

Update

Corporate Securities Law

August 15, 2006

Sears Canada Decision by Ontario Securities Commission

On August 8, 2006, the Ontario Securities Commission released its decision in the matter of *Sears Canada Inc. et al.* The OSC found that Sears Holdings Corporation, in its bid to buy out the minority shareholders of its subsidiary, Sears Canada Inc., violated applicable disclosure obligations, granted improper benefits to certain Sears Canada shareholders, and generally acted abusively and coercively in contravention of the public interest. The decision provides, in a period of greatly increased public M&A activity, detailed guidance as to the perspectives of the Commission on minority shareholder protections in the take-over bid context and its preparedness to intervene.

The Facts

In December, 2005 Sears Holdings, which then held approximately 54% of the outstanding shares in Sears Canada, announced its intention to make an offer to acquire the public's 46% interest at an offer price of \$16.86 per share. Sears Holdings also announced that its bid (an insider bid under applicable securities rules because of Sears Holdings' interest in Sears Canada) would be conditional upon acceptance by a majority of the minority shareholders, which would enable Sears Holdings to take Sears Canada private in a second stage transaction.

After the bid was launched in February, 2006, Sears Holdings learned that significant blocks of Sears Canada shares were held by Canadian financial institutions, including Royal Bank of Canada and the Bank of Nova Scotia (the latter the parent corporation of Sears

Holdings' financial advisor, Scotia Capital Inc.). Portions of those holdings were held as part of swaps or other derivative arrangements under which third parties maintained economic exposure to the performance of Sears Canada stock notwithstanding that the banks were nominally the shareholders. The banks had a material tax incentive not to have their Sears Canada shares acquired prior to December 2006 and then only pursuant to certain forms of second stage transactions. Sears Holdings entered into support agreements under which the banks agreed to vote in favour of a going private transaction for Sears Canada at a second stage, in consideration for which Sears Holdings agreed to extend the offer and structure the second stage transaction in a manner that would accommodate the banks' tax planning.

Sears Holdings subsequently entered into an agreement with another holder of a significant block of Sears Canada shares, Vornado Realty. This agreement was notable in that Sears Holdings agreed to pay an increased price of \$18 per share and also in that Sears Holdings agreed to release Vornado from any claims relating to Vornado's acquisition and sale of Sears Canada shares.

Sears Holdings took other steps to further its objectives, including disclosure that it would support elimination of Sears Canada's practice of paying quarterly dividends if its bid did not succeed, and publicly calling into question the good faith of the members of Sears Canada's independent committee of directors.

The OSC also considered Sears Holdings' allegations that Pershing Square Capital Management L.P., Hawkeye Capital Management LLC and Knott Partners Management LLC, institutional holders of Sears Canada stock (and the key proponents of the complaints about Sears Holdings' actions), failed to comply with their disclosure obligations (allegedly by using swaps and failing to properly take account of joint action among members of the group and Vornado, to avoid disclosure requirements), engaged in price manipulation by making

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purchases timed to maintain the stock price at a level higher than Sears Holdings' offer price, and generally engaged in abusive tactics.

Key Findings

The OSC's decision addressed a number of topical issues in M&A transactions, including the following:

Use of Swaps to Avoid Disclosure Requirements: The Commission concluded that there were insufficient facts to support a conclusion that Pershing had used swaps to avoid disclosure obligations. Notably, however, the OSC took pains to note that there may well be situations where, in the context of a take-over bid, the use of swaps to "park securities" in a deliberate effort to avoid reporting obligations could constitute abusive conduct sufficient to warrant regulatory intervention.

Joint Action: Sears Holdings' allegations concerning Pershing's failure to properly report hinged in large measure on assertions that Pershing had acted jointly or in concert with Vornado and/or had acted jointly or in concert with Hawkeye and Knott earlier than disclosed. The OSC determined that Pershing and Vornado had not been joint actors notwithstanding joint purchasing arrangements and Vornado's payment of a finder's fee to Pershing for the introduction to the Sears Canada opportunity. The Commission stated that there being no "smoking gun," and Pershing having provided plausible explanations for its actions, the evidence was insufficient to support the contention of joint action.

Firewalls within Financial Institutions: Pershing, in parallel to the allegations of joint action asserted against it, claimed that Scotia Capital and Bank of Nova Scotia had acted jointly with Sears Holdings. Of note, the OSC implicitly accepted the submission that the creation of firewalls between and within the Canadian banks and their investment banking subsidiaries is a well-established and recognized practice, and effectively sanctioned their use.

Collateral Benefits: Of the findings in the *Sears Canada* decision, likely the most significant element will prove to be the manner in which the OSC addressed the collateral benefits issue, *i.e.* the provision of securities legislation that prohibits payment of additional consideration or

benefits to certain but not all holders of target issuer shares.

The OSC determined that Sears Holdings granted an improper collateral benefit to Vornado by providing it with the litigation release, notwithstanding that Sears Holdings considered the release of no value because it had no basis for any claim against Vornado (and notwithstanding that all shareholders would obtain the benefit of Vornado's negotiation of an increased offer price).

The Commission also concluded that the terms of the support agreements entered into with the Canadian financial institutional shareholders of Sears Canada provided collateral benefits. The OSC rejected the arguments of Sears Holdings and the banks that other shareholders in the same tax position as the banks would realize the same benefits as had been achieved by the banks, because other shareholders had sold without knowledge of the benefits. It is notable also that the Commission confirmed earlier jurisprudence to the effect that the offeror and the recipient of unique consideration bear the onus of proving that the special features of their agreement do not give rise to consideration of higher value.

Disclosure Requirements: The Commission, not surprisingly, stated that there is a distinction between disclosure deficiencies which are simply failures to meet technical requirements and those which involve the failure to disclose information that may be material to an investor's decision to tender shares to a bid in the particular circumstances. The OSC noted the particular importance of adherence to disclosure requirements in the context of related party transactions such as insider bids and concluded that the failure of Sears Holdings to make certain disclosures (including disclosure of, among other things, the Vornado release, the terms, tax benefits and counterparties to the banks' support agreements, and the price protection given to a locked-up shareholder) constituted a breach of applicable requirements.

Coercive and/or Abusive Conduct: The Commission described its approach in identifying abusive conduct as

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similar to the approach adopted by the courts in defining obscenity, specifically “know it when they see it.” Having found breaches of the law on the part of Sears Holdings, the Commission did not need to consider whether the conduct was abusive so as to warrant exercise by the OSC of its jurisdiction to act in the public interest. However, the OSC examined Sears Holdings’ conduct and concluded that Sears Holdings’ attack on the integrity of the valuation obtained by Sears Canada, its threat to support cessation of the Sears Canada dividend if its offer was not successfully completed, the public questioning of the good faith of Sears Canada’s independent directors, and other factors, and concluded that those elements of Sears Holding’s conduct were coercive and abusive of minority shareholders.

Remedies

The OSC concluded that in light of its findings an unequivocal cease trade of the Sears Holdings’ offer would be too harsh a remedy. Instead, the Commission ordered (a) compliance with the disclosure requirements by Sears Holdings and, (b) given the determination that they had received collateral benefits, the exclusion of Vornado and the banks from the majority of minority approval requirement for a second stage going private transaction, thereby making achievement of Sears Holdings’ privatization objective more challenging.

Please contact any member of the Goodmans corporate securities team should you wish to discuss the implications of the OSC decision.

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