Rules of engagement

Changes to Canada's take-over rules by the Canadian Securities Administrators mark the first time in the country's history that the guidelines on take-over bids are nationally harmonized. However, they also change the relationship between buyers, targets and their shareholders. What impact will they have, and how will they change Canadian M&A? Mergermarket, in conjunction with Citi, asked four experts to discuss their thoughts on the changes, set to come into play on May 9.

Mergermarket (MM): The new take-over rules announced by the Canadian Securities Administrators include a provision that increases the number of days bidders must keep offers open for from 35 to 105. What does this change for targets and bidders?

GK: The extension in the timetable is likely to have a chilling effect on hostile M&A in Canada. One can argue, whether that will be a good or bad thing from a policy perspective. As an M&A practitioner I believe hostile M&A has a role in the market.

The issue comes down to financing. Take-over bids in Canada need to be fully financed when they're launched. An extension to this timetable, whereby you don't have the chance to conclude a hostile transaction even in the best circumstances for 105 days after you launch, puts acquirers and their banks in a difficult position, because the world can change significantly in 105 days. It'll be hard for banks to be willing to extend credit to finance these deals, knowing they're going to be out there for nearly a third of a year.

It's true that many hostile bids become friendly over time, therefore you have an opportunity at that point to shorten the timetable. But if you're looking at the outset of an offer period and you see it's 105 days...that's a lot of time, during which you run the risk of other buyers coming in. This lengthy period is

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unprecedented in comparison to other developed markets. I think it will be negative in the short term, but over time the market will adjust to it.

Instead of going to the shareholders with a bid, hostile bidders may opt to launch a proxy solicitation contest to replace the incumbent board with people who are more receptive to an acquisition. The threshold for shareholder resolutions in Canada is relatively low. It'll be interesting to see if people gravitate toward that tactic and we end up with large proxy battles.

AC: This changes the dynamics of the take-over defence program. Now, target shareholders have more time to organize and engage. Consider the example of a friendly acquisition in the old regime, the acquirer would still have to get the required majority of shareholders to agree, something that takes 30 days to arrange. With this in mind, 35 days for a hostile bid is very short. Now that's 105 days, and so has implications for take-over defence.

It is going to settle in that take-over defence can happen once a hostile offer is made. In a way, it will help defending firms not have to prepare preemptively as much. There will be more talk more about governance, leadership and the roles of boards and shareholders.

JE: The longer bid period will increase deal risk and financing costs for hostile bidders, and will certainly make bids more challenging for them. Target boards have had a relatively short period of time in Canada — compared with US target boards — to respond to a bid. Going forward, target boards will have more breathing room to evaluate a hostile bid, seek value-enhancing alternatives, or convince shareholders to reject the bid and stay the course.

However, the new rules do not simply provide an extended period of time for targets to respond to a bid — they will also undoubtedly strengthen a target board's negotiating leverage with the bidder. Requiring that bids remain open for 105 days will increase deal uncertainty for hostile bidders, exposing them, for example, to interloper risk for a much longer period of time. As a result, I think many bidders will be more motivated to negotiate a friendly transaction. This is especially the case

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>
> Grant Kernaghan, Citi

because the new rules give target boards the ability to lessen these deal risks for bidders by giving target boards the right to abridge the 105-day period to 35 days.

Hostile bidders will also be entitled to a shorter bid period if the target board provides one to a white knight. For example, if the target board subsequently enters into a white-knight deal with a 35-day period, then the hostile bidder will be able to amend its bid to shorten its 105-day period to match the period provided to the white knight. This shorter bid period will run from the date when the bidder launched its hostile bid, giving it a first-mover advantage over the white knight.

YA: This whole process is really a bargaining process between Quebec and Ontario, and it's an attempt to make it a little less friendly for hostile take-overs, which are fairly rare. All of the measures they've taken – including the 105 day extension — can be waived by a board that agrees with the transaction, bringing the process back to 35 days much like the old system. It's really an attempt to be a bit more stringent with the hostile take-overs, but we are still far more accepting and friendly of hostile take-overs in Canada than most US jurisdictions.

MM: Does the new minimum tender requirement — outlining that bidders must get more than 50% of target shares to succeed — hinder various kinds of deals such as partial bid, minority stakes and attempts to buy companies with significant minority shareholders? Will this make Canada's M&A market less competitive?

JE: The 50% minimum tender condition will prohibit the ability to make "any or all" bids. In addition, partial bids will be more difficult as a result of the new minimum tender requirement.

A non-waivable 50% minimum tender condition provides a voting mechanism that allows shareholders to make a collective decision to sell control of the company. Such a requirement would not be unique to Canada. In the UK, take-over offers are subject to a minimum acceptance condition of 50%-plus one. In addition, the new bid regime effectively codifies existing permitted bid terms (which also contain a minimum tender condition requirement) commonly found in Canadian poison pills.

Although bidders were not required to include a minimum tender condition under the old rules — or could choose to waive it — as a practical matter most bidders include a higher minimum tender condition, such as 66.6%, in order to ensure they can squeeze out the non-tendering shareholders and acquire 100% of a target.

There will be situations where a small number of shareholders — which may include management or other insiders — holding a significant number of shares may be able to influence the outcome of a bid due to the size of their collective holdings. Depending on the size of their holdings, the 50% threshold may be difficult, if not impossible, to achieve. The Canadian regulators have acknowledged that the new regime will provide control blockholders with more leverage. In some cases, depending on the parties' objectives, a proxy contest to replace the board rather than a hostile bid may be a preferable route.

GK: I don't think it will hinder those sorts of offers per se. That sort of deal structure is relatively uncommon, and there is still a route to execute a partial tender if that's what you want to do. What it does is it provides certainty to the market that if you're seeking to take control via a bid: there is a standard that you will be held to. Therefore you can't start off a take-over bid with the intent to take control, and then just take up shares to build up a significant minority position if you don't get it. Doing so would allow these "failed" bidders to be a spoiler. It therefore removes the coercion on shareholders to accept an offer because they don't want to run the risk of a potential hostile bidder having a 30% or 40% stake in a company that could be disruptive going forward. That's not a healthy state for a company to be in.

YA: The increase to 50% is just to make sure that the bid is a take-over bid and not a strategy or tactic to have a foothold in the company and then stay there with 30% of the shares.

However, you have to remember that you can always make an arrangement rather than a hostile bid. The law provides for arrangements, which are much more flexible, and I don't think they'd have any problems making arrangements around what are called partial bids or other potential types of deals between the target and the prospective partner buyer.

AC: Following the new rules, the cost for acquirers to reach a minimum tender has increased because they have to engage a lot more with the minority shareholders than they would have had to before. At the same time, however, it would cost them less to complete the acquisition after the tender offer. They still have to get the majority of shares but that majority threshold stays the same. In this second stage therefore the cost has fallen, and depending on the type of target – whether it's dispersed or concentrated ownership, and how many minority shareholders want the exit option or want to dissent — it's likely not to be a substantial impact on the overall cost. I'm not seeing a blow to competition domestically.

Canadian hostile M&A value, US$m

CANADIAN HOSTILE M&A VALUE ROSE FROM **US$463M** IN 2014 TO **US$5,459M** IN 2015

MM: How will the 10-day extension period combat coercive or defensive M&A tactics?

JE: This extension period coupled with the 50% minimum tender condition mitigates against the coercive features of the old regime. Shareholders may have felt compelled to tender their shares to a bid even if they did not support it because of the risk that a bidder may waive or reduce a minimum tender condition and take up a smaller number of shares, leaving them behind with a minority position in the target and potentially less liquid stock.

Now, shareholders can wait to see if the majority of independent shareholders support the bid before making a decision to tender during the 10-day extension period.

YA: Essentially they are trying to make sure that shareholders won't end up in a sort of prisoners' dilemma, where they are unsure whether to tender their shares or not. Ten days gives them time to see if the bid is likely to be successful. So for instance, if during the 10 days it becomes clear that the 50% barrier will be reached, then you can tender your shares.

GK: It takes the guesswork out, particularly for small shareholders deciding whether or not to accept an offer, and allows them to really focus on the terms and whether they find them to be sufficiently appealing to accept the bid.

Previously, you had a situation where if you were a small minority shareholder, one of your considerations might be that if you didn't accept a take-over offer immediately, you might be stuck with a stake when everyone else has accepted, a stake that will be illiquid, maybe see its value fall or risk the company will be delisted. By giving that 10-day extension, it gives the chance for shareholders to decide whether they like the offer or not. Ten days is a similar period to other jurisdictions such as the UK, and in the internet age it's probably enough.

"The new bid regime effectively codifies existing permitted bid terms which are commonly found in Canadian poison pills."

John Emanoilidis, Torys LLP

AC: If shareholders are indecisive or dissenting to the bid, they have nothing to lose by just holding out through the extension period. Once shareholders work out that other shareholders think similarly, it can coordinate their defensive efforts, so the small 10-day extension period can be effective if it coordinates expectations in this way. Of course, this is more relevant for dispersed ownership organizations, which are typically the larger firms.

MM: Where do the changes shift the balance of power between targets and acquirers? Do you think that balance is correct in comparison with other jurisdictions?

JE: In my view, the new take-over bid regime strikes the appropriate balance by giving target boards more effective leverage to deal with the hostile bidder, and greater scope through the benefit of additional time to respond to an unsolicited approach, while ultimately preserving the right for shareholders to collectively decide the outcome of a bid within a predictable time period.

AC: For dissenting minority shareholders, the changes improve fairness. Otherwise they can just be sidelined and lose money. However, it's unlikely that they will necessarily have their way with these rules. They can still be squeezed out eventually once the bidding process ends. So for them it's not a massive increase in defensive power.

For the majority and minority shareholders that have agreed: they have to be convinced before the 50% threshold is reached, so that's already done prior to the tender offer. Now suppose in spite of this support there's still substantial dissent, and the larger 105-day window and 10-day extension allows these dissenting shareholders to coordinate on these concerns. This is where the balance of power might shift. If the resolution in this group is to resist, that's where it gets interesting, because some defensive techniques aimed at increasing the cost of acquisition would now diminish in power.

Ceasing hostilities?

Canada's new take-over rules are set to shift power in the direction of target boards – however, a look at other jurisdictions suggests that the age of hostility is unlikely to be over.

The Canadian Securities Administrators (CSA) have said the changes made to Canada's takeover rules will help to give target boards and shareholders more time to make informed decisions. As Louis Morisset, chair of the CSA and President and CEO of the Autorité des marchés financiers, said after the final amendments were published: "The new regime will enhance the ability of security holders to make voluntary, informed and coordinated tender decisions while providing boards with additional time and discretion when responding to a takeover bid." In particular, the extension of the minimum tender period to 105 days has caused debate over what effect it will have on targets and acquirers.

The UK introduced similar rules in 2010 to address the perception that M&A had become buyer-friendly. However, while Canada's new 105-day minimum bid period does soothe the fears of boards in that respect, Grant Kernaghan, head of Canadian investment banking at Citi, points out that the rule changes in the UK did not go as far as extending timeframes. "The UK has a minimum offer period of 21 days and a maximum offer period of 60 days – so their maximum is less than Canada's minimum. It just goes to show that when they looked at their rules, the UK didn't consider time period as critical. Obviously Canada and the UK have many differences when it comes to takeovers, but it's interesting how both jurisdictions have chosen to tackle similar issues in different ways."

Middle ground

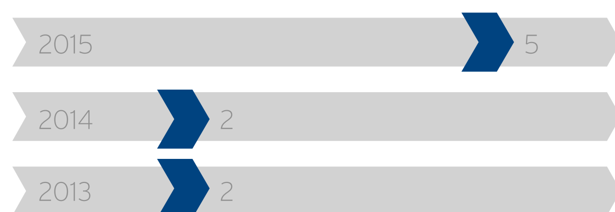
Despite this swing in favour of target boards and shareholders, Canada still provides more fertile ground for hostile bidders compared to its neighbors in the south. "Hostile bids in Canada will still be easier to execute than in the US," says John Emanoilidis, co-head of M&A at law firm Torys LLP. "Poison pills adopted by US boards have been a more effective bid defence than in Canada because they can be quite difficult and costly to remove. The removal of a poison pill in the US can typically only occur following a proxy contest to replace the board, which can take a considerable amount of time if there's a staggered board. In Canada, however, staggered boards are not an effective defensive measure because the entire board can be replaced at any time.Put simply, the Canadian regime is 'just say slow,' whereas the US regime is 'just say no.'"

The fact that Canada still appeals as a hostile takeover destination has led some to suggest that the changes haven't gone far enough. "We should have a Delaware-style system, where boards can say no," says Yvan Allaire, executive chair of the board of directors at the Institute for Governance of Private and Public Organizations. "Of course if you're a potential acquirer, you can challenge that in a court if they are refusing a deal for no good reason and you can show that you are taking over for strategic and financial reasons. But at least in a Delaware system the board has that power, and then the court decides if they are acting in a way that is selfish or in the long-term interests of the company."

Changing tactics

Unwittingly, the rule changes may see an increase in proxy battles – a rare sight in Canada – as hostile bidders look for different avenues to assume control. "There's never been a need for them in Canada before," says Kernaghan. "Boards weren't fully exposed to these corporate raiders knocking at the door, and courts could set aside poison pills if the target did not get their affairs in order in time. Now with the changes, a proxy battle is something that a hostile bidder can throw into the mix. It isn't necessary, but it is certainly something they have in their armoury."

Canadian hostile M&A volume



CANADIAN HOSTILE M&A ROSE FROM JUST **2 DEALS** IN 2013 AND 2014 TO **5 DEALS** IN 2015

Overall, these changes address some minority shareholder concerns without costing competition in the M&A market, and they support more informed decision making in acquisitions. The timelines will allow acquirers, targets, and other stakeholders to understand each other better before actually going ahead with the deal.

GK: The power balance now lies in the favour of targets. They have a very long time to muster their arguments against a transaction if they feel they need to find an alternative. The change in the timetable is not helpful to hostile acquirers. And whereas previously targets had to depend on the shareholder rights plan, and acquirers had to go to court, now this timetable is enshrined in law effectively and there's limited opportunity to argue in front of a court. That takes a tactic away from acquirers and definitely represents a shift back to targets.

With that said, in my experience the market typically adjusts to these sorts of rules. In the UK when the rules changed in 2010, people thought it would be very counterproductive to M&A. But dealmaking continued. If a transaction makes strategic and financial sense, the rules typically don't get in the way of that deal getting done. It may take longer and cost more, but at the end of the day, good deals that should happen tend to happen.

YA: The balance is still clearly with acquirers, especially in hostile takeovers. The small set of concessions that have been given to the board of the targets if they don't agree – particular the extension to 105 days – is really the only concession to a less liberal take-over system. In the US, the boards have a lot more power than that.

When the original rules were put in place in 1985, it was legitimate to claim that boards and management didn't want to be taken over because it would affect their job and status – so they would fight for personal reasons against the take-over that didn't make economic sense. Now, management has benefits from the take-over that it's come full circle, and I think in most cases they would want to be taken over because it's so rewarding financially.

This move seems to be outside the realm of what's actually happening. The rules should be changed further to accommodate the fact that they should in fact be more concerned about boards and management being receptive to take-overs they should not be receptive to.

MM: What does the rest of the year hold for Canadian M&A?

AC: Following the implementation of the new rules, acquisitions could shift towards smaller and more closely held firms. Hostile tender bids are rare and that is unlikely to change. But the preemptive preparation for target defence is likely to reduce, even if not something immediately for the year. Near term we may seem some cases head to courts rather than the agencies.

"The small set of concessions that have been given to disagreeing target boards are the only real ones in a less liberal takeover system."

Yvan Allaire, IGOPP

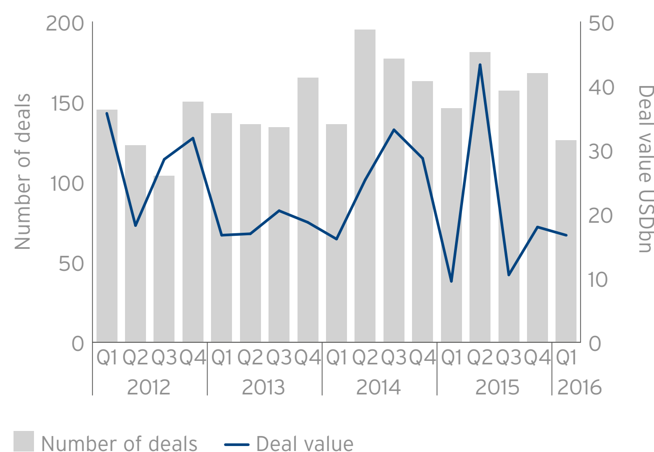
GK: We're coming on the heels of one of the strongest quarters ever in M&A, although there have been some headwinds. For instance, regulatory issues put paid to Canadian Pacific's bid for Norfolk Southern in April, and inversion regulations in the US are making those types of deals more challenging. However, equity markets and credit markets have largely recovered from their falls in Q1, energy prices have stabilized – clearly at a low level but if anything the trend is upward or flat rather than downward. There have been signs of improvement in the broader commodity market, too, while pension funds continue to be active. I'm encouraged and positive for Canadian M&A for the rest of the year on the back of all of that.

I think the new regulations will have an impact, but I do not think it will be significant. The rules really hit at the nub of hostile transactions. I don't think it will impact friendly deals whatsoever. Will there be some hostile transactions that will no longer proceed? Possibly, but these rules won't have a large enough impact to counteract everything positive that I see right now.

JE: A number of factors should create favourable opportunities for Canadian M&A in the months ahead. The CAD exchange rate should encourage US and other international investors to look for investment opportunities in Canada. The new federal government has also signaled an openness to foreign investment. Low commodities prices are providing opportunities for investors to acquire assets at a discount.

We are seeing asset disposals in the energy sector as interested buyers seize upon low valuations to acquire quality assets in a distressed environment. Canadian pension funds have been significant drivers of the growth of outbound investment activity, and we expect this trend will continue as they look for high-quality and diversified investment opportunities globally. Although there have been fewer megadeals, our pipeline points to robust activity at the mid-market level – traditionally at the core of Canadian M&A.

Canadian M&A by volume and value



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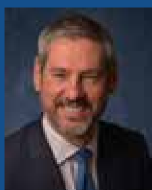

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