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OSC Provides Guidance on Special Committees and Disclosure in Conflict of Interest Transactions: The HBC Privatization Part II

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The Ontario Securities Commission recently released its reasons in *In the Matter of The Catalyst Group Inc.* in respect of the privatization proposal for Hudson's Bay Company (HBC) by a group of majority shareholders led by HBC executive chairman Richard Baker. The decision highlights the challenges companies face in dealing with their significant shareholders and underscores the Commission's view, signalled in CSA Multilateral Staff Notice 61-302, that it will rigorously scrutinize those dealings.

The decision also reflects the Commission's growing – and artful – use of forced disclosure to expose conduct it finds troubling but which does not rise to the level of abuse requiring a cease trade order.

The Commission's reasons confirm that in material conflict of interest transactions, it will scrutinize (i) the special committee's formation and mandate and the robustness and independence of the special committee's process in negotiating and reviewing a transaction, and (ii) whether that process and other factors material to minority shareholders were adequately disclosed in order to enable an informed shareholder vote.

Background

In February 2019, representatives of HBC, including Mr. Baker and other members of management, commenced discussions with representatives of HBC's European joint venture partner, SIGNA, about a potential sale to SIGNA of HBC's remaining interest in the joint venture (Asset Sale). Shortly thereafter, discussions ensued between Mr. Baker and HBC shareholders – representing, together with Mr. Baker, 57.7% of the outstanding HBC common shares (collectively, Majority Shareholders) – regarding the potential use of the proceeds of the Asset Sale to partially fund a privatization transaction involving HBC. The privatization transaction contemplated HBC buying back all of its outstanding common shares, other than those held by the Majority Shareholders, with the result that post-transaction HBC would be owned by the Majority Shareholders.

On March 27, 2019, Mr. Baker and other members of management informed HBC's lead independent director, David Leith, about Mr. Baker's desire to evaluate a potential privatization proposal along with the Majority Shareholders, contingent on the Asset Sale proceeding. Mr. Leith consented to Mr. Baker's sharing certain financial information with the other Majority Shareholders in the context of exploring a potential privatization transaction. Mr. Leith also consented to Mr. Baker's use of HBC's historical transaction counsel in connection with the initial evaluation of such a transaction.

Shortly thereafter, HBC's board of directors (Board) established a special committee of independent directors with a mandate to supervise the review of HBC's options with respect to the SIGNA joint venture and certain other businesses of HBC. At that time, the scope of the special committee's mandate did not expressly include the privatization proposal. In April and May 2019, the special committee retained counsel in connection with the possibility of receiving a privatization proposal and met to discuss potential modifications to its mandate as well as the potential appointment of financial advisers and an independent valuator in connection with any such proposal. During this time, Mr. Baker also reiterated his interest to the Board in evaluating the possibility of a privatization transaction.

The mandate of the special committee was not enlarged to consider a privatization proposal until June 9, 2019, three days after the special committee received the Majority Shareholders' proposal letter and proposed press release. Following consideration by the special committee, the Board also waived a standstill provision binding one of the potential Majority Shareholders in order to allow it to participate in the privatization proposal.

On June 10, 2019, HBC announced the Asset Sale and, minutes later, the Majority Shareholders announced their privatization proposal for HBC. The Majority Shareholders also informed the special committee that none of the Majority Shareholders were interested in an alternative transaction that would result in a sale of their interest in HBC. Beginning in the summer of 2019, The Catalyst Capital Group Inc. (Catalyst) pursued a competing bid to acquire shares of HBC.

In October 2019, HBC announced that it had entered into an arrangement agreement with the Majority Shareholders to privatize HBC (the Privatization Transaction). On November 25, 2019, HBC filed its management information circular for the special meeting of shareholders to vote on the Privatization Transaction. Following the special committee's rejection of Catalyst's offer on the basis that it was not capable of being completed without the support of the Majority Shareholders, Catalyst commenced its application to the Commission to block the Privatization Transaction. On December 6, 2019, the special committee issued a press release to provide additional information on the background to the Asset Sale and the development of the initial privatization proposal.

The Commission issued an interim order on December 13, 2019, delaying the shareholders' meeting to vote on the Privatization Transaction until HBC had delivered an amended information circular to the shareholders disclosing additional information on the background to the transaction and the board and special committee approval process.

For more details regarding the facts giving rise to the dispute and the submissions made by the parties, read our earlier Davies [bulletin](#).

The Special Committee Process

The Commission found that the process followed by HBC was compromised by Mr. Leith's decision to permit, on his sole authority, Mr. Baker's sharing of confidential information with the Majority Shareholders and Mr. Baker's use of HBC's historical transaction counsel without the benefit of a properly empowered special committee. In the Commission's view, the interrelationship between the Asset Sale and the privatization proposal gave rise to a conflict of interest that could only be managed by a special committee mandated to consider both transactions. In particular, the Commission noted that an earlier mandated special committee could have sought to negotiate

- the timing of the announcement of the Privatization Transaction relative to the Asset Sale, to give the market more time to assimilate the effect of the Asset Sale on HBC's financial position;
- the waiver of the standstill agreement binding one of the potential Majority Shareholders and any conditions that would be attached to the waiver; and
- the ability to consider superior proposals.

Although recognizing the uncertainty of whether an earlier, properly mandated special committee could have influenced or directed different results in a manner more protective of minority shareholders, the Commission required HBC to make further disclosures on the reasons for and effects of this delay in its amended circular. However, the Commission rejected the argument that the deficiencies in the process followed by the special committee were sufficient to cease-trade the transaction as abusive.

Inconsistencies in Disclosure

The Commission noted that HBC's information circular omitted material information that should have been disclosed to shareholders. After a review of the December 6 press release, Mr. Leith's affidavit and Mr. Leith's evidence under cross-examination, the Commission concluded that the presentation of the facts surrounding the evolution of the special committee process and mandate had inconsistencies. The Commission also took note of new material details that had emerged during the course of the hearing, including with respect to Mr. Baker's direct involvement in the negotiation of the Asset Sale and the special committee's preference for a longer duration

between the announcements of the Asset Sale and any privatization proposal. Accordingly, the Commission ordered that the circular be amended to provide a reconciliation of the disclosures made in the December 6 press release and in Mr. Leith's affidavit and testimony.

Disclosure of Benefits to Insiders

The Commission required HBC to disclose additional information regarding direct and indirect benefits to be obtained by directors and officers of HBC in the form of incentive compensation to be paid upon consummation of the Privatization Transaction and benefits to be obtained by the Majority Shareholders arising from the tax structure proposed to implement the Privatization Transaction.

The Commission noted that the amounts of the incentive compensation payouts were material information for minority shareholders to consider and that in negotiating or supervising the negotiation of material conflict of interest transactions, a special committee must be alert to all factors affecting value, including tax structuring. Because of the ever-present risk in a conflict of interest transaction that the interest of the conflicted parties may be favoured in the structuring of the transaction, including through the tax structuring of the transaction, it is important that the benefits of the tax structure to the conflicted parties be disclosed. If the special committee believes that it is necessary or appropriate for direct or indirect benefits to be conferred on certain parties, the information circular should include an explanation of the special committee's reasons for its recommendation.

Valuation Issues

The Commission was critical of the limitations of the real estate appraisal obtained by HBC with respect to the value of its flagship property and the effect of the appraisal on the valuation and fairness opinion delivered to the special committee in evaluating the Privatization Transaction. In ordering additional disclosures regarding the limitations on the scope of the review of the appraisal, the Commission noted that the appraisal scenarios had been directed to the appraiser by the special committee and had not been independently selected by the appraiser on the basis of its own professional judgment and assessments. The Commission concluded that, by virtue of the special committee's reliance on the appraisal, the valuation and fairness opinion obtained by HBC were similarly constrained and required remedial disclosure to address the impact of the appraisal's limitations on their contents.

Key Takeaways

- The decision reaffirms the guidance in Staff Notice 61-302 regarding the importance of a robust process and comprehensive disclosure in material conflict of interest transactions.
- Appropriate steps to be taken to manage conflicts of interest as soon as they arise include the following:
 - the early establishment of a special committee “before important decisions are made and rights are given up,” including with respect to the formation of bidding groups and the provision of confidential information;
 - the active engagement of the special committee in the evaluation and negotiation process, free from interference or undue influence by interested parties; and
 - the early involvement of independent counsel and financial advisers.
- Disclosure to the shareholders should include the following:
 - disclosure concerning the special committee's power to negotiate or supervise the negotiation of transactions and to consider alternatives;
 - comprehensive and accurate disclosure of the board's and the special committee's process and rationale for supporting a proposed transaction, and any other information material to the ability of minority shareholders to make an informed voting decision; and
 - disclosure of benefits that will be paid to directors and officers if a transaction proceeds.

- As for valuations,
 - neither the special committee nor the board should impose constraints on the valuation;
 - the special committee should test the work done by the valuator; and
 - the special committee should ensure that the valuator is free from undue influence.
- Although Multilateral Instrument 61-101 does not require the use of a special committee for all transactions regulated by the instrument, the decision reminds issuers that once a special committee process is undertaken in transactions that involve significant conflicts of interest, it will be subject to the same procedural and disclosure standards that would apply if a special committee were required. In each case, the relevant inquiry is whether effective measures were taken to mitigate risks to minority shareholders and to enable an informed shareholder vote.
- The decision reflects the Commission's increasingly activist role in policing board process and decision-making in conflict of interest transactions and, at the same time, demonstrates the Commission's restraint in the use of its cease trade power to sanction past conduct.

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