

The facts and issues at play in the *AiT* case were well-known to the securities law bar long before the Ontario Securities Commission released its decision.¹ The case raised the difficult question of when an issuer must disclose that it is negotiating a material merger or acquisition. The allegations suggested that enforcement staff had a different understanding from practitioners regarding the application of the relevant legal rules. However, the Commission's decision in the case was generally consistent with the current practices and approach of practitioners.

This article briefly describes the timely disclosure rules and the special challenges in applying them in the M&A context. It then discusses *AiT* and the lessons from the case, as well as some related disclosure considerations.

Timely Disclosure Rule

Canadian securities legislation does not require an issuer to promptly disclose all material *facts*, only material *changes*. This distinction between material changes and material facts has been critical in analyzing whether an issuer must disclose a potential M&A deal.

Material change and confidential material change reports: A “material change” is defined as a change in the business, operations or capital of an issuer that would reasonably be expected to have a significant effect on the market price or value of the issuer's securities. The definition includes a decision to implement a change by the board or by senior management who believe confirmation by the board is probable.² There is a limited exception to the requirement to disclose material changes immediately: provincial securities laws allow an issuer to temporarily delay public disclosure by filing a material change report on a confidential basis. This is permitted where the issuer reasonably concludes that the disclosure would be unduly detrimental to its interests or the material change consists of a decision to implement a change made by senior management who believe confirmation of the decision by the board is probable and have no reason to believe that persons who know about the material change have used this knowledge in trading the issuer's securities.³

Material fact and the prohibition on trading and tipping: A “material fact,” on the other hand, is defined more broadly than a material change and means any fact that would reasonably be expected to have a significant effect on the market price or value of the issuer's securities;⁴ a change need not have occurred in the issuer's business, operations or capital. Rather than requiring immediate disclosure of all material facts, securities legislation prohibits insiders from tipping (making selective

¹ *AiT Advanced Information Technologies Corporation*, OSCB, vol. 31, issue 3, January 18, 2008.

² *Securities Act*, R.S.O. 1990, c. S.5, s. 1(1).

³ *Ibid.*, s. 74(3). The ability to make a confidential filing highlights the competing policy considerations at play, recognizing that the public interest for timely disclosure may be outweighed by the detriment to the issuer. These filings are relatively rarely done. See also *infra* note 9.

⁴ *Supra* note 2.

disclosure other than in the necessary course of business) or trading based on material facts that have not been generally disclosed.⁵

Toronto Stock Exchange Policy: Although securities legislation therefore implicitly allows issuers not to disclose material facts (as opposed to material changes) immediately, the policies of TSX require immediate disclosure of all material facts as well as all material changes.⁶ The TSX Policy is not a legal rule, and the stock exchange's remedies for breach are limited (to delist the issuer). However, National Policy 51-201 states that securities regulators expect listed companies to comply with these broader timely disclosure requirements and may commence proceedings under their public interest jurisdiction for failure to do so. Historically listed issuers have often engaged in M&A negotiations without any public disclosure, even where they treat the negotiations as a potential material fact (imposing internal trading blackouts for those involved in or aware of the discussions). They have generally taken this approach on the basis of the provisions of the TSX Policy that allow an issuer not to disclose material facts where doing so might be "unduly detrimental" to the issuer's interests.⁷

The Disclosure Challenge in a Typical M&A Process

The fact that an issuer is considering or negotiating a material merger or acquisition will often, if known, affect the trading price of its securities and therefore constitute a material fact. However, arguably no material change occurs until an agreement is reached between the parties: mere negotiations are not a "change in the business, operations or capital" of the issuer.

This is important because premature disclosure of an M&A deal may damage the business of both parties, given the uncertainties and distraction usually involved. It can also reduce the likelihood of a deal by causing the stock price to rise, reducing the premium to market that the buyer is ultimately able to offer and impairing the target's ability to negotiate a better price because the pressure of completing a deal after disclosure can be quite significant. Therefore, third parties and issuers understandably resist participating in an M&A process if it cannot be conducted on a confidential basis. In fact, third parties often make their proposals conditional on there being no public disclosure.

That being said, M&A practitioners have always been sensitive to the fact that as negotiations of the detailed agreements and substantive business diligence progress, a point may come when agreement is fairly certain to be reached. Therefore, the distinction between a binding agreement and a non-binding agreement in principle has always been somewhat blurred.

Furthermore, concerns are often raised that regulators may treat an intermediate step in the process as a material change requiring disclosure. Those intermediate steps can include

- an issuer deciding to review its strategic alternatives, possibly appointing a special committee, engaging advisers to assist in the process, soliciting interest from one or more prospective buyers and authorizing management to conduct negotiations with them;
- an issuer providing access to confidential information, including entering into one or more confidentiality agreements with prospective buyers;
- an issuer and prospective buyer entering into an exclusivity agreement restricting the issuer from dealing with other interested parties for a specified period, often based on a proposed price but without any binding agreement to proceed with a deal; and

⁵ *Ibid.*, s. 76.

⁶ TSX Policy on Timely Disclosure [TSX Policy].

⁷ Premature disclosure of the M&A negotiations would in many cases be misleading and detrimental to the issuer (see "The Disclosure Challenge in a Typical M&A Process").

- the parties exchanging and negotiating non-binding term sheets or letters of intent setting out the key terms of the deal.

Before the *AiT* case, M&A practitioners would generally have argued that none of those events constituted a material change, provided that the parties had not agreed on the terms of a binding agreement, the buyer had not completed its business due diligence, and significant conditions had to be met before the deal could be concluded.

AiT

However, this disclosure analysis came under close scrutiny after the Ontario Securities Commission enforcement staff proceeded against Advanced Information Technologies Corporation (AiT), arguing that a disclosure obligation had been triggered during its M&A negotiations.

AiT, a listed technology company based in Ottawa, was under financial pressure when 3M made an unsolicited approach to acquire the company in February 2002. Management of the two companies held discussions, and 3M conducted preliminary due diligence. On April 24 of that year, 3M said that it would consider proposing a transaction at \$2.88 per share.

According to minutes of AiT's board meeting on April 25, the directors approved a resolution to recommend the transaction to its shareholders at that price (subject to receiving a fairness opinion and executing a definitive agreement), and authorized management to negotiate a letter of intent (an LOI).

On April 26, AiT signed a non-binding LOI with 3M, containing an exclusivity clause. The LOI contained a number of conditions that had to be satisfied before 3M would commit to a transaction; many of these conditions were beyond AiT's control, including the completion of due diligence to the buyer's satisfaction and obtaining lockup agreements from some key shareholders. The executive negotiating for 3M was not very senior, and it was clear that additional internal approvals within 3M would be necessary and that these were substantive as opposed to merely rubber stamping.

An unusual increase in the trading volume and price of AiT's shares prompted Market Regulation Services (RS) to contact AiT, which informed RS that it was in discussions to be potentially acquired. On May 9, AiT issued a news release that it was "exploring strategic alternatives."

The board of 3M approved the deal on May 14, subject to the CEO's approval of the due diligence report, which he gave on May 21. The AiT board approved the definitive merger agreement on May 22, and it was executed and announced the following day.

OSC staff proceeded against the issuer, its CEO and one director who was also a partner of the law firm that had been providing advice on the deal. Staff alleged that a material change had occurred as early as (i) April 25 (when the board met and "approved" the proposal subject to conditions); (ii) April 26 (when the LOI was signed); or (iii) May 9 (when AiT issued the news release). Neither staff nor the Commission dealt with the period beyond that time. Staff relied in particular on the fact that the board "approved" the proposal and the definition of material change includes a decision to implement a change.

The Commission ultimately concluded that no material change had occurred on any of those dates.

Key Principles Emerging from the Decision

Material change is different from material fact: Of critical significance is that the Commission upheld the distinction between material facts and material changes in the context of disclosing merger negotiations, concluding that the negotiations *were* a material fact for AiT. Therefore, insiders were prohibited from disclosing that the negotiations were ongoing, except in the necessary course of business, and were prohibited from trading AiT securities. However, the Commission found that the negotiations themselves as well as several of the steps in the process up to May 9 did not in this case amount to a

material change. Those steps included the signing of a non-binding LOI with an exclusivity provision and the conduct of due diligence and intensive negotiations.

No bright-line test; consider level of conditionality, certainty, commitment: The Commission took care to stress that there is no bright-line test for determining when in an M&A process a material change has occurred and that a material change could occur before a binding agreement is executed. However, the Commission also concluded that if a transaction is conditional and surrounded by uncertainties, a commitment from only one party to proceed would not normally be sufficient to constitute a material change.

Decision to implement a change: Although AiT may have been committed to proceeding with the transaction, as evidenced by the board's decision to "approve" recommending the transaction to AiT's shareholders, this did not amount to a "decision to implement a material change" because 3M had not committed to proceed with the transaction and significant uncertainties remained. In the Commission's view, a board decision would not constitute a material change "when a potential transaction is identified and discussed by the board, but instead, when the decision by the board to implement the potential transaction is based on its understanding of a sufficient commitment from the parties to proceed and the substantial likelihood that the transaction will be completed."

Executing a letter of intent and exclusivity agreement was not a material change in this case: Although the Commission noted that in some cases the signing of an LOI may trigger disclosure, that will depend on the provisions of the LOI and, again, the degree of commitment by the parties. In this case, the Commission concluded that entering into the LOI did not trigger disclosure obligations because (i) the LOI was non-binding (although the exclusivity provisions in it were binding); (ii) the stated price was not firm and was subject to a detailed due diligence review that had not yet been completed; (iii) several key terms (such as the break fee) had not been negotiated; and (iv) several conditions to 3M's commitment were beyond AiT's control, including the completion of 3M's due diligence, 3M's internal approvals being obtained and lockup agreements being made with some key shareholders.

Level of commitment will be significant to the disclosure analysis: As noted above, the Commission focused particularly on the lack of commitment by 3M to the transaction in concluding that no material change had occurred, essentially recognizing that no deal can occur without a commitment from both sides. The Commission said that it might have reached a different conclusion if (i) the buyer had been less process-driven; (ii) negotiations had been led by the buyer's chief executive officer and been within his authority; or (iii) a previous board resolution of the buyer had set out pre-authorized criteria for the acquisition. However, in this case, the person negotiating for 3M ranked several levels below the CEO, the CEO had to approve the deal and 3M had to complete a detailed diligence process under its internal policies. The diligence process and internal approvals were substantive hurdles whose positive outcome was not assured.

Relevance of "business judgment rule" and the importance of process and the record: The Supreme Court of Canada in *Kerr v. Danier Leather*⁸ held that disclosure obligations under securities law cannot be subordinated to the exercise of business judgment. The Commission acknowledged this principle in *AiT*, but also recognized that if the board's governance process in making disclosure decisions is effective, it would be difficult to interfere with the judgments produced by that process. That being said, the Commission raised a number of concerns that made it difficult to judge the quality of AiT's governance process in this case. In particular, the Commission noted that (i) the minutes of the critical April 25 board meeting were initially drafted approximately two months after the meeting and then amended to conform to the disclosure in the proxy circular for the meeting that sought approval of the transaction; (ii) the board had concerns that disclosure could result in 3M not proceeding with the

⁸ 2007 SCC 44.

transaction or cause negative reactions from AiT's competitors, and the degree to which these concerns affected its disclosure decision was unclear; (iii) no written record existed of the legal advice the board requested and received regarding its disclosure obligations; and (iv) the board had not been advised of the option of filing a confidential material change report.

Lessons Learned and Best Practices

A number of lessons emerge from *AiT*, many of which reflect current best practices:

Design and Documentation of Sale Process

- A sale process should be designed with the input of counsel and with disclosure obligations in mind.
- It would generally be helpful for counsel for both parties to discuss a detailed draft written agreement early in the process, so that it can be executed once key business terms are settled, both parties are committed to the deal and significant due diligence and other conditions outside the parties' control are satisfied. Discussing a draft written agreement in advance will minimize the risk of a disclosure obligation being triggered before comprehensive binding terms can be documented.
- It is typical and understandable for a target to require an indication of proposed price before incurring significant transaction costs, providing a prospective purchaser with diligence access or entering into an exclusivity agreement. However, it would be unusual to agree on any key term in isolation. Instead, parties usually prefer not to commit in the absence of a written agreement on all material terms and completion of diligence so that the purchaser cannot raise new issues as a basis for walking away from the deal or renegotiating its terms. Any exclusivity agreement, confidentiality agreement, LOI, term sheet or correspondence and all related board materials and resolutions should be reviewed by counsel so documents are clear and consistent. They should be clearly marked, where appropriate, as non-binding and should identify any material conditions to the parties' respective commitments. They should not suggest that agreement has been reached if that is not the case.
- If a party's commitment to proceed is subject to board or senior management approval, this should be made clear. However, issuers must be cautious not to rely on these internal governance requirements as necessarily justifying a delay in disclosure, particularly if the negotiating executive is very senior or has delegated authority or the approval is highly likely to be obtained.

Legal Advice and Minutes

- Although the Commission overcame its concerns regarding the AiT Board's records, it is clear that a careful process and written record will be critical in protecting a board's judgments on disclosure issues against second-guessing.
- Minutes should be prepared within a short time after the meeting and reviewed by counsel before they are finalized.
- Board minutes should highlight the factors that the board considered in reaching any disclosure decision, and should expressly state whether legal advice was sought and obtained. Wherever practically possible, that advice should be summarized in writing, although the summary can be separate from the minutes if that is desirable for reasons of privilege and confidentiality.
- Although the directors may be concerned about the potential negative implications of public disclosure of a prospective deal, the board should be advised that it is not entitled to subordinate its disclosure obligations to those business concerns, and the minutes should be clear that it has not done so.

Confidential Material Change Reports

- Although filing a confidential material change report may not be desirable in the particular circumstances, counsel should ensure that the board of directors is aware of the option to do so.⁹

Leaks

- If there is evidence that a leak has occurred or there has been selective disclosure regarding the M&A negotiations, it is difficult to argue that disclosure can be delayed, given the danger that trading may be based on leaked information. RS may well contact the issuer and insist that a news release be issued.
- For that reason, it is essential that the issuer and its advisers impose tight safeguards to protect confidentiality and avoid leaks.
- It is also critical that the company make no misleading public comments during the negotiations (see below, “Other Related Public Disclosure Considerations”).
- In that context, if the issuer is conducting a sale process, it should consider with its advisers whether it would be advisable to announce that fact in advance (where, for example, it will be difficult to conduct the process on a confidential basis in the circumstances).
- The issuer should also monitor trading and watch for any evidence that a leak may have occurred (including, for example, unsolicited calls from parties expressing an interest).

TSX Disclosure Policy

- The Commission did not refer to the broader requirements of the TSX Policy to disclose material facts (as well as material changes) on a timely basis.
- However, the Commission did acknowledge that the AiT directors had good faith concerns regarding the potential impact of disclosure. Concerns of that nature could presumably form a reasonable basis for concluding that disclosure would be unduly detrimental to the issuer, which the TSX Policy recognizes as an exception to the disclosure requirement. Ideally, an issuer’s governance process should explicitly consider the disclosure issue and its basis for relying on the exception.

Other Related Public Disclosure Obligations

In addition to penalties for failing to comply with timely disclosure requirements, issuers, their directors and officers and other “influential persons” face potential civil liability if the issuer releases a document or makes a public oral statement that contains a misrepresentation. A “misrepresentation” is defined as either an untrue statement of a “material fact” or an omission to state a material fact that is necessary to make a statement not misleading in light of the circumstances in which it was made.¹⁰

For that reason, an issuer engaged in confidential negotiations for a material M&A transaction must be particularly careful not to make misleading statements. The authorized spokespersons for the issuer should either be aware of the negotiations or their comments carefully scripted and reviewed to avoid inadvertent misleading statements. Similarly, any documents released by the issuer should be reviewed for potential misrepresentations in light of undisclosed ongoing M&A negotiations – this is particularly important where a news release is issued in response to a leak.

⁹ If it is not clear whether a material change has occurred, filing the report may be construed as conceding the point. This can be negated in the report by stating that the report is being filed as a precaution only, but this statement may be seen as self-serving and not persuasive in retrospect. In addition, the report must be renewed every 10 days, and it is unclear whether at some point the regulator may require evidence that disclosure will be “unduly detrimental,” or push for disclosure. Further, there is no comparable provision under U.S. securities laws, making the ability of a cross-listed issuer to effectively rely on a protective filing under this provision unclear.

¹⁰ *Supra* note 2.

The potential for misrepresentation can be particularly acute for issuers engaged in an M&A process at a time when their continuous disclosure documents are due to be filed. For example, the form requirements for management's discussion and analysis include requirements to analyze commitments, events, risks or uncertainties that the issuer reasonably believes will materially affect the company's future performance; known trends or expected changes in the issuer's capital resources; and the expected effect on the issuer's business of any proposed asset or business acquisition or disposition if the board has decided to proceed with the transaction, or management has decided to do so and believes confirmation by the board is probable.¹¹ In satisfying these form requirements, issuers may have to tread carefully to avoid making a misleading statement. Issuers should therefore keep their continuous disclosure timetable and deadlines in mind when commencing an M&A process.

Conclusion

It is fair to say that securities practitioners were very troubled by the allegations made in the *AiT* case and concerned that a decision in the case that supported those allegations would make it almost impossible to conduct M&A negotiations without triggering a requirement for damaging premature disclosure. However, the Commission's decision was ultimately balanced and practical, recognizing the inherent uncertainty of the typical M&A process and the need to balance the desirability of keeping the market informed and the damage that can be caused by premature disclosure. As a result, the case serves as a useful analytical framework for these disclosure decisions, and is likely to guide best practices in this area. **11**

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¹¹ Sections 1.4(g), 1.7(b) and 1.11 of Form 51-102F1, National Instrument 51-102. However, the form expressly recognizes in the latter case that this disclosure would not be required if a confidential material change report has been filed (see also *supra* note 3).