mcmillan securities bulletin

May 2012

defensive tactics – public interest powers of securities regulatory authorities continue to evolve – the *Fibrek* decision

In what has been one of the most litigated and acrimonious takeover bids of the past year, the Bureau de décision et de révision (Québec) (the "**Bureau**") exercised its public interest discretionary power to cease trade the issuance of shares by Fibrek Inc. ("**Fibrek**") to a "white knight". As a result, the shareholders of Fibrek were prevented from receiving a 40% premium to a hostile bid for Fibrek made by AbitibiBowater Inc. (doing business as Resolute Forest Products) ("**Resolute**").[1]

National Policy 62-202 – *Take-Over bids – Defensive Tactics* ("**NP 62-202**") of the Canadian Securities Administrators (the "**CSA**") sets out the views of the Canadian securities regulatory authorities with respect to the use of defensive tactics in the context of takeover bids. NP 62-202 specifically states that the CSA appreciates that defensive tactics, including the issuance of securities by a target, "may be taken by a board of directors of a target company in a genuine attempt to obtain a better bid". In light of the fact that this is exactly what the board of directors of Fibrek attempted to do and that NP 62-202 notes that the "primary objective of take-over bid provisions of Canadian securities legislation is the protection of the bona fide interests of the shareholders of the target company", the exercise by the

[1] *AbitibiBowater Inc v Fibrek Inc* ("***Fibrek***").

Bureau of its public interest discretionary powers in *Fibrek* may have been surprising to some. However, the decision of the Bureau was ultimately upheld by the Québec Court of Appeal and leave to appeal to the Supreme Court of Canada has been denied.

Fibrek once again brings into focus the tension between the public interest discretionary powers of Canadian securities regulatory authorities and the corporate law requirement for directors to exercise their fiduciary duty in the best interests of the corporation. The decision also raises interesting questions regarding the public interest jurisdiction of Canadian securities regulatory authorities and the extent to which that jurisdiction continues to evolve.

the facts

On November 28, 2011, Resolute announced its intention to launch an unsolicited bid for all the outstanding common shares of Fibrek. Prior to launching its formal bid, Resolute entered into irrevocable or "hard" lock-up agreements with three of Fibrek's largest shareholders, Fairfax Financial Holdings Limited (a 25.9% and 18% shareholder of Fibrek and Resolute, respectively), Oakmont Capital Inc and Pabrai Investment Funds (the "**Locked-up Shareholders**"), representing collectively 46% of the outstanding common shares of Fibrek. On December 15, 2011, Resolute launched a formal unsolicited bid for all the outstanding common shares of Fibrek, offering consideration of $1.00 per share (a 31% premium over the market price of the shares) which could be taken in cash, cash and shares ($0.55 in cash and 0.0284 of a Resolute share for each Fibrek common share) or in Resolute shares. On December 19, 2011, the board of directors of Fibrek unanimously recommended that its shareholders reject Resolute's bid, on the basis that the bid undervalued the price of Fibrek's shares and adopted a shareholder rights plan to counter Resolute's offer. The board of Fibrek also obtained, on February 3, 2012, a formal valuation of the common shares that valued the shares at between $1.25 and $1.45 per share. On February 9, 2012, Fibrek's shareholder rights plan was cease traded by the Bureau.[2]

Undeterred by the opposition of Fibrek's board, Resolute continued with its bid, and received tenders for approximately 52% of the outstanding shares of Fibrek. Specifically, the Locked-up Shareholders tendered their Fibrek shares, while Steelhead Partners LLC (also a significant Resolute shareholder) agreed to tender its shares to Resolute, representing an additional 4.7% of the outstanding shares.

Nevertheless, Fibrek sought alternatives, and, on February 10, 2012, found its "white-knight", Mercer International Inc ("**Mercer**"). Mercer made an offer of $1.30 per share for each Fibrek share – shareholders were once again allowed to choose a cash, cash and shares or a shares only option of payment. Fibrek, in order to facilitate Mercer's acquisition, simultaneously agreed to issue to Mercer, on a private placement basis, 32,320,000 special warrants at $1.00 each, which represented 19.9% of the shares of Fibrek after giving effect to the exercise of the special warrants.[3] The private placement was not contingent on Mercer's bid being successful.

The special warrants issued to Mercer could not be exercised for 21 days, after which, if within 12 months a proposal superior to the Mercer bid emerged, Mercer was required to tender its shares to such a superior proposal if the proposal was accepted by 50.1% of the Fibrek shareholders. If Mercer tendered its shares under a superior proposal it was obligated to return to Fibrek either the break fee or the profit obtained on tendering the shares to such superior proposal.

Fibrek also entered into a support agreement with Mercer, which provided Mercer with an $8.5 million break fee, representing 5% of the shareholders' equity in Fibrek.

---

[2] 2012 QCBDR 8.

[3] This being the maximum number of shares that could be issued without obtaining shareholder approval, which would have been impossible as the Locked-up Shareholders were contractually obligated to oppose any such transaction.

Resolute opposed the private placement and break fee provided to Mercer on the basis that they were contrary to the public interest, and requested that the Bureau cease trade the private placement and Mercer's bid. The Autorité des marchés financiers (the "**AMF**") opposed Resolute's application for relief.

the cases before *Fibrek*

Before delving into the reasoning of the Bureau and the Québec courts in *Fibrek*, it may be helpful to examine two decisions related to the issuance of securities by an issuer in the context of a possible change of control – one being a case before a securities regulatory authority, the other being before a court.

On August 10, 2009, the Alberta Securities Commission (the "**ASC**") released its decision in *ARC Equity Management (Fund 4) Ltd., Re*.[4] Profound Energy Inc, a junior oil and gas company, ("**Profound**") granted a private placement of special warrants to Paramount Energy Trust ("**Paramount**") for cash, that, if exercised, would represent 19.9% of the outstanding shares of Profound. The issue price of the private placement was $0.75 per special warrant (a greater than 15% premium to market price) and was in conjunction with a bid of $1.34 per share by Paramount that was announced on March 31, 2009. Related private equity funds, which are referred to herein as "**ARC**", were the largest shareholders of Profound (representing approximately 31% of the outstanding shares prior to the private placement and 24.45% thereafter), and initially requested that the Toronto Stock Exchange (the "**TSX**") not approve the private placement. The request to the TSX was denied and, on June 30, 2009, Paramount announced that it had taken up the shares tendered under its bid and had exercised the special warrants. On July 20, 2009, ARC asked the ASC to exercise its public interest discretion, in effect, to prevent Paramount from voting its shares acquired on the exercise of the special warrants in connection with the approval of a second-step amalgamation to squeeze out the minority shareholders, including ARC. ARC argued that the private placement was "abusive to the capital markets and contrary to the

[4] 2009 ABASC 390 ("***ARC***").

public interest". The ASC refused to do so. While observing that the transaction was potentially unfair to ARC and diluted ARC's shareholding, the ASC ruled that there was a legitimate business need for the private placement, namely the need for financing, and the terms of the placement had been publicly disclosed, allowing shareholders to tender their shares as they saw fit. The ASC concluded by noting that a ruling in favour of ARC could actually be "detrimental to investors or capital market integrity" by depriving Paramount of "an existing right legally acquired".[5]

Subsequent to ARC, the British Columbia Court of Appeal released its decision in *Lions Gate Entertainment Corp. v Icahn Partners LP*.[6] Icahn had launched an unsuccessful takeover bid of Lions Gate that was opposed by the Lions Gate board of directors. Icahn then sought to initiate a second bid, and began soliciting proxies to unseat Lions Gate's board of directors at the next shareholders' meeting. The board then approved a de-leveraging transaction with shareholders friendly to the board that permitted such shareholders to exchange convertible notes on favourable terms in exchange for shares, with the result of making it practically impossible for Icahn to win a proxy-battle to unseat the board. Icahn brought an oppression action against Lions Gate, claiming that the de-leveraging transaction unfairly diluted its shareholdings. The British Columbia Supreme Court as well as the British Columbia Court of Appeal dismissed Icahn's claim, finding that, while a secondary purpose of the transaction may have been as a defensive measure, the primary purpose was to improve the unstable financial position of Lions Gate, and was therefore a valid exercise of power by the board and protected under the business judgment rule.[7]

In considering the *ARC and Lions Gate* decisions, it would appear that similar reasoning was used to come to the same conclusion.

---

[5] *Ibid* at para. 115.

[6] 2011 BCCA 228 ("***Lions Gate***").

[7] *Ibid* at para. 76.

the Bureau decision[8]

In *Fibrek*, the Bureau released its preliminary reasons on February 23, 2012, with detailed reasons following on March 6, 2012, and accepted Resolute's argument that the private placement of special warrants was against the public interest, issuing a cease trade order. However, the Bureau also found that there was no reason to prevent Mercer from proceeding with its offer. The Bureau considered many factors before reaching its decision. The Bureau noted that it was not its place to assess whether the board of Fibrek complied with its fiduciary duties, as that is the domain of courts and not securities regulatory authorities. Rather, the Bureau was tasked with determining whether the defensive measures adopted by Fibrek were contrary to the public interest, focussing both on the effect on the shareholders of Fibrek and capital markets generally.

The Bureau noted the difference in the exercise price of the special warrants ($1.00 per share) and the proposed offer by Mercer ($1.30 per share).[9] It also noted that the private placement would dilute the shareholdings of the Locked-up Shareholders.

Fibrek claimed that it proposed to issue special warrants because it needed capital, but the Bureau did not accept this proposition. The evidence of Fibrek's CFO was that the proceeds raised by the private placement would only increase the "zone of comfort" of Fibrek. The Bureau found that there was no pressing need for capital; rather, the purpose of the placement was specifically to combat Resolute's bid and influence the ability of shareholders to make a decision between the competing offers. Importantly, the Bureau held that a dilutive private placement in the context of a takeover bid should not be allowed where there is no demonstrated and pressing need for capital. The Bureau contrasted the *ARC* decision, noting various differences including

---

[8] 2012 QCBDR 13, finalized on March 6, 2012 (2012 QCBDR 17).

[9] It is interesting to note that $1.00 represented an approximate 31% premium to market price prior to the Resolute bid, compared to a greater than 15% premium in *ARC*, which the Bureau viewed favourably. Also in *ARC*, the bid price by Paramount was significantly higher when compared to the special warrant issue price: $1.34 and $0.75, respectively, in *ARC*.

that in *ARC* the private placement was not completed in the context of an unsolicited bid to dilute the holdings of shareholders who had signed lock-up agreements, and that in *ARC* there was a demonstrated pressing need for capital.

The Bureau further held that, while defensive measures against takeovers are not illegal *per se*, when they affect the free vote of shareholders who tender in favour of a fair offering (which the Bureau seemed to imply the Resolute offer was), the Bureau should exercise its public interest discretion to not allow such defensive measures. The Bureau also held that a defensive measure, such as the private placement of special warrants in the *Fibrek* case, whose primary purpose was to interfere with validly negotiated lock up agreements, is prejudicial to the auction process and affects the right of shareholders to decide on their own whether or not to tender their shares to an offer. Furthermore, it prevents a bidder from securing the benefit of entering into lock-up agreements.

Regarding the 5% break fee, the Bureau held that the fee was unwarranted and together with the private placement constituted an abusive defensive measure. Having made such a finding regarding the break fee it was surprising that the Bureau did not also cease trade the Mercer bid. In any event, in reviewing break fees, the Bureau relied on information which showed that since January 1, 2000 there were 31 transactions in Canada in which break fees were agreed to with "white knights". In such transactions, the average, median and highest break fee was 3.4%, 3.4% and 4.7% of shareholders' equity, respectively.

the Court of Québec decision[10]

The Court of Québec heard Fibrek's appeal on March 5-7, 2012, and released detailed reasons on March 16, 2012, granting Fibrek's appeal and removing the cease trade order issued by the Bureau. The AMF supported Fibrek's appeal and contended that the Bureau's decision was inconsistent with NP 62-202 and was an

[10] 2012 QCCQ 1814.

unreasonable exercise of the Bureau's public interest discretionary power.

After determining that the standard of review of the Bureau's decision is reasonableness, the Court proceeded to discuss the public interest power of Canadian securities regulatory authorities generally.

Relying on precedent from the Ontario Securities Commission, the Court held that intervention in the public interest is restricted to situations where it is necessary to counter unfair, improper, or fraudulent practices, not to prevent the search for better offers by issuing warrants. Where securities laws have not been violated, intervention is only possible where there is an abuse of shareholders specifically, or of capital markets generally. Cases where securities regulators have intervened in the public interest are rare, and, when intervention is deemed appropriate, must be exercised prudently to prevent overreaching consequences.

Applying these principles to the facts, the Court held that the Bureau erred in concluding that, absent a legitimate need for financing as in *ARC*, the private placement was contrary to the public interest and interests of shareholders. The Court agreed with the view of the AMF that *ARC* merely required that the financing be of benefit to the target not that it be required due to financial difficulty. The Court noted that the cease trade order issued by the Bureau would have the effect of prejudicing all shareholders, even the Locked-up Shareholders, by eliminating an auction process that would yield more favourable share prices. The cease trade order would prevent shareholders from exercising their judgment as to which of the competing offers was better, which the Court believed undermined NP 62-202.

The Court went on to hold that the Bureau's role is not to consider the sufficiency of Resolute's bid, and deferred to the judgment of the board of Fibrek in concluding that the private placement was in its shareholders' best interests. The Court noted that the effect of the Bureau's decision was to find a right to non-dilution of stock, which the Court believed was without merit.

Regarding the break fee, the Court concluded that, while it was on the high end of the range of acceptable fees, it was not outside the bounds of market practices. The Court also noted that in not cease trading the Mercer bid, the Bureau must have accepted the possible payment of the break fee.

Based on these conclusions, the Court held that the decision of the Bureau was unreasonable. The Court noted that the Bureau's interpretation of NP 62-202 was inconsistent with that of the AMF's and that the dilution of significant shareholders is in the public interest when it allows for an auction process. According to the Court, the maximization of shareholder value, even for those shareholders who had agreed to sell at a lower price, is a principle that overrides the benefits of preserving the effects of validly negotiated lock-up agreements. For these reasons, the Court granted Fibrek's appeal.

the Québec Court of Appeal decision[11]

The Québec Court of Appeal released its judgment on March 27, 2012, reversing the decision of the Court of Québec and reinstating the cease trade order implemented by the Bureau. The Court of Appeal considered the Bureau decision at length, particularly its treatment of the *ARC* decision and its conclusion that Fibrek, unlike Profound, did not have a pressing need for capital to justify the private placement. The Court of Appeal then went on to consider the decision of the Court of Québec, particularly its conclusion that the private placement would maximize shareholder value.

Contrasting the conclusions of the Bureau and the Court of Québec, the Court of Appeal first considered the degree of deference to be given to the Bureau. The Court of Appeal concluded that the legislature granted the Bureau a broad and unfettered power to act in the public interest, and that the Bureau has specialized knowledge of capital markets and securities. Accordingly, the Court concluded that when an independent and specialized organization like the Bureau reaches a decision, its

[11] 2012 QCCA 569.

decision must be shown a high degree of deference. This high degree of deference means that the Court of Québec may not interfere with a Bureau decision unless it is not justifiable, transparent, or intelligible.

The Court of Appeal showed great deference to the decision of the Bureau that the private placement was a defensive tactic which was not motivated by a legitimate business concern and that unjustifiably interfered with validly negotiated lock-up agreements and the ability of shareholders to choose between the offers themselves.

The Court of Appeal held that based on the facts of the case, the jurisprudence and the evidence, it was not possible for the Court of Québec to conclude that the decision of the Bureau was unjustifiable. It added that it was wrong for the Court of Appeal to substitute itself for the Bureau to make decisions of a regulatory nature in the public interest by choosing to have the interest of minority shareholders prevail over the choices made by majority shareholders instead of favouring the stability of an auction process without hindrance from defensive tactics, which is a principle of NP 62-202 as recognized by all Canadian securities regulatory authorities.

For these reasons, the Court of Appeal granted Resolute's appeal and reversed the decision of the Court of Québec reinstating the cease trade order implemented by the Bureau.

Subsequent to the decision of the Court of Appeal, Steelhead Partners LLC reversed its decision to tender its shares to Resolute's offer, preferring to wait and see if Resolute's minimum tender condition was met before making a decision. On April 11, 2012, Mercer increased its offer to $1.40 per share.

the Supreme Court of Canada

On March 28, 2012, Fibrek announced that it was making an application for leave to appeal to the Supreme Court of Canada to challenge the decision of the Court of Appeal. The Supreme Court of Canada granted Fibrek an expedited leave application, but on April 18, 2012 it ultimately declined to hear the case.[12]

end of the saga

On April 30, 2012, Mercer withdrew its offer with the announcement that it had unilaterally terminated its support agreement with Fibrek thereby ending its battle with Resolute for control of Fibrek. As for Resolute's offer, it closed on May 17, 2012 leaving it with 74.56% of the Fibrek shares. Resolute plans to carry out a second step transaction to acquire the Fibrek shares not deposited under its offer.

observations

Although commentators, as well as directors, continue to struggle with the tension between the exercise of the public interest discretionary powers granted to Canadian securities regulatory authorities and a board's obligation to act in the best interest of the corporation, it is likely that other rules and laws may also impact upon the exercise of a director's fiduciary duty. The Canadian securities regulatory authorities have been granted clear and unambiguous discretionary power to make certain orders if they believe it is in the public interest, and to the extent tensions are created by the exercise of such powers it must be up to legislatures to resolve such tensions. It is not clear how courts or, for that matter, securities regulatory authorities can put an end to that tension. In this regard, it appears that the Bureau came to the right conclusion in holding that it was not necessary for it to assess whether the Fibrek board complied with its fiduciary duties.

However, other conclusions reached by the Bureau raise important questions regarding the public interest jurisdiction of securities regulatory authorities.

It cannot be denied that in considering whether to exercise its public interest discretion in the context of defensive tactics, Canadian securities regulatory authorities should seek to not only

[12] As is customary, the Supreme Court did not release reasons for its decision not to grant leave to appeal.

protect the interests of shareholders of the target, but secondarily must also consider the capital markets generally. This is consistent with NP 62-202. In this regard, the Bureau appears to believe that it is abusive of the capital markets to allow a dilutive financing that could either deprive a bidder from reaping the benefits of an irrevocable lock-up or prejudice irrevocably locked-up shareholders who have decided to sell their shares at a price which ends up being below fair market value, except in circumstances where the target has a pressing need for such financing. If Resolute had entered into "soft" lock-ups (thereby allowing the Locked-up Shareholders to tender to a higher bid), the private placement by Fibrek would have been unnecessary.

In assessing the Bureau's conclusion, it may be appropriate to consider the following questions:

- Can it be said that the issuance of shares by a target that would have the effect of defeating irrevocable lock-ups, while providing for greater consideration to the target's shareholders, is abusive of the capital markets (or, in other words, would the issuance of shares have a negative impact on the frequency of takeover bids or negatively impact the pricing of takeover bids)?

- Is it in the public interest to seek to provide additional protection for the right of a bidder to secure control of a company through the use of an irrevocable lock-up? In the words of the ASC in *ARC*, is it "detrimental to investors or capital market integrity" to deprive Resolute of "an existing right legally acquired" (in this case, the acquisition of de facto control, as opposed to the right to vote in *ARC*)?

With respect to the importance of the decision in *ARC* as interpreted by the Bureau in *Fibrek*, it is not clear that the necessity of a financing should be determinative as to whether such financing is contrary to the public interest. In practice, this may be a difficult threshold to assess. Also, if a target requires financing, why does it have to come from a bidder? Should the target have to prove that other sources of financing were not reasonably available? Finally, it would appear, based on the *Lions Gate* decision, that the necessity of a financing would be a more appropriate consideration in determining if the financing was consistent with the exercise of a board's fiduciary duty.

With respect to the Bureau's decision regarding break-fees, it may be argued that it was *obiter*. The Bureau held that 5% of shareholders' equity was in the circumstances abusive, but not abusive enough to cease trade Mercer's bid.

In any event, the one fact that is clear from the Bureau's decision in *Fibrek* is that after 25 years of NP 62-202 and its predecessor, the CSA needs to create more modern and workable rules in considering defensive tactics in the context of takeover bids. In this regard, we applaud the initiatives of the CSA to update NP 62-202 with respect to shareholder rights plans.[1313] However, in light of the difference of opinion in interpreting NP 62-202 in the *Fibrek* case between the AMF and the Court of Québec, on one hand, and the Bureau, on the other hand, it may be prudent for the CSA to update NP 62-202 in its entirety.

by Paul D. Davis, Assunta Di Lorenzo and Richard Yehia, articling student

For more information on this topic, please contact:

Toronto	Paul D. Davis	416.307.4137	paul.davis@mcmillan.ca
Montreal	Assunta Di Lorenzo	514.987.5018	assunta.dilorenzo@mcmillan.ca

[13] *OSC Dialogue 2011* (Toronto: Ontario Securities Commission, 2011).