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The Eco Oro Decision: OSC Weighs in on Tactical Private Placements in the Context of Contested Shareholder Meetings

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The Ontario Securities Commission's (OSC) reasons in *In the Matter of Eco Oro Minerals Corp.* were recently released, providing important guidance regarding private placements of voting securities in the context of proxy contests and articulating the OSC's views on the public interest in ensuring fairness in contested shareholder meetings.

Background

In February 2017 Eco Oro Minerals Corp. (Eco Oro) became embroiled in a proxy contest with dissident shareholders seeking to replace the incumbent board of directors at a requisitioned shareholders' meeting then scheduled for April. In the midst of this proxy contest, the board of Eco Oro approved the private placement of common shares (Subject Shares) to certain shareholders (Supporting Shareholders) who collectively held approximately 41% of the then-outstanding common shares and who had been solicited by Eco Oro management to deliver, and agreed to deliver, letters in support of the incumbent board. The issuance of the Subject Shares was effected by an early conversion, in part, of convertible notes of Eco Oro that had been issued to the Supporting Shareholders several months earlier and resulted in the Supporting Shareholders increasing their ownership to approximately 46% of the outstanding common shares.

Prior to the record date for the requisitioned shareholders' meeting, the Toronto Stock Exchange (TSX) conditionally approved the private placement. The TSX did not require prior shareholder approval for the private placement, and the issuance of the Subject Shares was completed without advance public disclosure, shortly before the record date for the meeting. The TSX's approval was based on its determination that the private placement did not "materially affect control of Eco Oro", because the issuance of the Subject Shares would not result in a single shareholder, or a combination of shareholders acting together, holding more than 20% of the outstanding voting securities.

The dissident shareholders applied to the OSC for a review of the TSX decision that approved the private placement and, in April, the OSC issued an order setting aside the TSX decision. In so doing, the OSC cease-traded the Subject Shares and ordered that shareholder approval be obtained for the issuance of the Subject Shares unless such issuance was reversed by Eco Oro and the Supporting Shareholders. In addition, the OSC ordered that until shareholder approval was obtained, Eco Oro was not to consider the Subject Shares to be outstanding for voting purposes and if shareholder approval was not obtained, Eco Oro was to take all necessary steps to reverse the issuance of the Subject Shares.

The OSC's Reasons

1. Oversight of the TSX

Although the OSC has the authority to review decisions of the TSX, it has historically demonstrated a reluctance to substitute its own decisions for those of the TSX except in limited circumstances.

In this instance, the OSC found that the TSX was either unaware of or "failed to absorb" a number of important facts, including that:

- a proxy contest for removal of the incumbent board was underway;

- the proxy contest resulted from a meeting requisitioned by dissident shareholders and that the record date for determining voting entitlements at the meeting was only days away at the time the TSX was asked to approve the private placement; and
- the Supporting Shareholders had been solicited by management to deliver letters supporting the incumbent board and had done so.

The OSC primarily attributed this lack of awareness to inadequate disclosure by Eco Oro in its submissions to the TSX but also suggested a weakness in the TSX's process for review of the private placement of the Subject Shares.

As a consequence, the OSC determined it was entitled to consider the private placement afresh.

2. Materially Affect Control

The key question before the OSC was whether the issuance of the Subject Shares would materially affect control of Eco Oro. In its own analysis of the question, the TSX applied the concept of "enduring control," looking exclusively at whether a new 20% shareholder was created either individually or through an express voting trust among shareholders. The TSX did not consider the impact that the private placement may have on a transient vote at an individual meeting.

The OSC rejected this narrow consideration of enduring control, finding that this approach was inconsistent with the definition of "materially affect control" as articulated in the TSX's own rules,[1] which include consideration of the impact on a vote on a case-specific basis. Moreover, the OSC found that failing to consider the transient vote is inconsistent with the public interest, stating "the public interest requires an evaluation of whether an issuance of shares by a listed issuer is for the purpose of entrenching management in the face of a proxy contest."

On the facts before it, the OSC concluded that there was overwhelming evidence of a tactical motivation by Eco Oro to influence the vote at the upcoming meeting and that the issuance of the Subject Shares to the Supporting Shareholders "could reasonably tip the balance in favour of management." Moreover, the OSC found no compelling business objective for the private placement to be completed prior to the record date for the requisitioned meeting so as to negate this tactical motivation. Indeed, the OSC found that the private placement, which provided no new funds and no covenant relief under the convertible notes, had little practical positive effect for Eco Oro.

3. Fashioning the Remedy

The remedy fashioned by the OSC has the effect of sterilizing the voting rights attaching to the Subject Shares unless Eco Oro obtains shareholder approval for their issuance and requires the "unscrambling of the egg" (that the private placement of the Subject Shares be unwound) if such shareholder approval is not obtained. In fashioning this remedy, the OSC outlined four factors that it considered relevant in determining whether it is in the public interest to order that a transaction be unwound:

a. whether the issuer afforded those who it knew were likely to object to the transaction an opportunity to raise objections to the TSX in advance of closing, including by means of a press release issued sufficiently in advance of closing;

b. whether those directly affected by the reversal of the transaction entered into the transaction knowing of the likelihood of objections;

c. whether those directly affected by the reversal of the transaction had an opportunity to be heard and/or make submissions; and

d. whether it is impractical for the transaction to be reversed in the circumstances.

In the present case, the OSC was not prepared to put the commercial interests of the Supporting Shareholders (who were opposed to unwinding the issuance of the Subject Shares) ahead of what the OSC considered to be the interests of the body of Eco Oro shareholders generally in a fair vote on the election of directors.

4. Observations on the Public Interest

The OSC's reasons contain a number of observations with respect to the OSC's consideration of the public interest, repeatedly stressing that whether a board should be reconstituted is a decision to be made by the shareholders without management being permitted to manipulate the vote. As stated, to allow a vote to be tainted by such conduct "would directly affect the integrity of Ontario capital markets, contrary to the Commission's mandate and the public interest."

The OSC directly analogized the issuance of voting shares intended to "tip the balance" in the context of a proxy contest to an improper issuance of shares designed to thwart a take-over bid. Referencing *National Policy 62-202 – Take-Over Bids – Defensive Tactics*, which focuses on the public interest in fairness to shareholders in the context of take-over bids, the OSC was clear that it perceives the considerations addressed in that policy to extend to ensuring fairness in contested shareholder meetings.

In this instance the OSC rendered its decision under its authority to review decisions of the TSX and, as a result of its findings described above, found it unnecessary to address the application of its public interest jurisdiction. However, actions taken under the OSC's public interest jurisdiction could be expected to effect a similar result.

Parallel Proceedings Before the B.C. Supreme Court

Shortly before commencing its application to the OSC, the dissidents in the Eco Oro proxy contest also brought an action for oppression against Eco Oro before the British Columbia Supreme Court, seeking an order to set aside the issuance of the Subject Shares. In the B.C. proceeding, the Court found that a case of oppression was not made out on the facts before it.

Although the decision of the B.C. Supreme Court and the decision of the OSC were arrived at through the application of different legal processes and principles, Eco Oro is yet another example of courts and securities commissions coming to very different conclusions on the conflicts of issuers and boards in the face of a proxy contest.

Implications of the Eco Oro Decision

The Eco Oro decision will have a number of implications for private placements in contested situations and offers a number of lessons for issuers and their advisers:

- We expect that the TSX will now bring greater scrutiny to the facts and circumstances surrounding a private placement, conducting some degree of its own due diligence and forgoing simple reliance on the submissions of the issuer.
- We also expect to see significantly circumscribed circumstances in which the TSX will permit a private placement to close without prior public announcement and some limited waiting period.
- The TSX will likely no longer apply a bright-line test in its assessment of "materially affect control" (i.e., creation of a 20% shareholder) and will instead undertake a more nuanced analysis that also considers the transient impact on voting dynamics.
- Issuers and their advisers should ensure that all relevant facts are squarely put before the TSX and that the implications of those facts are forcefully brought to the TSX's attention. In addition, issuers should be prepared for the possibility that the TSX may raise pointed questions and require further written submissions.
- The TSX may more frequently impose a requirement to obtain shareholder approval of private placements in appropriate circumstances.

Moreover, the Eco Oro decision is further evidence of the recently observed trend of the OSC's taking action in the proxy contest context to preserve the fairness of the vote. Of note:

- With respect to the OSC's perception of the public interest, issuers who undertake a private placement in the context of a proxy contest must be prepared to defend the bona fide nature of its business purpose (it is clear that the OSC found Eco Oro's position wanting in this regard).

- The considerations that the OSC will apply in the public interest context will necessarily be somewhat fact-specific. However, parallels can be drawn with the analysis undertaken by the OSC in its review of private placements undertaken by issuers in the context of contested take-over bids, including most recently in *In the Matter of Hecla Mining Company and Dolly Varden Silver Corporation*.[2]
- It is now clear that the OSC believes it has the flexibility to fashion a remedy to effectively sterilize voting rights and unwind a transaction. However, the very unique facts presented in the Eco Oro decision arguably presented little practical downside to imposing such a remedy. It is difficult to assess whether such a remedy will be readily imposed in more complex or grey circumstances and at what point it would become, in the eyes of the OSC, impractical to do so.

Appeal

Eco Oro has appealed the OSC's decision to the Ontario Divisional Court, and we will provide additional commentary on this matter after that appeal is completed.

[1] *TSX Company Manual, Part I. See also Request for Comments –Amendments to Parts V, VI and VII of the Toronto Stock Exchange Company Manual in Respect of Non-Exempt Issuers, Changes in Structure of Issuers' Capital and Delisting Procedures* (2004), 270 OSCB 249, at 319.

[2] (2016), 39 OSCB 8927 See the Davies Bulletin dated January 12, 2017 titled *If Pills are out, are Private Placements In?* in which we discuss the OSC's analysis of the factors that will be applied in determining whether a private placement of securities made in the face of a take-over bid is an inappropriate defensive tactic.

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