Canadian M&A Activity Continues to Grow as Securities Regulators Remain Focused on Protecting Minority Shareholders

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Notwithstanding the similarities between mergers and acquisitions (M&A) deal practice in Canada and the United States, there remains stark differences between our M&A landscapes.

For example, whereas securities legislation and regulators in Canada tend to focus on the protection of shareholder rights and ensuring minority shareholders have a voice in change of control transactions, U.S. courts appear to espouse a more director- centric model, which places a much greater emphasis on the role of boards. The focus on minority shareholder rights may simply be reflective of the fact that Canadian public companies are, on average, much smaller than their U.S. counterparts and are more likely to have controlling shareholders or groups of shareholders that materially affect control. As a result, transactions are more likely to be undertaken with insiders of a Canadian public company or other related parties, which could prove detrimental to minority shareholders.

The size of M&A transactions in Canada is another significant difference. Because Canadian companies are generally smaller than U.S. companies, transactions sizes are correspondingly smaller in Canada. The middle market continues to be the bedrock of Canadian M&A activity; and while the appetite for middle market deals in the United States. is similarly robust, in Canada, the vast majority of M&A transactions have deal values under CDN$250 million.[1]

This article reviews recent trends in the Canadian M&A landscape and then highlights two regulatory developments which reflect the ongoing focus of securities regulators on the protection of the rights of minority shareholders of Canadian public companies.

M&A Trends

The overall Canadian M&A climate in the last several years has been marked by significant growth. In Q1 2017, for example, announced deals represented a five-year high or an 11% increase over the previous quarter and a 28% increase over Q1 2016.[2] Most significantly, however, is the fact that the majority of the activity (91% of all transactions with reported values) came from transactions with deal values under CDN$250 million. These trends were consistent with the data for Q2 2017.[3]

Cross-border transactions continue to account for a considerable portion of activity, with 47% of all transactions involving either a foreign target or a foreign buyer. Despite the relatively weaker Canadian dollar, Canadian companies saw an increase in cross-border deal flow, with 152 (versus 132 in Q1 2016) inbound transactions and 207 (versus 151 in Q1 2016) outbound transactions recorded in the first quarter of 2017. Overall, however, outbound M&A continues to outpace inbound activity, with Canadian firms outnumbering the number of foreigners acquiring Canadian companies by a factor of 1.4 times.[4] This is consistent with past trends whereby cross- border M&A is more weighted toward outbound investment from Canada into the United States in terms of both number and value of transactions.[5] Indeed, the value of outbound transactions exceeded the value of inbound transactions in Q2 2017 by more than four times.[6]

Regulation of M&A Activity

M&A activity in Canada is regulated under provincial and federal corporate laws, provincial securities laws (in each of the 10 provinces and three territories) and stock exchange rules. The two principal stock exchanges in Canada are the Toronto Stock Exchange (TSX) (senior market) and the TSX Venture Exchange (junior market). These exchanges regulate selected aspects of M&A activity.

The provincial and territorial securities regulatory authorities coordinate their activities through the Canadian Securities Administrators (CSA), a forum for developing a harmonized approach to securities regulation across the country. The CSA has developed a system of mutual reliance pursuant to which

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1 Crosbie & Company Inc, "Crosbie & Company Canadian M&A Report Q1 2017" (March 31, 2017), online: http://www.crosbieco.com/docs/default-source/Publications-PDFs/crosbie-company-canadian-mergers-acquisitions-report-for-q1-2017---ian-macdonell-(mergers-acquisitions-divestitures-sale-of-a-business).pdf?sfvrsn=2.

2 Crosbie, Canadian M&A Report Q1 2017.

3 Crosbie & Company Inc, "Crosbie & Company Canadian M&A Report Q2 2017" (June 30, 2017), online: http://www.crosbieco.com/docs/default-source/Publications-PDFs/crosbie-company-canadian-mergers-acquisitions-report-for-q2-2017---ian-macdonell-(mergers-acquisitions-divestitures-sale-of-a-business).pdf?sfvrsn=6.

4 Crosbie, Canadian M&A Report Q1 2017.

5 Crosbie, Canadian M&A Report Q1 2017.

6 Crosbie, Canadian M&A Report Q2 2017.

securities regulatory authority acts as the lead authority for reviewing regulatory filings of "reporting issuers" (e.g. Canadian public companies). The Ontario Securities Commission (OSC) is generally regarded as the lead securities regulatory authority in Canada.

Changes to Take-Over Bid Legislation

On May 9, 2016, significant amendments to Canada's take-over bid regime made by the CSA became effective.[7] These changes provide boards of directors of target companies with significantly more time and leverage to respond to unsolicited take-over bids (or hostile tender offers as they are referred to in the United States.). Under the amended regime, take-over bids required to be made to shareholders are subject to the following requirements:

1. 50% Minimum Tender Requirement – The bidder must receive tenders of more than 50% of the outstanding securities subject to the bid (excluding securities of the bidder and its joint actors) prior to taking up any securities.
2. 10-Day Bid Extension – The bidder is required to extend the deposit period for a minimum of 10 days once the 50% minimum tender condition and all other terms and conditions of the bid are complied with or waived.
3. 105-Day Bid Period – All take-over bids are required to remain open for a minimum of 105 days unless:
    - the target board agrees to a shorter deposit period of not less than 35 days (which reduced period will apply to all competing bids), or
    - the target company announces that it intends to effect an "alternative transaction" – effectively a friendly change of control transaction that is not a take-over bid (such as an arrangement), in which case all other take-over bids will be entitled to a minimum 35-day deposit period.

Despite fears that the adoption of these amendments would have a chilling effect on unsolicited take-over bid activity, in the year following the imposition of the new regime, there appears to be very little (if any) change in activity.[8] What is clear, however, is that success for unsolicited bidders under this new regime has proven to be very difficult without the eventual consent of the target board.

It will take some time to fully understand the impact of these new rules, but one of the key goals of regulators has been achieved: litigation before the securities commissions regarding the use of poison pills in the context of unsolicited takeover bids has been non-existent.[9] On the other hand, securities regulators are watching closely to see if the new found power of target boards is being used to benefit their shareholders, as opposed to insiders, in a bidder's pursuit to negotiate friendly transactions.[10]

Fairness Opinions – Impact of MI 61-101

In Canada, five provincial securities regulators have adopted a regulation referred to as Multilateral Instrument 61-101 – Protection of Minority Security Holders in Special Transactions (MI 61-101). MI 61-101[11] seeks to mitigate risks to minority shareholders by imposing enhanced disclosure, valuation and majority of the minority shareholder approval requirements in respect of four forms of potential conflict of interest transactions: (1) bids made by insiders of a company (insider bids), (2) bids by companies to buy back their shares (issuer bids), (3) transactions that provide for the termination of a shareholder's interest in a company without the shareholder's consent (business combinations) and (4) transactions with an insider or other related party of the company (related party transactions).

On July 27, 2017, Staff of the securities regulatory authorities in each of the provinces subject to MI 61-101 published Staff Notice 61-302 (the Notice) which seeks to provide interpretive guidance and clarification on MI 61-101. Most notably, the Notice contains Staff's positions with respect to the role of special committees and fairness opinions in "material conflict of interest transactions." In the Notice, "material conflict of interest transactions" refers to insider bids, issuer bids, business combinations, and related party transactions that give rise to substantive concerns as to the protection of minority shareholders.

The Notice confirms that Staff review material conflict of interest transactions on a real-time basis in order to assess compliance with the requirements of MI 61-101 and to determine whether a transaction raises public interest concerns. Accordingly, Staff will typically initiate a review of a transaction upon the filing of the relevant disclosure document. Where Staff identify non-compliance with MI 61-101 or potential public interest concerns, they reserve the right to take enforcement action or other appropriate orders.

7 See "CSA Notice of Amendments to Take-Over Bid Regime – Amendments to Multilateral Instrument 62-104 *Take-Over Bids and Issuer Bids* and Changes to National Policy 62-203 Take-Over Bids and Issuer Bids and Consequential Amendments" (February 25, 2016), online: http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20160225_62-104_amd-take-over-bids.htm.

8 Poonam Puri & Hooman Tabesh, "So much for that chilling effect: the first year under the new hostile takeover regime" *Kingsdale Advisors* (May 9, 2017), online: http://www.kingsdaleadvisors.com/Hostile_Takeover_Regume%20-%20Canexus%20Chemtrade%20Case%20Study.pdf.

9 Puri & Tabesh, So much for that chilling effect.

10 Janet McFarland, "New takeover rules put chill on 'rolling the dice'" The Globe and Mail (March 8, 2017), online: https://beta.theglobeandmail.com/report-on-business/big-deals/new-takeover-rules-put-chill-on-rolling-the-dice/article34234688/?ref=http://www.theglobeandmail.com&.

11 See "Multilateral CSA Staff Notice 61-302 Staff Review and Commentary on Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions" (July 27, 2017), online: http://www.osc.gov.on.ca/documents/en/Securities-Category6/csa_20170727_61-302_sn-staff-review.pdf.

In addition, the Notice provides guidance regarding the active role to be played by special committees of independent directors in the context of material conflict of interest transactions. Despite acknowledging that a special committee of independent directors is only mandated by MI 61-101 in the case of insider bids, Staff are of the view that a special committee is advisable for all material conflict of interest transactions. To this end, the Notice sets out Staff's recommendations with respect to the formation, role and mandate of special committees. For example, Staff believe that special committees should be formed prior to the negotiation of a particular transaction, composed of independent directors; and have a mandate that includes the ability to (1) conduct or supervise negotiations,
(2) consider alternative transactions, (3) provide or withhold recommendations and (4) retain independent legal and financial advice.

With respect to fairness opinions, Staff believe that a special committee cannot substitute the results of a fairness opinion for its own judgment as to whether a transaction is in the best interests of shareholders. Rather, it is generally the responsibility of the board of directors and the special committee to determine whether a fairness opinion is necessary, and similarly to determine the terms and financial arrangements for the engagement of an advisor to provide a fairness opinion.

However, in the context of material conflict of interest transactions and where a fairness opinion has been obtained, the Notice indicates that such disclosure should include:

1. the compensation arrangement;
2. how the compensation arrangement was taken into account;
3. any other relationship between the financial advisor and the issuer;
4. a clear summary of the methodology, information and analysis underlying the opinion; and
5. how the opinion was utilized by the board or special committee.

Following recent court decisions in Canada, there has been significant debate as to whether (1) reliance on a fairness opinion from an advisor that is being paid a fee contingent on a successful outcome is appropriate, (2) the specific amount of an advisors' success and other fees should be disclosed (which disclosure is common in the United States.) and (3) fairness opinions should disclose the financial analysis underlying them. Although, the Notice makes it clear that Staff expects a fairness opinion to disclose the financial analysis underlying the opinion, it did not set out any clear rules regarding the other two issues of controversy.

Over time, we would expect that more fulsome disclosure of fee arrangements will become the norm in Canada. On the other hand, there has been much resistance to retaining an additional advisor to provide a fairness opinion on a fixed-fee basis, particularly for middle market or smaller transactions. Nevertheless, we expect that, in contested M&A transactions, the retention of a second advisor to provide a fairness opinion on a fixed-fee basis will become more prevalent in order to provide additional protection for the transaction and insulate a board of directors. In other words, a second fixed-fee opinion in contested M&A transactions may be insurance well worth buying.

The conduct of Canadian boards in material conflict of interest transactions with respect to independent special committees and fairness opinions will no doubt evolve over the next few years due to the increasing oversight and heightened regulatory scrutiny that has been a feature of the Canadian regulatory landscape for well over a decade.