is an obvious issue if the special voting class of stock is not itself publicly traded. But even if both the high-vote and low-vote classes of stock are publicly listed and freely transferable, the market for the more widely held shares is likely to be deeper and more liquid. This can create an unusual outcome whereby shares with special governance powers trade at a discount to the more widely held shares Many dual-class company charters seek to address these issues by including "sunset" provisions that automatically cause high-vote shares to convert into low-vote shares if transferred to third parties.

Of course, one reasonable response to the above concerns could be that, as time passes and circumstances change, the company and its controlling family could simply restructure the company's capital structure to do away with the dual-class structure.

In order to facilitate such flexibility, legal advisors need to carefully craft the relative rights of the two classes in anticipation of such a recapitalization. Margaret would need to address whether her descendants should be able to extract a premium for relinquishing control to public shareholders through a recapitalization. Additionally, attention should be given to antitakeover laws of a particular jurisdiction and how they might apply to a recapitalization involving a controlling shareholder.

Federal Securities Laws and Public Disclosure

Another important consideration for a family-controlled business looking to tap public equity markets is that the company will be accountable to its public shareholders and regulators. In particular, federal securities laws will require a myriad of public disclosures.

Periodic reports will require the company to disclose information about its financial condition. Such disclosures would make significant details about the finances of a controlling family public knowledge. Not only are the finances of a public company subject to disclosure, but controlling shareholders are personally subject to significant disclosure obligations. Rule 13d-1 of the Securities Exchange Act of 1934 requires that certain beneficial owners of more than five percent of a class of equity securities file reports with the Securities Exchange Commission on Schedule 13D. Most notably, Schedule 13D requires such shareholders to disclose their plans or proposals for the company on an ongoing basis. In addition, the proxy rules will require disclosure of related party transactions involving controlling shareholders.

Public disclosure can become an even bigger concern if there is a dispute among family members. For instance, if there is conflict that escalates into a contest for control of the company, a public proxy fight would necessitate extensive public disclosures. The prospect of a family feud is only made all the more troubling if it is to play out on a public stage.

Dispute Resolution

The risk of a family feud is something that must be taken into consideration. Simmering sibling rivalries can escalate when money and power are thrown into the cauldron. Disputes in family-controlled companies can garner a lot of press attention even if a company is private because the combination of wealth and the appearance of family dysfunction makes for an easy story for the press. Not only could publicity embarrass the family but it also could harm a company's relationship with suppliers, customers and distributors, who might be alarmed by the uncertainty surrounding the company's direction.

Although a private company is better positioned than a public company to maintain confidentiality in the midst of a dispute, public scrutiny of private companies is still possible through court filings made

in the course of litigation or through voluntary disclosures by indiscreet stakeholders. Various tools can be employed to maintain privacy. For instance, mandatory arbitration provisions, confidentiality agreements and the inclusion of non-disparagement clauses in shareholder agreements and other instruments can limit the ability of dissident family members to damage the company with negative publicity.

Conclusion

Family-controlled companies present many interesting issues at the intersection of estate planning and M&A. It is critical that a family's estate planning advisors coordinate closely with the company's M&A advisors to ensure a consistent and workable approach across both aspects of the company's future.

A CLOSER LOOK AT THE MIDDLE-MARKET M&A PICTURE

Is middle-market M&A (deals under $1 billion) now a seller's market? A survey of 2015 trends in the middle market by Seyfarth Shaw LLP turned up some interesting findings that suggest sellers are now in a favorable position in some aspects of middle-market M&A. *The M&A Lawyer* talked to Andrew Lucano, a partner in Seyfarth Shaw's New York office, about the firm's *2016 Middle-Market M&A SurveyBook,* whose findings can be viewed here: http://viewer.zmags.com/publication/f4efd8b8#/f4efd8b8/1.

The M&A Lawyer*: Would it be fair to describe 2015 as being something of a seller's market in middle-market M&A?*

Andrew Lucano: The results of our survey showed evidence that sellers had an advantage with respect to the negotiation of certain deal terms. For example, the data showed a decrease in median escrow amounts and a higher percentage of deals employing an indemnity cap of 10% or less. In addition, the combination of heavy competition among buyers for quality assets, cheap financing and other factors contributed to high valuations for many target companies. A valuation gap has appeared to emerge in the middle market where the prices that sellers believe their companies are worth, versus the values that buyers believe targets are worth, can be very, very different. Also, middle-market sellers have seen large mega-mergers getting done in the past few years at very high valuations, and saying 'well, if the big guys can sell for that price why can't I?' Valuations relative to actual financial results of certain target companies were very high.

In an effort to close this valuation gap and avoid overpaying, certain buyers have resorted to offering better contract terms in lieu of increasing their purchase price to make their overall bid more attractive. That's one contributing factor to why there was a more seller-favorable market in 2015.

MAL*: So far this year, has anything changed from your survey's findings?*

Lucano: It's hard to tell given that we're only a few months in but I would say that things are roughly the same in my experience so far in 2016. We're not seeing any drastic moves one way or the other from what we experienced last year. The M&A middle market still appears to be very healthy. While certain buyers continue to be cautious in dealing with high price expectations of sellers, there certainly are plenty of deals still getting done.

MAL*: One of the survey's findings was that there was an increase in the number of escrow periods of 12 months or less for middle-market deals during 2015.*

Lucano: Shorter escrow periods are always better for sellers because they can get their money more quickly. This trend was driven in part by the over-

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all seller-favorable market as well as by more buyers purchasing representations and warranties insurance. The purchase of representations and warranties insurance gives the buyer more leeway in indemnity provisions. With insurance backing up the indemnity, buyers are more apt to live with less indemnity protection directly from the sellers, including agreeing to a shorter escrow period.

***MAL**: What's driving the increase in reps and warranties insurance purchases?*

Lucano: A few things are. Mainly it's that the product has greatly improved in recent years. It's less expensive, more user-friendly and now provides more thorough coverage than in the past. Insurance companies are able to put policies in place relatively quickly. So it's kind of a win-win for buyers and sellers. For example, on the buy side, the insurance can provide longer survival periods than you would otherwise probably obtain from a seller, and buyers can get higher caps from insurance companies than they might otherwise would have obtained directly from the sellers. There is a higher level of comfort for buyers in making indemnity claims against a large highly rated insurance company, as opposed to chasing individual sellers. Also, when the former owners of a target company continue to work for the target post-closing, being able to make claims against an insurance company as opposed to the sellers makes for a much better working relationship.

From the seller's perspective, the main thing that many sellers want is a clean break. They want to sell their company and they don't want to hear from the buyers again. Maybe they'll put a portion of the purchase price in escrow to cover claims for a period but otherwise if there's a problem, they don't want to hear about it, and would prefer buyers to seek recourse from insurance companies. The idea of having a clean break is a really positive thing for sellers and keeps the sale proceeds in their pockets.

***MAL**: When did reps and warranties coverage improve? Relatively recently?*

Lucano: In the past five years or so there have been some really big improvements in the product. It's been around for a while but it was not as easy a product to work with in the past. Now insurers are polishing their offerings and they're able to act very quickly to get policies in place. The policies are becoming more standardized, and insurance companies are more flexible in putting a good product out there that's easy to understand, easy to work with and provides real coverage.

***MAL**: Your survey looked at the size of baskets in middle-market deals. Did anything surprise you in your findings*?

Lucano: The size of baskets have been relatively stable for a couple years. In our survey it actually showed that the use of true deductible baskets versus tipping baskets went down a little bit in 2015 as compared to 2014. This was a bit surprising in light of our more seller-favorable survey results with respect to certain other deal terms included in the indemnity package, because tipping baskets are buyer-favorable and deductible baskets are seller-favorable. That said, our survey showed that the vast majority of middle-market deals continue to use deductible baskets. As you know, with a true deductible basket, the indemnifying party is only responsible for losses in excess of the basket amount as opposed to a tipping basket which requires the indemnifying party to pay for losses from dollar one once the basket amount is achieved.

***MAL**: You've been running this survey for three years now: do you intend to keep doing it as an annual service*?

Lucano: Yes, we certainly intend to continue to

distribute our annual survey of these deal terms. We view this as a quick and easy reference guide which is more real-time in its findings. You're seeing transaction data as recent as of just a few months prior to distribution. We try to keep it short, to the point, and easy to understand and providing data points concerning issues that are negotiated in almost every private company M&A deal.

FROM THE EDITOR

Working for the Clampdown

Less than two days after the U.S. Treasury Department released two barrages of new U.S. federal tax regulations on April 4, 2016, Pfizer and Allergan pulled the plug on their long-planned merger. The culprit was apparently "the "serial inverter" rule contained in the new temporary section 7874 regulations and possibly the proposed anti-earnings-stripping rules," as Jones Day's Raymond Wiacek, Andrew Eisenberg and Edward Kennedy write. "Treasury regulations are not supposed to target specific taxpayers, and while the new anti-inversion regulations are broad in effect, they seem uniquely tailored to target the Pfizer-Allergan transaction."

Allergan CEO Brent Saunders would likely concur. After the deal was pulled, he told CNBC that "it really looked like [Treasury] did a very fine job of constructing a rule here—a temporary rule—to stop this deal, and obviously it was successful. . . For the rules to be changed after the game has started to be played is a bit un-American, but that's the situation we're in. We built this deal around the law, the regulations, all the notices that were put out by the Treasury and it was a highly legal construct. We followed the rules that Congress had set for companies looking to move to foreign domicile."

In their detailed examination of the rationale and implications of the Treasury regulations, the authors conclude that "Treasury's proposed rules are unprecedented, overreaching and unnecessary. . .We can only hope that Treasury will reevaluate its decision to police earnings stripping and the deduction of interest with a more appropriate tool. The authority granted to Treasury under section 385 was limited to providing factors for determining the substance, as debt or equity, of a purported debt instrument based on the relationship created under the instrument in question, not to determine debt or equity treatment based on the mere relationship between the debtor and creditor. This distinction is one apparently lost on the Treasury."

The end of Pfizer/Allergan, while not a stated goal of the Obama Administration, certainly wasn't mourned by the Administration (and both Sen. Bernie Sanders and Sec. Hillary Clinton have publicly attacked the deal). Nor was it the last mega-merger to founder in the current environment. In early May, Halliburton ended its planned acquisition of Baker Hughes, which U.S. Attorney General Loretta Lynch praised, saying "the companies' decision to abandon this transaction—which would have left many oilfield service markets in the hands of a duopoly—is a victory for the U.S. economy and for all Americans." Given how this year has gone, such a victory likely won't be the last.

Chris O'Leary

Managing Editor

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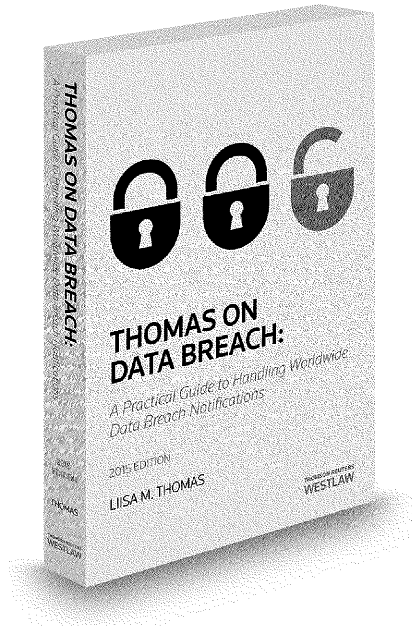

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A Practical Guide to Handling Worldwide Data Breach Notifications

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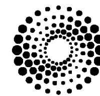
As the nation – and the world – debate issues about data breach laws, this guide gives you a comprehensive overview of where we are right now, and how to best prepare for the future. It will also aid you in assessing specific data breach questions, such as What are our legal obligations? Do we have to notify under various data breach notification laws? Whom do we notify? How quickly? What should be included in the notice? What is our potential exposure after the notice goes out? And finally Did we do all that we could have to prevent the attack?



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