January 12, 2017

A version of this article originally appeared in Listed Magazine.

# If Pills Are Out, Are Private Placements In?

By Poonam Puri with Patricia Olasker

Consider this: a cash-strapped junior resource company listed on the TSX Venture Exchange is looking for ways to continue its exploration program for the coming year. With only $200,000 in its bank account, a $2-million loan from a significant shareholder that's coming due, and an expected burn of $4 to $5 million for its drilling plans for the next year, financing is top of the agenda for both the board and management. Sound familiar?

The company considers extending the existing loan, but the lender refuses to commit to an extension until closer to renewal. Wanting certainty, the company decides to pursue a $6-million private placement, which it plans to use to pay off the existing loan and continue drilling. However, immediately after talks break down with the lender over loan amendments, the lender announces its intention to launch a hostile bid at a 55% premium over the market price. A week later, the company announces a private placement that would dilute existing equity by 43%, and the lender runs to the securities regulators demanding that they intervene by cease-trading the private placement. Should the securities commissions intervene?

This is exactly what happened in Hecla Mining's unsolicited takeover bid for Dolly Varden Silver Corp. (TSX-V:DV) in July 2016. The Ontario and B.C. securities commissions refused to intervene and in October released a rare joint decision, explaining why. Simply put, they found that the company made the private placement for non-defensive business purposes. They noted that the company was contemplating an equity financing well before the offer was announced, the size of the private placement was reasonable, and it had not changed in size or scope after the bid surfaced. The commissions also explicitly recognized the market reality in Canada that junior listed companies often have to engage in dilutive equity transactions for legitimate business purposes.

Dolly Varden was the first contested transaction since Canada's new takeover bid regime came into effect in Canada in May 2016. Different from the principles underlying takeover legislation in the United States, where boards can "just say no," Canada's takeover bid framework is premised on the principle that shareholders should ultimately decide whether to accept or reject a takeover bid. The new rules change the balance of power between target boards and target shareholders, and between target boards and hostile bidders. Here, we've compiled a list of six implications of the new takeover code and the new approach to the regulation of defensive tactics in the post-poison-pill era.

1. Hostile bids will be more difficult to complete successfully. The 105-day time period that a bid must now remain open means that a hostile bidder will incur greater costs and uncertainty. It will bear the risk of changed market conditions, volatility in underlying prices and changes to the target's business. Other competing bidders might step in, and the initial bidder's efforts in uncovering the opportunity may be all for nothing. This will, no doubt, make some potential bidders pause and think twice about bidding at all.

2. Target boards have more time. Target boards now have more time to evaluate a bid, look for white knights, pursue alternatives and/or make a strong case to shareholders to reject the bid. A target board and its advisers can establish a strategic process with some greater certainty on timing (as opposed to the shorter, more variable periods that securities commissions have historically allowed for poison pills).

3. Target boards have more leverage. Interested bidders are more likely to negotiate directly with target boards. Bidders who negotiate a friendly deal directly with the target's board can have the target reduce the 105-day bid period to 35 days. This clearly gives the target's board some negotiating leverage.

4. Bids cannot succeed without the support of a majority of shareholders. The new requirement for a 50% minimum tender means that shareholders won't be able to tender their shares to the bidder if the bid isn't supported by a majority of the target's shareholders. Under the old regime, bidders would often reserve the right to waive their own self-imposed minimum tender condition. This meant that even if a bidder was unsuccessful in achieving a majority of the target's shares, it might have seized the opportunity to become a significant minority shareholder (e.g., 30% owner) by waiving its minimum tender condition and achieving a blocking position. Not possible anymore.

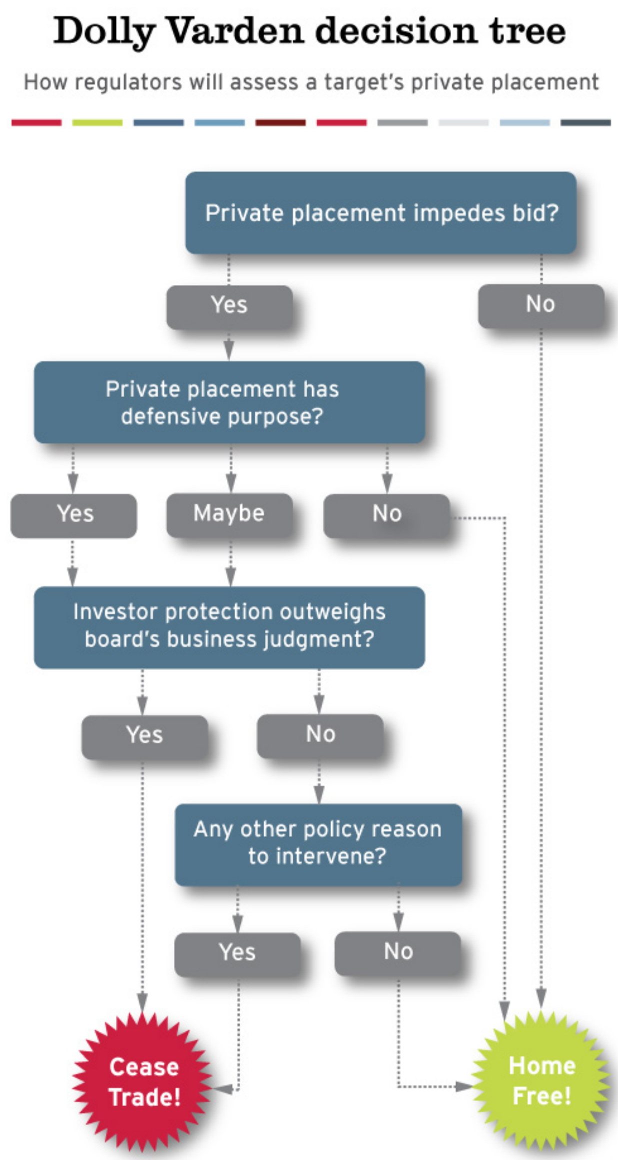
5. Poison pills as a bid defence will be a thing of the past. The new regime is silent on shareholder rights plans but, given the significant extension of the minimum bid period and the codification of the minimum tender condition and 10-day bid extension typically required by rights plans, we see fewer companies adopting rights plans. And we don't expect that regulators will allow issuers to use rights plans to further postpone takeup by hostile bidders beyond the 105 days.

That said, depending on their circumstances, some issuers may want to maintain rights plans so that they can have some protection against "creeping bids." Creeping bids involve the practice of assembling positions over time greater than 20% of a company's outstanding shares through acquisitions (like private placements and market purchases) that are exempt from the takeover bid rules.

6. Other defence tactics will emerge and be scrutinized by regulators. Although poison pills (and the usual pill hearings at which they were challenged as an illegal defensive tactic) are likely a thing of the past, target boards are going to be more carefully scrutinized on other defensive tactics, including private placements. This is where the fine print of the commissions' decision in Dolly Varden is important.

Here's their analysis in four simple stages (see accompanying diagram).

**A: Threshold Question.** Can the bidder show that the private placement has a material impact on the bid? For example, is there significant dilution? Or will it make it impossible for the bidder to satisfy the mandatory 50% tender condition? If yes, then go to stage B. If the answer is no, the commission won't intervene.



**B: Preliminary Analysis.** Can the target board show that the private placement was not a defensive tactic designed to alter the dynamics of the bid process? This question looks at intention and purpose, not effect. At this step, the target is responsible to provide evidence of the following:

• it had a serious and immediate need for the financing;

• it had a bona fide business strategy involving equity financing by way of private placement;

• the private placement was not planned or modified in response to, or in anticipation of, a bid.

If the answer is yes, then the commission won't intervene. If the answer is no or maybe, then go to the next stage.

**C: Full-Blown Analysis.** If the private placement is (or might be) a defensive tactic, then securities commissions must do a more extensive analysis to decide if they should intervene, focusing on their investor protection mandate but taking into account that corporate law defers to a large extent to board decision-making. In addition to the factors set out in the previous step, they'll also consider the following:

• Does the private placement benefit shareholders by, for example, allowing the target to continue its operations through the term of the bid? Or in allowing the board to engage in an auction process without unduly impairing the bid?

• To what extent does the private placement alter the preexisting bid dynamics, for example, by depriving shareholders of the ability to tender to the bid?

• Are investors in the private placement related parties to the target? Or is there other evidence that some or all of them will act in such a way as to enable the target's board to "just say no" to the bid or a competing bid?

• Is there is any information available that indicates the views of the target shareholders with respect to the takeover bid and/or the private placement?

• Did the target's board appropriately consider the interplay between the private placement and the bid, including the effect of the resulting dilution on the bid and the need for financing?

**D: Final Stage.** Is there any other policy reason to interfere with the private placement under the commissions' public interest power?

In the 105 days it will now take to consummate a hostile bid, target boards will likely struggle more with how to meet their financing needs during that lengthy period. This will be especially true for junior resource companies whose only source of financing is typically equity. Hostile bidders can be expected to heavily scrutinize these financing transactions and challenge them routinely.

**Takeaways**: For companies contemplating a financing and wanting to protect it from a Dolly-Varden-like challenge, here are some things to think about:

• Make sure you document in board minutes your earliest considerations of a possible financing, plus the need for and the intended use of proceeds, so that the record establishes that your plan was under consideration before any bid was announced.

• Make sure the private placement is "right-sized," i.e., no bigger than necessary to meet the demonstrable financing need.

• Don't increase or otherwise tinker with a private placement in the face of or in anticipation of a bid.

• Make sure board minutes reflect the board's consideration of the impact of the private placement on the bid.

• Ensure that some of your key shareholders are supportive of the private placement in case you need their support at a defensive tactics hearing.

• Avoid placing the securities in the hands of related parties or others known to be supportive of the target and likely opposed to the bid.

• Consider offering the bidder the opportunity to participate in the private placement.

• Avoid structuring the private placement so that the bidder's failure to meet the required 50% minimum condition is inevitable.

• Consider pre-emptively applying to the securities commission for an order excluding the newly issued securities from the required minimum tender condition.

*If you have any questions regarding the foregoing, please contact Patricia Olasker (416.863.5551) or Alexander Moore (416.863.5570) in our Toronto office or Franziska Ruf (514.841.6480) or Olivier Désilets (514.841.6561) in our Montréal office.*

*Davies Ward Phillips & Vineberg LLP is an integrated firm of approximately 240 lawyers with offices in Toronto, Montréal and New York. The firm focuses on business law and is consistently at the heart of the largest and most complex commercial and financial matters on behalf of its clients, regardless of borders.*

*The information and comments herein are for the general information of the reader and are not intended as advice or opinions to be relied upon in relation to any particular circumstance. For particular applications of the law to specific situations, the reader should seek professional advice.*