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Weed Wars Part II: Tactical Poison Pills and Lock-up Agreements in Hostile Bids

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The Ontario and Saskatchewan securities commissions recently released joint reasons in *In the Matter of Aurora Cannabis Inc.* in respect of the unsolicited takeover bid by Aurora Cannabis Inc. for all the shares of CanniMed Therapeutics Inc. and CanniMed's adoption of a shareholder rights plan in response to the bid.

In cease-trading CanniMed's shareholder rights plan, refusing to alter provisions of the takeover bid rules, and declining to find bidder Aurora and the locked-up shareholders to be joint actors, the securities commissions made important statements about a number of subjects, including the following:

- the use of tactical poison pills and other defensive tactics under the new takeover bid regime
- the utility of lock-up agreements
- the nature of the joint actor relationship
- the sharing of material non-public information by parties in the M&A context

The decision is equally important for what it does not comment on, which we will discuss below.

The decision covers numerous issues, but two overarching themes anchor most of the findings:

1. Predictability in the takeover bid regime is an important objective of takeover bid regulation and of the recent reforms, and investors and market participants are entitled to know with reasonable certainty what rules will govern the bid environment.
2. Given the very recent "rebalancing" of the bid rules, it will take a compelling case to justify the making of "piecemeal changes" to the bid rules, absent the need to protect shareholder choice.

Background

In November 2017, Aurora launched an unsolicited bid to acquire CanniMed in consideration for Aurora shares. The bid was instigated and supported by four CanniMed shareholders representing 38% of CanniMed's outstanding shares (collectively, the Locked-Up Shareholders) who had entered into "hard" lock-up agreements with Aurora. The bid was launched immediately prior to CanniMed entering into an arrangement agreement with Newstrike Resources Ltd. which it had been negotiating over the prior several weeks. Over the period of those negotiations, the Locked-Up Shareholders or their director nominees on the board of CanniMed made known their vigorous objections to the acquisition of Newstrike. Ultimately, one of those shareholders initiated the discussions with Aurora that led to the bid, supported by lock-up agreements from the four CanniMed shareholders, three of which were represented on the board of CanniMed. When Aurora formally launched its unsolicited offer, it was made conditional on the non-completion of the Newstrike acquisition. The Newstrike acquisition required CanniMed shareholder approval of the dilutive share issuance and prohibited CanniMed from soliciting other transactions, subject to typical "fiduciary out" provisions.

In immediate response to the Aurora bid, CanniMed adopted a shareholder rights plan. The rights plan operated to prevent Aurora from acquiring any CanniMed shares other than those tendered to its bid or from entering into new lock-up agreements other than those it had already entered into. In particular, it would have prevented Aurora from relying on the 5% exemption, a limited exemption that allows bidders to purchase target shares outside of the takeover bid in open market transactions.

The facts giving rise to the dispute and the submissions made by the parties are addressed in greater detail in our earlier Davies bulletin on this matter available here.[1]

Rights Plan Cease-Traded as Defensive Tactic

The securities commissions held that the rights plan constituted an impermissible defensive tactic under National Policy 62-202, *Take-Over Bids – Defensive Tactics*, and cease-traded the rights plan. The securities commissions considered that the rights plan had "primarily a tactical motivation" in protecting the Newstrike deal in the face of a bid that was conditional on the Newstrike transaction being abandoned and in resisting the Aurora bid by preventing additional lock-up agreements and market purchases. Importantly, the commissions rejected the argument that the rights plan was also intended to permit potential higher bids for CanniMed, since there was no evidence that CanniMed intended to seek other transactions and was in fact contractually prohibited from doing so under its arrangement agreement with Newstrike.

In striking down the pill, the securities commissions made the following key points:

- Shareholder choice was being promoted without the operation of the rights plan since CanniMed shareholders would have the ability to vote on the Newstrike transaction well before the Aurora offer expired.
- The recent rebalancing of the takeover bid regime provides sufficient protections for shareholder choice to occur while allowing bids to be made and management to respond in an appropriately predictable and even-handed manner.
- Lock-up agreements are a lawful and established feature of the planning for M&A transactions in Canada and are even more important in a bidder's planning after the adoption of the takeover bid amendments since the risks to the completion of the transaction have been increased by virtue of the extension of the bid period to 105 days.
- If tactical shareholder rights plans could operate to prevent lock-ups and permitted market purchases, "the takeover regime would be made far less predictable and the planning and implementation of shareholder value-enhancing transactions made more difficult or inappropriately discouraged." It will be a rare case in which a tactical plan will be permitted to interfere with the established features of the takeover bid regime.
- Issuers should not adopt pills that reproduce the requirements of the takeover bid regime but alter the manner in which the requirements are to be satisfied. This approach generates confusion and serves no useful purpose. The commissions were critical of the fact that the rights plan deemed Aurora to beneficially own the CanniMed shares held by the Locked-Up Shareholders. In the reasons, the commissions stated that "such plans should not generally be utilized to deem a bidder to beneficially own locked-up shares in circumstances where they would not be deemed to be joint actors under the applicable rules."

The Future of Poison Pills?

Nothing in the reasons would discourage the use of shareholder-approved rights plans that protect against creeping acquisitions so long as the pill does not reproduce requirements of the takeover bid regime and then graft on confusing variations on how the requirements are to be satisfied.

It is less clear whether the long-standing, ISS-approved pill definition of beneficial ownership, which includes locked-up shares but carves out soft lock-ups, is permissible.

The reasons leave open the possibility that even a tactical pill might withstand challenge if it could be demonstrated that it was necessary to facilitate an auction or support shareholder choice.

The Preclusive Effect of Lock-up Agreements

What the commissions did not address was the potentially preclusive effect of the lock-up agreements when combined with additional market acquisitions under the 5% exemption and the possibility of additional lock-up agreements. Striking the pill, as the commissions did, would allow Aurora to acquire a de facto blocking position against an alternative bid. Nonetheless the commissions determined on the facts that shareholder choice was promoted by striking the pill.

As the issue of preclusion was argued before the commissions and was clearly evident on the facts, what we can infer from the absence of express reference to it, in light of the more general statements regarding the legitimacy of lock-up agreements and their acknowledged benefits in facilitating bids, is this:

1. In the context of an arm's-length bid, lock-up agreements are not per se offensive just because they may give a bidder a de facto blocking position against an alternative bid. They are not inimical to shareholder choice; they are a manifestation of shareholder choice. This is only true, of course, where the parties are at arm's length and where there are no other benefits to the locked-up shareholders.
2. Given that the commissions held that the rights plan had "primarily a tactical motivation" in protecting the Newstrike deal and resisting the Aurora bid, and the CanniMed board was not in fact conducting an auction or soliciting alternative transactions, the question of whether a rights plan would be allowed to stand to prevent preclusive "hard" lock-up agreements and additional market purchases in circumstances where a board was in fact conducting an auction or seeking alternative bids remains open.
3. Where the bidder is a hostile *insider*, the bidder has informational and other advantages over other shareholders. In this situation, it remains open for securities commissions to find that lock-up agreements that preclude other bids and take the transaction entirely out of the hands of the board are antithetical to shareholder choice and contrary to the public interest.

We will report separately on additional issues arising out of these reasons. Please watch for our further communications.

[1] Davies bulletin dated January 3, 2018, titled *Weed Wars: Securities Commissions Weigh In on Aurora/CanniMed Hostile Bid*.

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