Goodmans LLP Update

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OSC and BCSC Establish New Framework for Regulating Tactical Private Placements

On October 24, 2016, the Ontario Securities Commission (OSC) and British Columbia Securities Commission (BCSC) released joint reasons for their decision, *In the Matter of Hecla Mining Company and Dolly Varden Silver Corporation* (available here), denying an application by Hecla Mining Company (NYSE: HL) ("**Hecla**") to cease trade a private placement by Dolly Varden Silver Corp. (TSX.V: DV) ("**Dolly Varden**") that had the effect of thwarting an unsolicited take-over bid by Hecla for Dolly Varden. The background and facts of the case are described in our July 26, 2016 Update, *OSC and BCSC Permit Dolly Varden Private Placement Impeding Hecla Mining Take-Over Bid* (available here).

Market participants have eagerly awaited the decision as it represents the first opportunity for securities regulators to apply National Policy 62-202 – *Take-Over Bids – Defensive Tactics* ("**NP 62-202**") to an alleged defensive tactic – and in particular, a private placement – since the recent amendments to Canada's take-over bid regime took effect in May 2016. The reasons establish a new framework for evaluating when securities regulators will intervene in a private placement implemented during an unsolicited take-over bid, and highlight a number of challenges that securities regulators face in regulating private placements as defensive tactics. However, the relatively unique facts of *Dolly Varden* leave open a number of important questions regarding the circumstances in which issuers can proceed with private placements in anticipation of, or in response to, an unsolicited take-over bid.

May 2016 Amendments to Canada's Take-Over Bid Regime and the Role of Private Placements

On May 9, 2016, the rules applicable to take-over bids in Canada were amended to, among other things, require all non-exempt bids to (a) remain open for a minimum bid period of 105 days (unless the target board reduces that period to a minimum of 35 days), and (b) receive tenders of more than 50% of the shares subject to the bid (excluding shares owned by the bidder). These amendments effectively render the primary tool historically used by target boards – the shareholder rights plan or "poison pill" – irrelevant as a tactical response to a hostile bid (because, unlike in the U.S., rights plans in Canada generally can only be used to delay – not prevent – a take-over bid that is made to all shareholders). At the same time, private placements can be used by boards to potentially frustrate hostile bids under the new regime by making it more difficult for bidders to satisfy the mandatory minimum tender condition. As a result, there has been an increased focus on the potential use of private placements as part of target boards' responses to hostile bids. These developments, and the principal legal and practical issues raised by the use of private placements in the new bid regime, are discussed in detail in our May 9, 2016 article, *The Role of Private Placements in Canada's New Take-Over Bid Regime* (available here).

New Legal Framework

In declining to intervene in Dolly Varden's private placement, the Commissions adopted a new analytical framework that involves a two-part inquiry. The first question focuses on the *purpose* of the private placement. If it can be clearly established that a private placement was not used (in whole or in part) as a defensive tactic, then NP 62-202 is not engaged and securities regulators will not intervene (absent other circumstances that suggest an abuse of target shareholders or the capital markets). If the private placement has a material impact on the bid (as was the case in *Dolly Varden* with a potential 43% dilution), the burden of proving that the financing is not a defensive tactic is on the target based on the following non-exhaustive list of factors:

- whether the target has a serious and immediate need for the financing;

- whether there is evidence of a *bona fide*, non-defensive, business strategy adopted by the target; and
- whether the private placement has been planned or modified in response to, or in anticipation of, a bid.

If, on the other hand, a private placement is at least in part a defensive tactic (or there is insufficient evidence as to purpose), then the principles of NP 62-202 are engaged. However, unlike with rights plans where the question generally was "when", not "if", the pill must go, the Commissions in *Dolly Varden* established a new paradigm that requires a balancing between the policy considerations underlying NP 62-202 and respecting a board's business judgment. In addition to the factors described above, regulators will now consider the following factors in determining whether intervention is warranted:

- other benefits of the private placement to target shareholders (*e.g.,* allowing the target to continue its operations through the term of the bid or in allowing a board to engage in an auction process without unduly impairing the bid);
- the impact of the private placement on pre-existing bid dynamics, including the ability of target shareholders to tender to the bid;
- the participation of related parties or other "friendly" investors in the private placement;
- available information regarding the views of the target shareholders with respect to the bid and/or the private placement; and
- whether the target's board appropriately considered and balanced the benefits of the private placement and its impact on the bid.

Based on the "relatively straightforward" facts in *Dolly Varden*, the Commissions determined that the private placement in question was instituted for the non-defensive business purposes of addressing an immediate need for financing and implementing the Dolly Varden board's business strategy of continuing its exploration program. In doing so, the Commissions focused significantly on the fact that Dolly Varden was already contemplating an equity financing considerably in advance of Hecla's announcement of its bid (notwithstanding that certain key details – including the size of the private placement – were apparently not determined until after Hecla's announcement) and that the size of the private placement was appropriate given Dolly Varden's financing needs and business objectives.

Key Takeaways

The Commissions' determination that the private placement was not – even in part – a defensive tactic may confine the conclusions in *Dolly Varden* to the facts of this particular case and in any event dispensed with the need for the Commissions to provide further guidance regarding the balancing exercise in determining whether to intervene. Nevertheless, the Commissions' reasoning and ancillary comments provide some insight as to how regulators may approach future cases with different facts, as well as practical guidance for bidders and targets in this context:

1. *Private placements can be an effective tactical tool in appropriate circumstances.* The Hecla bid was withdrawn within hours of the release of the Commissions' order denying Hecla's application to cease trade Dolly Varden's private placement. This case provides a clear illustration of the potential tactical effectiveness of private placements that survive regulatory scrutiny under the new bid regime.

2. *The importance of establishing a proper record.* The Commissions engaged in an extensive examination of the evidence – including minutes of Dolly Varden board meetings – in concluding that Dolly Varden's private placement was not a defensive tactic. Had this evidence not been available, the Commissions would likely have been required to engage in the more difficult analysis of balancing the alleged benefits of the private placement against its impact on Dolly Varden's shareholders' ability to tender to Hecla's bid. A clear and consistent record is likely to assist targets both in establishing whether the transaction is a defensive tactic and, if so, in persuading regulators that deference to the board's business judgment is warranted.

3. *Deference to business judgment.* Unlike the approach that regulators have taken with respect to rights plans, the business judgment of a target's board will play a much more prominent role in the review of private placements, both in the context of determining whether the private placement was undertaken for a

defensive purpose and the balancing exercise of determining whether to intervene. In particular, the Commissions' willingness to consider longer term business objectives (such as Dolly Varden's exploration aspirations) beyond immediate liquidity needs is somewhat of a departure from prior decisions evaluating tactical private placements. These developments further underscore the importance of establishing a robust process for, and appropriate record of, directors' decision-making and strategy.

4. *Unresolved issues.* The facts in *Dolly Varden* alleviated the need for the Commissions to deal with a number of complex issues that can arise with private placements in the new bid regime, including:

- the extent to which alternative remedies – such as a modification of the mandatory minimum tender condition by disregarding the private placement shares – may be appropriate if it will allow both the private placement and the bid to proceed (in this case, Hecla was not willing to proceed without taking up at least a majority of all of the outstanding shares);
- whether the Commissions have the ability (legally and practically) to unwind a completed private placement (in this case, Dolly Varden provided undertakings to the Commissions to not complete the private placement until their order had been rendered); and
- issues regarding forum and deference if a stock exchange has already approved a private placement (in this case the TSX Venture Exchange deferred its decision regarding the private placement pending the regulatory review).

5. *Proxy Contests.* The Commissions did not comment on the potential tactical use of private placements in other contexts, such as proxy contests or voting transactions. We expect both targets and activists to make similar arguments to those advanced by Dolly Varden and Hecla if and when those issues come before securities regulators, and that the guidance under the new bid regime will at least influence regulators' approach to addressing those situations.

Ultimately, we do not believe private placements will be an appropriate response to all bids, or that the Commissions' reasons in *Dolly Varden* establish a "just say no" defence in Canada. However, the new framework established by the Commissions in *Dolly Varden* does provide an opportunity for target boards to use private placements as a response to a bid (or potential bid) if it can be demonstrated that the benefits of the private placement outweigh any adverse impact on the ability of shareholders to tender to the bid.

Formal Valuation Requirement

Somewhat overshadowed by the defensive tactic analysis was Dolly Varden's application to cease trade Hecla's bid on the basis that, among other things, Hecla failed to obtain a formal valuation of the Dolly Varden shares as required by MI 61-101 – *Protection of Minority Security Holders in Special Transactions* ("**MI 61-101**"). Given that Dolly Varden's current Interim Chief Executive Officer had been a consultant of Hecla until January 2016, Dolly Varden disputed Hecla's position that it was exempt from the formal valuation requirement on the basis that it had no board or management representation within the previous 12 months and no knowledge of any inside information. The OSC determined that Hecla had not discharged its burden of establishing that the exemption was available, and accordingly cease-traded the Hecla bid until Hecla provided the formal valuation, and required that the bid, if it proceeded, not expire until at least 35 days after the valuation had been provided. Interestingly, the BCSC, which considered this issue under its general public interest jurisdiction (given that MI 61-101 has not been adopted in British Columbia), neglected to intervene on the basis that failure to provide the valuation did not amount to an abuse of shareholders or the capital markets. The juxtaposition of these rulings reinforces the notion that regulators will intervene where material breaches of statutory requirements occur, without the need to further establish that such intervention is required in the public interest.

Please contact any member of our Corporate Securities Group to discuss the implications of this decision and for more information about the potential use of private placements in the context of hostile take-over bids.