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Will the TSX's Restrictions on Stock-for-Stock M&A Deals Send More Acquirors to the Capital Markets?

By Thomas Yeo

The Ontario Securities Commission's decision in the *Hudbay Minerals* case in January 2009 marked the beginning of the end for Hudbay's acquisition of Lundin Mining and the beginning of the end for the largely unfettered use of company stock as transaction currency in Canadian M&A deals.

For many years, while most other major stock exchanges required shareholder approval for dilutive acquisitions, the Toronto Stock Exchange did not require shareholder approval for a listed company issuing stock in connection with the acquisition of another public company unless the transaction "materially affected control" of the listed issuer or the TSX otherwise exercised its discretion to require a shareholder vote. Over the years, the TSX had raised the possibility of amending its rule to require a shareholder vote above a certain threshold of dilution, but the proposals never gained much momentum. In the meantime, acquirors structured deals using stock in lieu of cash without much fear of the TSX exercising its discretion to require a shareholder vote, even in the most highly dilutive transactions.

That all changed when the OSC ruled that the TSX should have exercised its discretion to require approval by Hudbay's shareholders for the proposed acquisition of Lundin, given the 100% dilution involved and the transformational nature of the transaction. The OSC made this ruling even though it agreed with the TSX that the transaction did not materially affect control of Hudbay. With the market suddenly unsure of exactly when shareholder approval might be required, the TSX soon published a request for comments on a proposal to require shareholder approval for acquisitions of public companies resulting in dilution to existing shareholders of more than 50%. By November of 2009, the TSX had enacted a new rule, albeit at a lower threshold of 25% to trigger the shareholder approval requirement.

Concerns with the New TSX Rule

Despite bringing the TSX in line with other major exchanges, the new rule has not been without controversy, as evidenced by the widely divergent comments received by the TSX when it first proposed the rule. While many expressed support for the rule, numerous commentators argued that TSX issuers tend to be smaller than listed companies on major U.S. and other stock exchanges and that imposing a shareholder approval requirement would be unduly restrictive for such issuers. In particular, as the TSX acknowledged in its April 2009 Request for Comments, resource issuers tend to engage in a substantial amount of M&A activity and generally use securities as consideration in an effort to preserve cash for exploration and development.

Concern has also been expressed that the rule will put strategic acquirors at a disadvantage against financial players who are able to offer cash consideration without the uncertainty of a veto from their shareholders. Even without competition from financial players, an acquiror requiring shareholder approval may be faced with a target's board attempt to mitigate the risk of a failed deal by requesting a reverse break fee payable in the event of a failed shareholder vote.

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The Impact of the TSX Rule on Canadian M&A

It is still too early to assess the full impact of the TSX's new rule since M&A activity has not yet returned to its frothy highs of 2007. That said, while we can expect to see some impact on the structure of M&A deals, the TSX's shareholder approval requirement may not significantly dampen M&A activity, but may lead to a boom in capital markets activity.

The new rule will lead to more strategic acquirors looking to finance deals with cash, or a mix of stock and cash, to avoid a shareholder approval condition that would make their offer less attractive to the target or that the acquiror may want to avoid for reasons related to cost, distraction or deal uncertainty. We have seen a recent example of that in the U.S. context, as Kraft Foods reworked its mix of stock and cash in its bid for Cadbury to avoid triggering the New York Stock Exchange's 20% dilution threshold for shareholder approval. Originally Kraft intended to seek shareholder approval and even called a meeting and mailed a proxy statement, only to have its largest shareholder publicly oppose the deal. By reducing the amount of stock to be issued and selling off some of its pizza brands to fund an increase in the cash consideration, Kraft was able to proceed with the deal over the objection of its major shareholder, Warren Buffett's Berkshire Hathaway.

Public Offerings Instead of a Shareholder Vote

In Canada we are likely to see more capital markets activity in connection with strategic M&A transactions. Bidders looking to finance a cash offer can undertake a public offering of stock to raise the necessary money. While such an approach may end up with the same level of dilution for an issuer as if it had issued the stock directly to the target's shareholders, the TSX has made clear that its 25% dilution threshold is not meant to apply to a widely available public offering even if that would result in more than 25% of a listed issuer's shares being issued. In such a public offering, existing shareholders would presumably be able to protect against dilution by purchasing additional shares from the public offering and the cash consideration received by the company is transparent for all shareholders. This is not the case with private placements, however, and the TSX's rules clearly spell out that shares to be issued on a concurrent private placement are taken into account in determining whether the 25% dilution threshold has been triggered.

A public offering to finance an acquisition will have its own challenges, though, and may not completely remove conditionality from a transaction. If the proposed transaction is one that would constitute a "significant acquisition" on the basis of the complex tests set forth in the Canadian prospectus rules (which would seem likely if the consideration to be paid is substantial enough to result in 25% dilution), the prospectus for any concurrent public offering would need to include comprehensive information on the target company, including audited historical financial statements and pro forma financial statements for the new combined entity. In hostile transactions, this is not significantly different from the previous state of affairs since the acquiror's takeover bid circular needs similar prospectus level disclosure, including pro forma financial statements, if stock is being paid as part of the consideration.

However, in a friendly stock-for-stock transaction, parties previously could often reach agreement on a transaction and then proceed to prepare a proxy circular for the target's shareholder meeting after announcing the deal, giving the parties time to pull together the financial and other information needed for the proxy statement to contain "prospectus-like" disclosure. If a friendly acquisition is to be financed through a public offering, the target and acquiror will need to be working on the required prospectus disclosure concurrently with definitive transaction documentation and will need to be prepared to launch the offering quickly upon announcement.

Of course, transactions structured as a takeover bid are subject to the requirement for committed financing, with conditions permitted only if the offeror reasonably believes the possibility to be remote that if the conditions of the bid are satisfied or waived, the offeror will be unable to pay for the securities deposited due to a financing condition. We are likely to see bought deal letters signed concurrently with transaction announcements so that the only risk regarding financing will be the traditional bought-deal termination rights granted to underwriters, such as a "disaster out." Issuers with existing shelf

prospectuses in place will also have the advantage of going straight to a prospectus supplement without the delay of the regulatory review period associated with the filing of a preliminary short form prospectus.

A Canadian Solution: Subscription Receipts

One benefit for Canadian acquirors is that the Canadian market is well-accustomed to subscription receipt offerings, unlike jurisdictions such as the United States where the subscription receipt structure is still a foreign concept. Subscription receipt offerings allow an issuer to raise capital to finance an acquisition through the sale of subscription receipts that entitle the holder to automatically receive a security of the issuer on the closing of the acquisition. The subscriber pays in full when the subscription receipt is issued, and the funds are held in trust until such time as the acquisition closes and the subscription receipts convert into the underlying security. In the event that the acquisition does not close by a specified date, the subscriber's money is returned, with interest, and the subscription receipts are cancelled.

These structures are attractive because they ensure that the acquiror has the cash needed to complete the acquisition well in advance of closing but without the acquiror's having to find a way to deploy the additional capital if the acquisition ultimately does not close. Viterra, formerly Saskatchewan Wheat Pool, used the structure quite effectively in its successful 2007 hostile takeover bid for Agricore United. Viterra completed three separate public bought deal offerings of subscription receipts, as well as a private placement, between January and April 2007, allowing it to increase the amount of cash offered to Agricore shareholders each time.

Seasoned issuers may even be able to raise capital through the direct issuance of equity, without the need for subscription receipts. In November 2009, Brookfield Infrastructure Partners LP raised C$615.5 million in a public offering of limited partnership units to finance its participation in the recapitalization of an Australia-based publicly traded infrastructure group. That offering involved the issuance of more units than the limited partnership had outstanding. This suggests that some issuers may be able to raise new equity in amounts that would have required securityholder approval had the equity been issued directly as consideration in an acquisition, without having to make the equity raise conditional on the acquisition's closing. Such cases will require a lot of confidence from investors that the acquisition will be completed and that, if it is not completed, management will be able to find alternative means of earning a return on that capital.

Canada's short form prospectus and bought deal regimes are conducive to the types of offerings noted above; they allow issuers and underwriters to complete deals relatively quickly and reduce financing risk early in an M&A transaction. In contrast, bought deals are not done in the U.S. market, and overnight marketed deals are still rare in that market. Coupled with a lack of any market for subscription receipt offerings, U.S. issuers are less likely than their Canadian counterparts to turn to the public markets to finance acquisitions from the outset and, instead, are more likely to try to finance acquisitions through debt or by seeking shareholder approval for a stock-for-stock deal.

The Old (Fairly) Reliable Solution: Debt

Of course, as the debt markets open up again, debt financing will be another means for Canadian issuers to finance acquisitions with cash as opposed to stock. This too is likely to lead to more capital markets activity as companies look to refinance expensive bridge financing with public debt, following a successful acquisition.

Conclusion

As both M&A and capital markets activity continue to find their footing after the last few tumultuous years, it is still far too early to determine the full effect of the TSX's rule on shareholder approval for dilutive acquisitions. However, the rule does bring the TSX in line with other major exchanges, and Canada's capital markets already appear to be better suited than others to adapt to an increased need for issuers to raise equity quickly in the context of an M&A transaction.