



Conflict of Interest Transactions in Canada and Recent Regulatory Guidance

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In several jurisdictions in Canada, conflict of interest transactions are subject to the regulatory regime set out in *Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions* (“**MI 61-101**”). Every issuer listed on the TSX or TSXV (subject to limited exemptions) is subject to MI 61-101.

MI 61-101 establishes a securities regulatory framework intended to protect the interests of minority security holders when “related parties” (including insiders) of an issuer are involved in certain transactions (including take-over bids and other business combinations). Fundamentally, MI 61-101 is intended to ensure all security holders are treated in a manner that is fair and perceived to be fair in material transactions, where the interests of related parties differ materially from the interests of minority security holders. MI 61-101, which is a codification of many of the principles articulated in Delaware’s Court of Chancery decision in *In re MFW Shareholders Litigation*, implements these principles through procedural protections. Depending on the circumstances, MI 61-101 requires one or more of formal valuations, enhanced disclosure, and minority security holder approval, as well as the involvement of a special committee of independent directors. Certain market practices have developed to achieve technical compliance with MI 61-101, which to a large degree would mitigate – if not eliminate – regulatory intervention in a proposed transaction.

Issuers and their counsel must rethink their historical practices in light of the recent Multilateral CSA Staff Notice – 61-302 (the “**Staff Notice**”), published by the Canadian Securities Administrators (“**CSA**”). The Staff Notice:

- Provides that CSA staff (“**Staff**”) will now proactively scrutinize transactions subject to MI 61-101, not only for technical compliance with MI 61-101 but to assess whether the transaction – or the process by which it has been implemented – is contrary to the public interest.

- Sets out important new guidance regarding various aspects of transactions governed by MI 61-101, including the role of boards of directors and special committees and disclosure obligations in connection with a transaction subject to MI 61-101.

This guide provides an overview of some of the key legal considerations relevant for issuers engaging in conflict of interest transactions in Canada in light of the Staff Notice, as well as guidance on avoiding the potential delays, administrative burdens and reputational issues that may arise when engaging in these transactions.

MI 61-101 - The Basics

Historically, Canadian securities regulators have taken a prescriptive approach to regulating conflict of interest transactions. This differs significantly from the case law approach of U.S. courts in analyzing corporate legislation and fiduciary duties of directors in conflict of interest transactions. Canadian regulatory authorities adopted a number of policies and legislation, dating back to 1977, in an effort to regulate conflict of interest transactions. MI 61-101 is the most recent iteration. Each of these policy and legislative formulations have generally prescribed certain procedural safeguards when an issuer was undertaking a conflict of interest transaction.

As a means to promote the fair treatment of, and equal access to relevant information for, all security holders, MI 61-101 prescribes enhanced procedural requirements in the context of the following types of transactions, each of which involves one or more “related parties”¹ in some way:

- **Insider Bids:** An insider bid is a take-over bid (the equivalent of a U.S. tender offer) in which the offeror is currently, or was at any time within 12 months preceding commencement of the bid, (i) an insider of the target, (ii) an associate or affiliate of the target or of an insider of the target or (iii) a joint actor with any such person.

¹ A related party of an entity includes directors, officers and significant shareholders of the entity, external managers, entities controlled by any of the foregoing and all of their directors, officers and affiliated entities.

- **Business Combinations:** A business combination is a transaction (similar to a U.S. merger) under which the interest of a holder of an equity security may be terminated without consent, regardless of whether the equity security is replaced with another security, and in which a related party is not treated identically to other security holders (e.g., because the related party receives different consideration or some other “collateral benefit”).
- **Related Party Transactions:** Related party transactions include a broad range of transactions between the issuer and a related party of the issuer.
- **Issuer Bids:** An issuer bid is an offer by an issuer to acquire or redeem its own securities.

Generally speaking, and subject to a number of exemptions, the enhanced procedural requirements mandated by MI 61-101 are:

- Oversight by a special committee of independent directors.
- A formal valuation of the target securities and other non-cash consideration by an independent valuator.
- Approval of the transaction by a simple majority of minority shareholders (i.e., “majority of the minority” approval requirement).
- Enhanced disclosure, including a detailed summary of the background to the transaction as well as prior valuations and offers within the previous two years.

The following table summarizes these procedural requirements as they apply to each type of transaction regulated by MI 61-101, subject to applicable exemptions and waivers.

Transaction Type	Enhanced Disclosure	Formal Valuation	Special Committee	Minority Approval
Insider Bids	Required	Required	Required	Not applicable
Business Combinations (e.g., Plan of Arrangement)	Required	Required for certain transactions	Recommended (and customary market practice)	Required
Related Party Transactions	Required	Required for certain transactions	Recommended	Required
Issuer Bids	Required	Required	Recommended	Not applicable

These requirements are subject to detailed and highly technical exemptions that should be carefully analyzed in the context of each relevant transaction.

New Guidance on Material Conflict Transactions

General

The Staff Notice is intended to clarify the expectations of Staff of the relevant securities regulators for issuers and their counsel and, in particular, reduce the discrepancy between Staff's expectations and current market practice. The Staff Notice consolidates Staff's views on a number of issues pertaining to conflict of interest transactions. Among other things, the Staff Notice:

- Confirms that Staff has implemented a formal review program to proactively review material conflict of interest transactions on a real-time basis, but has elected not to adopt a system of advance review of proxy materials before they are sent to shareholders (in contrast to SEC rules requiring review of proxy materials before mailing in the U.S.).
- Establishes that board / special committee processes and disclosure in material conflict of interest transactions that satisfy technical form requirements, may not sufficiently satisfy securities regulatory authorities that intervention is not warranted where efforts have been focused on "check the box" compliance and not on compliance with the overarching principles enunciated in MI 61-101, its companion policy, and any relevant decisions of Canadian securities regulatory authorities.
- Expands the level of disclosure required with respect to financial advice and fairness opinions received by a target board or special committee and clarifies that fixed fee arrangements (as opposed to success-based fees) for financial advisors are not mandated.

The Review Program

The Staff Notice confirms that Staff are now proactively reviewing transactions subject to MI 61-101 and applying heightened scrutiny to ensure regulatory compliance and identify and address public interest concerns.

Key features of the review program include the following:

- Staff will generally initiate a transaction review when the relevant disclosure document (i.e., the take-over bid circular or proxy circular) is filed. Historically, Canadian securities regulators have generally only engaged in this type of detailed review upon receiving a complaint from an interested party. While Staff indicated that it will seek to identify and resolve issues in real-time, it reserves the right to intervene (including through a temporary cease-trade order) if it believes it is in the public interest to do so, which could delay the transaction.
- Staff's review will focus on both technical compliance with MI 61-101 and public interest issues. Of particular importance is the statement by Staff that it will examine whether the process employed by the issuer's board of directors and/or special committee in negotiating and reviewing a proposed transaction raises concerns that the interests of minority security holders have not been adequately considered and protected. This expanded mandate may result in securities regulators inserting themselves into matters that have traditionally been regulated solely by Canadian courts (based on the fiduciary duties of directors).
- If potential compliance or public interest issues are identified, Staff may contact the issuer (or its legal counsel) and ask detailed questions and/or request supporting information (including board of directors and special committee minutes, special committee mandates, work product associated with a formal valuation and other relevant materials).
- Staff will factor into its review any complaints received from third parties.
- When Staff identifies non-compliance with MI 61-101 or public interest concerns (e.g., where materially misleading disclosure has been made or other requirements of applicable securities law have not been complied with), it may seek timely corrective disclosure or other appropriate orders under securities legislation in relation to the transaction, or enforcement action in certain circumstances.

Unlike U.S. securities regulators, which require issuers to submit disclosure documents to them for advance review before mailing to shareholders (allowing issuers to address regulator concerns without the need for supplemental or corrective disclosure after mailing), Canadian securities laws do not require such prior review and regulatory approval. However, Staff have shown a willingness to engage in pre-filing discussions with issuers and their counsel where the applicability of certain elements of MI 61-101 are uncertain.

Special Committees

The Staff Notice reiterates Staff's view that a special committee is advisable for all material conflict of interest transactions, even where not technically required.

The Staff Notice provides guidance with respect to Staff's expectation about a special committee's role in material conflict of interest transactions, including that:

- A special committee should be formed early in the process, be composed entirely of independent directors and engage in a robust review of the circumstances leading to the transaction, the transaction itself and available alternatives.
- A special committee should have a broad mandate, which includes the authority to (i) negotiate, or supervise the negotiation of, a proposed transaction (rather than to simply review and "consider" it), (ii) make a recommendation to the board regarding the fairness of a proposed transaction and (iii) hire its own independent legal and financial advisors, without any involvement of, or interference from, interested parties or their representatives.

A special committee formed late in the process or that does not actively participate in the negotiation process and appears to simply act as a "rubber stamp", will likely not be viewed by Staff as achieving the policy rationale of MI 61-101 and could result in regulatory intervention such as a cease trade order restricting the transaction from proceeding or requiring amended and enhanced disclosure documents for the transaction, which could impact timing and therefore execution.

Enhanced Disclosure

The Staff Notice emphasizes the importance of enhanced disclosure given the asymmetry of information that may exist between insiders and minority shareholders in material conflict of interest transactions. In that context, Staff stresses that this disclosure must not only meet the technical line item requirements of MI 61-101, but achieve the "spirit and intent" of the underlying policy objectives. Furthermore, the Staff Notice indicates that the enhanced disclosure requirements presuppose that an effective process has been undertaken such that a board of directors is able to appropriately inform security holders as to the desirability or fairness of the transaction proposed to them.

The Staff Notice also clarifies Staff's expectations regarding the substance of certain key disclosure requirements, noting that:

- There should be a thorough discussion of (i) the context and background to a proposed transaction, (ii) the desirability or fairness of a proposed transaction, (iii) the board or special committee's process and rationale for supporting a proposed transaction, (iv) any dissenting views of directors with respect to a transaction, (v) the pros and cons of a transaction and (vi) reasonable alternatives to the transaction.
- There should not be overly one-sided or self-serving disclosure intended primarily to further the interests of an interested party.
- The failure of the directors to recommend how minority security holders should vote on a proposed transaction, without detailed reasons, generally would cause the disclosure to be viewed as insufficient.

Fairness Opinions

Fairness opinions are not expressly required by MI 61-101, and the Staff Notice recognizes it is the responsibility of an issuer's board of directors or special committee to determine whether a fairness opinion is appropriate. Nonetheless, the Staff Notice outlines certain expectations where a fairness opinion is obtained, including that:

- It is generally the responsibility of the board or special committee to determine the terms and financial arrangements for the engagement of an advisor to provide a fairness opinion.
- A special committee cannot substitute the results of a fairness opinion for its own judgment about whether a transaction is in the best interests of the issuer and its minority shareholders.
- A special committee should engage in a thorough review of any fairness opinion that is obtained and should not blindly accept the assumptions and methodologies utilized by the financial advisor.
- A special committee should consider any prior financial work product produced by the financial advisor or any other financial advisors that is relevant to the committee's recommendation, and whether such work product needs to be disclosed to security holders.

The Staff Notice expresses concern that current market practice regarding disclosure of fairness opinions for transactions regulated by MI 61-101 does not provide security holders with a meaningful understanding of the fairness opinion and how it was considered by the board or special committee. Furthermore, the Staff Notice indicates such disclosure should include:

- The compensation arrangement, including whether the financial advisor is being paid a flat fee, a fee contingent on delivery of the final opinion, or a fee contingent on the successful completion of the transaction.
- An explanation of how the board or special committee took the compensation arrangements into account when considering the advice provided.

- Disclosure of any other relationship or arrangement between the financial advisor and the issuer or an interested party that may be relevant to a perceived lack of independence in respect of the advice received or opinion provided.
- A summary of the methodology, information and analysis (including, as applicable, financial metrics, and not merely a narrative description) underlying the opinion sufficient to enable a reader to understand the basis for the opinion.
- An explanation of the relevance of the fairness opinion to the board of directors and special committee in determining to recommend the transaction.

Notably, the Staff Notice also states that if a fairness opinion has been requested and a financial advisor is not able or willing to provide one, the disclosure document should set out the financial advisor's reasons for not providing the fairness opinion and explain how the special committee and board of directors took the financial advisor's decision into account and its relevance to any recommendation made to security holders concerning the transaction.

Conclusion

The Staff Notice highlights the need for issuers and advisors to carefully consider the regulatory requirements set out in MI 61-101 and the principles underlying these requirements when undertaking a conflict of interest transaction, as historical practices may no longer be deemed sufficient. As a result of the new formal review program adopted by several Canadian securities regulators, conflict of interest transactions will be scrutinized by Canadian regulators for compliance with MI 61-101 and failure to properly and fully comply with these requirements may result in regulatory intervention that could add to significant deal uncertainty, delay or reputational risk. We strongly recommend that when undertaking these types of transactions, issuers retain knowledgeable Canadian counsel early in the process so these risks can be effectively addressed.

About Goodmans

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