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Borden Ladner Gervais

Are Private Placements the new poison pill? No, but they may cause some indigestion

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On October 24, 2016, the British Columbia Securities Commission and Ontario Securities Commission (the "Commissions") issued reasons for their July 22, 2016 decision, *In the Matter of Hecla Mining Company*. The decision confirmed that Dolly Varden Silver Corporation could close a C$6 million private placement offering notwithstanding that an unsolicited take-over bid had been launched by Hecla Mining Company and its affiliates for all of Dolly Varden's common shares. Also, the OSC cease traded Hecla's bid until Hecla obtains a formal valuation required by Multilateral Instrument 61-101 — *Protection of Minority Shareholders in Special Transactions* and delivers such valuation to Dolly Varden's shareholders. Following the announcement of the Commissions' decisions, Hecla withdrew and terminated its bid.

The decision raises important questions as to the circumstances in which private placements will be treated as improper defensive tactics by Canadian securities regulators, as well as when formal valuations are required to be prepared in connection with insider bids.

The Parties

Dolly Varden is a junior mining exploration company, with its shares (the "Shares") listed and trading on the TSX Venture Exchange. As of July 15, 2016, Dolly Varden had a market capitalization of C$10.9 million.

Hecla is a senior silver mining company and has been one of Dolly Varden's largest shareholders since 2012, continuously maintaining a greater than 10% interest in the Shares. As of July 15, 2016, Hecla had a market capitalization of US$2.38 billion.

Background

In September, 2012, Hecla became a shareholder of Dolly Varden by participating in a private placement resulting in it holding 19.9% of the Shares. Hecla also entered into an ancillary rights agreement with Dolly Varden (the "Ancillary Rights Agreement"), whereby Hecla was granted certain rights, such as the ability to nominate a member of the board of directors of Dolly Varden, maintain its *pro rata* equity interest in Dolly Varden in connection with any future issuances of equity securities, and appoint a member to Dolly Varden's technical committee.

At a shareholders' meeting on July 26, 2013, Ms. Rosalie C. Moore, then a consultant to Hecla, was elected to the Dolly Varden's board of directors (the "Board") as Hecla's nominee. On January 23, 2015, Hecla amended Ms. Moore's consulting agreement to allow her secondment to Dolly Varden as Interim President and CEO. Ms. Moore served in those positions from that date on and at the relevant times was Dolly Varden's only full time employee. She ceased to be a consultant to Hecla on January 16, 2016.

In September 2015, Dolly Varden entered into a credit agreement with Hecla, as agent and lender, and another lender (the "Restrictive Loan") with an initial advance of C$1.5 million. The Restrictive Loan was secured by Dolly Varden's property, and prohibited Dolly Varden from (i) issuing, incurring, assuming or otherwise becoming liable for or in respect of

additional indebtedness, other than permitted indebtedness, or (ii) issuing any securities without the consent of Hecla. The use of proceeds for the Restrictive Loan was limited to covering Dolly Varden's obligations for flow-through spending in 2015 and, thereafter, for bare minimum working capital purposes.

From December, 2015 to April, 2016, Dolly Varden tried to obtain the consent of Hecla and the other lender to either convert the Restrictive Loan to equity or allow Dolly Varden to conduct an equity financing in an effort to repay the Restrictive Loan and have additional funding to explore the Dolly Varden silver property. Hecla and the other lender declined to consent to either alternative.

In May, 2016, the Board developed a plan to raise the funds required to eliminate the Restrictive Loan and continue exploration of the Dolly Varden silver property. Dolly Varden would take out an additional loan sufficient to pay out the Restrictive Loan in full, and upon full payment and discharge of the Restrictive Loan, announce a private placement equity issuance to pay for the new loan and provide Dolly Varden with capital for exploration, staff augmentation and working capital. Ms. Moore began contacting potential investors to test interest in a private placement.

On June 13, 2016, Dolly Varden entered into a loan agreement (the "New Loan Agreement"), which provided short-term loan proceeds of C$2.5 million from new lenders. The New Loan Agreement allowed Dolly Varden to repay the loan with proceeds from an equity issuance without lenders' consent. Dolly Varden provided the 10-day notice period required by the Restrictive Loan, notifying Hecla that it would be prepaying the outstanding balance of the Restrictive Loan.

On June 27, 2016, the Board met and, among other things, discussed a potential press release regarding a private placement and instructed Ms. Moore to advance the private placement with a proposed finder and report back. During the course of this Board meeting, Hecla issued a press release announcing its intention to make an offer to acquire all of the outstanding Shares not already owned by Hecla at a price of $0.69 per Share in cash (the "Insider Bid").

At a reconvened board meeting later that day, Ms. Moore reported on her communications with the proposed finder for the private placement, who had contacted potential private places who might be willing to invest in Shares at a price of $0.69 per Share. The Board instructed Ms. Moore to follow up with the finder to further advance the private placement.

On June 29, 2016, Dolly Varden's legal counsel, Borden Ladner Gervais LLP, notified Hecla that its Insider Bid required preparation of a formal valuation to be overseen by a committee of independent directors of Dolly Varden pursuant to Multilateral Instrument 61-101 *Protection of Minority Shareholders in Special Transactions* ("MI 61-101"). Hecla responded that it was exempt from the obligation to prepare a formal valuation under MI 61-101.

On July 4, 2016, Dolly Varden used the proceeds from the New Loan to pay off and extinguish all obligations of the Restrictive Loan. The Board met and appointed a special committee consisting of independent directors to consider the formal offer, if and once it was received.

On July 5, 2016, Dolly Varden announced its intention to conduct the Private Placement. Dolly Varden did not place any restrictions on whether investors in the Private Placement would be able to tender their Shares to an offer, if an offer was made by Hecla or any other bidder. Under the Ancillary Rights Agreement, Dolly Varden sent required notifications so that Hecla could participate in the Private Placement to maintain its *pro rata* shareholding in Dolly Varden.

On July 8, 2016, 1080890 British Columbia Limited, a wholly owned, indirect subsidiary of Hecla Mining Company, formally launched the Insider Bid by filing a take-over bid circular. The Insider Bid was subject to a condition that Dolly Varden would not issue, sell or authorize the issuance of any securities of Dolly Varden. On the same day, Hecla applied to the BCSC for an order to cease trading the Private Placement (the "Private Placement Hearing").

On July 11, 2016, Dolly Varden filed an application to cease trade the Insider Bid with the OSC (the "Insider Bid Hearing") as the take-over bid circular for the Insider Bid did not include a Formal Valuation as required by MI 61-101.

On July 12, 2016, Hecla notified Dolly Varden of its intention to maintain its *pro rata* interest and participate in the Private Placement.

On July 15, 2016, the Commissions issued a notice for a simultaneous hearing of the Private Placement Hearing and the Insider Bid Hearing for July 20 and 21, 2016 in Vancouver and Toronto.

On July 22, 2016, the Commissions dismissed Hecla's application to cease trade the Private Placement, and the OSC cease traded the Insider Bid until Hecla obtains (at its own expense) a formal valuation required by MI 61-101 and delivers such formal valuation to Dolly Varden's shareholders as an addendum to the original Insider Bid circular (the "Amended Insider Offer"). The OSC ordered that the Amended Insider Offer shall, unless earlier terminated, remain open until the later of 35 days after the delivery of the Amended Insider Offer or the "Expiry Time" defined in the original Insider Bid circular.

Following the announcement of the Commissions' decisions, Hecla withdrew and terminated the Insider Bid.

Decisions

(a) Was the Private Placement a Defensive Tactic?

National Policy 62-202 — *Take-Over Bids — Defensive Tactics* ("NP 62-202") expresses concern that certain defensive measures taken by a target's management may have the effect of denying shareholders the ability to make a decision whether to tender or not to a take-over bid and "frustrating an open take-over bid process". In particular, NP 62-202 states that a securities issuance could, in certain circumstances, constitute a defensive tactic attracting regulatory scrutiny on the basis that it may frustrate the ability of shareholders to respond to a bid.

The Commissions acknowledged that, to date, much of their activity involving defensive tactics has involved shareholder rights plans and the focus has been upon determining when such plans no longer serve the purpose of maximizing shareholder value and choice and should be cease traded.

The Commissions noted that private placement transactions, by contrast, were "more challenging" to review as these financing transactions may serve multiple corporate objectives, whereas the only corporate objective of a shareholder rights plan is to alter the dynamics of a bid environment. In particular, the Commissions agreed with previous decisions that "securities regulators should tread warily in this area".

When reviewing a private placement under NP 62-202, the Commissions acknowledged the need to balance: 1) the extent to which the private placement serves *bona fide* corporate objectives, for which corporate law gives significant deference to a board of directors in exercising its business judgment, with 2) the securities law principles of facilitating shareholder choice with regard to corporate control transactions and promoting open and even-handed bid environments.

Accordingly, the Commissions adopted a two part test to determine whether a private placement is an improper defensive tactic.

The first portion of the test is to determine whether the principles set out in NP 62-202 are engaged at all. In making this determination the salient question is: whether the evidence clearly establishes that the private placement is not, in fact, a defensive tactic designed, in whole or in part, to alter the dynamics of the bid process.

A non-exhaustive list of considerations that would be relevant to answering this question would include:

a. whether the target has a serious and immediate need for the financing;

b. whether there is evidence of a *bona fide*, non-defensive, business strategy adopted by the target; and

c. whether the private placement has been planned or modified in response to, or in anticipation of, a bid.

In considering whether a private placement is a defensive tactic, the Commissions also addressed the question of evidentiary onus. Where an applicant is able to establish that the impact of a private placement on an existing bid environment is material - as was held to be the case with Dolly Varden's proposed Private Placement due to its potential 43% dilution - then the target board will have the onus of establishing that the private placement was not used as a defensive tactic.

If the private placement is found not to be a defensive tactic, then the principles in NP 62-202 are inapplicable, and it would only be left to consider whether there was some other reason under the Commissions' broader public interest mandate to interfere with the private placement.

The second portion of the test arises where a panel is unable to clearly find that a private placement was not used as a defensive tactic, either because there appear to be multiple purposes or there is insufficient evidence as to purpose. In that circumstance, the principles set out in NP 62-202 are engaged and it will be necessary to find the appropriate balance between those principles and respecting a board's business judgment.

In finding this appropriate balance, in addition to the considerations listed in the first portion of the test, the following non-exhaustive list of considerations are relevant to whether a private placement should be interfered with:

i. would the private placement otherwise be to the benefit of shareholders by, for example, allowing the target to continue its operations through the term of the bid or in allowing the board to engage in an auction process without unduly impairing the bid?

ii. to what extent does the private placement alter the pre-existing bid dynamics, for example by depriving shareholders of the ability to tender to the bid?

iii. are the investors in the private placement related parties to the target or is there other evidence that some or all of them will act in such a way as to enable the target's board to "just say no" to the bid or a competing bid?

iv. is there any information available that indicates the views of the target shareholders with respect to the take-over bid and/or the private placement?

v. where a bid is underway as the private placement is being implemented, did the target's board appropriately consider the interplay between the private placement and the bid, including the effect of the resulting dilution on the bid and the need for financing?

In the case of Dolly Varden's proposed Private Placement, the Commissions found the application of NP 62-202 to be "relatively straight forward" and held that the Private Placement was instituted for non-defensive business purposes. The evidence established that Dolly Varden was contemplating an equity financing considerably in advance of Hecla's announcement of the Insider Bid. Further, the size of the Private Placement was not inappropriate given Dolly Varden's current liabilities (including the obligation to repay the New Loan Agreement) and what would be required to carry out the next phase of the exploration work on the Dolly Varden silver property. Finally, there was evidence that Dolly Varden considered a larger financing and decided not to pursue that opportunity. In the circumstances, the Commissions decided it was not appropriate to second guess the Board's decision to implement a *bona fide* corporate strategy, born of changes in commodity prices and market conditions, to pursue an equity financing over a loan from Hecla that contained restrictive conditions.

However, the Commissions noted that other cases may involve a record where there is evidence of mixed motivations that will require the balancing of the other factors they identified, and other factors applicable in new circumstances.

In addition, the Commissions also did not see any reason to interfere with Dolly Varden's Private Placement under their broader public interest mandate, as the transaction was not abusive of target shareholders or the capital markets.

Finally, the Commissions also acknowledged that a bidder could potentially seek alternative relief from the Commissions, such as not including the shares issued in a private placement with a tactical motivation in the number of outstanding shares (*i.e.*, the denominator in the calculation), for the purpose of the satisfaction of the 50% required minimum bid condition. Although such relief was not sought by Hecla, the Commissions noted that different considerations would have applied — as such a remedy would have been less drastic.

(b) Was a Formal Valuation Required?

MI 61-101, which is only in force in Ontario and Québec, sets out enhanced disclosure requirements for insider bids, issuer bids, business combinations and related party transactions. In particular, it requires the offeror in an insider bid to, among other things, obtain a formal valuation of the target at its own expense — subject to certain exemptions. The formal valuation is supervised by an independent committee of the target, and the valuation can form the basis of arm's-length negotiations between the special committee and the bidder and also provide target shareholders with sufficient information to determine whether the offer appropriately values the target considering the nature of the acquirer. The OSC noted that the formal valuation requirement under MI 61-101 is "essential" to address the asymmetry of information between insiders and other shareholders and that the failure to provide a formal valuation when one is required is a "serious allegation".

Hecla claimed that it's Insider Bid was exempt from these formal valuation requirements on the basis of subsection 2.4(1)(a) of MI 61-101. That exemption is available where:

"neither the offeror nor any joint actor with the offeror has, or has had within the preceding 12 months, any board or management representation in respect of the offeree issuer, or has knowledge of any material information concerning the offeree issuer or its securities that has not been generally disclosed."

The OSC noted that the phrase "board or management representation" refers to the bidder having an individual who is an employee of the bidder or in a contractual or close relationship with the bidder who is placed on the target board or target management by the bidder to fulfil their duties to the target while being "mindful of the bidder's interests". The OSC noted that such arrangement may be formal or informal. Information asymmetry is

presumed in circumstances where a bidder has access to the inner workings of the target through representatives on the board of directors or management of the target. The onus lies on the insider bidder to demonstrate that it did not have board or management representation in the preceding 12 months and that it therefore fits into the four corners of the subsection 2.4(1)(a) exemption.

The OSC determined that the need for Hecla to include a formal valuation in its Insider Bid circular was "not a close call". The OSC found that Hecla had board representation at Dolly Varden, via Moore, within the 12 months preceding the Insider Bid.

In particular, Ms. Moore had been a consultant to Hecla through January 2016. Ms. Moore's position as a director and then as Interim President and CEO of Dolly Varden was arranged by Hecla. Furthermore, it was anticipated by all parties that Ms. Moore may have returned to Hecla upon completion of her secondment to Dolly Varden. Ms. Moore's secondment provided Hecla insider advantages, including close communications and a good reporting relationship with Dolly Varden.

In light of Hecla's Board representation, it was unnecessary for the OSC to determine whether Hecla had knowledge of undisclosed material information received from Dolly Varden.

Finally, in an *obiter* comment, the OSC strongly discourages bidders and their counsel from “rolling the dice” and proceeding with a bid in the absence of a formal valuation without firm grounds for the availability of an exemption under MI 61-101, as such non-compliant bids harm the integrity of the market and raise the spectre of tactical bids designed to interfere with the corporate objectives of the target company which the bidders can walk away from if regulators insist upon preparation of a valuation.

In contrast, the BCSC declined to exercise its public interest jurisdiction to cease trade the Insider Bid due to the lack of a formal valuation, in part because it did not find that Hecla possessed material undisclosed information regarding Dolly Varden that would make the BCSC concerned that the Insider Bid, without a valuation, would constitute an abuse of the capital markets or investors. The BCSC noted that the situation advocates for a narrow application of the public interest jurisdiction where a cease trade order of the Insider Bid would be significant not only for Hecla but also for the Dolly Varden shareholders. The BCSC was particularly concerned that a cease trade order of the Insider Bid until a valuation could be prepared would likely necessitate a delay in the Insider Bid and might potentially result in a termination of the Insider Bid.

Commentary

Defensive tactics adopted in response to take-over bids are regulated in Canada under National Instrument 62-104 *Take-Over Bids and Issuer Bids*. The Dolly Varden decision is the first case in which the Commissions have had to consider whether a contemplated private placement is an inappropriate defensive tactic after the adoption of the changes to the Canadian take-over bid regime that became effective in May 2016. These changes included a 50% minimum tender condition, a ten day extension period and a 105-day deposit period.

There has been considerable speculation in the financial press that tactical private placements may become the next "poison pill" in the wake of these changes, as a preferred defensive strategy in response to hostile take-over bids in Canada. This decision, however, should certainly not be taken as *carte blanche* for targets to adopt private placements in response to unsolicited bids.

The Commissions will take a nuanced and balanced approach, which will be fact specific, when considering private placements which occur concurrently with an unsolicited bid. In the case of Dolly Varden's Private Placement, there were a number of factual circumstances (Dolly Varden having contemplated the financing considerably in advance of Hecla's announcement of its Insider Bid, an appropriate financing size for Dolly Varden's business needs, and evidence that Dolly Varden had elected not to pursue the opportunity for a larger private placement) which suggested that the financing was not an abusive defensive tactic.

In responding to unsolicited bids, Boards should be careful and take focused advice as to whether in the factual matrix of their circumstances a private placement is justified as serving *bona fide* corporate objectives without unduly frustrating the takeover bid process.

BLG Team

BLG is counsel to Dolly Varden and represented Dolly Varden at the simultaneous hearing.

The BLG securities team was led by Fred Pletcher and Melanie Bradley with support from Warren Learmonth, Stephen P. Robertson, Julie Bogle, Joelle Dudelzak, and students Kelsey McIntyre, Breanne Lehodey and Lauren DeGoey.

The BLG litigation team in British Columbia was led by Robert Deane with support from Steve Warnett, Hunter Parsons and student Benjamin Reedijk and in Ontario was led by David Di Paolo with support from Caitlin Sainsbury, Maureen Doherty, and Graham Splawski.

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