STIKEMAN ELLIOTT

U.S. Private Equity and VC Investments in Canada

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Acknowledgments to Roanne C. Bratz of the Montreal office of Stikeman Elliott for her advice on tax issues and to Andrew S. Cunningham, Curtis A. Cusinato, Samantha G. Horn and Simon A. Romano of the firm's Toronto office for their valuable contributions.

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INTRODUCTION

Traditional venture capital ("VC") and private equity investment activity in Canada has increased markedly over the past year or two from the relatively weak investment environment of 2000 and following. In addition, one of the most important trends in the M&A markets in Canada, as in the U.S. and elsewhere, has been the increased involvement of private equity firms. The leading private equity players have included both Canadian firms (such as Onex and OMERS Financial) and large U.S. firms (such as KKR and Bain).

The Canadian private equity and VC market is well developed, with nearly the same level of overall investment, adjusted for population, as the U.S. The profile of these investments is significantly different, however. According to figures compiled by Thomson Macdonald, nearly twice as many Canadian as U.S. companies received funding in 2005 (on a "per capita" basis), but the average investment in those Canadian companies was only about 30% of the typical level in the U.S. ($3.1m vs. $10.5m, in Canadian dollars).*

* All monetary figures are in Canadian dollars unless otherwise indicated

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EXECUTIVE SUMMARY

The purpose of this guide is to outline the current legal environment for "traditional" VC and private equity investments, including trends in structuring, documentation and exit strategies, as well as to deal with issues relating to the private equity M&A phenomenon. In view of the significance of U.S. VC and private equity investors in the Canadian marketplace, special attention is paid to U.S. practices and cross-border issues.

The following key points emerge from the discussion:

- The most popular securities in Canadian private equity and VC transactions are **convertible debt** (particularly for tax reasons and in small investments) and **convertible preferred shares**. Convertible debt often takes the form of **convertible debentures**. It should be noted that it is less common in Canada for convertible preferred shares to be entitled to vote on an as-if-converted basis. (see pages 4-12)

- Many Canadian jurisdictions have **director residency requirements** specifying that a certain proportion of a board of directors must consist of resident Canadians. (see page 9)

- Most major Canadian business corporations acts allow shareholders to create a **Unanimous Shareholder Agreement** (USA) that, among other things, can restrict any or all of the directors' powers. It is now standard practice in Canada to insert protective provisions and other rights (such as the right to appoint a specified number of directors) into the USA rather than in the share conditions. (see pages 17-19)

- **ROFRs, ROFOs, puts** and **calls** often feature in Canadian private equity and VC transactions – ROFRs and ROFOs should be drafted so as to ensure, among other things, that offers cannot contain "superior proposal" provisions and limit exposure on a potential sale to "several" (rather than "joint") liability, which should be capped. (see pages 21-22 and 24)

- The formation of **income trusts** and the use of **London's AIM market** have recently emerged in Canada as efficient IPO exit strategies, often offering 100% exits that are difficult to obtain through common share IPOs in the Canadian equity markets. (see pages 24-25)

- Canada has no national securities regulator, but the provincial securities commissions have achieved a considerable degree of harmonization through their recently implemented **private placement rules.** (see pages 14-16)

- There are a number of ways in which a public company can be taken private in Canada, the most popular of which is through a **plan of arrangement.** (see pages 28-32)

- **Consolidated tax returns** for related companies are not permitted under Canadian taxation legislation. (see pages 36-37)

- U.S. private equity and VC investors can often structure transactions using a **Nova Scotia or Alberta unlimited liability company** (unlimco) in order to achieve "check-the-box" flow-through status under U.S. tax law. This generally results in favourable tax treatment. (see pages 38-41)

- U.S. LLCs can often structure private equity or VC investments in a tax-efficient structure by **interposing a Luxembourg "Soparfi"** between themselves and the Canadian business in which they wish to invest. (see pages 41-42)

- Canada's **usury laws,** which set the maximum legal interest rate at 60%, sometimes create an issue where warrants, "free" shares or other "equity kickers" form part of a loan transaction. There is a small but real risk that a court could re-characterize overly generous collateral arrangements as "interest" that could potentially exceed the allowable rate. (see pages 12-13)

FORMS OF INVESTMENT

Introduction

In Canada, as in the U.S., the securities forming the basis of VC and private equity investments typically fall into one or more of the following classes:

- common shares
- convertible preferred shares
- convertible subordinated debt
- subordinated debt and warrants

While the same securities are used, U.S. investors should note that Canadian VC and private equity deals are more likely than their U.S. counterparts to be funded with debt. This may be partly because subordinated debt is more frequently secured in Canada than it is in the United States. Canadian VC and private equity investors generally see little practical difference between equity and subordinated debt deals from a corporate perspective, so that the considerable potential tax advantages of convertible, cross-border debt deals are often decisive.

Common Shares

Although common shares are not as popular as convertible preferred shares, VC and private equity investors are still willing to acquire them in certain circumstances. For example, an investor with a longer time horizon and capital gain objectives may prefer the simplicity of a common share investment, particularly in a more mature company with a stable earnings history. Common shares will typically enjoy the benefits of a return on capital in the form of dividends, the right to vote (possibly even a multiple vote) and the upside on potential growth through the right to receive the remaining assets of a Canadian corporation on its liquidation, dissolution or winding up.

Convertible Preferred Shares

General

As in the U.S., convertible preferred shares can offer significant advantages to VC and private equity investors over common shares. The attributes of these preferred shares could include the following:

- a preferred return in the form of dividends (usually cumulative)
- a preference on liquidation or sale
- preferential voting or consent rights in respect of material matters (contained in either the share conditions themselves or shareholder's agreement, and often reinforced by statutory requirements mandating class voting)
- a right of conversion to common shares to facilitate participation in liquidity transactions.

Dividends

Preferred share investments by VC and private equity investors invariably provide for a preferential dividend. This could be a stipulated percentage of the paid-up or stated capital or it could be tied into a variable rate, such as the "prime rate" or LIBOR.

Such dividends are usually cumulative in nature. In other words, if they are not paid, they accrue and must be paid before dividends are declared and paid on common shares (and perhaps on other classes of preferred shares). Cumulative dividends are important, even if future dividends are not anticipated, because they will affect investors' liquidation preference and conversion rights.

It is also possible to provide that the holders of preferred shares participate with the holders of common shares, usually on a *pro rata* basis, on all dividends in excess of the aggregate preferred share dividend.

It is important to note that under most of the leading Canadian corporations statutes – and in particular the *Canada Business Corporations Act* ("CBCA") and Ontario's *Business Corporations Act* ("OBCA") – no rights, privileges, restrictions or conditions

attaching to a *series* of shares may confer on those shares a priority in respect of dividends or return of capital (and in the latter circumstances under the OBCA, only in the event of the return of capital upon the liquidation, dissolution or winding-up of the corporation) over the shares of *any other series of the same class*. These restrictions often preclude the use of "blank check" preferred shares issuable in series, a common practice in the U.S.

Finally, there are statutory and common law restrictions on the declaration and payment of dividends by a corporation in Canada. For example, both the CBCA and OBCA prohibit the declaration or payment of a dividend (i) if the corporation is unable to pay its liabilities as they become due (or would be, after making the payment) or (ii) if the realizable value of the corporation's assets would be less, after the payment, than the aggregate of its liabilities and its stated capital of all classes. As with comparable tests for redemptions, there are jurisdictions in Canada, such as Nova Scotia, that provide more flexibility in this connection.

Liquidation Preference

A liquidation preference on preferred shares will provide investors with a right to a return of their investment upon the liquidation, dissolution or winding up of the corporation before any money is paid to holders of common shares and possibly other classes of preferred shares.

As is the practice in the U.S., in Canada the liquidation preference is usually a multiple of the original stated or paid-up capital of the preferred shares plus accumulated and unpaid dividends (if dividends are cumulative) or, less frequently, declared but unpaid dividends (if dividends are non-cumulative).

It is also possible to provide the holders of preferred shares with a participation feature upon the liquidation, dissolution or winding up of the corporation, such that a holder of preferred shares has the right to receive, along with the holders of common shares, the remaining assets of the corporation following payment of the aggregate preferential liquidation amount. In the event that VC and private equity investors are able to negotiate a participating liquidation feature, it is often limited to a specified amount (such as 3 to 5 times the original subscription price). Obviously when such a

limit is in place, there is a valuation at which it becomes advantageous for the investor to convert the preferred shares to common shares in order to participate fully in the liquidation or deemed liquidation. The lower the liquidation preference, the lower the threshold value.

Typically, VC and private equity investors will insist upon provisions in the share conditions providing that an acquisition of the corporation will be deemed to be a liquidation. Exceptions are often carved out with respect to amalgamations or other transactions in which there is no effective change of control of the corporation, such as an amalgamation with a wholly-owned subsidiary.

Conversion/Anti-Dilution Provisions

Typically, the conversion ratio of preferred shares into common shares is subject to adjustment for potentially dilutive transactions. It is important to note, however, that in Canada there are significant regulatory barriers to punitive anti-dilution provisions and ratchets in the case of public companies. Specifically, the Toronto Stock Exchange (TSX) will likely require shareholder approval of any such provisions. This is a significant issue, given the current trend among U.S. private equity investors toward investment in Canadian public companies.

The share conditions would also typically provide that all outstanding preferred shares will automatically convert on specified events. For example, mandatory conversions are often provided for in the event that a private company makes a "qualified IPO".

Anti-dilution provisions are intended to offer investors protection against subsequent share issuances that may dilute their equity position. They include *event-based* anti-dilution protection for stock splits, stock dividends and similar events and *price-based* anti-dilution protection against subsequent share issuances at a price lower than investors' purchase price. There are various formulas for adjusting the conversion price in the event of subsequent dilutive issuances (although, as noted above, these are restricted in the case of exchange-traded companies governed by the TSX rules):

- A “broad-based” weighted average formula (which is based on a weighted average of the purchase price(s) and numbers of then outstanding common and preferred shares, as well as (i) shares issuable on the exercise of options or warrants or the conversion of other securities and (ii) the newly-issued shares)

- A “narrow-based” weighted average formula (which takes into account only the purchase price(s) and numbers of preferred shares being adjusted and will typically exclude options, warrants or even other classes/series of preferred shares)

- A “ratchet-based” adjustment which results in an adjustment of the conversion price to the price per share of the newly-issued shares

From the investor’s point of view, in a so-called “down round”, “ratchet-based” adjustments are generally more favourable than “narrow-based” weighted average adjustments which, in turn are more favourable than “broad-based” weighted average adjustments. However, some form of weighted average formula is most commonly used in Canada.

In addition, exceptions are typically included in the adjustment formula, including exceptions for shares issued (or to be issued) to executives or employees (usually with a cap), for shares issued upon a conversion of outstanding securities and for securities issued in connection with specified types of transactions (e.g. shares issued to lenders to facilitate credit lines).

Redemptions

A typical redemption right would permit the corporation to redeem preferred shares at any time at a specified price per share (or based on a formula). However, such a right may force investors holding convertible preferred shares to convert if the value of the common shares exceeds the redemption price. They would thereby lose their preferential status while cashing out at a price yielding a relatively low return on investment. These effects can be countered by setting a high enough redemption price or by making the preferred shares redeemable only after a specified date.

It is not uncommon to have a mandatory redemption feature requiring a corporation to redeem preferred shares at a specified price on a specified date (or dates) or at any time after a specified date (or dates), upon investor demand. In this connection, it should be noted that under the CBCA and the OBCA, a corporation is prohibited from redeeming its shares if there are reasonable grounds for believing (i) that the corporation is, or, after the payment, would be unable to pay its liabilities as they become due, or (ii) that after the payment, the realizable value of the corporation's assets would be less than the aggregate of its liabilities and the amount that would be required to pay the holders of shares who have a right to be paid on a redemption or in a liquidation prior to the holders of the shares to be purchased or redeemed. However, much as was noted above with respect to the parallel restriction on dividends, some Canadian jurisdictions, notably Nova Scotia, provide greater flexibility with respect to preferred share redemptions.

Pay to Play

In circumstances where it is anticipated that there will be a sustained period of declining stock prices for new issuances of securities (that is, "down rounds"), it is common to find "pay to play" provisions restricting the right of investors to opt out of opportunities to participate in further (dilutive) financings while at the same time retaining the benefits of anti-dilution. A pay to play provision achieves this through (i) a mandatory conversion, or (ii) the establishment of a "shadow" series of preferred shares such that an investor declining to participate in a "down round" is automatically converted to a shadow series lacking anti-dilution protection, freezing the conversion price at the price in effect immediately prior to the dilutive financing (or at the issue price of the relevant preferred shares). The rationale for "pay to play" is that if an investor wants the benefit of convertible preferred share ownership, it has to be in for the long haul.

Voting Rights

Very often, holders of convertible preferred shares are entitled to vote directly, possibly even with a multiple vote. Sometimes, although much less frequently in Canada than in the U.S., they are entitled to vote on an "as-if-converted" basis, i.e. with as many votes as they would have if they converted all their preferred shares into voting common shares.

It should also be noted that both the CBCA and OBCA provide holders of non-voting shares with the right to vote in certain

circumstances (the CBCA being broader than the OBCA). For example, whether or not it otherwise carries voting rights, each share of a CBCA corporation has a statutory right to vote in respect of a number of events, including (among others) a long-form amalgamation, "export" (continuance) to another jurisdiction and the sale, lease or exchange of all or substantially all of the corporation's property. In addition, both the CBCA and the OBCA also provide for class or series votes in certain circumstances.

Election of Directors

Holders of preferred shares or of a particular class or series of preferred shares often negotiate the right to elect a specified number of directors to the board of directors. Alternatively, investors sometimes simply provide for a separate class or series vote of preferred shareholders with respect to the election of directors. In Canada, this type of provision is usually found in a Unanimous Shareholder Agreement (see pages 17-19), rather than in the articles. However, "nominee" directors in Canada are bound by the basic duty – applicable to all directors – of acting in the best interests of the corporation as a whole. This is so even where that interest diverges from the interest of those who nominated the director. Directors' obligations are discussed below at pages 19-21.

It should also be noted that a number of Canadian corporate statutes have residency restrictions on directors – for example, the CBCA requires that at least 25% of the members of a board be resident Canadians and the OBCA that resident Canadians comprise a majority of the board (or, one of two in the case of an Ontario corporation with only two directors). Notable exceptions include the New Brunswick *Business Corporations Act* (NBBCA) – a CBCA-type statute – and the Nova Scotia *Companies Act* (NSCA), which is based on the English "memorandum and articles of association" model. OBCA and CBCA corporations are often "continued" under the NBBCA or NSCA where Canadian director requirements become an issue. "Continuance" is generally a simple, quick and tax-neutral transaction.

Other director residency restrictions exist with respect to certain regulated industries. For example, the federal *Telecommunications Act* requires that at least 80% of the directors of a common carrier must be resident Canadians.

Protective Provisions
It is possible to insert a prohibition in the share conditions preventing the corporation from taking certain fundamental actions without a vote of the preferred shares voting as a class, either as a majority or on a super-majority basis. Again, the practice in Canada is to insert such provisions in the Unanimous Shareholder Agreement.

Special Voting Rights
Holders of preferred shares can in certain circumstances be provided with specified voting rights (such as the right to elect a majority of the board of directors) on the occurrence of certain unfavourable events, such as default on mandatory redemptions, default on dividend payments or failure to achieve specified financial results.

Cumulative Voting
It is also possible to have cumulative voting whereby a shareholder can generally ensure proportional representation. In practice, cumulative voting is not often used, as private equity and VC investors generally prefer to insert their rights to appoint directors in a Unanimous Shareholder Agreement or, less frequently, in the share conditions.

Other Rights
Other rights are invariably included in a shareholder agreement and not in the share conditions themselves. These typically include "registration rights", confidential information rights, rights of first refusal, pre-emptive rights, etc., discussed below at pages 21-26.

Convertible Debt
It is not uncommon for VC and private equity investors to advance funds by way of secured, subordinated (usually to prior senior secured bank financing) convertible debt. This gives the investor the best of all worlds:

- in a bankruptcy or insolvency scenario, a priority over all equity (preferred and common) and, subject to certain exceptions, priority over unsecured creditors;
- a "priority" return on investment through interest that is paid ahead of all dividends (interest not being subject to statutory restriction or payment, as are dividends);
- security on the assets of the corporation;

- the right to convert into equity at the optimum time with the conversion price being protected for "event-based" and "price-based" anti-dilution; and

- potentially, debt on a demand basis, permitting a full return of the funds advanced on relatively short notice.

Interest on this type of debt can be fixed or floating and accrued interest may also be converted at the same conversion rate and on the same terms as the principal. Often the debt will be expressly subordinated to prior senior bank debt. Where the debt is secured (subordinated debt in Canada tends to be secured, in contrast with its U.S. equivalent), it is sometimes "deeply subordinated" to the extent that it ranks pari passu with the unsecured creditors in the event of bankruptcy or insolvency or possibly even ranks behind secured and unsecured debt in the event of bankruptcy or insolvency. In addition, there are a variety of positive and negative covenants (similar but usually not quite as extensive as those required in typical bank financing) and events of default, the breach of which can result in the right to demand immediate payment and to realize upon security.

Typically the debt takes the form of a promissory note (or debenture) that may be converted at any time during its term (except in the case of specified events) for a specified class, and possibly series, of shares. In a start-up scenario, the promissory note may be convertible into whatever securities are issued in the next equity financing of the corporation, subject to minimum aggregate proceeds being received by the corporation. The notes may be convertible (i) on demand, or (ii) automatically on the next equity financing of the corporation, or (iii) on the occurrence of certain specified events (such as the sale of the corporation).

The security for such a note would typically include a general security agreement and possibly charges or mortgages against real property. It should be noted that most provinces have personal property security (PPSA) legislation similar to UCC Article 9 (Quebec has a civil law equivalent). The use of "debentures" is still quite common in Canada, being a holdover from security regimes derived from English law. A debenture typically contains all of the features of the promissory note but would also include a grant of security against personal property (and sometimes real property) of the issuer.

It should be noted that Canada applies thin-capitalization rules (2:1 debt to equity ratio) to acquisitions financed through cross-border debt from related parties, the breach of which may result in the disallowance of interest deductions claimed by the Canadian debtor.

In addition, withholding tax of 10% will normally be imposed on payments of interest by a Canadian resident to a U.S. debtholder. The "5/25 Debt Rule", a provision of the federal *Income Tax Act*, exempts most interest payments to arm's-length non-resident parties, provided that under the terms of the obligation, the Canadian debtor cannot be required to pay more than 25% of the principal amount within five years of the date of issue. The rule is considered below at page 34.

Warrants

In Canada, warrants are quite commonly issued to VC and private equity investors, particularly in debt financings, as additional consideration. Warrants are essentially options to acquire common shares, convertible preferred shares or other securities. In circumstances where a corporation is anticipating a new round of financing, it will often issue a warrant for the series to be issued in the next financing at the next-financing price per share, defaulting to the current preferred share price if the financing does not close within a reasonable period of time.

The typical warrant term is five to ten years. There will often be provision for termination of the warrant upon an amalgamation, merger or acquisition of the corporation or an IPO, since outstanding warrants are dilutive to potential acquirors and underwriters.

Warrants can also contain an anti-dilution provision to deal with "event-based" dilution through stock splits, recapitalizations, etc. (but usually not with "price-based" dilution). In addition, a provision may be contained in a warrant allowing the warrant holder to satisfy the exercise price by netting out the actual purchase price in the shares that it would otherwise receive upon the exercise.

Caution should be observed in issuing warrants or "free" shares, as Canadian usury laws have sometimes been held to recharacterize the equity component of a loan transaction as hidden interest in excess of the maximum legal rate of 60% per annum. The lengths to which Canadian courts sometimes go to find "criminal rates of interest" in

ordinary commercial relationships are illustrated by *Boyd v. International Utility Structures Inc.* (2001), 13 B.L.R. (3d) 156 (B.C. S.C.), aff'd (2002) 216 D.L.R. (4th) 139 (C.A.). The case concerned a commercial loan to finance the acquisition of technology to be used in the manufacture of metal utility poles. In addition to interest on the loan, the borrower was to receive a royalty payment for every pole made with the technology. The court characterized the royalty payments – which the parties seem to have considered a profit-sharing equity relationship collateral to the loan – as "in substance if not in form, charges paid or payable for the advancing of the loan" and hence as "interest". While criminal usury charges in commercial cases are unlikely, in a civil context a contract calling for an effective rate of interest above 60% can be found void for illegality. In some circumstances, however, the rate will simply be reduced to a legal level by the court (*Transport North American Express Inc. v. New Solutions Financial Corp*. (2001), 54 O.R. (3d) 144 (S.C.J.), aff'd [2004] 1 S.C.R. 249, rev'g (2002), 60 O.R. (3d) 97 (C.A.)).

SECURITIES LAW IMPLICATIONS

Private Placements

In order to avoid the onerous registration and prospectus requirements of applicable securities legislation, VC and private equity investors investing in Canadian corporations have traditionally sought refuge in various exemptions under such securities legislation – including the "private company" exemption and the $150,000 purchase price exemption – which varied from province to province.

The very recent implementation by Canadian securities regulators of National Instrument 45-106 ("NI 45-106") has resulted in the consolidation and harmonization of many of the more common prospectus and registration exemptions that had existed in different provinces. With respect to equity financings, several possible capital raising exemptions may be available, including the following:

Accredited Investors

Securities of any value can be issued and traded on an exempt basis to "accredited investors", including Canadian financial institutions and entities with net assets over a specified amount (currently $5,000,000) purchasing as principals. This exemption requires a report to be filed and the payment of a fee.

Private Issuers

Securities, of any value, of "private issuers" can be issued and traded on an exempt basis to a long list of specified investors, purchasing as principal (including directors, executives and certain of their relatives, existing security holders, accredited investors and persons who are not members of the public). A "private issuer" is one whose constating documents or shareholder agreements (see pages 17-19 below) contain restrictions on the transfer of its securities (other than non-convertible debt securities). Note that such a restriction would have to appear on the security document itself – in the case of convertible debt, for example, the restriction would have to appear in the debenture or convertible note. In addition to the requirement for explicit restrictions, the constating documents of a private issuer must also restrict the number of shareholders to not more than 50 persons

(not including employee shareholders or ex-employee shareholders); and prohibit any invitation to the public to subscribe for its securities. No report need be made (nor is any fee required) with respect to the issuance or trade of exempt securities of private issuers.

The nature of an "invitation to the public" under Canadian law is amorphous. Two tests, both rather subjective, are commonly applied: the "common bonds of interest" test and the "need to know test". The first, formulated in *R. v. Piepgrass* (1959), 29 W.W.R. 218 (Alta. C.A.), excludes a prospective investor from "the public" if that person has "common bonds of interest or association" with the issuer. Broadly speaking, such a bond will usually involve a close personal or business relationship with the issuer. The second test, originating in *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119 (1953), excludes investors who can "fend for themselves" – i.e. who don't need the information that would appear in a prospectus. Note that this is usually held to be something more than a general "sophisticated purchaser" test: reliance should not be placed on the "need to know" test unless the purchaser is "sophisticated" specifically with respect to the issuer in question.

In many judicial opinions – for example, *R. v. Zitzerman* (1996), 11 C.C.L.S. 199 (Man. Prov. Ct.) – both tests have been referred to. Because the jurisprudence on this issue is highly subjective, the practice in Canada is to err on the side of caution and assume, wherever there is a significant doubt, that a distribution would likely be found to be "to the public".

$150,000 Minimum Purchase

Securities can be issued and traded on an exempt basis to any purchaser purchasing as principal if the securities have an acquisition cost of at least $150,000, paid in cash on closing. If an issuer wants to rely on this exemption for additional investments they must also have an acquisition cost of at least $150,000. In addition, this exemption requires a report to be filed and payment of a fee.

Offering Memorandum

Except in Ontario, a trade by an issuer of its own issue will be exempt if, among other things, the purchaser purchases the security as principal, the issuer delivers an offering memorandum in prescribed form to the purchaser and obtains a risk acknowledgement statement

from the purchaser. It should be noted the exemption does not operate uniformly across all jurisdictions and that the filing requirements are quite onerous.

Acquisitions

Any take-over bid, even of a "private" company, would normally be subject to the rigorous take-over bid provisions of relevant securities legislation unless an exemption is available. One important exemption, found in section 93(1)(d) of Ontario's *Securities Act*, applies if (i) the target is not a reporting issuer, (ii) there is no published market in respect of the securities that are the subject of the bid and (iii) the number of holders of securities of that class is not more than 50, exclusive of employee-shareholders of the target or any of its affiliates. This exemption is frequently relied on in private equity and VC transactions.

SHAREHOLDER AGREEMENTS

Unanimous Shareholder Agreements

Traditionally, many of the terms and conditions applicable to investments by VC and private equity investors in Canadian companies have not been contained in the share conditions themselves but in a separate shareholder agreement. A Canadian shareholder agreement is an omnibus agreement that often contains all the provisions which, in U.S. practice, would be found in separate shareholder agreements, "investor rights" agreements and "registration rights" agreements. A shareholder agreement is a contract between two or more shareholders and is therefore treated, in most respects, as a commercial contract. It is subject to the articles and by-laws of the corporation and the provisions of the relevant corporate statute.

The CBCA and a number of its provincial counterparts provide for a special type of shareholder agreement known as a "Unanimous Shareholder Agreement" (USA). A USA is an agreement among *all* registered shareholders of *all* classes – voting or non-voting, common or preferred – that restricts, in whole or in part, the powers of the directors to manage, or supervise the management of, the business and affairs of the corporation. A Unanimous Shareholder Agreement overrides the common-law rule against fettering the discretion of the directors. It is a corporate law hybrid, part contractual in nature and part constitutional in nature and for certain purposes forms part of the constating documents of the corporation.

In a USA, shareholders will typically exercise their right to contract out of certain statutory requirements. For example, they may (i) require more votes of directors or shareholders than required by the statute or (ii) limit the directors' discretion over such matters as issuing shares, making or amending by-laws, appointing officers, fixing remuneration (of directors, officers and employees), borrowing money, providing guarantees, or granting security interests in the corporation's property.

The advantages of a USA are many. Two of the most important are (i) that USAs are binding upon purchasers without signing, as long

as the share certificates contain an appropriate legend and (ii) that there are methods of enforcement under the relevant corporate statutes that go beyond ordinary contractual remedies, including having the regulator appointed under the relevant corporate statute enforce a compliance order.

To the extent that a Unanimous Shareholder Agreement restricts the powers of the directors to manage the business and affairs of the corporation, shareholders who are given that power have all the rights, powers and duties of directors under law. In addition to this, however, shareholders also take on all of the *liabilities* of directors and officers, which could include:

- Liability under corporate statutes (e.g. for six months' wages for employees, for issuing shares for property of insufficient value, or for payment of dividends or redemption/acquisition of shares by the corporation in breach of statutory solvency tests).

- Tax liabilities, such as source deductions, and amounts owing under the federal Goods and Services Tax (GST) and provincial sales tax (PST).

- Liability for amounts owing under other non-corporate statutes, such as the *Employment Standards Act*, *Environmental Protection Act*, and *Pension Benefits Act*.

Whether a USA will relieve directors of statutory obligations and liabilities under non-corporate legislation will depend on the wording of the statute in question. For example, section 2(2) of Ontario's *Occupational Health and Safety Act* effectively precludes the shifting of OHSA compliance duties from directors to shareholders. Where obligations are contained in statutes from different jurisdictions, it is necessary to determine whether liability is shifted. In the event of a conflict between federal and provincial law, this may engage Canada's "paramountcy doctrine", which says, in effect, that federal law prevails over conflicting provincial law. Thus, for example, it might be asked whether a director of a corporation incorporated under a provincial corporations statute would be liable for source deductions under the federal *Income Tax Act* even though his or her powers were ostensibly transferred in their entirety to shareholders under a Unanimous

Shareholder Agreement. Paramountcy would suggest that the answer is probably yes.

It is possible to ensure that the shareholder agreement in question is not a USA. For example, it is possible to have a nominee shareholder with a single non-voting share who is not a signatory to the shareholder agreement. Alternatively, the shareholder agreement could permit "negative" or "veto" control by allowing the directors to vote on any particular matter while requiring shareholder approval (by majority or super-majority vote) for a specified list of material matters, such as the issuance of shares.

Governance and Control

Generally VC and private equity investors will require the appointment of nominees to the board of directors. If nominees are to be appointed, it is important to consider the circumstances under which a shareholder's right to nominate directors is to be reduced or terminated. Such circumstances could include:

- An increase or decrease in the shareholder's proportionate ownership from its initial percentage, including as the result of the purchase or sale of shares, and

- Material default by the shareholder in discharging certain specified obligations.

In each case, it is important to consider whether the shareholder would lose all of its nominees or just some of them.

The agreement should also provide that any corporate law requirements relating to the number of Canadian resident directors are complied with by the nominating shareholders.

It is also critical to remember that, as is generally the case in the U.S., directors of Canadian corporations who are nominees of a particular shareholder have a fiduciary duty, like all directors, to act in the best interests of the corporation – even where this is inconsistent with the interests of the shareholder who nominated them. This can sometimes leave the director in a very awkward position. Interestingly, the Supreme Court of Canada recently ruled in *Peoples Department Stores v. Wise* (2004), 244 D.L.R. (4th) 564 that directors' duties are

to be determined on an *objective* basis. While the implications of this in VC and private equity contexts have yet to be worked out, it would appear that the *Peoples* decision makes it difficult to maintain that the sophistication of many directors nominated by private equity and VC shareholders justifies holding them to a higher standard of conduct.

Conflict problems can be overcome by removing all of the rights and powers of the board and giving them to the shareholders. A less drastic solution is to require that any matter not approved unanimously by the directors be approved by the shareholders or a specified percentage of the shareholders (once again, more of a "negative control" approach). It is also very common to include a provision that all extraordinary matters require shareholder approval. VC and private equity investors are usually less concerned with the right to involve themselves in routine day-to-day decisions than with the right to approve major events directly effecting their economic interests such as retaining a veto over amendments to the articles, a change in the nature of the business, the annual business plan, amalgamations or other business combination, the issuance of securities or significant non-arms length transactions, etc.

For VC or private equity investors, an alternative to board representation may be observer status. Observer status entitles the shareholder to receive notice of and attend board meetings, providing input and specialized knowledge without actually voting. In such circumstances, the ability of the observer to participate in or be excluded from deliberations on certain matters should be considered. It should be noted, however, that while observers are not subject to the same fiduciary duties as directors, there is a real risk that observers who regularly attend board meetings could be named in an action against the directors of the corporation. Under the CBCA and OBCA, "director" is defined in relation to the functions that a person actually performs "by whatever name called". Canadian courts – for example the Alberta Court of Queen's Bench in *Agbi v. Durward* (1998), 36 C.P.C. (4th) 305 – have sometimes held that significant active participation in meetings, particularly with respect to acts (such as the passing of resolutions) that are the essence of a director's role, can turn a non-director (arguably including an observer) into a "de facto" director. Because a de facto director generally has the same liabilities as any other director (*Northern Trust Co. v. Butchart et al.* [1917] W.W.R. 405 (Man. K.B.)), a prudent "observer" may wish to obtain

indemnification and liability insurance of the sort normally obtained by directors, if it is available.

The shareholder agreement should also deal with matters such as how often board meetings are to be held and quorum requirements. It is useful to provide for the possibility of a reduced quorum after a certain number of adjournments due to the failure of a particular director or shareholder representative to attend.

Restrictions on Share Transfers

In order to qualify the corporation as a private issuer for securities law purposes, there is invariably a restriction on transfer of shares, save and except as otherwise specifically provided in the agreement. However, in order to provide the VC or private equity investor with liquidity, the following procedures are common, either alone or in combination:

Right of First Refusal ("ROFR")

A ROFR provides that, prior to selling its shares to a third party pursuant to a *bona fide* arm's-length binding offer, a shareholder is obliged to offer its shares to the other shareholders on the same terms and conditions as the third party offer. If the right of first refusal ("ROFR") is not exercised, the offering shareholder is typically free to sell to the third party for a stipulated period of time on terms and conditions that are no more favourable than those offered to the other shareholders. As a general proposition, ROFRs are usually very restrictive, requiring a binding third party offer and often requiring restrictive terms (e.g. all cash). Thus they should *not* be viewed as providing much liquidity.

ROFRs have received considerable support in Canadian jurisprudence, notably in *GATX v. Hawker-Siddeley Corp*. (1996), 27 B.L.R. (2d) 251 (Ont. Gen. Div.), an Ontario decision in which an attempt by one shareholder to avoid a ROFR through a contrived multi-stage transaction was rebuffed by the court. It is also possible to circumscribe the terms and conditions that such a third party offer may contain. For example, the ROFR could specify that any such offer must not require non-competition covenants, that representations and warranties must be on a several basis, that specified caps or limitations on indemnity are provided, etc. The recent decision of the Court of Appeal for Ontario in *Katotakis v.*

William R. Waters Ltd. (2005), 1 B.L.R. (4th) 168 holds that a "superior proposal" provision in a selling notice under a ROFR can be effective, provided that it does not expressly contradict the language of the shareholder agreement. In the judge's opinion, the superior proposal provision precluded an order for specific performance against shareholders who pursuant to a ROFR had offered their shares to their fellow shareholder at a specified "set price" but who then – in spite of their fellow shareholder's purported acceptance of the offer – turned around and accepted a subsequent and much higher offer ("superior proposal") from an outside party that their fellow shareholder was unwilling to match. The response to *Katotakis* has been to make it clear in a shareholder agreement that selling notices cannot allow for superior proposals and are void to the extent that they do.

Right of First Offer ("ROFO")

A ROFO is similar to a ROFR but does not require a binding third party offer and is generally *much more flexible*. It merely requires a shareholder wishing to exit to offer its shares to the other shareholders on specified terms and conditions (often cash only, with very few conditions). If the other shareholders do not wish to accept the offer, the offering shareholder is free to sell to a third party on terms and conditions no more favourable than those originally offered, once again only during a stipulated period. Once again, the agreement could and probably should limit the terms and conditions of any such offer.

Tag-Along/Piggy-Back Rights

A tag-along right is the right of a shareholder to require a prospective purchaser of another shareholder's shares to purchase its shares on the same terms and conditions (i.e. the minority shareholder has the right to piggy-back or tag-along in a sale by the majority). Tag-along rights are usually exercised in the wake of a ROFO or ROFR as the result of which the shareholder would be left in a minority position.

Drag-Along Rights

Drag-along rights are the reverse of tag-along rights, whereby a specified majority of shareholders who have an agreement with a third party to sell their shares on specified terms and conditions can require that the holders of the remaining shares sell their shares to a third party to whom the majority are selling their interest. Drag-alongs are a popular method

for preventing a dissenting minority from blocking transactions that the majority desires. Contrary to the situation in some U.S. states, there is unlikely to be an issue under the CBCA, OBCA and similar Canadian statutes with respect to the enforceability of a drag-along as an effective waiver of statutory rights of dissent, provided that it is appropriately drafted and contained in a Unanimous Shareholder Agreement.

If a VC investor can be "dragged", it is important to ensure that its liabilities for breaches of representations, warranties and indemnities are *pro rata* rather than joint and several, preferably capped at the amount of the purchase price paid to it. and not providing for (or limiting) non-competition covenants, non-disclosure provisions or other restrictive covenants. Additionally, there should not be any provisions that would affect the investor's right to own, use or exploit its assets or prevent or restrict in any way its ability to make investments in any business.

Considerations Applying to All of the Foregoing
Shareholder agreements should provide for detailed transaction mechanisms, including time periods for all notices and actions to be taken and details regarding closing of the sale (such as delivery of share certificates, resignations and/or releases of nominee directors, powers of attorney if the selling shareholder is unable or unwilling to effect the sale, etc.). The devil is certainly in the detail in a shareholder agreement.

It is also critical to know whether a shareholder must sell "all but not less than all" of its shares or whether partial sales will be permitted. Transfers should also be subject to the availability of exceptions from applicable prospectus and registration requirements under securities legislation and compliance with any other regulatory requirements. In addition, any transferee should become a party to the existing shareholder agreement.

Exit Alternatives

A shareholder agreement involving a VC or private equity investor will invariably provide for multiple means to exit the corporation. These exit alternatives would include the following:

Sale to a Third Party
Under a shareholder agreement, the right of any shareholder to sell to a third party is invariably subject to rights of other shareholders.

Please see the discussions above regarding ROFRs, ROFOs, tag-alongs and drag-alongs.

Put or Call Options

"Put" (the right to sell) or "call" (the right to buy) options can be exercisable at any time, after a period of time, or upon the occurrence of specified events. For example, a "put" option could provide that it can be triggered as against all other shareholders on a *pro rata* basis or alternatively as against the corporation. In such circumstance, it is important to consider who is the appropriate buyer, whether the corporation or the remaining shareholders. The choice is generally driven by cash availability and tax considerations. Any purchase by the corporation will also be subject to compliance with applicable statutory solvency requirements and to restrictive covenants in loan agreements or other contracts.

Registration Rights

A very common feature of shareholder agreements involving VC and private equity investors are so called "registration" or "prospectus" rights. These allow the shareholder to force a private corporation to go public or to force a public corporation to list the shares of VC and private equity investors for trading after a given period of time in specified circumstances. Probably the most significant change in this area has been emergence of income fund public offerings in lieu of common share IPOs.

Income trusts have become a very effective public market exit vehicle for private equity participants and a significant majority of the initial public offerings in Canada in the last several years have been by way of income trusts. The basic income structure is generally the same across all industries although it is often modified in order to accommodate specific tax, corporate, regulatory or planning objectives. In a typical situation, a Canadian resident trust issues and sells interests, usually in the form of units of the trust and uses the proceeds from the sale to acquire a business or income-producing asset. The business or asset is recapitalized, principally with debt held by the trust and often with senior debt held by a bank or other financial institution, with the result that the taxable income of the business is reduced significantly or even eliminated as a consequence of the cost of carrying the debt.

With respect to a common share IPO, it is rarely a 100% exit for a significant investor and even when a substantial block of existing shares can be sold, may need to be shared between all would-be sellers, unless the VC or private equity investor has pre-negotiated preferred status on the exit. Needless to say, underwriters and prospective investor will have requirements as to how much of the initial public offering can be made up of existing stock to pay out departing shareholders versus new stock to assist the corporation itself. Further issues arising on an IPO include (among many others) who will sign the prospective certificate as a promoter and/or agree to indemnify the underwriters, how the board will be constituted (and any special veto rights), provisions for amendment of articles and by-laws, escrow arrangements or other resale restrictions, expense allocation and the extent of management road-show participation obligations.

An income trust IPO has a number of advantages over a common share IPO, including the fact that pricing has generally been very good (to date) and can provide a 100% (or close to 100%) exit.

Another trend worthy of note is the use of the London Alternative Investment Market ("AIM"). AIM is increasingly seen as an attractive forum for initial public offerings by Canadian (and indeed foreign) corporations, particularly for high tech companies. Its advantages include the prestige of a London listing; no minimum float; no minimum market "cap"; no trading record requirement; a simplified regulatory regime; and generally lower ongoing fees than an IPO on the TSX, for example.

Shotgun

A shotgun sale is an arrangement whereby one shareholder can force a transfer of its shares to the remaining shareholder or shareholders by simply giving notice and naming the price per share. In its simplest form, the recipient shareholder must either buy or sell at that price. Shotgun provisions can work very well in circumstances where there are two roughly equal shareholders, with shareholders of similar financial capability and the corporation can continue following closing on substantially the same basis as prior to the closing. Because shotgun provisions are usually considered quite draconian, qualifications are often inserted on their use. Typically there might be a "honeymoon period" (say, of three years) after the implementation of the venture capital or private equity investment.

Shotguns are rarely provided in Canadian VC and private equity transaction documentation.

Shareholder Agreements: Tips for VC and Private Equity Investors

In negotiating and settling shareholder agreements, VC and private equity investors have special circumstances and requirements and should consider the following:

- **Director issues:** ensure frequent board meetings; consider observer status; consider D&O insurance; consider indemnities not only from the corporation but also key shareholders; and (in the case of U.S. VC and private equity investors) consider how to comply with any "resident Canadian" director requirements.

- **ROFOs vs. ROFRs:** ROFOs are much more flexible from a shareholders' perspective in providing liquidity.

- **ROFRs, ROFOs etc.:** be careful that the terms and conditions applicable to any offer under a ROFR, ROFO, etc. are fairly "vanilla" and, for example, do not or cannot contain restrictive covenants against such an investor; can only provide for "several" (not joint) liability of any such investor; provide for limitations of liability against such an investor (e.g. cap of 25% of purchase price; no consequential damages; limited survival periods for representations and warranties; limited escrow period, etc.)

- **Foreign ownership restrictions:** consider the implications of exercising ROFOs, ROFRs, shotgun or other exit rights in corporations which are subject to foreign ownership constraints (e.g. *Telecommunications Act*) since the potential market is much smaller for a sale and a U.S.-controlled VC or private equity investor may not be able to acquire voting shares, may require a Canadian "partner" or may require other devices (e.g. a Canadian trustee). Similarly, one must also bear in mind the possibility that a transfer of ownership to a non-resident investor may jeopardize a company's status as a Canadian-Controlled Private Corporation (CCPC), which is a favourable tax status applying to certain Canadian small businesses.

- **Registration rights**: ensure they are adequate and, if nothing else, onerous enough to provide leverage in negotiations with management.

- **Forced sale:** consider a right in certain circumstances for the shareholders to force the corporation to auction itself or its assets. Coupled with a "controlled auction", this can prove to be a very attractive exit strategy.

- **Confidentiality provisions:** ensure the ability to disclose confidential information to investors in VC and private equity funds, financiers and potential purchasers of shares.

- **Restrictive covenants**: be very careful about providing non-competition or non-solicitation covenants or other restrictive covenants, either during the shareholding period or thereafter.

- **Financing and capital calls**: never, ever provide for unlimited capital calls.

- **Governance rights**: having a veto on the business plan will provide effective control over the business and affairs of the corporation.

- **Dispute resolution mechanisms:** consider arbitration as an alternative to the courts, particularly where it might be possible for one shareholder to bring an action in a potentially unfavourable jurisdiction.

GOING PRIVATE

Introduction

As noted previously, a recent phenomenon in Canada has been the involvement of private equity investors in the M&A markets, including taking a public company private. In Canada, such "going private" transactions are generally effected in one of two ways, namely (i) through a take-over bid and (ii) through a squeeze-out merger (by way of a plan of arrangement, amalgamation, share consolidation or other transaction). All such transactions are regulated by the applicable provincial or federal corporations statute.

Take-Over Bids

Unless an exemption from the take-over bid requirements of applicable legislation is available, a take-over bid is typically pursued by means of a take-over bid circular, the contents and particulars of which are subject to the applicable provincial securities legislation. A copy of the take-over bid circular must be sent to all shareholders of the issuer corporation. In Ontario, the specific matters that must be disclosed in a take-over bid circular include (among many others):

- The particulars of any arrangement or agreement made or proposed to be made between the offeror and any of the directors and senior officers of the offeree issuer, including particulars of any payment or other benefit proposed to be made or given by way of compensation for loss of office (i.e. golden parachute) or as to their remaining in office if the bid is successful.

- The particulars of any plans or proposals for material changes in the affairs of the issuer, including for example any contract or agreement under negotiation, any proposal to liquidate the issuer, to sell, lease or exchange all or a substantial part of its assets, to amalgamate it with any other business organization or to make any material changes in its business, corporate structure (debt or equity), management or personnel.

In addition, in Ontario, if the take-over bid is being made by an "issuer insider" (a defined term in the Ontario *Securities Act*, but generally as the term suggests, including major shareholders, directors and senior officers), the bid would constitute an "insider bid" and Ontario Securities Commission Rule 61-501 (see further discussion below), which provides a set of rules which attempt to ensure fair dealing in the treatment of minority shareholders, including those related to enhanced disclosure and independent valuation requirements in the case of insider bids, would generally apply (subject to certain exceptions). Provincial securities legislation also provides certain rules governing take-over bid procedures and timing.

Where a take-over bid has been made, the board of directors of the issuer corporation must prepare and deliver a directors' circular within 15 days to all those who are entitled by law to receive it. The principal purpose of a directors' circular is to provide the directors of the issuer corporation with the opportunity to recommend acceptance or rejection of the bid and to disclose the reasons for such recommendation. The contents and particulars that must be included in a directors' circular are set out in the applicable provincial securities legislation. The directors of the target corporation are obligated to act in the best interests of the corporation. As a practical matter, this usually involves getting a fairness opinion from an investment bank. Special committees of independent directors are often involved.

Squeeze-Out Transactions

One alternative to a take-over bid would be to pursue a squeeze-out merger, by way of a plan of arrangement, amalgamation, share consolidation or other transaction. This would necessitate, among other things, the preparation of a management information circular by the corporation and the convening of a shareholders' meeting to approve the transaction. Moreover, in Ontario such a transaction would generally constitute a "business combination" for the purposes of OSC Rule 61-501. As with an insider bid, such a squeeze-out transaction would therefore be subject to certain disclosure and valuation requirements intended to protect minority shareholder interests as set out in OSC Rule 61-501, in addition to the disclosure required by the applicable corporate statute, and "majority of minority" shareholder approval (discussed in greater detail below).

Rules Governing Going Private Transactions

In Canada, going private transactions are generally regulated through a combination of the corporate statute under which the corporation is then existing and applicable securities laws.

Corporate Laws

The CBCA, OBCA and other similar provincial and territorial acts regulate certain corporate transactions, including amalgamations, stock consolidations and plans of arrangement. Most corporate statutes in Canada require shareholder approval of these transactions by special resolution (generally two-thirds of the votes cast) and generally provide shareholders with rights to dissent and demand fair value for shares that are affected by such transactions.

Also of note is the so-called "oppression remedy", found in many corporate statutes in Canada, which provides a mechanism for complainants to apply to a court in connection with conduct by a corporation that is "oppressive" or that is unfairly prejudicial to or that unfairly disregards the interests of any securityholder, creditor, director or officer. In such circumstances, the courts have a very broad authority to intervene. Generally speaking, the courts can make almost any order that they think fit, including orders (i) restraining the conduct complained of, (ii) varying or setting aside a transaction or contract to which a corporation is a party and compensating a corporation or any other party to the transaction or contract, and (iii) compensating an oppressed person. To be entitled to such a remedy, a complainant does not have to show bad faith or wrongdoing, but simply that the relevant actions or omissions have had the effect referred to above. A remedy will generally be available where the court concludes that the "reasonable expectations" of a shareholder have been frustrated.

Securities Laws

As noted above, going private transactions that are subject to Ontario securities law will often trigger the enhanced disclosure, independent valuation and "majority of minority" shareholder approval requirements set out in OSC Rule 61-501.

While similar in principle to a typical acquisition, a going private transaction will usually have greater possibility for conflicts of interest. The people who are running the business for the benefit of

the shareholders will at the same time be involved in negotiating, pricing and structuring a deal where they will often continue with the company while the public shareholders are cashed out. This situation results in a heightened level of scrutiny and disclosure. As OSC Rule 61-501 shows, the view of the Ontario Securities Commission is not that going private transactions are unfair intrinsically, but rather that they are capable of being abusive or unfair, and therefore require additional regulation. OSC Rule 61-501 attempts to ensure fair dealing in the treatment of minority shareholders in connection with transactions whereby the shareholdings of the minority in Canadian public companies are eliminated by not only requiring a heightened level of disclosure, but also requiring a formal valuation (there are certain available exemptions, including discretionary exemptions) to be prepared.

The offeror (in the case of an insider take-over bid) or the issuer corporation (in the case of a squeeze-out) must obtain formal valuations of the securities to be acquired, as well as of any non-cash consideration. The valuator must be appropriately qualified and independent of all "interested parties" (e.g. including, in the case of an insider take-over bid, the offeror). Whether the valuator is independent of an "interested party" is a question of fact, but certain parties are expressly excluded: for example, a person that is an associated or affiliated entity or issuer insider of the interested party, a person that is getting paid a "success fee", and any affiliated entity of such persons. In any case, the choice of valuator would be made by the board of the issuer corporation or by an independent committee of the board of the issuer corporation, who must also supervise the preparation of the formal valuation. In the case of an insider bid, a special committee is required.

The issuer should give the valuator access to its management, advisors and all relevant material information in its possession. The valuator is expected to perform a comprehensive review and analysis of the information. No limit should be placed upon the scope of the valuation. Among other things, the compensation of the valuator (or any entity affiliated with it) cannot depend in whole or in part upon an agreement, arrangement or understanding that gives the valuator or affiliated entity a financial incentive in respect of the conclusions reached in the valuation or the outcome of the transaction. Unless the formal valuation is included in its entirety, a summary must be

included in the circular submitted to shareholders. "Prior valuations" must also be disclosed in most cases.

In addition, fairness opinions may also be sought. Fairness opinions serve a number of critical functions in corporate transactions, particularly public market transactions. They are designed to offer an independent perspective on a deal's fairness, may have a significant impact on a shareholder's decision to approve or not approve a transaction (or to tender or not tender) and are intended to provide directors with enhanced protection from breach of fiduciary duty and duty of care claims.

Finally, in addition to any shareholder approval requirements set out in the applicable corporate statute, the approval of the "majority of the minority" of shareholders of the issuer corporation is typically required in a "one step" transaction (such as a squeeze-out merger or amalgamation) to which OSC Rule 61-501 applies. In an insider bid, there is no "majority of the minority" approval requirement *per se*. However, if an insider bid is not accepted by holders of at least 90% of the shares of each class (excluding shares held by the acquirer and its affiliates), a "second step" transaction would generally be required in order to complete the going private transaction. At that stage, the "majority of the minority" shareholder approval requirements would likely be triggered.

TAX STRUCTURING FOR U.S. VC AND PRIVATE EQUITY INVESTORS

Non-resident VC and private equity investors will confront a number of Canadian income tax issues in structuring investments in Canadian corporations, including certain rules for preferred share financings, withholding taxes and capital gains. Generally, the *Income Tax Act* (Canada) (the "Tax Act") favours the utilization of convertible debt, rather than convertible preferred shares for *smaller* investments (generally less than 25% of votes and value) made by such non-resident investors in start-up (usually not profitable, at least initially) or other corporations which are not generating taxable income. For the purposes of the present section, it is assumed that any potential U.S. investor (and any related entities) will *not* own 25% or more of the votes and value of the Canadian target and is not a U.S. LLC (see note, page 37). Generally an exemption is available where shareholdings exceed such threshold.

Preferred shares may not be a tax-effective financing technique for Canadian corporations that are not yet profitable, since dividends on such shares may attract a tax under Part VI.1 of the Tax Act at a rate of 25%, 40% or 66⅔% on the gross amount of the dividend. Generally, preferred shares are characterized as "term preferred shares" for purposes of the Tax Act and may be "short term preferred shares" (in which case there are further tax implications). While the issuer may effectively deduct this tax, if it is not generating taxable income, the Part VI.1 tax may represent a significant cash-flow detriment to a Canadian investee corporation. Amendments have been proposed to the Tax Act to reduce the rates mentioned above so that profitable corporations (and hence their shareholders) will be effectively indifferent to Part VI.1 tax.

Canada also imposes a 25% withholding tax on dividends paid to non-residents, subject to reduction under any applicable tax treaty (no existing treaty eliminates this tax completely, however). The *Canada-U.S. Tax Convention* (the "Tax Convention") reduces the rate to 15%, or 5% if the non-resident investor is a company that owns 10% or more of the voting stock of the Canadian corporation in question.

A debt obligation issued by the Canadian investee corporation that is convertible into common shares of the Canadian investee corporation at the option of the non-resident venture capital investor may provide certain tax efficiencies prior to conversion, as the interest on such a debt obligation will be deductible by the Canadian investee corporation.

Generally, interest paid by a corporation resident in Canada to a non-resident will be subject to a non-resident withholding tax at a rate of 25% (subject to reduction under the Tax Convention to 10%). In most cases, however, interest should qualify for exemption from Canadian non-resident withholding tax if the debt obligation qualifies for the so-called "5/25" exemption. This exemption is available if the following conditions are met:

- The issuer corporation and the non-resident investor deal at arm's length

- The issuer is not obliged under the terms of the debt obligation (or any related agreement) to pay more than 25% of the principal amount of the debt obligation within five years from the date of advance except, generally, in the event of failure or default on the exercise by the holder of a right to convert or exchange the obligation for a "prescribed security"

A "prescribed security" for these purposes is defined to include most common shares. In addition, no portion of the interest on the debt obligation can be contingent on the use of or production from property in Canada or computed by reference to revenue, profit, cash flow, commodity price or similar criteria for this withholding tax exemption to be available.

A further advantage of convertible debt arises under the Canadian capital gains tax regime. Subject to relief under an applicable tax treaty, Canada taxes capital gains of non-residents who dispose of "taxable Canadian property". Taxable Canadian property includes shares of Canadian corporations not listed on a prescribed stock exchange and options to acquire such shares. However, the exercise of a conversion right attached to debt or shares is not considered to be a disposition under the Tax Act and will accordingly not give

rise to a capital gain. Common shares acquired on a conversion will have a cost for tax purposes equal to the original investment in the debt or preferred shares with any gain being taxed on a disposition of the common shares (subject to relief under a tax treaty). Shares listed on a prescribed stock exchange are taxable Canadian property only if the non-resident (together with arm's length persons) held 25% or more of the issued shares of any class or series of the issuer during the previous five years.

A convertible debt instrument may be more effective to protect a non-resident investor from Canadian capital gains taxation than a convertible preferred share, particularly as private placements of convertible preferred shares may involve a non-resident holding 25% or more of the shares of a class or series of preferred shares prior to the time the investee corporation becomes a public corporation. However, in any event, the Tax Convention would generally exempt a U.S. VC or private equity investor from Canadian income tax on any capital gain arising from the disposition of shares that are taxable Canadian property unless the value of those shares is derived principally from real property in Canada. This exemption is not available for U.S. LLCs (see below).

A non-resident investor must notify the Canadian taxation authority of any disposition of taxable Canadian property and obtain a clearance certificate, whether or not the disposition gives rise to a capital gain. Property excluded from this requirement includes a debt obligation (including convertible debt), an option to acquire taxable Canadian property and shares listed on a prescribed stock exchange. If the non-resident fails to comply with the clearance procedure, the purchaser of the taxable Canadian property is liable to pay, as a tax on behalf of the non-resident, 25% of the purchase price, even if the non-resident seller isn't liable for Canadian tax on the disposition of the property because there is no capital gain (or because whatever gain there is qualifies for a treaty exemption). Because of this, a non-resident investor may wish to structure an investment in Canada a convertible debt, rather than as convertible preferred shares. Doing so ensures that all debt obligations are excluded property not subject to these reporting rules.

U.S. LEVERAGED BUYOUTS

U.S.-based private equity investors are now very active in acquiring Canadian corporations invariably in leveraged financing arrangements. Several tax efficient structures have been developed to accommodate such financings.

Conventional Structure

The "conventional structure" would create an interest expense in Canada and presupposes that the effective combined Canadian federal and provincial income taxes payable by the amalgamated corporation (described below) are higher than the effective U.S. federal and state income taxes payable by the U.S. investor on the resulting interest income. Such a structure would require the private equity investor to incorporate a Canadian acquisition corporation (usually in the same jurisdiction as the Canadian target) and fund it by way of interest-bearing debt (usually unsecured and subordinated to senior secured bank debt) and equity on a 2:1 basis in order to comply with Canadian thin-capitalization rules. This acquisition corporation then acquires all of the shares of the Canadian target and the acquisition corporation and target are "amalgamated" under the relevant corporate statute.

Amalgamation is similar to, but not the same as, a U.S. merger. It is a statutory means of combining two or more corporations subsisting in the same jurisdiction into one continuing amalgamated corporation with all of the property, assets, rights and liabilities of each of the amalgamating corporations. Amalgamation is generally tax neutral, although, for tax purposes, it does trigger a year end for each amalgamating corporation. It is also very efficient from a commercial perspective since assets and liabilities are not considered to be transferred or assumed. Rather, they shift to the amalgamated corporation as the result of the operation of the statute, which means, for example, that an amalgamation does not generally trigger consent requirements or transfer taxes.

It should be expressly noted that the Tax Act does *not* provide for consolidated tax returns – hence the two-step acquisition structure

noted above (funding the acquisition "sub" and subsequent amalgamation of the "sub" with the target).

Interest on the amalgamated corporation's debt to the U.S. private equity investor is deductible against the earnings of the acquired business, but is subject to a withholding tax on the interest (when paid) of 10% under the Tax Convention. In addition, the U.S. private equity investor can transfer funds to the U.S. without attracting Canadian withholding tax by repaying the principal of the debt and returning the paid-up capital of the amalgamated corporation's shares by way of redemption or repurchase. In general, the amount of such paid-up capital will equal the amount the U.S. private equity investor originally invested in the Canadian acquisition corporation. Finally and most significantly, the U.S. private equity investor (unless it is a U.S. LLC – see below) can sell the shares of the amalgamated corporation without triggering Canadian tax on any capital gain realized, provided such shares do not derive their value primarily from Canadian real property.*

Under Canadian law, equitable subordination in bankruptcy is rare. Canadian courts have generally been reluctant to accept the "Deep Rock" doctrine in *Taylor v. Standard Gas Co*., 306 U.S. 307 (1939).

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* U.S. investors typically use LLCs for foreign investments because of their flow-through status and limited liability. Accordingly, the Canada Revenue Agency does not consider such LLCs as eligible for the exemption under the Canada-U.S. Tax Convention, as is discussed below. If the U.S. investor is an individual, an S Corporation is typically used for an investment in Canada; where the investor is corporate, a C Corporation. For Canadian income tax purposes, assuming the shares of Amalco constitute a "capital asset," only one half of the resulting capital gain would be includible in income and subject to Canadian income taxes. For U.S. federal income tax purposes, if the U.S. investor is a C Corporation, the entire capital gain would be subject to U.S. federal income tax and there would be no preferential U.S. federal corporate income tax rate levied on said gain, so on first impression, assuming the U.S. investor can obtain full foreign tax credit, the fact that there would be an exemption from Canadian tax may not seem that beneficial.

However, should Amalco be a controlled foreign corporation or CFC (which would be the case if, for example, the U.S. corporate shareholder owned more than 50% of Amalco's voting stock), Code section 1248 would recharacterize what would otherwise constitute "capital gain" as a dividend for U.S. federal income tax purposes, to the extent of Amalco's E&P. In addition, the U.S. corporate shareholder would be entitled to claim an indirect foreign tax credit (against the U.S. federal income taxes otherwise payable) for its allocated share of Amalco's underlying Canadian corporate income taxes. Because of this, the imposition of a Canadian capital gains tax could be a pure "cost" to the U.S. corporate shareholder.

"Check-the-Box" Unlimited Liability Companies – Asset Acquisitions

Alternatively, a U.S. private equity investor may consider acquiring a Canadian business in an asset acquisition using a tax flow-through form. Two provinces, Nova Scotia and Alberta, provide for unlimited liability companies ("ULCs" or "unlimcos"), which are corporations incorporated under the applicable corporate legislation but the shareholders (or members) have unlimited liability. In view of this potential shareholder liability, U.S. investors often insert a Delaware LP (itself a tax flow-through vehicle) or take other protective measures to shield themselves from creditors or claimants of the unlimco. For U.S. tax purposes, an unlimco can be a disregarded entity (if it is wholly-owned) or treated as a partnership (if it has more than one shareholder).

Under this structure, the U.S. private equity investor incorporates an unlimco and capitalizes it by way of interest-bearing debt and equity on a 2:1 basis to comply with Canadian thin-capitalization rules. It is important to note that the unlimco is treated as a corporation for Canadian tax purposes even though it is disregarded for U.S. tax purposes. The unlimco then incorporates another corporation (usually a normal *limited* liability corporation) in a Canadian jurisdiction and the unlimco, limited liability corporation and possibly other investors (such as management) establish a limited partnership ("LP"), under provincial legislation (but which could be an "extra-provincial limited partnership" and registered under applicable legislation) that acquires the assets of the business from the seller. The LP is a partnership for Canadian tax purposes, but would "check-the-box" to be treated as a corporation for U.S. tax purposes. The unlimco, as the limited partner, normally has a very high partnership interest allocated to it with the remainder held by the normal limited liability corporation, as the general partner.

The result is that income of the LP is allocated to the partners for Canadian tax purposes and the unlimco can deduct its interest expense on debt owing to the U.S. private equity investor against its share of the LP's income. Canadian withholding tax of 10% must be remitted on the interest (when paid). In addition, the U.S. private equity investor can extract funds from the unlimco without paying Canadian withholding tax by having the principal of the debt repaid and by having the paid-up capital of its shares returned by way of

redemption or repurchase. As with the previous structure, the U.S. private equity investor (unless a U.S. LLC) can generally sell the shares of the unlimco and not be subject to any Canadian tax on any realized capital gain, provided the unlimco's shares do not derive their value primarily from Canadian real property. This structure is efficient from a U.S. tax perspective depending on the nature of the U.S. investor. The unlimco is disregarded for U.S. income tax purposes, as is the subordinated loan owed by the unlimco. The U.S. private equity investor is taxed on distributions from the LP, which are regarded as distributions from a corporation, to the extent of earnings and profits.

The major benefit of this structure is to permit interest expense on the inter-company debt to be deductible for Canadian tax purposes against the business income of the LP but not taxable in the U.S. Only the U.S.-recognizable income in respect of distributions from the LP is taxable in the U.S., unless the check-the-box LP is not in receipt of "passive-type" income which would be currently taxable (whether or not distributed by the LP to the unlimco). In addition, Canadian taxes payable by the unlimco in respect of its earnings may be eligible for a foreign tax credit to the U.S. private equity investor for U.S. income tax purposes.

Use of Unlimcos – Share Acquisitions

A variation of the foregoing structure can be used for a U.S. private equity investor to acquire the shares of a Canadian corporate target. However, this requires the *selling* shareholders to "continue" the Canadian target under the *Companies Act* (Nova Scotia) or the *Business Corporations Act* (Alberta), depending on the intended jurisdiction of incorporation of the unlimco. Continuance is a tax-neutral event for Canadian tax purposes and is relatively straightforward from a corporate perspective.

All of the steps described in the preceding section are first implemented (incorporate unlimco; capitalize 2:1 on an interest-bearing debt to equity basis; establish a limited liability corporation; form the LP; LP "checks the box" to be treated as a corporation for U.S. tax purposes). The unlimco invests all of its funds in equity of the LP and the LP borrows the debt portion of the acquisition price from third-party lenders ("bank debt"). The LP then incorporates another acquisition unlimco, on-lends the bank debt proceeds to it and invests in subordinated debt and equity of such acquisition unlimco in a 2:1 ratio in the same manner as the top unlimco ("first-

tier unlimco") was capitalized. The acquisition unlimco then acquires the Canadian target's shares and "amalgamates" with it, leaving the amalgamated unlimco ("Amalco") with the same capital structure as the acquisition unlimco.

For Canadian tax purposes, Amalco can deduct the interest on the subordinated debt and also on the on-lent bank debt in computing its income. However when the first-tier unlimco pays interest to the U.S. private equity investor, a Canadian withholding tax of 10% must be remitted. The LP will have interest income on the on-lent bank debt which will be matched by the interest expense on the bank debt. The LP will also have interest income in respect of the subordinated loan to Amalco, which interest for Canadian tax purposes will be allocated to the unlimco limited partner (which will have an offsetting interest expense on the matched subordinated loan from the U.S. private equity investor).

For U.S. income tax purposes, Amalco is disregarded so that LP (a foreign corporation for U.S. tax purposes) will be considered to have acquired assets at fair market value, creating a high tax basis for U.S. tax purposes (to shelter the earnings of the LP for U.S. tax purposes).

For U.S. income tax purposes, the first-tier unlimco is disregarded, as is the subordinated loan owed by the first-tier unlimco and the interest on such loan will not be interest for U.S. income tax purposes but will be regarded as a distribution from the LP (and taxable in the U.S. only to the extent of the earnings of the LP).

As with the previous structure, the U.S. private equity investor (i) repatriate funds to the U.S. on a tax free basis through repayment of principal of its debt and the return of the paid up capital on its shares in the first-tier unlimco by redemption or repurchase; and (ii) can generally (provided it is not a U.S. LLC under the *Canada-U.S. Tax Convention,* as discussed below) sell its shares and not be subject to Canadian income tax on the realized capital gain, provided the first-tier unlimco's shares do not derive their value primarily from Canadian real property.

Alberta vs. Nova Scotia Unlimcos

To date, U.S. investors have favoured Nova Scotia unlimcos over Alberta unlimcos. The primary reason is simply that Nova Scotia

unlimcos have been around much longer, allowing advisers and their clients to grow accustomed to their advantages, disadvantages and quirks. The "quirkiness" results mainly from the fact that the Nova Scotia *Companies Act* is based on the old English *Companies Act,* with memorandum and articles of association, rather than articles and by-laws, as the constating documents. Secondly, and perhaps equally important, is the fact that a shareholder in a Nova Scotia unlimco has no direct liability to creditors unless and until the unlimco is wound up or liquidated with insufficient assets to satisfy the obligations of the unlimco to all of its creditors. Under Alberta's *Business Corporations Act*, the liability of shareholders of an unlimco arises with the creation of the liability on a joint and several basis. Thirdly, Nova Scotia's *Companies Act* is a very flexible statute, including the tests applicable to the payment of dividends, return of capital etc. Because it does not provide for Unanimous Shareholder Agreements, however, it may be more difficult to avoid the common law doctrine of fettering the discretion of directors of Nova Scotia companies.

However, it should be noted that financial institutions are often reluctant to take a pledge of shares of an unlimco as security (even if they do not have such shares registered in their name or that of a nominee) for fear of inheriting unlimited liability. Generally, removing or restricting the rights and powers of the secured party (prior to enforcement vis-à-vis the unlimco) in the stock pledge agreement can minimize any such concerns.

Luxembourg Structure

Many U.S. private equity investors are structured as limited liability companies ("LLCs") and, as such, are flow-through vehicles for U.S. income tax purposes and do not pay income taxes in the U.S. Accordingly, the Canada Revenue Agency does not consider such LLCs as eligible for the exemption under the Tax Convention from income taxes on realized capital gains when shares in a Canadian corporation are sold (assuming that the value of such shares is not attributable primarily to real property in Canada). In addition, withholding tax on dividends and interest must be paid at the higher rate prescribed in the Tax Act (25%) rather than the lower rates prescribed in the Tax Convention. To deal with such issues, a number of investments by U.S. private equity investors in Canadian corporations have recently been structured with a Luxembourg

company as an intermediary. Canada and Luxembourg have a tax treaty and any capital gains and other taxes are paid in Luxembourg which has a more favourable rate.

Under Luxembourg law, companies with certain restricted activities (e.g. holding of investments) are exempt from taxation on income and capital gains. To qualify as such a holding company, the company's sole activity must be the holding and management of *participations* in other companies. *Participations* may consist of (i) shares, (ii) bonds, (iii) loans to a company in which the holding company has a direct and significant interest or (iv) patents. Companies that conduct industrial, commercial or service activities, either alone or in combination with holding activities, are not eligible for this form of tax relief under Luxembourg law. Recent legislative amendments may also make it unavailable in certain circumstances. A further drawback is that traditional holding companies are generally not eligible for favourable treatment under Luxembourg's tax treaties.

As a result, a *société à participations financières* ("Soparfi") is often employed. A Soparfi generally has the same purposes as a Luxembourg holding company (that is, the holding of shares in Luxembourg and foreign companies), but is taxed like any other Luxembourg company. A Soparfi is liable for corporate income tax of 22.88% and municipal income tax (7.5% in the City of Luxembourg) on worldwide income, including capital gains, but is exempt from tax on dividends or capital gains relating to qualifying *participations*, under certain conditions.

Luxembourg also recently announced a new investment vehicle specifically for private equity and venture capital investments, the *société d'investissement en capital à risque*, or "Sicar", which is available only to sophisticated investors who provide minimum subscribed share capital of €1 million and only with the approval of the Luxembourg regulator. The Sicar may take a number of different corporate forms, is not subject to investment restrictions and enjoys advantageous tax treatment.

REGULATORY CONSTRAINTS ON ACQUISITIONS

Investment Canada Act

In the event that the shareholding interest acquired by a U.S. VC or private equity investor is large enough, a transaction will be subject to review or notification under the *Investment Canada Act* ("ICA"). Subject to certain exemptions under the ICA, the "acquisition of control" by a "non-Canadian"(which would include the Canadian subsidiary of a foreign investor) of a "Canadian business" is generally either notifiable or reviewable under the ICA. An acquisition of (i) a *majority* of the voting interests attaching to all shares of a corporation is *deemed to be* an acquisition of control, (ii) less than a majority but *one-third or more* of such voting interests is *presumed to be* an acquisition of control (which presumption is rebuttable) and (iii) an acquisition of *less than one-third* of such voting interests is *deemed not to be* an acquisition of control.

Therefore, if a VC or private equity investor from the U.S. (which is a "WTO investor") proposes the "acquisition of control" of a "Canadian business", the investment will be reviewable under the ICA if (i) in the case of an acquisition of control of an entity carrying on the Canadian business, the value of the assets of that entity and all other entities in Canada, the control of which is being acquired, is equal to or greater than an amount to be prescribed annually (the "WTO Threshold"), and (ii) in the case of the acquisition of the assets used in carrying on a Canadian business, the value of those assets is equal to a greater than the WTO Threshold. If, in fact, such an acquisition is "reviewable", the federal Minister of Industry must be satisfied that the investment is likely to produce a "net benefit to Canada".

The WTO Threshold is adjusted annually for inflation and the growth in Canada's gross domestic product. The figure for 2006 is $265 million. The asset values are generally determined by reference to the most recent audited financial statements of the Canadian business. The definition of "WTO investor" under the ICA is complex but, in general, an individual is a WTO investor if he or she is a "national" of WTO member country or has a right of permanent residence in such

a country. The U.S. and virtually all other major developed countries are WTO members. The thresholds are much lower where the investor is not a WTO investor or where the acquisition relates to a "cultural business" (which can include many types of business activity – for example, selling books or videos as an incidental part of a retail business) or certain other types of business (including businesses providing financial services and transportation services).

A "Canadian business" means a business carried on in Canada that has (i) a place of business in Canada, (ii) an individual or individuals in Canada who are employed or self-employed in connection with the business, and (iii) assets in Canada used in carrying on the business.

In any event, however, you must file a notice in prescribed form on closing or within 30 days thereafter.

Competition Act

The provisions of the *Competition Act* must be considered in respect of any investment by a VC or private equity investor, although it would be unlikely the "substantive" merger test would be of concern unless the investor has existing investments in similar businesses. For "mergers", the principal substantive test under the *Competition Act* is whether an actual or proposed transaction "would or would be likely to prevent or lessen competition substantially" in the relevant market. This is the test that the Commissioner of Competition (the federal antitrust authority) would use when deciding whether to initiate an application to the Competition Tribunal and the test that the Tribunal would use in its adjudication of the application.

In addition, certain large transactions trigger advance notice requirements under the *Competition Act*, which are similar to those under the U.S. Hart-Scott-Rodino Anti-Trust Improvement Act. Pre-merger notification filings are required in connection with the proposed acquisition of assets or shares or an amalgamation or other combination to establish a business in Canada where thresholds relating to the "size of the transaction" and the "size of the parties" are exceeded. In share acquisitions, certain shareholdings must also be exceeded.

If the parties to a transaction, together with their respective affiliates, have total assets in Canada exceeding $400 million in

aggregate value or had total gross annual revenues from sales in, from, or into Canada that exceed $400 million in aggregate value – the "size of the parties threshold" – the Commissioner must be notified of: (i) an acquisition of assets in Canada where the aggregate value of those assets or the gross revenues from sales in or from Canada generated from those assets, would exceed $50 million; (ii) an acquisition of voting shares of a corporation which, together will all other corporations controlled by it, where the aggregate value of the assets in Canada, or annual gross revenues from sales in or from Canada generated from those assets would exceed $50 million (note that all cited figures are in Canadian dollars).

With respect to the acquisition of voting shares, it should be noted that notification will be required only if, consequent to such an acquisition, certain "shareholding" thresholds would be exceeded. For example, 20% and 35%, in the case of the initial acquisition of voting shares of a public company or private company, respectively.

Where the above-noted thresholds are met, and unless a specific statutory exemption applies, a pre-merger notification filing obligation is triggered and the parties to the transaction must complete either a "short form" or "long form" filing in the prescribed form. The Commissioner generally has 14 days ("short-form filing") or 42 days ("long-form filing") to review the proposed transaction to determine whether it would be likely to result in a substantial lessening of competition.

The *Competition Act* also establishes an advance ruling process through which parties to a proposed merger transaction may seek an advance ruling certificate from the Commissioner confirming that, on the basis of a review of the facts they have presented in their application, the Commissioner will not challenge the proposed merger.

Other Foreign Ownership Constraints

There are also a number of federal statutes (such as the *Telecommunications Act*, *Insurance Companies Act* and *Aeronautics Act*, to name but a few) and provincial statutes (such as the *Paperback and Periodical Distributors Act* (Ontario), *Insurance Act* (Ontario) and *Mortgage Brokers Act* (Ontario), once again to name but a few)

that can include restrictions on foreign ownership (or foreign directors) or prohibitions or restrictions on the carrying on of certain kinds of business by "non-Canadians".

These kinds of restrictions may make it difficult for U.S. VC and private equity investors in such business to exercise ROFRs, ROFOs or shotguns, for example, since the potential acquirers are often non-Canadians. This difficulty has arisen a number of times in the context of the Canadian telecommunications industry, among others.

Employment Law

U.S. VC and private equity firms must bear in mind that Canada's employment and labour law landscape is often more employee-friendly and union-friendly than that found in many American states. Of particular significance in the M&A context is the fact that Canada has no concept of "at will" employment. Due diligence will often involve extensive efforts to cost out potential severance liabilities with respect to the termination of employees if that is contemplated.

CONCLUSION

VC and private equity investors have developed a number of investment practices in Canada that are similar but not identical to those in the United States. In addition to a high return, commensurate with the risk, such investors seek preferred status over common shareholders and sometimes unsecured creditors, and tremendous flexibility in exit strategies (ROFOs, ROFRs, "puts", registration rights and possibly a right to force the corporation to sell itself). Fortunately the recent emergence of the income trust structure has provided such investors with not only a viable exit strategy but one permitting virtually 100% exit from an investment. If you want to aim high, also consider the London-based AIM market – even for Canadian companies. Cross-border complications can arise for U.S. VC and private equity investors, but through the use of appropriate types of investment (convertible debt, for example) and appropriate structures (such as Nova Scotia unlimcos, LPs and Luxembourg companies), difficulties can be minimized.

Finally, it remains to be seen whether the involvement of private equity investors in the Canadian M&A markets is a passing fancy or here to stay. But the bottom line is that creative planning can minimize obstacles in cross-border acquisitions by U.S. private equity firms.

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Printed May 2006