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Pulp, Paper and Proxies… Recent Developments Concerning the Validity of Support Agreements in M&A Transactions

The recent battle between Pacifica Papers Inc. and its largest shareholder in the context of the merger of Pacifica and Norske Skog Canada Limited has resulted in some interesting and cautionary jurisprudence concerning the validity and effect of support (or lock-up) agreements in the context of public M&A transactions.

Background

Pacifica and Norske are both large public companies in the West Coast pulp and paper industry. In March 2001, the companies entered into an agreement whereby Norske would acquire Pacifica in a share exchange merger. The transaction was structured as a plan of arrangement under the *Canada Business Corporations Act*. As such, before the merger could be consummated, it had to receive the support of holders of at least two-thirds of the shares voted in respect of the merger. Additionally, the British Columbia Supreme Court had to conclude that the transaction was, among other things, "fair and reasonable" to the securityholders of Pacifica.

Cerberus Capital Management Limited Partnership was Pacifica's largest shareholder, holding approximately 18.8% of the outstanding shares. Cerberus did not support the merger: it apparently believed, among other things, that management of Pacifica had not run an efficient "auction" and had not obtained a "fair value" for Pacifica shareholders. At the Pacifica shareholders' meeting, Cerberus voted against the merger - nevertheless, the merger was approved by 73.6% of the votes cast.

In July 2001, Pacifica petitioned the British Columbia Supreme Court for a final order approving the plan of arrangement. Cerberus opposed the petition. Cerberus asserted that the plan should not be approved because of certain procedural issues or, alternatively, because the plan was not fair and reasonable to the securityholders of Pacifica.

Mr. Justice Lowry of the British Columbia Supreme Court, in a relatively lengthy decision, approved the plan of arrangement. He held that the plan was fair and reasonable to the securityholders of Pacifica and that none of the procedural issues raised by Cerberus justified non-approval of the plan. Cerberus appealed the decision. On August 10th, the British Columbia Court of Appeal dismissed Cerberus' appeal.

The Support Agreements

A central element of Cerberus' complaints related to agreements entered into by certain shareholders of Pacifica to "support" the transaction. In the course of negotiations, Norske had insisted that Pacifica obtain the support of holders of 50% of its shares before Norske would enter into a definitive agreement. Pacifica secured commitments from ten of its major shareholders (holding, in aggregate, more than 50% of the Pacifica shares) to support the merger. These shareholders agreed, among other things, that they would give proxies to permit the shares they held to be voted in favour of the merger. These agreements were signed well before Pacifica distributed its proxy circular relating to the shareholders' meeting.

Cerberus argued that these agreements were obtained in contravention of the proxy solicitation rules of the *Canada Business Corporations Act* because they were solicited **before** Pacifica's proxy circular was distributed. Cerberus argued that the illegal solicitation rendered the shareholder vote

invalid and, as a result, the plan of arrangement could not be approved by the Court.

Justice Lowry noted that the support agreements were commitments to give proxies to vote in favour of the merger and, in seeking the agreements, Pacifica was soliciting proxies. The issue that the Court focussed on was whether the language in section 150 of the *Canada Business Corporations Act* permitted the solicitation of proxies **prior to** the distribution of a proxy circular to the shareholders whose proxies were solicited. Justice Lowry determined that the *Canada Business Corporations Act* prohibited the solicitation of proxies before a proxy circular was delivered to shareholders and that the support agreements were illegal and unenforceable. Nevertheless, he held that as the support agreements had not impacted the vote at the meeting of the shareholders of Pacifica (because the locked-up shareholders voted to approve the merger and did not themselves challenge the support agreements), there was no basis for not approving the arrangement due to this technical issue.

The British Columbia Court of Appeal expressed reservations with respect to the conclusion that Pacifica had breached the *Canada Business Corporations Act*. In its decision, the Court stated that Justice Lowry's interpretation appeared to import into section 150 a restriction on proxy solicitation that the language, on a plain reading, does not bear. The Chief Justice, writing for the Court, appears to suggest that there is no requirement to send a proxy circular to a shareholder **prior to** soliciting his or her proxy. The Court of Appeal nevertheless concurred with Mr. Justice Lowry's conclusion that the shareholders who had signed the support agreements could not be required to vote in favour of the merger. The basis for this conclusion was the Court's view that proxies are **always revocable**. This conclusion is interesting in light of the fact that the support agreements not only compelled the shareholders to deliver proxies to permit the shares they held to be voted in favour of the merger, but also required the shareholders to "support" the merger.

Conclusion

The decisions in *Re Pacifica Papers Inc.* create some uncertainty in the law relating to support (or lock-up) agreements in the context of public M&A transactions. In many transactions, support agreements with significant shareholders of the target are a critical element from the perspective of the acquiror to entering into an agreement. The decisions in *Re Pacifica Papers Inc.* may require counsel for the acquiror to be more careful in structuring support agreements to avoid the pitfalls, or potential pitfalls, that have been created by these decisions. We invite you to contact the experienced M&A team at Goodmans to discuss these matters.

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