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M&A

M&A: A look back at 2021 and ahead to 2022

As the world worked towards returning to a “new normal,” Canadian public M&A deal volumes in 2021 outpaced those in 2020 on both a quarterly and an aggregate basis. In a year of increased deal-making activity, there was also no shortage of significant legal developments in Canadian public M&A.

Busted deal litigation in the aftermath of the pandemic

Since COVID-19 was declared a global pandemic in March 2020, there have been three notable Canadian M&A transactions that were the subject of “busted deal” litigation. These cases focused on assertions that the target had suffered a material adverse effect (MAE) or had otherwise breached the ordinary course interim operating covenants in the governing transaction agreement.

In *Rifco Inc. v. ACC Holdings Inc. and CanCap Management Inc.*, CanCap had committed to purchase Rifco by way of an arrangement. CanCap claimed that Rifco suffered an MAE and purported to terminate the transaction. In response, Rifco sought specific performance of the acquisition by CanCap in the Court of Queen’s Bench of Alberta. The case settled before the court disposed of the litigation, which included a payment by CanCap to Rifco and mutual releases.

In *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, which concerned a private M&A transaction, the Ontario Superior Court of Justice found that no MAE had occurred, nor had the ordinary course operating covenants been breached by actions taken by the vendor in response to the COVID-19 pandemic. The Court awarded specific performance in favour of the vendor and required Duo Bank to complete the acquisition.

In *Fairstone*, the Court adopted a legal test for an MAE similar to the test that applies in Delaware. This test requires an unknown event, a threat to overall earnings potential and durational significance. While each of these items were established in *Fairstone*, the Court held that no MAE had occurred because there was an exception for material adverse effects resulting from, among other things, emergencies, which included the pandemic.

In interpreting whether the ordinary course covenants had been breached, the Court found that the ordinary course covenant should be read in the context of the entire transaction. Given the emergency exclusion in the MAE clause, the Court concluded it would not be appropriate to use the more general ordinary course provision to effectively override the more specific MAE provision. Doing so would not read the contract as a whole – a cardinal rule of contract interpretation – but would instead read it as a series of unrelated, stand-alone provisions. The Court also found the target's response to the pandemic was consistent with its past practices.

Given the emergency exclusion in the MAE clause, the Court concluded it would not be appropriate to use the more general ordinary course provision to effectively override the more specific MAE provision.

The Court's decision in Fairstone stands in stark contrast to the November 30, 2020 decision of the Delaware Court of Chancery in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al*. In that case, the Delaware Court found that significant changes to the target's business in response to the COVID-19 pandemic violated the target's covenant to operate its business in the ordinary course consistent with past practices. The Court made this finding despite also having concluded that the pandemic did not constitute an MAE, as it was excluded from the definition by an exception. The *AB Stable* decision was appealed to the Delaware Supreme Court and a decision is pending.

Cineplex Inc. v. Cineworld Group plc is the latest busted deal to be litigated. The decision is still pending before the Ontario Superior Court of Justice following the conclusion of the trial earlier in 2021. The case raises similar ordinary course covenant and MAE interpretational issues to those considered in *Fairstone* and *AB Stable*, but also raises novel and complex damages issues.

On December 16, 2019, Cineworld and Cineplex entered into an arrangement agreement pursuant to which Cineworld agreed to acquire all of the issued and outstanding common shares of Cineplex for $34 per share in cash. The transaction was subject to a number of conditions, including the requirement to obtain *Investment Canada Act* (ICA) approval, as well as a more bespoke condition in favour of Cineworld that Cineplex not have more than $725 million in net debt at closing.

In response to the pandemic, Cineplex took a number of steps to minimize costs. These included implementing cash management strategies, reducing spending and ceasing to pay third-party suppliers such as landlords, movie studios and film distributors.

In June 2020, Cineworld withdrew its ICA application and delivered a notice terminating the arrangement agreement on the basis that Cineplex had failed to operate its business in the ordinary course and that an MAE had occurred. This was despite the fact that there was a specific carve-out in the MAE definition for an outbreak of illness that expressly allocated the risk of a pandemic to Cineworld.

Instead of suing for specific performance under the arrangement agreement, Cineplex accepted what it alleged to be Cineworld's repudiation of the deal and sued for damages. Cineplex's damage claim included $1.3 billion for the shareholders' loss of bargain – the difference between the $34 deal price and the market price following Cineworld's termination. For the 52-week period ending December 1, 2021, Cineplex's share price has ranged from a low of $8.11 to a high of $16.76.

Based on the *Fairstone* decision, Cineplex at first blush may appear to have the better legal position. However, Cineworld has sought to distinguish *Fairstone* in part on the basis that Cineplex took certain actions in response to COVID-19 with a view to ensuring that the net debt condition was not breached and not merely in good faith to preserve the value of the business for Cineworld's benefit.

Even assuming Cineplex wins the case on the merits, there are difficult damages issues that need to be resolved. The arrangement agreement is between Cineplex and Cineworld. Cineplex's shareholders are neither parties nor third-party beneficiaries under the contract. Accordingly, Cineworld argues that Cineplex is only entitled to damages suffered by the company – not the loss of bargain suffered by its shareholders.

In addition, Cineworld argues that there was an explicit specific performance clause that Cineplex could have invoked, but chose not to. If specific performance had been granted, the clause would have required Cineworld to perform its obligations and ultimately complete the transaction. Presumably Cineplex chose not to avail itself of this remedy in part due to the uncertainty as to whether Cineworld could have successfully been compelled to obtain ICA approval in the midst of the pandemic. It was not clear on what terms the federal government would have concluded that the transaction was of "net benefit to Canada" in circumstances where Cineworld may have been forced to close theatres, lay off employees and not comply – at least in the short term – with customary undertakings. Moreover, the arrangement agreement did not include a reverse break fee in favour of Cineplex if Cineworld failed to obtain ICA approval.

M&A practitioners are anxiously awaiting the Court's decision. In the meantime, parties should carefully consider the interplay between the ordinary course of business covenants and the MAE definition in a transaction agreement to ensure risks are clearly allocated. Specific closing conditions and additional negative covenants may also be negotiated to address the allocation of risk between transacting parties. On the damages front, parties may be inclined to negotiate liquidated damages clauses in the form of reverse break fees to limit a buyer's downside and achieve certainty of damages for a target in the event of a busted deal arising from a failure to obtain regulatory approval.

Implications of total return swaps in toehold accumulation strategies

On July 12, 2021, the Alberta Securities Commission (ASC) rendered its decision in connection with Brookfield Infrastructure's (Brookfield) unsolicited take-over bid (Offer) for Inter Pipeline Limited (IPL) and IPL's subsequent proposed white knight merger transaction with Pembina Pipeline Corporation (Pembina). The decision is the first in Canada to consider the use of derivatives to acquire a toehold position in the target and will likely have a chilling effect on the future use of this strategy.

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Between March and October 2020, Brookfield acquired an aggregate economic interest in IPL common shares totaling 19.65% of the outstanding shares. Of this amount, 9.9% was economic exposure in IPL through a series of cash-settled total return swap transactions (collectively, the Total Return Swap). Between November 2020 and January 2021, Brookfield and IPL engaged in discussions regarding a potential acquisition of IPL by Brookfield. In late January 2021, IPL's Board of Directors advised that it was not prepared to move forward with Brookfield's bid at the indicative offer price of $18.25 per share, which was payable in cash and up to 20% in Brookfield's common shares.

On February 10, 2021, Brookfield announced its intention to make the Offer at $16.50 in cash for each IPL share or 0.206 of a Brookfield common share for each IPL common share. Brookfield formally commenced the Offer 12 days later. On March 8, 2021, the IPL Board announced that it had rejected Brookfield's Offer. In the same month, the IPL Board adopted a Supplemental Rights Plan (poison pill). The new rights plan expanded the definition of "Beneficial Ownership" in IPL's existing shareholder rights plan (Rights Plan) to include certain financial derivatives held by an acquiror, including the IPL shares subject to the Total Return Swap, as equivalent to beneficial ownership.

On June 1, 2021, IPL announced that it had entered into a white knight transaction with Pembina where Pembina agreed to acquire each of the outstanding IPL common shares in exchange for 0.5 of a Pembina common share pursuant to a plan of arrangement.

On June 4, 2021, Brookfield increased its Offer to $19.50 per IPL common share. The revised Offer was rejected by the IPL Board on June 9, 2021. One day later, Brookfield announced that it had initiated proceedings before the ASC seeking, among other things, the ASC's intervention with respect to IPL's alleged inappropriate defensive tactics.

On June 18, 2021, Brookfield revised the Offer to include an option for IPL shareholders to elect 100% cash consideration at its increased offer price. Brookfield stated that it was further prepared to increase its offer to $20.40 per IPL common share, subject to a successful challenge at an ASC hearing against the $350 million (4.2%) break fee payable by IPL to Pembina in the event that IPL accepted a superior proposal.

In its application to the ASC, Brookfield sought orders to cease trade IPL's Rights Plan and Supplemental Rights Plan. These plans had the effect of preventing Brookfield from acquiring 5% of the IPL common shares in the market as

otherwise permitted by the take-over regime. As well, Brookfield applied to cease trade the proposed Pembina plan of arrangement and to restrain the break fee that IPL had agreed to pay Pembina.

IPL cross-applied to the ASC for orders requiring that Brookfield provide public disclosure regarding the material terms of the Total Return Swap and that the IPL shares relating to the Total Return Swap (TRS Shares) be considered as securities beneficially owned, or over which control or direction is exercised, by Brookfield or by a person acting jointly or in concert with Brookfield. This would have resulted in the TRS Shares being excluded from determining whether the statutory 50% minimum tender condition applicable to the Offer was satisfied.

IPL also sought an order deeming the TRS Shares to be voted at the upcoming meeting of IPL shareholders in connection with the Pembina arrangement, either in the same proportion for and against the special resolution of IPL shareholders to approve the Pembina arrangement as all other IPL common shares voted at the meeting, or in the alternative, to prevent the TRS Shares from being voted at the meeting.

The ASC dismissed Brookfield's application, finding that Brookfield had not demonstrated that IPL had engaged in improper defensive tactics either by implementing its Rights Plan and Supplemental Rights Plan or by agreeing to the break fee.

In response to IPL's application, the ASC panel, in short oral reasons delivered when issuing its order, found that the economic interest in the TRS Shares had been separated from the ownership of, and voting control over, those shares. The ASC therefore concluded that the owners of the TRS Shares did not share the same motivation to maximize shareholder value as other IPL shareholders.

The ASC did not find that Brookfield beneficially owned the TRS Shares or that the swap counterparty was acting jointly or in concert with Brookfield. Rather, the ASC was taking action to address "empty voting" concerns in this case. The ASC also acknowledged that the identities of the holders of the TRS Shares could not be ascertained. Accordingly, the ASC ordered that an adjustment be made to the minimum tender condition for Brookfield's bid such that Brookfield was not permitted to purchase IPL common shares under the Offer unless more than 55% of IPL common shares – excluding those beneficially owned by Brookfield or parties acting jointly with it – had been deposited (the Modified Minimum Tender Condition). This remedy had substantially the equivalent effect as deeming Brookfield to be the beneficial owner of the TRS Shares. The ASC also required Brookfield to make enhanced disclosure regarding the nature of Brookfield's relationship with its swap counterparty, including the name of and any material information concerning its commercial relationship with such party.

The ASC's order is particularly notable in light of the Canadian Securities Administrators' (CSA) previous statements and policy positions on derivatives. In 2013, the CSA proposed that investors include "equity equivalent derivatives" – equity derivative positions that are substantially equivalent in economic terms to conventional equity holdings, including total return swaps – in calculating their ownership levels for the purposes of determining whether the early warning reporting threshold has been exceeded. The CSA's original proposal had sought to provide greater transparency as to potential "hidden ownership" positions

accumulated by sophisticated investors through the use of derivatives to achieve economic exposure to public companies while avoiding public disclosure. In 2014, however, the CSA decided not to implement the proposal in response to market feedback expressing opposition to the change properly structured. Market participants generally took this as tacit approval by the CSA of the use of total return swaps in building toehold positions without the need for public reporting or any changes to transaction terms.

The ASC's written reasons, which have not yet been published, will be critical in understanding the implications of the decision for toehold accumulation and stake-building strategies.

Osler acted as legal counsel to the swap counterparty in connection with the ASC proceedings.

Policy of predictability of the take-over bid regime and preservation of the shareholder franchise

Since May 2016, bids under National Instrument 62-104 – Take-Over Bids and Issuer Bids have been subject to a mandatory minimum tender requirement of more than 50% of the outstanding securities of the class that are subject to the bid, excluding those beneficially owned by the bidder and its joint actors. On February 23, 2021, the OSC released the reasons in the first case to address a request for a discretionary exemption from the 50% mandatory minimum requirement, unsuccessfully brought by ESW Capital Inc. (ESW), the largest shareholder of Optiva Inc. (Optiva).

ESW, a holder of approximately 28% of the Optiva subordinate voting shares, had sought an exemption from the OSC from the mandatory minimum tender requirements before it made an unsolicited offer to acquire the outstanding shares of Optiva that it did not already own. ESW's proposed bid price was at a 122% premium to the 20-day volume-weighted average price and a 92% premium to the 10-day closing high. Rival shareholders, Maple Capital Partners Inc. and EdgePoint Investment Group Inc., who collectively owned 40.5% of Optiva, were expected to reject ESW's offer. Since ESW's 28% had to be excluded from the calculation, Maple Rock and EdgePoint's shares were sufficient to block ESW's bid from meeting the 50% threshold unless a discretionary exemption was granted. ESW alleged that the two insiders were not aligned with minority shareholders. Accordingly, ESW believed that the minimum tender requirement should exclude the shares of ESW, MapleRock and EdgePoint.

In dismissing ESW's application, the OSC followed its earlier decision in Aurora Cannabis Inc. (Re) in which it rejected an application to shorten the 105-day minimum tender period. The OSC emphasized the essential role of predictability of take-over bid regulation in ensuring that market participants know with reasonable certainty what rules govern the bid environment. Absent exceptional circumstances or improper or abusive conduct, exemptive relief will not be granted.

It is interesting to contrast the OSC's decision with the ASC's decision in *Brookfield/Inter Pipeline*, where the ASC chose to amend the minimum tender condition.

The OSC emphasized the essential role of predictability of take-over bid regulation in ensuring that market participants know with reasonable certainty what rules govern the bid environment.

One of the consequences of the 50% minimum tender condition under the bid regime is that it enhances the leverage of major shareholders vis-à-vis the bidder and the target. The OSC, in its reasons, noted that this could result in bids not being made or shareholders being deprived of the ability to respond to a bid. Market participants will note that the extraordinary premium provided by ESW was insufficient to justify the granting of exemptive relief.

Outlook for 2022

M&A activity in Canada has been remarkably robust so far in 2021 relative to this time last year. This is understandable given the uncertain and unpredictable 2020 that was defined by the global pandemic, trade wars, geopolitical tensions, the U.S. federal election and the fragility of Canada's minority parliament. During the first three quarters of 2021, there were 2,257 announced M&A transactions having approximately $114 billion in total transaction value. This represents a nearly 300% year-over-year increase in transaction value and a nearly 20% year-over-year increase in transaction volume.

Transaction volumes have been driven by several factors. One such factor is the renewal of cross-border inbound and outbound M&A flow. Another is the active deployment of capital by private equity sponsors and other private capital pools, including pension funds, sovereign wealth funds, hedge funds and family offices. Further contributing factors include strategic M&A in furtherance of domestic and global growth objectives, a low interest rate environment, and facilitative debt and equity capital markets.

These fundamental drivers of M&A activity remain strong. Consequently, we are continuing to observe a robust cycle of deal-making activity for the final stretch of 2021 and the first half of 2022 across a range of sectors, including technology, real estate, metals and mining, and consumer products.

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