Do I Hear An Eco? OSC Approach To Share Issuances In Proxy Fight Echoes The Approach In Take-Overs

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On June 16, 2017, the Ontario Securities Commission ("OSC") released its Reasons for Decision in the *Re Eco Oro Minerals Corp.* case (the "Decision"). These reasons provide additional guidance regarding the use of a share issuance as a defensive tactic in a fight for corporate control, following other cases such as *Dolly Varden* in this regard (please see our bulletins dated July 25, 2016 and October 26, 2016). In *Eco Oro*, the OSC overturned a decision of the Toronto Stock Exchange ("TSX") to allow an issuance of shares in the middle of a proxy fight without requiring shareholder approval.

The Decision is lengthy with much of the focus on procedural and jurisdictional issues such as the standing of various parties to appear and make submissions at the hearing, the ability of the OSC to make the order it did, and the nature of the OSC's role in reviewing a decision of the TSX. This summary will focus on those portions of the Decision which explain the OSC's reasons for overturning the TSX's approval. It also briefly addresses the somewhat conflicting decisions in the B.C. courts involving the same facts.

Background

The facts and parties involved in the Eco Oro case are complicated but the essential facts may be summarized as follows:

- Eco Oro's shares are listed on the TSX. Its principal asset was an arbitration claim against the government of Colombia for the loss of a mineral asset.
- Several shareholders[1] (the "Participating Shareholders") had agreed, pursuant to an Investment Agreement, to expend significant sums of money to fund Eco Oro in pursuing the arbitration.
- Under the Investment Agreement, the Participating Shareholders received, among other securities and rights, notes that were convertible, at the option of Eco Oro, into common shares of Eco Oro ("Notes"). The Participating Shareholders were also to receive common shares representing in excess of 100% of Eco Oro's then-outstanding common shares or, in the alternative if the common share issuance was not approved by Eco Oro's disinterested

shareholders, contingent value rights ("CVRs") entitling the Participating Shareholders to approximately 70% of the proceeds of the arbitration.

- Because the common share issuance exceeded 25% dilution and was offered at a discount to market, disinterested shareholder approval was required pursuant to the *TSX Company Manual*. At the shareholder meeting, the common share issuance was voted down and, as a result, Eco Oro issued the CVRs instead. It also issued the Notes, the issuance of which had not been subject to shareholder approval.
- Certain shareholders (the "Opposing Shareholders") were upset by the terms of the Investment Agreement including the issuances of the shares, Notes and CVRs. The Opposing Shareholders brought an oppression claim in the Supreme Court of British Columbia and also requisitioned a new shareholder meeting for the purpose of voting in a new board of directors.
- In response, Eco Oro called a shareholder meeting and set a Record Date for determining shareholders entitled to vote.
- Eco Oro then approached the Participating Shareholders and obtained their written (albeit non-binding) support for the existing board of directors. It also obtained their permission for an accelerated conversion of the Notes into common shares so that the shares would be issued before the Record Date and therefore entitled to vote at the requisitioned shareholder meeting.
- The issuance of the shares on conversion of the Notes was subject to approval by the TSX, and Eco Oro submitted an application. One of the key questions to be answered in determining whether the TSX will require shareholder approval for a share issuance is whether the issuance will materially affect control of the issuer. In this regard, Eco Oro's application stated that the issuance would not materially affect control and the TSX specifically confirmed this with Eco Oro.
- The application made no mention of the proxy contest or support letters from the Note holders. Also, the TSX undertook no review of Eco Oro's recent disclosure record – which would have revealed the existence of the proxy contest. Accordingly, the TSX proceeded on the basis that the application was routine. The TSX did not therefore take into consideration that there was an ongoing proxy contest or that the recipients of the shares had given support letters for the existing board. There was some evidence that Eco Oro had discussed the proxy contest with the TSX prior to submitting the application; however, the OSC determined that the TSX Manager who approved the application either did not know of the proxy contest or, if disclosed orally, did not absorb the information. The share issuance, including the accelerated time frame, was therefore approved.
- Eco Oro announced the issuance of the shares upon conversion of the Notes only after it had been completed.
- In light of the announcement, the Opposing Shareholders applied to the OSC to reverse the TSX decision. According to press releases issued by the Opposing Shareholders, the vote on replacing the Board was going to be very close and the newly issued shares had the potential to swing the vote in favour of the incumbent directors.
- As noted above, the Opposing Shareholders also applied to the B.C. Supreme Court to set aside the Note conversion based upon an oppression claim.

The OSC Decision

As noted above, much of the OSC's decision is focussed on procedural and jurisdictional issues. In this regard, the OSC granted both the Opposing Shareholders and Participating Shareholders standing to appear and make submissions (Eco Oro, TSX and OSC had standing as of right). Based on the test applied by the OSC to its review of the TSX decision, the OSC held that it would consider the matter de novo – that is, it would reconsider the application for approval of the share issuance as if it were being heard for the first time and substitute its decision for that of the TSX. The OSC also explained how, in its view, it had jurisdiction to craft the order it imposed on the parties given its unusual nature.

On the key point of whether the share issuance in the midst of a proxy fight should be allowed, the OSC was clearly of the view that, in the circumstances, it should not. This determination turned on whether the issuance would "materially affect control".

The *TSX Company Manual* elaborates on what is meant by this concept and states that it means the ability to influence the outcome of a vote of security holders and, while it will depend on the circumstances of a particular case, a new holding of more than 20% will be considered to materially affect control. At the hearing, the TSX elaborated on its considerations regarding whether a private placement materially affects control by saying that, in applying the test, it looked at "the concept of enduring control", not one-off voting situations.

The Eco Oro share issuance did not result in a new 20% shareholder. However, one of the Participating Shareholders did increase its holdings from approximately 10% of Eco Oro up to almost 16%. These additional shares could well affect the voting results in the proxy fight.

The OSC was of the view that the share issuance should not have been allowed and set aside the TSX decision. In reaching this conclusion, the OSC pointed to a number of factors:

- The shares were not issued until Eco Oro received the letters of support from the Participating Shareholders, which was part of an effort to influence the vote.
- The share issuance did not raise any new money for Eco Oro – it just improved the balance sheet by substituting equity for debt. Further, the conversion did not diminish in any way the restrictive covenants arising from the Notes (including restrictions on the ability of Eco Oro to raise new funding without permission of the Participating Shareholders) and the interest on the Notes was found to be nominal. This was unlike the situation in Dolly Varden where the share issuance had been in response to a genuine financial need and had been initiated before the fight for control began.
- Any improvement to Eco Oro's balance sheet would have had little practical positive impact, because the Participating Shareholders held the right to the vast majority of the proceeds from Eco Oro's sole material asset, all the restrictive covenants arising from the CVRs and the Notes remained in effect with no diminution, and the interest rate on the outstanding debt was nominal.
- For the reasons above, there was no compelling business reason to accelerate closing so as to complete the issuance before the Record Date – other than for the tactical purpose of tipping the vote in favour of management.

- This tactical motivation demonstrated that management was attempting to influence the vote and any bona fide business purpose for the issuance could not negate this tactical motivation.

The OSC found that the TSX had proceeded on incorrect principles in determining whether there was a material effect on control. Limiting itself to "some abstract consideration of voting blocks" and not taking into account where the vote stands in relation to a pending meeting was incorrect. The OSC did take these considerations into account, and found that the share issuance would materially affect control because of its potential to change the results of the pending shareholder vote. The OSC also determined that the TSX did not have (or did not consider) all relevant facts concerning the share issuance, particularly the existence of the proxy fight and the support letters, and the effect the share issuance could have on the results of the proxy fight. The OSC was clearly motivated by a desire to ensure shareholders had the ability to decide the future of the company "without management's ability to manipulate the vote". This was determined to be within the jurisdiction of the OSC as a securities regulator because to allow such conduct "would directly affect the integrity of the Ontario capital markets contrary to the Commission's mandate and the public interest".

Because the share issuance had already closed, the OSC's order required Eco Oro to call a shareholder meeting in order for the shareholders to have an opportunity to vote on the issuance and, if the shareholders vote so required, to reverse the issuance of the shares. In the meantime, the shares were not to be counted in any shareholder vote pending shareholder approval. Suffice it to say, the OSC found it had the jurisdiction to make its order.

B.C. Court Proceedings

As noted above, the Opposing Shareholders had also applied to the B.C. Supreme Court for similar remedies as had been requested of the OSC – essentially to set aside the share issuance on the basis that the actions of the Eco Oro board constituted oppression.

In its initial decision, the B.C. Supreme Court held that the share issuance did not constitute oppression. The judge was not persuaded that the Eco Oro Board's actions in issuing the shares were oppressive at law. In fact, rather than viewing the issuance of the shares as being manipulative, the trial judge was of the view that the Opposing Shareholders should have anticipated that the Notes would be converted into shares and that it was "entirely reasonable" for the conversion to occur before the Record Date so that the shares could be voted at the requisitioned shareholder meeting. The Court also relied on the business judgment rule in paying deference to the Eco Oro Board's decision to convert the Notes and issue the shares.

In another twist, however, upon learning that the OSC had issued its ruling preventing the new shares from being voted at the shareholder meeting, the judge concluded that his and the OSC's decision were, "in effect, […] at odds," and so he issued an order to adjourn the shareholder meeting. Thus, the Opposing Shareholders were prevented, for the time being, from possibly voting out the incumbent Board.

On appeal to the B.C. Court of Appeal, the order to adjourn the meeting was set aside, as the Court of Appeal found that the OSC's order and the trial court's decision were not

in actual conflict and that the trial court had no basis to "attempt to modify or delay the predictable consequences of the OSC's order". Both the OSC ruling and the B.C. Supreme Court's decision on oppression had been appealed. However, on August 1, 2017, Eco Oro announced that it had entered into a "comprehensive settlement agreement" with a number of its shareholders which, subject to shareholder approval of various corporate steps to settle the disputes between the parties, should result in the appeals being dropped by the parties to the settlement agreement. If that happens and the appeals do not proceed, the decisions as discussed above will stand as is without further judicial analysis.

Lessons to be Drawn

The circumstances surrounding the Eco Oro decision are fairly unique but the case does speak to the OSC's willingness to become involved in proxy contests. The decision also provides additional guidance on the use of private placements or other share issuances as a defensive tactic in a contest for control. The key lessons are as follows:

1. Shareholder activists and unsolicited bidders can be expected to draw future control contests to the TSX's attention early in the process in an effort to pre-empt any defensive share issuances which may influence the outcome of the contest.
2. The TSX is likely to be more vigilant in reviewing future applications for approval of share issuances and is likely to take a more expansive view of whether an issuance will materially affect control than it has in the past. Certainly, if an issuance is proposed during a control contest, and may affect its results, the TSX will probably take the view that control will be materially affected.
3. It is extremely important that issuers be forthcoming and provide the TSX with a complete picture of their transaction at the time of seeking approval for any share issuance. This is particularly true if there is a shareholder dispute, proxy contest or a take-over bid ongoing at the time, as these events may alter the TSX approach towards determining whether a transaction would have a "material effect on control" of the company. While it is not clear that disclosure of the proxy battle would have affected the TSX's decision in *Eco Oro*, the OSC did dwell on the issuer's non-disclosure at length in its decision, despite some evidence of an oral conversation between Eco Oro and the TSX Manager.
4. Future share issuances during the course of a proxy contest that tip the vote in management's favour, and which are done without a compelling business reason, are unlikely to withstand OSC scrutiny. The OSC's approach in this decision appears to be consistent with its position in take-over cases, as exemplified in *Dolly Varden*, of letting shareholders have their say without "manipulative" share issuances. While the OSC in *Eco Oro* declined to make an order under its broader public interest jurisdiction, having made its decision based on its power to review the TSX decision, the wording of the OSC's reasons in *Eco Oro* suggests that the OSC may exercise its public interest jurisdiction if called upon in a future case in the right circumstance. The OSC clearly was of the view that what had happened would affect the integrity of the capital markets and the public interest.
5. The decision raises the interesting question of forum and proceeding shopping. The Opposing Shareholders clearly had more success in persuading the OSC as to the fairness of their case in the context of the TSX's jurisdiction over share issuance than they did the B.C. Supreme Court in the context of oppression. If

the B.C. Court had not issued an order adjourning the shareholder meeting, the vote might well have gone ahead and, with the benefit of the OSC order, the Opposing Shareholders might have been successful. The results in this matter suggest that, arguably, the broader public interest focus of the OSC may be more accommodating to dissidents trying to block a share issuance than the route of bringing an oppression application where judges are more likely to pay deference to board decisions.

[1] The shareholders were involved to different extents and had different shareholdings in Eco Oro, as well as somewhat different rights and interests. For the sake of simplicity, they are treated as a uniform group in this summary.

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