Securities

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$16 Million Awarded for Breach of Bought Deal Engagement Letter by Dealer

Overview

On March 1, 2013, the Ontario Superior Court of Justice determined that Stifel Nicolaus Canada Inc. (formerly Thomas Weisel Partners Canada Inc.) breached its bought deal engagement letter with Stetson Oil & Gas Inc. To compensate Stetson for damages stemming from the 2008 failed private placement bought deal financing, the court has ordered Weisel to pay Stetson damages of approximately C$16 million.

The court found that the engagement letter between Weisel and Stetson was a binding agreement and that Weisel had breached its obligations under that agreement. The decision serves as a warning to investment bankers eager to put firm deals in front of companies that it is not easy to back out of bought deal commitments.

History of the Claim Against Weisel

In July 2008, Stetson announced through Weisel that it had entered into an agreement with Weisel as lead underwriter to purchase, on a bought deal private placement basis, C$25 million worth of Stetson's subscription receipts at a price of C$0.55 per subscription receipt. The proceeds of the private placement were required by Stetson to meet its commitments under certain land leases in the Bakken Formation in North Dakota.

After placing only C$2 million of its position after a week of marketing, Weisel did not close the bought deal even after the closing date of July 31, 2008 was extended by Stetson, nor did Weisel take any steps to terminate the engagement letter prior to the closing date. After failed attempts in early August 2008 to negotiate alternatives, including new terms for the financing, Weisel offered to make a debt investment of C$8 million in return for a release of its obligations under the engagement letter. A few days later, Stetson informed Weisel that it would not release Weisel from the engagement letter and that if Weisel did not fulfill its obligations under the agreement, Stetson would take action.

As early as August 1, 2008, Stetson began to pursue alternatives to the Weisel financing. In order to meet its lease payment obligations during this period, Stetson had to obtain two bridge loans. At the end of August 2008, Stetson eventually signed an agreement with Canaccord Capital Corporation for a C$12 million financing on a "best efforts" basis for 60 million units at C$0.20 per unit. In addition to the reduced price, as a sweetener, Stetson agreed to issue approximately 85 million preferred shares to existing Stetson shareholders to entitle them to a portion of the proceeds of any final judgment or settlement received by Stetson resulting from its claim against Weisel. The Canaccord financing closed in mid-September 2008, but the net proceeds were insufficient to fund the development of Stetson's Bakken lands.

"Bought Deals" Generally

A bought deal financing is a type of offering fundamentally characterized by the transfer of market risk from the issuer to the underwriter. The issuer and the underwriter enter into a "bought deal engagement letter" (sometimes, referred to as a bought deal bid letter) fixing the terms of the offering. In a bought deal transaction, the underwriters agree to purchase the securities offered as principal.

After having executed the bought deal engagement letter, the issuer and the underwriter typically sign an underwriting agreement at the time of filing a preliminary short form prospectus in the case of a public financing and, in the case of a private placement, on or before the closing time of the offering. Termination provisions in the bought deal engagement letter and the corresponding underwriting agreement are fairly narrow and generally only include what are referred to as "disaster out", "litigation" or "regulatory out" and "material adverse change out" clauses. "Market out" and "not profitably marketable out" clauses are never part of a bought deal underwriting agreement as the essence of a bought deal is to shift the market risk to the underwriter.

Why This Decision Matters

The Stetson decision is interesting because it confirms certain fundamental aspects of the Canadian bought deal financing system. In the context of a bought deal: (i) the engagement or bid letter is a binding agreement, notwithstanding that it contemplates an underwriting agreement to be entered into at a later date; (ii) a standard "material adverse change out", also known as a "MAC" clause, cannot be construed to provide underwriters with what would effectively be a "market out"; and (iii) the reasonable expectation of market participants is that a "disaster out" provision can only be invoked in the event of a catastrophic or "macro" event and, again, not with the effect of providing underwriters with a "market out".

The decision also serves to remind underwriters that simply refusing to close is a risky substitute to formally terminating an engagement.

Discussion

Binding Agreement

The two pillars of Weisel's defense to Stetson's claim were: (1) that the engagement letter signed by the parties was not a binding agreement and therefore did not commit Weisel to a bought deal obligation to take the private placement; and (2) in any event, the standard "material adverse change out" and "disaster out" clauses that would have been included in the underwriting agreement (and which were explicitly contemplated in, but were not provisions of, the engagement letter), would have provided it with the basis to refuse to close.

The language of the engagement letter quoted by the court in its decision is fairly typical language for private placement bought deal engagement letters and the court found ample support in both the language of the engagement letter and the conduct of the parties to support its conclusion that the engagement letter was, and was intended by the parties to be, a binding agreement. The court further noted that, "[n]o Weisel witness testified that Weisel acted as it did on the basis that the engagement letter was not a binding agreement or that the engagement letter was viewed by them as not being a binding agreement."

Internal Weisel correspondence after signing the engagement letter and after it encountered difficulties selling its position were noted in the judgment as evidencing the fact that Weisel clearly understood that it had a bought deal liability that it wanted to sell out before it was required to close with Stetson.

While not discussed in the decision, whether Weisel complied with IIROC's regulatory capital requirements for bought deals at the time it entered into the engagement letter would have shed additional light on the extent to which Weisel believed it had a firm obligation under the engagement letter.

The “Out Clauses”

In its closing arguments Weisel attempted to rely on the “material adverse change out” and “disaster out” clauses, which, as the court noted, were not contained in any agreement between the parties and, as such, could not be relied upon by Weisel as a basis for terminating its obligations. The court held that Weisel never attempted to negotiate the underwriting agreement (which would have included such clauses) before it failed to close the transaction as required by the engagement letter.

Further, the court was not convinced that Weisel ever purported to rely on either of these “out” clauses as its basis for not closing. It found that, in order for Weisel to so rely, it would have had to: (i) form an opinion that there had been a MAC or “disaster”; and (ii) provide Stetson with written notice to that effect before the scheduled closing date. The court noted that Weisel’s arguments that it could rely on these two clauses to deny liability to Stetson were “supported by no plausible evidence”. The Court also noted that Weisel did not give Stetson written notice that it was terminating the engagement letter in reliance on the “out” clauses. In brief, Justice Newbould stated,“in my view, and I so find, even if the out clauses relied on by Weisel were applicable, there were no facts present that would have entitled Weisel to rely on them or that entitle Weisel to rely on them in this trial.”

The decision includes some useful commentary regarding standard MAC and disaster-out clauses. It is well understood by market participants that bought deal engagements cannot contain a “market out” provision which would allow an underwriter to refuse to close simply because the subject securities cannot be marketed profitably. This is because a fundamental feature of the bought deal is that the market risk is transferred to the underwriter when the deal is signed. As such, in the context of a bought deal, MAC and disaster out clauses (and any other clause for that matter) can never be interpreted or applied so as to, “effectively provide the underwriters with a market out by another name.”

The court agreed that where no MAC clause was negotiated by the parties, other than a reference to the parties negotiating in good faith an underwriting agreement that contained a standard MAC clause, such clause would restrict changes to those that materially affect the issuer rather than just businesses in the industry generally.

The court also agreed with the following view offered by Stetson’s expert witness, noting further that this interpretation was consistent with IIROC’s form of disaster out clause, that disaster out clauses are somewhat analogous to force majeure provisions and are properly invoked,“…in the event of a catastrophic ‘macro’ event, circumstance or change in law or national or international general application which is not specific to a particular issuer or (except in the most extraordinary circumstances) industry.”

Take-aways

Underwriters that may wish to rely on industry-standard termination provisions customarily found in bought deal underwriting agreements prior to the execution of an underwriting agreement should include those provisions (or clear and specific references to them) in their bought deal engagement letters. At the very least, the bought deal engagement letter should specify that the application of such clauses will commence upon acceptance by the issuer of the offer set out in the bought deal engagement letter and will terminate on closing of the offering. This caution applies to other conditions (such as a due diligence condition) that the underwriter wants to be able to rely on during the period prior to signing a definitive underwriting agreement. These conditions should be specifically set out as operative conditions in the engagement letter.

As soon as it appears to an underwriter that it is not going to close a bought deal private placement and is unable to negotiate satisfactory revised terms with the issuer, rather than simply not showing up at the closing or advising the issuer that it cannot close, the underwriter should immediately speak with legal counsel about what steps to take in order to terminate the engagement letter before the closing date. This will require careful consideration as most of the time underwriters in that situation are working feverishly to either sell the deal or negotiate revised terms. As such, with a view to managing reputation and potential liability, underwriters should give serious thought before deciding to switch gears and effectively throw in the towel on the deal.

Weisel has indicated that it intends to appeal the decision so stay tuned.

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