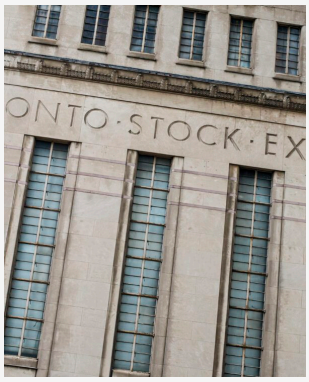
The Eco Oro decision – OSC draws the line on private placements during proxy contests



APRIL 25, 2017 9 MIN READ

Related Expertise

- Banking and Financial Services
- Capital Markets
- Corporate Governance
- Mergers and Acquisitions
- Mining and Natural Resources

Authors: Douglas Bryce, Jeremy Fraiberg, Alex Gorka

The Ontario Securities Commission (OSC) has overturned a decision by the Toronto Stock Exchange (TSX) conditionally approving a private placement of shares in the context of a proxy contest. The TSX approved the issuance of almost 10% of the common shares of Eco Oro Minerals Corp. (Eco Oro) to existing shareholders supportive of the incumbent board of directors just eight days prior to the record date for a shareholders meeting requisitioned to replace Eco Oro's board of directors. As a result of this decision, private placements in the context of an ongoing proxy contest and other contested situations may be subject to enhanced scrutiny by the TSX in determining whether the issuance should be subject to shareholder approval. The OSC's decision also effectively unwinds the private placement unless and until it is approved by Eco Oro's shareholders. The OSC's jurisdiction to make this kind of order has been the subject of considerable debate.

In a separate ruling issued on the day after the OSC's decision, the Supreme Court of British Columbia (the B.C. Court) dismissed a petition by Eco Oro shareholders to set aside the issuance of Eco Oro's shares on the basis of oppression. In supplementary reasons issued in light of the OSC's decision, the B.C. Court indicated that "the OSC's decision and my decision are at odds" and adjourned Eco Oro's shareholders meeting "to allow the parties an opportunity to take whatever steps they deem appropriate to resolve the conflict between the OSC's decision and my decision."

While the B.C Court and OSC decisions on their face may appear to be conflicting, they can potentially be reconciled by the fact that the B.C. Court was ruling on whether the share issuance was oppressive under corporate law, whereas the OSC was ruling on whether the TSX should have required a shareholder vote to approve the share issuance. Nevertheless, they highlight the fact that contested corporate actions can be subject to review by both courts and regulators, with potentially differing results.

Background

Eco Oro is a TSX-listed mining company whose principal asset is an arbitration claim against the Government of Colombia to recover damages for the loss of the Angostura gold/silver mining project in Colombia.

In July 2016, Eco Oro entered into an investment agreement with Trexs Investments LLC

(Trexs) under which Trexs would invest in Eco Oro in two tranches, for the purpose of funding the arbitration and ancillary expenses. Under the first tranche (the First Tranche), Trexs purchased 9.99% of Eco Oro's shares. Under the second tranche (the Second Tranche), Trexs would receive shares of Eco Oro that would result in Trexs owning an aggregate of 49.99% of Eco Oro and an unsecured convertible note (the Note). In the event that the required Eco Oro shareholder approval for the Second Tranche share issuance was not obtained, the Second Tranche would consist of the Note and secured contingent value rights (the CVRs) entitling Trexs to 51% of the gross proceeds of the arbitration. Eco Oro subsequently entered into similar investment agreements with Amber Capital LP, Paulson & Co. Inc. and Eco Oro's Executive Chairman, Anna Stylianides (collectively, with Trexs, the Investors), with the result that Eco Oro would be obligated to issue notes with an aggregate value of approximately $9.7 million to the Investors (the Notes) and potential CVRs entitled to receive approximately 51% of the gross proceeds under the arbitration if the Eco Oro shareholders did not approve the Second Tranche.

On November 3, 2016, Eco Oro shareholders voted against the issuance of common shares pursuant to the Second Tranche, with 93.4% of the disinterested shareholders voting against the share issuance. As a result, Eco Oro issued the Notes and the CVRs to the Investors.

On February 10, 2017, certain Eco Oro shareholders (the Requisitioning Shareholders) requisitioned a shareholders meeting for the purpose of reconstituting the Eco Oro board by removing each of the incumbent directors and electing six new directors.

On March 2, 2017, Eco Oro announced that it had set April 25, 2017 as the date of the requisitioned meeting (the Meeting) and March 24, 2017 as the record date for notice and voting at the Meeting.

On March 16, 2017, Eco Oro announced that it had converted a portion of the Notes through the issuance of 10,600,000 common shares to the Investors (the Share Issuance). Eco Oro viewed the Share Issuance as in the best interest of the corporation, since it reduced the amount of debt outstanding. The Share Issuance had been conditionally approved by the TSX on March 10, and resulted in the Investors increasing their aggregate voting control of Eco Oro from approximately 41% to 46%. The Requisitioning Shareholders, by contrast, took the view that the Share Issuance was oppressive and done for the improper purpose of preventing the board's replacement.

On March 22, 2017, the Requisitioning Shareholders filed a petition with the B.C. Court seeking to overturn the Share Issuance on the grounds that it was oppressive.

On March 27, 2017, the Requisitioning Shareholders applied to the OSC for orders setting aside the TSX's conditional approval of the Share Issuance, requiring shareholder approval for the Share Issuance, and cease trading the common shares issued pursuant to the Share Issuance.

The OSC decision

The OSC exercises regulatory oversight over the TSX and is empowered to review and overturn the TSX's decisions. While the OSC generally defers to the TSX's decisions, it has held that it may overturn a TSX decision if the TSX has proceeded on an incorrect principle, erred in law, or overlooked material evidence. The OSC may also intervene if new and compelling evidence is presented to the OSC that was not presented to the TSX or if the OSC's perception of the public interest conflicts with that of the TSX.

This is not the first time that the OSC has been asked to review a share issuance that had

been approved by the TSX in the context of an ongoing proxy contest. In August 2014, the OSC held a hearing to consider an application filed by a dissident shareholder for a temporary cease trade order in respect of a TSX-approved private placement of voting securities of Tuckamore Capital Management Inc. (Tuckamore). The private placement occurred in the context of an ongoing proxy battle and after the dissident had requisitioned a shareholder meeting to replace the board of directors. The parties ultimately settled prior to a final hearing before the OSC.

One reason it is difficult to challenge a stock exchange decision to permit a private placement made in the context of a proxy contest is that the private placement is generally announced only after the transaction has closed. Accordingly, any subsequent challenge of the TSX decision must contend with the question of whether the transaction can be unwound. In the Tuckamore OSC hearing, Tuckamore undertook to the OSC that, among other things, the investor in the private placement would not transfer, vote or otherwise deal with the common shares issued under the private placement without providing prior written notice to OSC staff and that it could and would unwind the private placement in the event that the application to the OSC was successful. In the case of Eco Oro, the private placement involved the issuance of equity for existing debt, making it arguably easier to unwind than some other forms of private placement, such as a private placement for cash that may have already been spent.

While the OSC has yet to publish its reasons, it has set aside the TSX's conditional approval of Eco Oro's Share Issuance and has ordered that Eco Oro ask shareholders at a meeting of shareholders — to be held no later than September 30, 2017 (to the extent that the Share Issuance has not otherwise been reversed) — to either ratify the Share Issuance or instruct the board of Eco Oro to reverse the Share Issuance. The OSC has also ordered the board of directors of Eco Oro to take all necessary steps to reverse the Share Issuance should shareholders instruct the board of directors to do so. Finally, pending shareholder ratification of the Share Issuance, the OSC has cease traded the shares issued pursuant to the Share Issuance and has ordered Eco Oro and the Chair of any Eco Oro meeting not to consider such shares to be issued for the purposes of voting at any shareholder meeting.

The OSC's decision reflects a broad interpretation of the OSC's jurisdiction. In particular, an order that Eco Oro and the Chair of any Eco Oro meeting not consider shares to have been issued for purposes of voting at any shareholder meeting is similar in substance to a prohibition on voting of shares, which under the *Securities Act* (Ontario) is a remedial power which a court may exercise on application from the OSC. Going forward, parties should be mindful of this broad interpretation of OSC powers in the context of hearings involving the review of TSX decisions.

As a result of this decision, greater scrutiny is likely to be placed on the application that issuers currently submit to the TSX when seeking approval of a private placement in the context of an ongoing proxy contest and other contested situations. A similar level of scrutiny may also occur with respect to private placements made during or in anticipation of a formal take-over bid. The reasons, when released, are likely to shed more light on the relationship between the TSX review process and subsequent OSC review in similar situations going forward.

The B.C. Court decision

The B.C. Court, which issued its decision the day after the OSC, found that the Share Issuance was not oppressive on the basis that there was no evidence that it was not in the best interests of Eco Oro. The B.C. Court said that although it was understandable that the petitioning shareholders might question the timing of the Share Issuance, the evidence suggests that the primary purpose of the Share Issuance was debt reduction. The B.C. Court

concluded that the Share Issuance was a reasonable exercise of the board's discretion and therefore entitled to deference.

In contrast to Canadian law, under Delaware law courts review director conduct under a standard of enhanced scrutiny where there is a conflict of interest. The B.C. Court's decision, consistent with Canadian practice, did not review the directors' conduct under enhanced scrutiny despite the fact that the Share Issuance was made to insiders that were supportive of the incumbent directors in the proxy contest. While the B.C. Court may have been of the view that the board's decision was reasonable despite the conflict, the formal analysis did not consider the relationship between conflicts of interest and the board's ability to avail itself of the benefit of the business judgment rule. This is an issue that has been addressed in other cases and that we expect will be the subject of ongoing judicial consideration.

We also note that the B.C. Court's decision is similar to an earlier decision of the B.C. Court in Lions Gate Entertainment, which also involved a challenge to a board's decision to approve a share issuance on conversion of debt hours prior to the launch of an unsolicited bid. These two decisions highlight the difficulties, at least in British Columbia, of successfully challenging a decision of the board of directors approving a share issuance.