

New guidance on special committees and going private transactions

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Introduction

The Ontario Securities Commission's (OSC) reasons for its decision in *Re The Catalyst Capital Group Inc.* [PDF] have important disclosure and procedural implications for material conflict of interest transactions. Although the OSC did not cease trade the privatization proposal by a group of shareholders led by Hudson's Bay Company (HBC) executive chairman Richard Baker (the Baker Group), it ordered remedial disclosure to address a number of deficiencies as well as the mailing of a blacklined circular to HBC shareholders. In addition, the OSC was critical of the fact that certain business judgments were made by HBC's lead director prior to the formation of a special committee.

The decision reiterates the importance of establishing a special committee and the engagement of independent legal and financial advisors early in the process of considering a material conflict of interest transaction, as well as the need for detailed disclosure of key judgments made in the course of reviewing and approving the transaction.

Background

In February 2019, representatives of HBC, including Mr. Baker, commenced exploratory discussions with representatives of HBC's European joint venture partner, SIGNA, about a potential sale to SIGNA of HBC's remaining 50% interest in its European joint ventures (the SIGNA Transactions). Shortly thereafter, Mr. Baker and members of HBC management also commenced exploratory discussions with certain other HBC Shareholders as to whether proceeds from the potential SIGNA Transactions could provide a portion of the financing for a potential privatization transaction involving HBC.

In March 2019, Mr. Baker and certain members of HBC management informed HBC's lead director about their desire to evaluate a potential privatization transaction together with a limited number of other HBC shareholders that ultimately comprised the Baker Group, contingent on HBC proceeding with and completing the SIGNA Transactions. The lead director consented to Mr. Baker exploring such a transaction and sharing limited financial information with these shareholders and also consented to the use by Mr. Baker of HBC's historical transaction counsel.

These business judgments would prove to be key issues at the heart of this case: whether the lead director made critical decisions in the nascent stages of the transaction that should have more properly been made by a special committee with the benefit of independent legal advice.

Two days later, the HBC board of directors established a special committee of independent directors (the Special Committee) to oversee and supervise the review and evaluation of HBC's strategies and options with respect to its European joint ventures as well as the Lord + Taylor business unit. Notably, the Special Committee's mandate at this time did not include the review of the privatization transaction.

Over the course of April and May 2019, the Special Committee supervised the negotiation of the SIGNA Transactions, engaged legal counsel in the event that a privatization proposal was received, contacted and considered potential financial advisors, and undertook preparatory steps in anticipation of receiving a privatization proposal. Mr. Baker also reiterated to the lead director his interest in evaluating the possibility of a privatization transaction during this period.

On June 4, 2019, the Special Committee received a draft of the privatization proposal letter and proposed press release (to follow HBC's announcement of the SIGNA Transactions). On June 9, 2019, the HBC board approved a revised and expanded mandate for the Special Committee to evaluate a privatization proposal. Following consideration by the Special Committee, and having concluded that a privatization proposal would not be forthcoming absent waiver of the standstill provision, the HBC board (excluding conflicted directors) waived the standstill provisions applicable to one of the major shareholders forming part of the Baker Group.

On June 10, 2019, HBC announced the SIGNA Transactions and the Baker Group announced their proposal to privatize HBC at a price of \$9.45 per common share (the Initial Proposal). At the same time, the Baker Group informed the Special Committee that they would not be sellers in any alternative transaction.

Between June 10, 2019 and October 20, 2019, the Special Committee negotiated the terms of the privatization proposal with the Baker Group while the independent valuator and financial advisor undertook the analysis required in support of a formal valuation of HBC. During this time, Catalyst launched and completed a "mini-tender" and acquired a 10.05% interest in HBC's common shares at a premium to the Initial Proposal. HBC and the Baker Group ultimately entered into an arrangement agreement providing for the privatization of HBC at a price of \$10.30 per common share.

On December 2, 2019, Catalyst filed a notice of application for a hearing with the OSC requesting that the OSC permanently prohibit the Baker Group from acquiring HBC or, in the alternative, requesting, among other things, that the OSC require HBC to amend and restate its proxy circular and postpone the HBC shareholders' meeting that had been scheduled for December 17, 2019. Among other things, Catalyst was critical of the lead director's decisions in March 2019 and alleged that they might have resulted in a suboptimal process and therefore a lower price for the minority shareholders.

Following a hearing, the OSC issued an interim order on December 13, 2019, with reasons to follow, rejecting Catalyst's request to permanently prohibit the privatization and granting Catalyst's request that the HBC proxy circular be amended. Among other things, the OSC ordered that the amended circular include details regarding the lead director's decision-making process. The OSC also ordered that the circular be reviewed by OSC staff prior to being sent to HBC shareholders.

Catalyst, the Baker Group and the Special Committee subsequently negotiated certain amendments to the privatization transaction and, on January 3, 2020, Catalyst entered into a support agreement in respect of the privatization transaction at an increased price of \$11.00 per share. HBC is scheduled to hold a shareholder meeting to approve the privatization transaction on February 27, 2020.

Formation of special committees

In considering the lead director's March 2019 authorization of the sharing of confidential information with other members of the Baker Group and the use of HBC's historical transaction counsel, the OSC suggested that the lead director should not have made these decisions on his own. The OSC stated that: "[b]efore important decisions are made and rights are given up, a properly mandated and advised special committee should be in place to apply its best and well-informed judgment to the process and the negotiations, and to consider the possible ramifications of these early decisions."

The OSC was also focused on the relationship between the privatization proposal and the SIGNA Transactions, and indicated that a special committee should have been formed to consider both at the same time: "Given that the SIGNA Transactions were interrelated with Baker's privatization proposal in that they were intended to be a source of funding, and given that conflicts of interest arose from that fact alone, prudence would dictate that a special committee would be in place to address all of these transactions and their interrelationships at this early stage. We question whether the absence of a special committee at this time compromised the Special Committee's later effectiveness, since it was not active during the early stage of negotiations, at which time critical issues such as Fabric's participation and the allocation of the proceeds from the SIGNA Transactions were being addressed."

The decision to waive the standstill provisions and allow the Baker Group to proceed with its offer was ultimately made in June 2019 by the HBC board following consideration by the Special Committee, whose mandate then extended to the privatization. Any conditions attached to the waiver of the standstill or the making of the proposal could have been made by the Special Committee at that time.

On the facts of the case, it is debatable whether the lead director actually gave up any rights or made any decisions that ultimately prejudiced minority shareholders, and while the OSC reasons discussed other speculative outcomes, it is not clear that the end result would have been any different if a special committee had been formed and made these decisions instead of the lead director.

Conclusion

Ultimately the OSC did not cease trade the privatization proposal despite the procedural concerns it identified and concluded that amended disclosure was a sufficient response in the circumstances. Nevertheless, the OSC's statement regarding the need to form a special committee early in the process should guide boards and their advisors when designing and implementing procedures in connection with potential material conflict of interest transactions. The OSC has signalled a preference for forming special committees at nascent stages of going private transactions, and market participants that do not do so risk additional regulatory intervention. This is particularly important in the case of management buyouts, where the conflicts are especially acute and key decisions about access to confidential information and group formation can have material impacts on the outcome of the transaction.