THE HBC PRIVATIZATION: OSC PROVIDES NEW GUIDANCE FOR A SPECIAL COMMITTEE PROCESS AND RECONFIRMS DISCLOSURE OBLIGATIONS IN CONFLICT OF INTEREST TRANSACTIONS

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Introduction

In *Re The Catalyst Capital Group Inc.*,[1] the Ontario Securities Commission (the "**Commission**" or the "**OSC**") provided new guidance regarding the role and responsibilities of a special committee in a conflicted going-private transaction and reconfirmed long-held principles regarding disclosure obligations of issuers under Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions* ("**MI 61-101**"). The decision will have a significant impact on future going-private transactions and reminds issuers of the importance of adopting a proper process in considering and approving conflicted material transactions that are subject to MI 61-101.

Background

Before the markets opened on June 10, 2019, a group of shareholders of Hudson's Bay Company ("**HBC**") announced a proposal to take HBC private at $9.45 per share. The group (the "**Baker Group**") was led by Richard Baker, HBC's Governor and Executive Chairman, and collectively controlled approximately 57% of HBC's shares. The proposal contemplated that the privatization would be funded with the proceeds from the sale of HBC's remaining European real estate and retail joint ventures (the "**SIGNA Transactions**"), which had been announced by HBC just a few minutes before. The Baker Group disclosed that its members would not be sellers in any alternative transaction.

In late February 2019, several months prior to the announcements on June 10, 2019, representatives of HBC, including Mr. Baker, commenced exploratory discussions in respect of the SIGNA Transactions. Shortly after, Mr. Baker also commenced exploratory discussions with respect to a potential privatization transaction with the other members of the Baker Group, on the premise that the proceeds of the SIGNA Transactions would provide a portion of the financing required.

On March 25, 2019, Mr. Baker and another member of HBC management informed David Leith, HBC's lead independent director, about the Baker Group's desire to explore a going-private transaction conditional on HBC proceeding with the SIGNA Transactions. Mr. Leith consented to Mr. Baker sharing certain financial information with the Baker Group. No confidentiality agreements were entered into between HBC and the members of the Baker Group in respect of the shared information. Mr. Baker also requested that he be allowed to use HBC's historical transaction counsel, which Mr. Leith agreed to.

On March 27, 2019, HBC's 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 Lord + Taylor business unit and the company's European joint ventures and assets, which were the subject of the SIGNA Transactions. As such, the Special Committee formed two days after Mr. Baker informed Mr. Leith of the Baker Group's intention to evaluate a going-private transaction did not have a mandate to review such transaction.

Management of HBC negotiated the SIGNA Transactions in April and May 2019 and provided updates to the Special Committee. Towards the end of April 2019, Mr. Baker reiterated his interest in evaluating a going-private transaction to Mr. Leith, and the Special Committee engaged independent counsel to act in the event a privatization proposal was received. The Special Committee and its counsel discussed modifying the mandate of the Special Committee to address a potential going-private proposal, but the mandate was not expanded at that time.

At the end of May 2019, Mr. Baker advised that he was continuing to consider a going-private transaction which would be subject to the closing of the SIGNA Transactions. On June 4, 2019, the Special Committee received a draft proposal letter from the Baker Group and a draft press release which was intended to follow HBC's announcement of the SIGNA Transactions. The mandate of the Special Committee was revised and expanded on June 9, 2019 to include evaluation of a going-private proposal. On the same day, following consideration by the Special Committee, the HBC board determined that no proposal would materialize without a waiver of certain standstill provisions applicable to HBC's largest shareholder ("**Fabric**"), which was a member of the Baker Group and provided the waiver. The HBC board also approved the SIGNA Transactions.

On June 10, 2019, both the privatization proposal and the SIGNA Transactions were announced.

On October 21, 2019, HBC and the Baker Group announced that they had reached an agreement (the "**Arrangement Agreement**") to take the company private at $10.30 per share (the "**Transaction**"), and that a special meeting of shareholders would be held in December 2019 to approve the Transaction. The Transaction would need the approval of: (i) 75% of the shares voted at the meeting and (ii) a majority of the minority of the shares (excluding those held by the Baker Group and its affiliates).

HBC's largest minority shareholder, The Catalyst Capital Group Inc. ("**Catalyst**"), expressed concerns publicly and directly to HBC and the Baker Group about the value of the initial $9.45 proposal and the increased offer of $10.30 per share.

HBC filed its management information circular detailing the Transaction on November 15, 2019 (the "**Initial Circular**"). The Initial Circular included a formal valuation by TD Securities Inc. purporting to find a fair value of $10.00 to $12.25 per HBC common share, and a fairness opinion (the "**TD Valuation**"). The financial advisors to the Special Committee also each provided a fairness opinion. Additionally, HBC had engaged CBRE, Inc. to conduct an appraisal of its Saks Fifth Avenue flagship store in New York City (the "**CBRE Appraisal**") and Cushman & Wakefield, Inc. to conduct appraisals of HBC's other 100%-owned and joint venture owned real estate properties. These appraisals were not filed with the Initial Circular, but were later posted online on HBC's website.

Catalyst continued to express concerns that the Baker Group's proposal undervalued HBC. When the Arrangement Agreement was announced, Catalyst held approximately 17.5% of HBC's common shares, 10.05% of which had been acquired in a "mini-tender" completed in August 2019. On November 27, 2019, Catalyst announced its own proposal to acquire all of the issued and outstanding HBC common shares at $11.00 per share. The Special Committee rejected the proposal on December 2, 2019, citing that as the Baker Group had indicated it was not willing to sell its shares, the Catalyst proposal was incapable of being completed.

Shortly before the Special Committee's rejection of Catalyst's offer, Catalyst filed an application with the Commission seeking an order, under section 127 of the *Securities Act* (Ontario), for the cease trade of the Transaction or, in the alternative, for the Initial Circular to be amended. Catalyst's application alleged abusive conduct, a flawed Special Committee process and a number of disclosure deficiencies in the Initial Circular.

After commencement of Catalyst's application, HBC issued a press release (the **"December 6 Press Release**") restating a section of the Initial Circular discussing the background to the Transaction.

A panel of the OSC (the "**Panel**") heard the application on December 11, 12 and 13, 2019. On December 13, 2019, the Panel ordered HBC to amend the Initial Circular. The reasons for the order were released on February 20, 2020.

Standing

After initial attendances, the first issue argued by the parties was whether Catalyst had standing to bring the application. The respondents (HBC and the Baker Group) opposed Catalyst's bringing of the application on the grounds of standing. The issue was important to the parties because the application would be dismissed if Catalyst was denied standing.

It is established jurisprudence that a private party must satisfy the factors set out in the *MI Developments*[2] decision to be granted standing to bring an application under the section 127 public interest provision of the *Securities Act* (Ontario). There was little doubt that all but the last of these factors were met in this case.

The last factor in the *MI Developments* decision has become the most elaborate in Commission jurisprudence. This factor is whether the "Commission is satisfied that it is in the public interest to hear the application". Cases since *MI Developments* have construed various elements to be read into this factor.[3] The Panel focused on two elements in relation to this public interest factor.

First, the Panel found that Catalyst acted in a timely manner. The issue of timing was accentuated due to the proximity of the application to the shareholders' meeting to approve the Transaction. Catalyst's application was commenced on December 2, 2019 and the meeting date was scheduled for December 17, 2019.

The Panel found that Catalyst's application was timely "considering the timing of its engagement with HBC and Staff before and after dissemination of the circular".[4] Indeed, Catalyst sought information from HBC prior to commencing its application to determine if its concerns arising from the disclosure merited intervention.[5] The Panel also relied on the December 6 Press Release, issued after commencement of the application, to find that Catalyst acted in a timely way.

Second, the Panel held that Catalyst raised "fundamental securities regulatory issues",[6] which the Panel equated to being "sufficient to demonstrate the existence of a *prima facie* case".[7] These fundamental issues:

- included the timing of the formation and mandate of the Special Committee, questions around the Special Committee's consideration of the relationship between the Transaction and the SIGNA Transactions, and the effect of the CBRE Appraisal on the TD Valuation;[8] and
- involved compliance with MI 61-101 and the protection of minority shareholders who were faced with a management-led going-private transaction.

The Panel noted that these issues were apparent from the application record and were important "in a transaction subject to significant conflicts of interest".[9]

With standing granted, the Panel considered Catalyst's allegations on their merits.

Special Committee Process

MI 61-101 is the primary securities law framework for material conflict of interest transactions. MI 61-101 requires special protections, including enhanced disclosure requirements (further discussed below), preparation of a formal valuation by an independent valuator, and majority of the minority approval at a shareholders' meeting.

Catalyst raised two issues related to the process adopted by the Special Committee and HBC. First, that the process was so flawed that the Transaction should be cease traded. Second, that there was insufficient disclosure regarding the process adopted and the key decisions made in connection therewith.

The Panel questioned the effectiveness of the Special Committee, as it was formed after early negotiations between Mr. Baker and Mr. Leith. The December 6 Press Release revealed that significant discussions took place two months before the Transaction was subject to the expanded Special Committee mandate.[10] Mr. Leith had consented to Mr. Baker exploring a privatization proposal contingent on the SIGNA Transactions and sharing financial information with the Baker Group on a confidential basis. It was clear that at least some members of the Baker Group were not subject to confidentiality agreements. Mr. Leith also consented to Mr. Baker using HBC's historical transaction counsel.

The Panel found Mr. Leith's explanation during cross-examination (that he did not want to use resources until the proposal had more certainty) did not adequately explain why he made important decisions that might have affected later negotiations and could have far-reaching consequences.[11]

Mr. Leith's early decisions permitting sharing of confidential information and discussions with Fabric made it potentially difficult for the Special Committee to refuse to release Fabric from its standstill obligation.[12] Without the waiver of the standstill, any conclusion about how the negotiations would have proceeded would be impermissibly speculative. Mr. Baker might not have proceeded with the proposal if Fabric's 23.5% position had to be bought out. The waiver of the standstill could also have been negotiated for commitments on terms of the Transaction.[13]

The Panel found that "before 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 negotiations, and to consider the possible ramifications of these early decisions".[14]

The Special Committee should have been in place at an earlier stage to address the interrelationships of the SIGNA Transactions with the Baker Group privatization proposal, given the conflicts of interest.[15] The Panel questioned whether the absence of a special committee during the early stage of negotiations compromised the Special Committee's effectiveness later, and whether Mr. Leith was authorized to make potentially far-reaching decisions.[16]

A special committee is only required by MI 61-101 in the context of an insider bid. The Panel nevertheless held that once a special committee process is used for a significant conflict of interest transaction, it will be scrutinized based on the same standards as a required special committee. Whether or not a committee is required by securities laws, investors should not have to rely on a weak process when a special committee asserts it has a robust process. Heightened disclosure is required regarding a special committee process in

connection with a significant conflict of interest transaction.

The Panel adopted comments in Multilateral CSA Notice 61-302 on the effectiveness of a special committee.[17] A special committee is ineffective if it was formed after a transaction is substantially negotiated, where it was passive and where it failed to conduct a robust review of the circumstances, alternatives to the transaction and the transaction. A special committee is also ineffective or failed to fulfill important functions if it was formed after critical decisions that limit the special committee have already been made. It is critical that preliminary negotiations do not bind the board of directors and special committee.

Mr. Leith's early negotiations were potentially difficult to reverse and compromised the process to be undertaken by the Special Committee.[18]

The Panel also noted that a special committee should test the work done by a valuator preparing a formal valuation under MI 61-101 to ensure that it results in an appropriate valuation of the subject securities, and it should ensure that a valuator has the necessary access to information to conduct the valuation and help ensure that the valuator is free from undue influence.[19] A special committee should not only refrain from imposing any limitations on the scope of the valuator's review but, in fact, has a positive obligation to ensure that the valuation is free from unnecessary constraints.

Disclosure

Although diverse in subject matter, many of Catalyst's concerns related to inadequate disclosure in the Initial Circular, as well as the Initial Circular as amended by the December 6 Press Release.

Part 4 of MI 61-101 mandates that a circular for a business combination include certain disclosure. This includes a description of the background to the transaction, a discussion of the process adopted by the board of directors or special committee, disclosure of any limitations or constraints imposed on the valuations and related implications and disclosure of any direct or indirect benefits to directors and officers from accepting the transaction.

Catalyst submitted that the Initial Circular was deficient in each of those areas, and the December 6 Press Release did not cure many of these deficiencies.

The *Magna*[20] decision sets out the standard for disclosure. There must objectively be sufficient detail to enable a reasonable shareholder to make an informed decision. Disclosure must be complete, accurate and contained within the four corners of the circular. The Panel quoted *Magna* to the effect that "while the applicable disclosure standard does not change based on the circumstances, how that standard is applied is contextual and will vary with the circumstances."[21]

Where a special committee is formed to mitigate conflicts of interest, disclosure of the special committee's process will be critical to investor confidence and for an informed vote on the transaction. The Panel acknowledged that "investors reasonably need disclosure concerning decisions related to the Special Committee's power to negotiate or supervise the negotiation of transactions and to consider alternatives."[22]

The Panel found the disclosure in the Initial Circular to be lacking in several respects. First, a plain reading of the Initial Circular and the CBRE Appraisal leads to the conclusion that constraints were imposed by the Special Committee in the CBRE Appraisal, which the TD Valuation relied upon. The Special Committee appeared to have directed CBRE, Inc. to consider three specific scenarios in its appraisal of the Saks Fifth Avenue flagship. The Panel required that CBRE, Inc. confirm whether constraints were imposed upon it.

The Panel held that a valuation can be inappropriately constrained. This may occur if a valuator relies on an appraisal of a highly material asset without independent investigation and does not provide clear reasons why scenarios determined by the board or special committee are being accepted.[23] The Panel found that limitations contained in the CBRE Appraisal would similarly constrain the TD Valuation.[24]

Second, the Initial Circular did not contain adequate disclosure of benefits accruing to officers and directors approving the Arrangement Agreement. In this case, payouts to directors and officers were material information for minority shareholders given the benefits officers and directors were to receive from the Transaction.[25] This disclosure is specifically required under MI 61-101.

The Panel also found that the Initial Circular was deficient with respect to disclosure on how the Transaction structure, a share buyback as opposed to a sale to another party, benefited the Baker Group. The Initial Circular had disclosed that the structure of the Transaction would result in negative tax consequences for certain minority shareholders and that such shareholders might be better off selling their shares in advance of the Transaction closing. The respondents submitted that it was sufficient to disclose that the Baker Group would hold all of HBC's shares upon completion of the Transaction.

The Panel found that the respondents' view of what constituted direct and indirect benefits of a transaction was too narrow.[26] It was not sufficient to merely state that the Baker Group would benefit from the Transaction by virtue of being continuing shareholders.[27] The Panel ordered additional disclosure, including how the Special Committee considered the tax structure and an explanation of the benefits of this structure realized by the Baker Group.[28]

Third, the Initial Circular was deficient in setting out the background to the Transaction and the process taken by the Special Committee. Substantial discussions took place well before the Special Committee's mandate was expanded to consider the privatization transaction on June 9, 2019. In particular, the fact that Mr. Leith had consented to Mr. Baker sharing confidential information of HBC with others in the Baker Group to advance the

privatization discussion, and had consented to Mr. Baker engaging HBC's historic transaction counsel to act for the Baker Group, were not disclosed until the December 6 Press Release.

The Panel noted that by making early decisions without advice of counsel, Mr. Leith had compromised the process to be undertaken by a special committee.[29] The Panel emphasized the importance of properly constituting a special committee at the correct time. Given the way the process unfolded, the Panel ordered the Initial Circular be amended to provide disclosure on Mr. Leith's analysis leading to his decisions and the HBC board of directors' reasons for deciding that a special committee was not required to address the conflict of interest until June 9, 2019.[30]

Fourth, no discussion of the Special Committee's analysis on the timing of announcing the privatization proposal and the SIGNA Transactions was provided in the Initial Circular. The Baker Group announced the proposal within minutes of HBC announcing the SIGNA Transactions, and both announcements occurred prior to markets opening.

The respondents' evidence disclosed that while Mr. Leith would have preferred a longer period of time between the announcements of the two transactions, ultimately the decision was made by the Baker Group.[31] Considering this issue, the Panel again stressed the importance of disclosure about the mandate of the special committee and its timing.

Catalyst's oral submissions highlighted a number of inconsistencies between the disclosure in the Initial Circular, the December 6 Press Release and the respondents' evidence. For example, the Initial Circular stated that the Special Committee was formed on March 27, 2019 to consider options with respect to HBC's Lord + Taylor business unit and its European retail and real estate joint ventures. The December 6 Press Release, however, disclosed an expanded mandate which included the evaluation of "various possible strategic alternatives".[32] Mr. Leith's evidence on cross-examination then reverted back to the more limited scope disclosed in the Initial Circular.[33]

Given the differences in narrative highlighted by Catalyst, the Panel ordered the Initial Circular be amended to provide a reconciliation of the disclosure made in the December 6 Press Release and the respondent's evidence, including the testimony of Mr. Leith at the hearing.

Availability of a Cease-Trade

Despite expressing concerns with the process, the Panel held that the conduct did not rise to the level of abuse required to cease trade a transaction. The Panel found that:

- the Special Committee was not properly mandated as soon as it should have been;[34]
- there was deficient orchestration of the Special Committee timing and process;[35]

- Mr. Leith's decision to permit sharing confidential information with the Baker Group and waiver of Fabric's standstill would have benefited from a properly mandated and advised Special Committee;[36] and
- Mr. Leith could have investigated the confidentiality and standstill requirements more thoroughly.[37]

The consequences of the disclosure of confidential information were too speculative and the questions of the Special Committee's lack of independence were too inconclusive on their effects on minority shareholders. The Panel concluded that additional disclosure would address its key concerns. The Panel also appeared to be influenced by the likelihood that the "Baker-led offer was the most realistic opportunity to provide a premium sale opportunity to HBC's shareholders". The Panel noted that independent directors should not be held to a standard of perfection.[38]

Observations

This decision will no doubt add to the ongoing debate regarding the roles of securities regulators and courts in contested conflicted M&A transactions and whether greater deference should be shown to directors by securities regulators. We note, however, that the remedies provided by the Panel relate solely to disclosure, which is clearly within the expertise and purview of securities regulators.

HBC's decision to amend the Initial Circular with the December 6 Press Release was likely viewed as an admission of deficient disclosure in the Initial Circular. The Panel agreed with Catalyst that additional disclosure was required and that all new disclosure should be included in an amended circular that should be mailed to the HBC shareholders.

The decision had key implications for market participants and their advisors. We would suggest that the key takeaways are:

- The utilization of a special committee in a significant conflicted transaction, which serves as a protective mechanism, requires clear disclosure regarding the mandate, timing and material decisions made by or relating to the special committee.
- A special committee should be formed as soon as practicable when conflicts of interest arise for a significant transaction. In this case, Mr. Baker was leading the negotiations of the SIGNA Transactions and he expressed the view that he was thinking of sponsoring a going-private transaction using the proceeds from the SIGNA Transactions – this is when the Special Committee should have been put in place with respect to a possible going-private transaction.
- Notwithstanding that a process is flawed, the Commission is unlikely to cease trade a transaction and thereby take the decision to complete the transaction out of the hands of minority shareholders.

> However, in such circumstances, in order to ensure that the minority shareholders are making an informed decision, significant disclosure regarding any flaws in the process will be required. The Commission is unlikely to exercise its public interest discretion to cease trade a transaction without clear evidence of abuse that goes to the essence of the transaction.

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[1] 2020 ONSEC 6 [*Catalyst*]. McMillan LLP represented The Catalyst Capital Group Inc. in the application that led to this decision.[ps2id id='1' target='/]
[2] 2009 ONSEC 13.[ps2id id='2' target='/]
[3] See e.g. *Pearson (Re)*, 2018 ONSEC 53 and *Re Central Goldtrust*, 2015 ONSEC 44.[ps2id id='3' target='/]
[4] *Catalyst* at para 28.[ps2id id='4' target='/]
[5] A portion of Catalyst's written argument on standing was entitled "Catalyst Attempts to Get Answers".[ps2id id='5' target='/]
[6] *Catalyst* at para 29.[ps2id id='6' target='/]
[7] *Catalyst* at para 33.[ps2id id='7' target='/]
[8] *Catalyst* at para 29.[ps2id id='8' target='/]
[9] *Catalyst* at para 33.[ps2id id='9' target='/]
[10] *Catalyst* at paras 92-93.[ps2id id='10' target='/]
[11] *Catalyst* at para 97.[ps2id id='11' target='/]
[12] *Catalyst* at para 106.[ps2id id='12' target='/]
[13] *Catalyst* at para 98.[ps2id id='13' target='/]
[14] *Catalyst* at para 99.[ps2id id='14' target='/]
[15] *Catalyst* at para 100.[ps2id id='15' target='/]
[16] *Catalyst* at paras 100-101.[ps2id id='16' target='/]
[17] *Catalyst* at paras 103-106.[ps2id id='17' target='/]
[18] *Catalyst* at para 106.[ps2id id='18' target='/]
[19] *Catalyst* at para 74.[ps2id id='19' target='/]
[20] *Magna International Inc (Re)*, 2010 ONSEC 13, (2011) 34 OSCB 1290 [Magna].[ps2id id='20' target='/]
[21] *Catalyst* at para 53; Magna at para 128.[ps2id id='21' target='/]
[22] *Catalyst* at para 47.[ps2id id='22' target='/]
[23] *Catalyst* at para 71.[ps2id id='23' target='/]
[24] *Catalyst* at para 73.[ps2id id='24' target='/]
[25] *Catalyst* at paras 82-83.[ps2id id='25' target='/]
[26] *Catalyst* at para 88.[ps2id id='26' target='/]

[27] C*atalyst* at para 88.[ps2id id='27' target='/]
[28] *Catalyst* at para 90.[ps2id id='28' target='/]
[29] *Catalyst* at para 106.[ps2id id='29' target='/]
[30] *Catalyst* at para 108.[ps2id id='30' target='/]
[31] *Catalyst* at para 117.[ps2id id='31' target='/]
[32] *Catalyst* at para 125.[ps2id id='32' target='/]
[33] *Catalyst* at para 126.[ps2id id='33' target='/]
[34] *Catalyst* at para 141.[ps2id id='34' target='/]
[35] *Catalyst* at para 143.[ps2id id='35' target='/]
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[37] *Catalyst* at para 145.[ps2id id='37' target='/]
[38] *Catalyst* at para 145.[ps2id id='38' target='/]

a cautionary note