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Top Canadian public M&A legal developments in 2022

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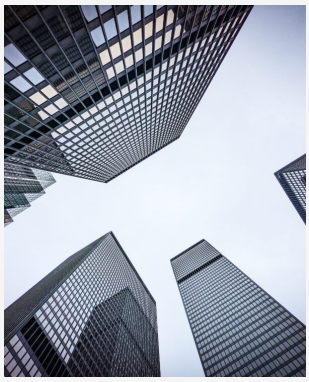

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The pace of Canadian M&A activity slowed in 2022 relative to record deal activity levels in 2021. Inflation, a higher interest rate environment and geopolitical risks all contributed to volatile markets and greater macroeconomic uncertainty. However, activity levels remained robust across a range of industries and there were several notable regulatory and deal-making developments. We discuss the use of derivatives in toehold accumulation strategies, the implications of the delayed appeal of the Cineplex/Cineworld decision, recent examples of public M&A deals being announced on the basis of term sheets, modifications to dual class share structures and recent developments in Rio Tinto's proposed take-private acquisition of Turquoise Hill Resources.

Toehold accumulation strategy

Buyers will often consider whether to acquire a "toehold" position in a target prior to making an offer or proposal to acquire it in its entirety. Toehold positions can allow the buyer to acquire the toehold shares without paying a premium. They also provide the buyer with some leverage when negotiating with a target's management. In addition, toeholds can deter potential rival buyers and increase the possibility of recouping transaction expenses should a competing bid succeed. Further, they permit the offeror to assert rights as a shareholder under corporate law, including the right to requisition a meeting of shareholders.

Potential buyers also use derivatives such as cash-settled total return swap transactions to gain economic exposure to the target's shares without obtaining beneficial ownership or control or direction over the shares. The use of derivatives in toehold accumulation strategies must now take into account the decision of the Alberta Securities Commission (ASC) in connection with Brookfield Infrastructure's (Brookfield) unsolicited take-over bid for Inter Pipeline Limited (IPL) and IPL's subsequent proposed white knight merger transaction with Pembina Pipeline Corporation (Pembina). The ASC released its reasons for the decision [PDF] on December 21, 2021.

As we discussed last year, between March and October 2020, Brookfield acquired a toehold interest in IPL common shares equivalent to 19.65% of IPL's outstanding common shares. Of this amount, 9.75% represented beneficial ownership and control and direction over IPL

common shares. However, 9.9% of this amount represented economic exposure in IPL through a series of cash-settled total return swap transactions (the TRS). At a hearing before the ASC, IPL argued among other things that the TRS undermined the early warning reporting regime by enabling Brookfield to acquire an economic interest in IPL of almost 20% without triggering the 10% early warning reporting threshold.

The ASC found that the economic interest in the shares underlying the TRS had been separated from the ownership of, and voting control over, those shares. The ASC then concluded that the owners of the TRS shares did not share the same motivation to maximize shareholder value as other IPL shareholders.

The ASC did not find that Brookfield beneficially owned the TRS shares or that the swap counterparties were acting jointly or in concert with Brookfield. Rather, the ASC took action to address "empty voting" concerns and ordered that an adjustment be made to the mandatory minimum tender condition of Brookfield's offer. As a result, Brookfield was not permitted to purchase IPL common shares under its offer unless more than 55% of IPL common shares – excluding those beneficially owned by Brookfield or parties acting jointly with it – had been deposited to the offer. This remedy had effectively the same result as deeming Brookfield to be the beneficial owner of the TRS shares. In addition, the ASC required Brookfield to make enhanced disclosure regarding the nature of Brookfield's relationships with its swap counterparties, including the name of those parties and any material information concerning its commercial relationships with such parties.

This decision illustrates how derivative instruments continue to raise significant policy issues for securities regulators, including "hidden ownership" and "empty voting" concerns, as more fully described in our previous Osler Update on this topic.

The ASC's decision is particularly notable in light of the Canadian Securities Administrators' (CSA) previous statements and policy positions on derivatives. In 2013, the CSA proposed that investors include "equity equivalent derivatives" – equity derivative positions that are substantially equivalent in economic terms to conventional equity holdings, including total return swaps – in calculating their ownership levels for the purposes of determining whether the early warning reporting threshold has been exceeded (the CSA 2013 Proposal). The CSA 2013 Proposal sought to provide greater transparency as to potential "hidden ownership" positions accumulated by sophisticated investors through the use of derivatives to achieve economic exposure to public companies while avoiding public disclosure. In 2014, however, the CSA decided not to implement the proposal in response to market feedback expressing opposition to the change. Market participants generally took this as tacit approval by the CSA of the use of total return swaps in building toehold positions without the need for public reporting or any changes to transaction terms.

The ASC's decision now calls into question the future use of derivatives in building a toehold. It is not clear if the ASC's decision was limited to the specific facts of the case, where the ASC found that the swap counterparty had a number of relationships with the bidder.

In light of the uncertainty, a formal securities regulatory review of the issues raised in the decision may be necessary to provide guidance to market participants. We note that the U.S. Securities and Exchange Commission (SEC) published proposed changes to the Schedule 13D reporting regime with respect to cash-settled derivatives that are similar to the CSA 2013 Proposal. Under the SEC proposal, holders of certain cash-settled derivatives would be deemed to beneficially own the reference security if the derivative is held with the purpose or effect of changing or influencing control of the issuer, or in connection with, or as a participant in, any transaction having such purpose or effect.

Osler acted as legal counsel to a swap counterparty in connection with the ASC proceedings.

Delays to a blockbuster sequel

On December 14, 2021, an Ontario court held that Cineworld Group plc improperly terminated its December 2019 agreement to purchase the outstanding shares of Cineplex Inc., awarding $1.2 billion in damages. Notably, the court held that Cineplex was entitled to the present value of the "synergies" it would have realized as a result of the transaction closing. A more detailed description of the decision and the background leading up to it can be found in our Osler Update.

On January 12, 2022, Cineworld filed an appeal and on January 27, 2022, Cineplex filed a cross-appeal. The appeals were scheduled to be heard on October 12 and 13, 2022 (the Appeal).

However, on September 7, 2022, Cineworld and certain of its subsidiaries commenced bankruptcy proceedings in the United States. As a result, Cineworld took the position that Cineplex's claim against it was stayed. Cineplex sought an order from the U.S. court to modify the bankruptcy stay of proceedings to permit the Appeal to proceed in the Canadian courts. The U.S. Court declined to grant Cineplex's requested relief.

The Cineworld bankruptcy proceedings remain ongoing and, accordingly, the Appeal has been adjourned. It remains unclear when, if ever, the Appeal will be heard. This will potentially leave two important legal issues unaddressed by an appellate court. First is the interplay between a material adverse effect clause (MAE) and ordinary course of business operating covenants. The second issue is the measure of damages in the event of a breach of a transaction agreement.

As we discussed last year, Cineworld alleged that Cineplex had failed to operate its business in the ordinary course, even though the MAE clause allocated the risk of outbreaks of illness to Cineworld. Following the decision in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada* (*Fairstone*), the court concluded that Cineplex did not breach the ordinary course operating covenants when it took a number of unprecedented actions in response to the COVID-19 pandemic.

The court's decisions in *Cineplex* and in *Fairstone* stand in stark contrast to the Delaware Supreme Court's decision in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al*. In that case, the Delaware Supreme Court found that significant changes to the target's business in response to the COVID-19 pandemic violated the target's covenant to operate its business in the ordinary course consistent with past practices. The Court made this finding despite also having concluded that the pandemic did not constitute an MAE, as it was excluded from the definition by an exception.

The court's damages award in *Cineplex* was based on Cineplex's "lost synergies," despite the fact that it was Cineplex's shareholders that were to receive the consideration under the transaction. We are not aware of any other reported decision in Canada awarding damages in favour of a target public company based on its lost synergies where its shareholders were to receive the consideration. With the stay in place, the decision remains both anomalous and intact.

Not quite the back of a napkin

Parties to a Canadian public M&A transaction will customarily announce a transaction only upon obtaining board approvals and finalizing and entering into binding and definitive transaction agreements. Among other things, this sequencing is designed to provide deal

certainty to the parties and also mitigate the risks of significant business disruption and uncertainty that may arise in the event of a premature disclosure of a material transaction. This approach also allows the board of directors to maintain control over its process, including negotiation, review, evaluation and approval of an M&A transaction.

While announcement of a non-binding letter of intent (or even one purporting to be binding, or binding as to certain matters) is more common in the junior market, it is the exception for larger, more seasoned issuers. However, two recent transactions demonstrate that definitive transaction agreements are not a prerequisite for announcing a material transaction for major issuers.

On August 9, 2022, Recipe Unlimited Corporation (Recipe) entered into and announced a letter of intent with Hamblin Watsa Investment Counsel Ltd., investment manager on behalf of certain affiliates of Fairfax Financial Holdings Limited (collectively, Fairfax), in respect of a take-private transaction. Recipe and Fairfax subsequently entered into a definitive arrangement agreement on September 1, 2022.

Shortly thereafter, on September 1, 2022, Turquoise Hill Resources Ltd. (TRQ) entered into and announced a term sheet with Rio Tinto International Holdings Ltd. (Rio Tinto) in respect of a take-private transaction. TRQ and Rio Tinto subsequently entered into a definitive arrangement agreement on September 5, 2022.

In both cases, a special committee of the target company board received a fairness opinion and a formal valuation from an independent financial advisor, recommended that the board both approve the transaction and recommend that shareholders vote in favour of the transaction, notwithstanding that definitive transaction agreements had not yet been negotiated, executed or delivered. Prior to public announcement of the transaction, the board of directors of Recipe approved the transaction and recommended it to shareholders. In TRQ, the unconflicted directors of the board approved the transaction and recommended it to shareholders after the public announcement of the deal at the time of entering into definitive transaction agreements.

We do not anticipate that these novel announcements will mark the beginning of a new trend. Both transactions are distinguishable from more conventional M&A transactions in that the purchaser was a controlling shareholder proposing to take the remainder of the target private. Thus, the target corporation had limited opportunities to realize value through a third-party transaction. Moreover, the transactions had been the subject of robust negotiations and increased price proposals over a protracted period. Additionally, in the case of TRQ, a potential transaction with Rio Tinto had already been made public.

Announcing a transaction on the basis of a letter of intent or term sheet is, however, a potential alternative to the conventional playbook, depending on the circumstances. Care should be taken to consider the potential downsides of doing so.

No side deals!

The pending acquisition of all of the shares of TRQ not already owned by Rio Tinto has drawn both public and regulatory scrutiny. On November 1, 2022, Rio Tinto announced that it had entered into agreements with certain funds and other entities related to Pentwater Capital Management LP (Pentwater) and SailingStone Capital Partners LLC (SailingStone). These agreements were in relation to the special meeting of shareholders of TRQ to vote on the proposed transaction. Prior to the announcement, Pentwater and SailingStone had both publicly opposed the proposed transaction. Pursuant to the agreements, both shareholders agreed to withhold their votes at the TRQ shareholder meeting and to exercise their dissent

rights in respect of the transaction.

Under the agreements, the dissent proceedings were first to be conducted through mediation and then confidential arbitration. The agreements guaranteed Pentwater and SailingStone 80% of the deal price within two business days of closing of the transaction. The remaining 20% of the deal price, plus interest thereon, was to be paid upon final determination of the dissent procedures. This was to be in addition to any increased amount that might be awarded in resolving the dissent proceedings and the damages or compensation amount, if any, to be paid by Rio Tinto to Pentwater and SailingStone to resolve their oppression claims against Rio Tinto.

Following public interest concerns raised by Québec's Autorité des marchés financiers (the AMF), as well as critical comments made by a former chair of the Ontario Securities Commission (OSC) (who was also a disclosed shareholder of TRQ), Rio Tinto terminated the agreements with Pentwater and SailingStone. As a result, all minority shareholders of TRQ now have access to the same dissent rights.

Given their termination, the agreements were never scrutinized in a public interest hearing before the AMF. The AMF has also not publicly elaborated on its public interest concerns. However, Canadian securities laws include guidance indicating that, as a general principle, security holders should be treated equally in the context of a business combination. Guidance also suggests that giving a security holder preferential treatment to obtain that holder's support of the transaction will not normally be considered justifiable. The deal consideration payable to Pentwater and SailingStone was not altered under the agreement. However, the prospect of a higher payout in a dissent proceeding backstopped by guaranteed payments under mediation and arbitration and coupled with a commitment by Pentwater and SailingStone to withhold their votes (and thereby not assist in blocking the transaction) may have been viewed by the AMF as creating unequal and preferential treatment of those shareholders. This prospect, together with public complaints about the arrangements, may have informed the AMF's public interest concerns.

Osler is acting as legal counsel to one of the financial advisors involved in this transaction.

Dual class share structure amendments

The use of dual class share structures continues to be an established feature of the Canadian capital markets. These structures have also proven to be a popular feature in many recent initial public offerings. Dual class share structures enable significant shareholders to maintain control despite the disproportionate economic interest held by public shareholders.

Amendments to such dual class share structures typically require the approval of minority shareholders. In 2022, there were two examples of companies that sought to modify their existing dual class share structure.

On June 10, 2022, Shopify Inc. (Shopify) successfully completed a shareholder-approved and court-approved arrangement that modernized its governance structure to support its continued long-term growth. The updated governance structure provides for the creation of a new class of share, designated as the Founder share, and the issuance of such Founder share to the Shopify's Founder and Chief Executive Officer.

The Founder share provides the Founder and CEO with a variable number of votes that, when combined with the Class B multiple voting shares beneficially owned by him, his immediate family and his affiliates (and certain Class A subordinate voting shares), represent 40% of the total voting power attached to all of the company's outstanding shares. This effectively sets

and preserves the Founder and CEO's voting power at that level.

The Founder share will sunset if the Founder and CEO no longer serves as an executive officer, board member or consultant whose primary engagement is with the company. The sunset provision is also triggered if the Founder and CEO, his immediate family and his affiliates no longer hold a number of Class A and Class B shares equal to at least 30% of the Class B shares held by him and his affiliates on implementation of the arrangement.

On November 11, 2022, in connection with an announced leadership transition, Onex Corporation (Onex) announced that it would be proposing an amendment to its Multiple Voting Shares (MVS) to maintain their current voting entitlement following the appointment of a new Chief Executive Officer. Onex announced that a five-year sunset provision will be added to the MVS and that shareholder approval of the amendment will be sought at the company's annual general meeting in 2023.

A combination of legacy dual class share capital structures and dual class share structures resulting from recent IPOs continues to be typical in the Canadian capital markets. As a result, we anticipate that there will be continued and renewed debate regarding the merits of these structures. Additionally, debate is likely to continue regarding certain key aspects of dual class share structures, particularly the appropriate "sunset" provisions that trigger the collapse of such structures.

The importance of dual class structures to maintaining Canada's competitiveness in the context of increasingly global public markets (especially in the technology sector) is likely to remain at the forefront of these discussions. Finally, as circumstances change for founder and controlling shareholder-led issuers with dual class share structures, many of these issuers will need to face questions of whether modifications or modernizations are required to these structures to foster long-term growth and/or enable leadership transition.

Osler acted for Shopify's Founder and CEO in his proposal to modernize the company's governance and multi-class share capital structure.

Concluding remarks

The breadth of issues that caught our interest in 2022 matches the broad range of transactions and participants that characterize the Canadian public M&A markets. Looking forward to 2023, we anticipate that a key driver of M&A activity in the first half of 2023 will be well-capitalized buyers taking advantage of depressed target prices.

We will also be on the lookout for responses from the OSC with respect to a number of outstanding proposals included in the Ontario Capital Markets Modernization Taskforce final report. Among other things, it remains to be seen how the OSC will respond to recommendations to decrease the ownership threshold for early warning reporting disclosure from 10% to 5%. Additionally, we await a response to the recommendation to adopt requirements and guidance on the role of independent directors in conflict of interest transactions.